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Financial Leverage and Performance of Beverage Manufacturing Companies in Nigeria

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Abstract: *This work examined the relationship between financial leverage and financial performance of beverage manufacturing companies in Nigeria. The work aimed at ascertaining the relationship between debt ratio, debt to equity ratio, short-term debt to total asset, long-term debt to total asset as well as interaction of debt ratio and debt to equity ratio and performance of selected quoted beverage companies in Nigeria. Multiple regression analysis was used to test the five formulated hypotheses. Secondary type of data was employed in this research which was collected from Nigerian Stock exchange as well as financial statement of the five selected beverage companies. The findings revealed that there is a strong positive correlation between performance and debt ratio, debt equity ratio, long-term debt to total asset as well as interaction of debt ratio and debt to equity ratio. The findings also show a negative relationship between performance and short-term debt to total asset. The study concludes that financial leverage has a strong connection with the performance of beverage companies in Nigeria. The implication of the findings is that beverage firms that employ debt in funding their businesses perform better and make more profits than those who employ only equity funds.*

Key Words: *financial leverage, performance, beverage manufacturing companies, Nigeria.*

1. INTRODUCTION:

The importance of capital to a business cannot be over-emphasized. It is the foundation upon which the business operates. A company can finance its investments by debt or equity or both, and a company may also use preference shares. The ratio of the fixed-charge sources of funds, such as debt and preference shares to owners' equity in the capital structure is described as financial leverage[1]. Financial leverage decision is a vital one since the performance of a firm is directly affected by such decision; hence, financial managers should trade with caution when taking debt-equity mix decision. There are various alternatives of debt-equity ratio, these includes; 100% equity: 0% debt, 0% equity: 100% debt and X% equity: Y% debt [2]. From these three alternatives, option one is that of the unlevered firm, that is, the firm that shuns the advantage of leverage (if any). Option two is that of a firm that has no equity capital. This option may not actually be realistic or possible in the real life economic situation, because no provider of funds will invest his money in a firm without equity capital. This partially explains the term "trading on equity", that is, it is the equity element that is present in the firm's capital structure that encourages the debt providers to give their scarce resources to the business. Option three is the most realistic one in that, it combines both a certain percentage of debt and equity in the capital structure and thus, the advantages of leverage (if any) is exploited.

There are two main benefits of debt for a company. The first one is tax shield as interest payments are not taxable; hence the debt can increase the value of a firm. Second benefit is that debt disciplines managers use free cash flows of the company to invest in projects to pay dividends, or to hold-on cash balance. It has been argued that profitable

firms were less likely to depend on debt in their capital structure than less profitable ones, and that firms with high growth rates have high debt to equity ratios [3]. This mix of debt and equity has long been the subject of debate concerning its determination, evaluation and accounting. Therefore, right choices of the combination of debt and equity are very important for the managers of companies. Some companies who dislike borrowing funds for the financing of their assets have to rely completely on equity financing; therefore they are free from any fixed amount of charges to pay which means there is no financial leverage associated with that company. Firms take money from lenders in order to increase sales volume which leads to higher earnings, such money which companies have taken from lenders show the financial leverage associated with that company. Financial leverage is measured by ratio of total debt which a company owes and total assets show the extent to which a company has used borrowed funds in order to finance its capital structure.

2. STATEMENT OF THE PROBLEM:

The motivation for this study emanated from the fact that many researchers have conducted different studies on financial leverage in different sectors of the economy but a gap still exist in their varying findings. Researchers are not in agreement in terms of the causal order of these constructs, and suggest that empirical justification is necessary to determine the true nature of this relationship. Findings from ([4]; [5]; [6]) showed that financial leverage has a positive significant effect on company performance.

Conversely, other studies reported that financial leverage has an insignificant effect on company performance ([7]; [19]). Based on the various empirical studies carried out both in other countries and in Nigeria as enumerated, a varying literature gap still exist and a consensus has not been reached on the effect of financial leverage on company performance. This identified inconsistency is a research gap which this study seeks to address. The findings from the previous studies are at best inconclusive as the debate has not been resolved. In the light of the above challenges, this study seeks to investigate the relationship between financial leverage and performance of beverage companies in Nigeria.

3. OBJECTIVES OF THE STUDY:

The main purpose of the study is to ascertain the relationship between financial leverage and performance of selected quoted beverage companies in Nigeria. The specific objectives of the study are to;

1. Investigate the relationship between debt to total asset and performance of beverage companies in Nigeria.
2. Determine the relationship between debt to equity ratio and performance of beverage companies in Nigeria.
3. Assess the relationship between short-term debt to total asset and performance of beverage companies in Nigeria.
4. Examine the relationship between long-term debt to total asset and performance of beverage companies in Nigeria.
5. Establish how the interaction of debt ratio and debt equity ratio relates to the performance of beverage companies in Nigeria.

