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ASSESSING THE INFLUENCE OF FINANCIAL LEVERAGE ON FIRM VALUATIONS OF SELECTED INDIAN FMCG FIRMS

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Abstract:

The main objective of this study is to work out the relationship between financial leverage and firms' value, as well as analyse the impact of financial leverage on firms' value. A sample of five companies listed on National Stock Exchange (NSE) for a period of five years from 2016 -2020 was used. Data were sourced from annual reports of sample companies and websites. The study revealed that there is no significant relationship between financial leverage and firms' value and that financial leverage has no significant effect on firms' value. The study concludes that financial leverage is a better source of finance than equity to firms when there is need to finance long-term projects. However, various economic factors may have despicable effects on the profitability of Indian FMCG company.

Key words: Financial Leverage, Valuation of Firm, Price Earnings Ratio, Indian FMCG Companies.

1. Introduction

Every firm whether small scale firms or large-scale firms need funds to operate; exclusively large-scale firms, they have funds to expand their operations and activities. The motive of every company is to earn profit, maximize owner's wealth, and to accomplish this goal they need to source for fund in order to finance their operations and activities. Firms have multiple financing sources to finance their investment. Basically, funding sources can be categorized into two; the internal financing sources which include reserves and retained earnings; external financing which includes long-term loans, bond issuance, ordinary and preferred stock issuance. (These sources are long-term sources of finance).

Firms should choose the best funding sources to reach the optimal capital structure so that they can make suitable financing decision that would enable them achieve positive returns. Financial leverage is the extent to which fixed income securities (debt) are used in a firm's capital structure. A firm's capital structure is the composition or structure of its liabilities. Furthermore, financial leverage reflects the amount of debt used in capital structure of the firm. Debt carries fixed obligation of interest payment. Thus, financial leverage increases as the fixed financial expenses of a firm increases i.e., interest expenses increase as higher amount of debt is incurred. Also, with a high level of debt relative to equity, a small percentage change in earnings before interest and tax (EBIT) will lead to a large percentage change in net income.

Technically, financial leverage is defined as the percentage change in earning after tax (EAT) divided by percentage change in EBIT. A company can be either highly levered (having a lot of debt than equity in its capital structure) or lowly levered (having more equity than debt in its capital structure). In addition, having debt in a firm's capital structure is favourable to a company; this is how a firm with debt in its capital structure enjoys tax savings as interest is paid before tax is deducted from the company's profit. Financial experts also stated that financial leverage is a financial tool that is broadly used to improve a firm's rate of return and its value. However, financial leverage irrespective of its benefit to a company, also creates financial risk such as risk to the company; if a highly levered firm is incapable to earn adequate EBIT, such firm might go into liquidation as it may not be able to meet its interest liabilities and also finance other expenses of the firm.

2. Review of literature: -

(Mochi, R and Dani, M. 2018) conducted research on "Impact of Leverage on Profitability of Selected Companies in Indian Cement Industry" In this, study researchers have taken objective of investigate the financial leverage has an effect on financial performance. For this purpose, they have selected the top 10 listed cement companies. The ten years secondary data of the selected companies had been collected from 2007-08 to 2016-17 for this study. In this study researchers have found relationship between financial leverage and earning per share, return on Assets, Net profit margin, Return on equity, Sales growth. Result found that there is a negative relationship between debt equity ratios and earning per share which shows that as debt increase, the interest payment will also raise, so earning per share will decrease. The relationship between debt equity ratio and ROE is positive shows that the large debt will increase the ROE.

(Talla, N. 2014) The researcher has studied on "Impact of Leverage, Capital Structure and Dividend Policy Practices on Shareholders Wealth in Larsen and Toubro Limited, India" This paper concentrates on their impact on the long-term financial performance of the firm. In this present research paper, an attempt is made to analyse the impact of leverage of Larsen and Toubro Limited on its shareholders wealth which is reflected in market price of shares. The exploratory research design is adopted in this study which employs secondary data. The financial statements of Larsen and Toubro Limited have been collected over a period of 10 years from 2002-03 to2011-12. The data collected is analysed by financial ratios, Degree of leverage, Degree of Financial Leverage, Combined Leverage, the correlation and multiple regressions analysis tools. The research results reveals that there is positive correlation between operating leverage and market price of share as well as combined leverage and market price of share but financial leverage is negatively correlated with the market price of share. The financial leverage has negative impact on its market price of share but not significant statistically. Therefore, it is suggested to the company that it should modify the existing dividend policy and practices so that market value of share is maximized but it should not affect its growth prospects.

(Abubakar, A. 2017) "Effects of Financial Leverage on Financial Performance of Non-Financial Quoted Companies in Nigeria". The broad objective of this study was to determine the effects of financial leverage on financial performance of non-financial firms listed on the Nigerian Stock Exchange. The population of this study was made up of 66 out of the 94 non-financial firms quoted on the Nigerian Stock Exchange that were listed between 2005 and 2014. Data were collected on the basis of secondary data collection method like, the annual reports and financial statements of companies, daily official list and fact book of the Nigerian Stock Exchange for the period of the research. Descriptive statistics in the form of mean, median, maximum value and minimum value were used describe the selected variables. While panel data technique in the form of Random Effects Model (REM) was used to heteroscedasticity establish the relationship between the independent and dependent variables. T-test, Hausman's specification test and the Breusch-Pagan Lagrange Multiplier Test was also conducted to select the best model between Pooled Ordinary Least Squares, Fixed Effects Model and Random Effects Model. It is concluded that the financing behaviour of non-financial firms