4. RESEARCH QUESTIONS:

Based on the objectives of this study, the following research questions are formulated;

1. To what extent does debt to total asset relate to the performance of beverage companies in Nigeria?
2. To what degree does debt to equity ratio relate to the performance of beverage companies in Nigeria?
3. How does short-term debt to total asset relate to the performance of beverage companies in Nigeria?
4. To what dimension does long-term debt to total asset relate to the performance of beverage companies in Nigeria?
5. How far does the interaction of debt ratio and debt to equity ratio relate to the performance of beverage companies in Nigeria?

5. RESEARCH HYPOTHESES:

The following hypotheses are formulated in their alternative structures to guide the study;

H1: Debt to total asset has a significant relationship with the performance of beverages companies in Nigeria.
H2: Debt to equity ratio has a significant relationship with the performance of beverage companies in Nigeria.
H3: Short-term debt to total asset has a significant with the performance of selected quoted companies in Nigeria.
H4: Long-term debt to total asset has a significant relationship with the performance of beverage companies in Nigeria.
H5: Interaction of debt ratio and debt-equity ratio has a significant relationship with the performance of beverage companies in Nigeria.

6. SCOPE OF THE STUDY:

This study is limited to studying financial leverage and financial performance of selected quoted companies in Nigeria. Precisely, the study is limited to studying five beverage companies. The selected companies are 7up Bottling

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Company, Guinness Plc, Champion Breweries, Nigerian Bottling Company Plc and International Breweries company. A time frame of six years was utilized which covers from 2013 - 2018.

7. REVIEW OF RELATED LITERATURE:

Conceptual Framework

Financial Leverage

[1] Defines financial leverage as the use of the fixed charges sources of funds, such as debt and preference capital along with the owner's equity in the capital structure. [8] views financial leverage as the ratio of total debt to total equity. [1] opines that the leverage decision is a significant managerial decision because it influences the shareholder's return and risk and the market value of the firm. The ratio of debt-equity has implications for the shareholders' dividends and risk, this affect the cost of capital and the market value of the firm. [9] observes that financial leverage occurs when a firm obtains financing for its investment from sources other than the firm's owners. [10] sees financial leverage as the extent to which debt is used in a firm's financial structure or the ratio of total debt to total assets in respect of total value of the firm.

Financial Performance

[11] captures that there are many measures of financial performance. For instance, return on sales reveals how much a company earns in relation to its sales, return on assets explain a firm's ability to make use of its assets and return on equity reveals what return investors take for their investments. Company's performance can be evaluated in three dimensions. The first dimension is company's productivity, or processing inputs into outputs efficiently. The second is profitability dimension, or the level to which company's earnings are bigger than its costs. The third dimension is market premium, or the level to which company's market value exceeds its book value. Firm performance from an accounting perspective hinges on profitability and performance of stocks in the capital market. The measures of firm performance based on literature can be broadly classified into two namely the market oriented measures and the accounting oriented measures. Some of the authors provide evidence that boards prefer accounting measures market to measures in evaluating managerial performance. Accounting based measure is adapted to measure performance in this study. Return on equity measures profitability by revealing how much profit a company generates with the money shareholders have invested. It is regarded as a hybrid measure of firm performance because it incorporates profit which is accounting based and equity which is market based. Interestingly, return on equity is determined by dividing profit by equity.

Theoretical Framework

Intermediate theory as coined by [1] states that a judicious mix of debt and equity can increase the value of the firm by reducing the weighted average cost of capital (WACC) up to a certain level of debt. This implies that a firm has an optimal capital structure when WACC is minimum, thereby increasing the value of the firm. He opines that WACC decreases only within a reasonable limit of financial leverage and reaching the minimum level, it starts increasing with financial leverage. He stated that financial leverage is very critical to the survival and performance of corporate entities. Therefore, this study is anchored on this theoretical framework which serves as the foundation for examining the relationship between of financial leverage and performance of beverage companies in Nigeria. This framework for this study is very pertinent as it is the basis on which financial leverage stands since firms trading on debt run less risk due to tax shield than those trading on equity financing.

Review of Related Empirical Studies

[12] conducted a study on the relationship between financial leverage and performance of textile companies in Pakistan. Their findings showed that financial leverage has a negative significant effect on firm return on equity. [13] examined the effect of financial leverage on financial performance in a developing country. Their findings show that financial leverage has a positive effect on return on equity. [14] carried out a study on the relationship between financial leverage and financial performance: evidence from quoted pharmaceutical companies in Nigeria for the period 2001-2012. The results showed that debt to total asset and debt-equity ratio have negative and insignificant effects on ROA. [15] studied the effect of financial leverage on bank performance using six banks from Nigeria. The findings revealed mixed results. While some banks reported a significant positive relationship between leverage and performance, others revealed a significant negative relationship between leverage and performance. [16] conducted a study on the determinants of financial leverage of savings and credit co-operative societies in Kenya. Their findings showed significant relationships between financial leverage and the variables measured. [17] assessed the relationship between financial leverage and firm performance using 10 Nigerian firms. The findings show that financial leverage impact on firm performance. [5] investigated the effect of financial leverage on corporate performance of selected

companies in Nigeria for the period (1999-2006). His finding evidenced that leverage shocks (debt/equity ratio) have significant effect on corporate performance. [18] examined the effects of debt-equity ratio on performance of firms listed at the Nairobi Securities Exchange for the period 2002- 2011. The study found that firms rely more on short-term debt. The result also revealed that significant negative relationship exists between debt-equity ratio and performance. [6] assessed the relationship between financial leverage and financial Performance: evidence from fuel and energy sector in Pakistan. The result revealed that financial leverage has significant and positive effect on financial performance.

Research Gap

Based on the available literature reviewed; some authors' findings indicated that financial leverage has a significant positive relationship with company performance such as ([5]; 6]). Conversely, some authors found that financial leverage has no significant relationship with performance measured by return on equity ([19]; [1 4]). Regrettably, studies from Africa countries on the subject matter are still few.

In addition, studies by the following authors ([17]; [5]) found a significant relationship between financial lever age and company performance while ([15]; [14]) found a negative and insignificant association between financial leve rage and company performance. Therefore, more empirical evidences are needed since the arguments have not been resolved.

8. METHODOLOGY:

This study adopted ex-post facto research design which focuses mostly on secondary data. In ex- post facto research design, the researcher only attempts to link some already existing relationship or observation to some variables as causative agents and the researcher finds that the subject are already assigned to the various levels of the variables whose effects are being investigated [20]. The researcher by collected already existing data and averted any form of manipulations. The target population for the study consists of beverage companies quoted on the floor of Nigerian Stock Exchange). The researcher used purposive sampling technique and selected five beverage companies out of 10 beverage companies quoted on the Nigerian Stock Exchange. They were selected because they have the data needed for this study whereas others were excluded because of not having all the required data for this study.

The chosen beverage companies are as follows: 7up Bottling Company, Champion Breweries, Guinness PLC, Nigeria Bottling Company PLC., and International Breweries Company. The study covered six accounting period from 2013–2018. Multiple regression analysis using ordinary least square method was used to test the hypotheses. Decision rule**:** accept alternative hypothesis if the p-value is less than 0.05 (5%) level of significance.

Model Specification and Operationalization

Our study utilized debt to total asset, debt-equity ratio, short-term debt to total asset and long-term to total asset as proxies for financial leverage while return on equity (ROE) was used to proxy financial performance. These variables were also used by the previous studies ([17]; [14]; [18]; [21; [15]).

The model for the study

ROE = $\beta_0 + \beta_1 DR + \beta_2 DER + \beta_3 SDTA + \beta_4 LDTA + \beta_5 DR*DER + \mu$

Where: ROE = return on equity (Y)
DR = debt to total asset (Debt ratio)
DER = debt-equity ratio
STDTA = short-term debt to total asset
LTDTA = long- term debt to total asset
DR*DER= interaction of debt ratio and debt to equity ratio
μ = Error term

9. RESULTS

Table 1: Multiple Regression Analysis Result

Hypotheses	Constructs	β	T-values	p-values	Results
	Constant	0.061	0.706	0.085	
H1	DR -> ROE	2.170	2.339	0.037	Significant
H2	DER -> ROE	3.769	2.437	0.032	Significant
H4	STDTA -> ROE	-0.974	-1.727	0.126	Not significant
H3	LTDTA -> ROE	3.982	2.810	0.023	Significant

H5	DR*DER -> ROE	8.565	4.469	0.000	Significant
Model 1	R = 0.605, R^2 = 0.547, Adjusted R^2 = 0.502	F statistics = 28.285	F. p-value = 0.000	Std error = 0.026	Durbin W. = 1.99

Note: Path is significant at 1%, 5% and10% level of significance
ROE = return on equity (financial performance surrogate)
Predictors: debt ratio, debt equity ratio, short term debt to total assets, long term debt to total assets, interaction of debt ratio and debt equity ratio.
Source: E-view Computation Output, 2020.

The result of the regression analysis using ordinary least squares method is shown on table 3. The regression model (R) has a value of 0.605 which shows a strong positive relationship between the independent and dependent variables. The coefficient of determination (R^2) is 0.547, which is approximately 55%. This indicates that about 55% variations in return on equity were accounted for by the variations in the independent variables used as surrogates for financial leverage. The F-statistics was used to estimate the overall significance of the overall model. The f-value = 28.285 with its p-value of 0.000. This shows that all the explanatory variables (DR, DER, STDTA, LTDTA and DR*DER) collectively have significant relationship on return on equity used to proxy financial performance. In addition, the Durbin Watson statistics value of 1.99 which is approximately 2 indicates that the model have no autocorrelation among the constructs. This implies that the model suit well with the data used in the study. The results of tested hypotheses are discussed as follows:

Based on result on table 1, debt ratio (DR) had a positive significant relationship with return on equity (β = 2.170, t = 2.339, $p < 0.05$). Debt to equity ratio (DER) had a positive significant relationship with return on equity (β = 3.769, t = 2.437, $p < 0.05$). Short-term debt to total assets (STDTA) had a negative and insignificant relationship with return on equity (β = -0.974, t = -1.727, $p > 0.05$). Long-term debt to total assets (LTDTA) had a positive significant relationship with return on equity (β = 3.982, t = 2.810, $p < 0.05$). Also, the combination of debt ratio and debt to equity (DR*DER) had a positive significant relationship with return on equity (β = 8.565, t = 4.469, $p < 0.05$). Accordingly, H1, H2, H4 and H5 were supported while H3 was not supported.

10. DISCUSSION:

The main purpose of this study is to ascertain the relationship between financial leverage and performance of selected quoted beverage companies in Nigeria. The specific objectives sought to investigate how debt ratio, debt to equity ratio, short-term debt to total assets, long-term debt to total assets as well as the interaction of debt ratio and debt to equity ratio relate to performance of beverage companies in Nigeria. Related literatures were reviewed and relevant theory highlighted. Based on the findings as shown on table 1, debt ratio had a positive significant relationship with the performance of beverage companies. The finding is in agreement with the findings of ([23]; [24]) who found that debt to total assets has a significant relationship with the performance of the firm. Our finding is not in accord with the findings of ([14] and [25]) who found that debt ratio has no significant relationship with company performance. Also, an examination of results on table 1 indicates that debt to equity ratio had a positive significant relationship with the performance of beverage companies. This finding is consistent with the findings of ([21] and [24]) who found that debt to equity ratio had a positive significant relationship with company performance. The finding of our study is contrary to the findings of ([14] and [26]) who found that debt to equity ratio has no significant relationship with company performance.

A cursory look on table 1 results signals that short-term debt to total assets had no significant relationship with company performance. This finding is in line with the findings of ([26 and [25]) who found that short-term debt to total assets has no significant relationship with company performance. Also, it negates the findings of ([27] and [23]) who found that short-term debt to total assets has a positive significant relationship with company performance. In addition, the results in table 1 prove that long-term debt had a positive significant relation with the performance of beverage companies in Nigeria. This finding affirms with the findings of previous scholars ([8]; [27] and [23]) who found that long-term debt to total assets had a positive significant relationship with company performance contrary to the findings of ([26] and [25]) that reported an insignificant relationship between long-term debt to total assets and firm performance. Additionally, a critical analysis of result in table I demonstrates that the interaction of debt and debt to equity ratio had a positive significant relationship with the performance of beverage companies in Nigeria. This finding is in tandem with the findings of [8] who found a positive significant relationship between the combination of debt and debt to equity ratio and the performance of quoted companies in Nigeria.

11. CONCLUSION :

Based on the findings, we conclude that debt to total asset, short-term debt to total asset, long-term debt to total asset and the interaction of debt ratio and debt-equity ratio have significantly contributed in improving the performance of the selected quoted companies in Nigeria. Long-term debt to total asset, short-term debt to total asset and the interaction of debt ratio and debt equity ratio as well as debt to total asset are significantly instrumental with resounding contributory effect on the performance of the quoted companies in Nigeria. The study therefore concludes that long-term debt to total asset is the most important predictor of financial leverage and most significant determinant of company performance.

12. SUGGESTION FOR FURTHER STUDIES:

This study is limited to the fact that only quoted beverage companies in Nigeria were studied. Therefore, the findings of this study ought not to be generalized to non quoted companies. Since not all financial leverage variables as well as financial performance were used in this research, therefore future researchers may attempt to use other leverage and performance measures. Also, future scholar may expand the scope to cover non-quoted companies in Nigeria, micro finance banks in Nigeria as well as non-banks' financial institutions in Nigeria.

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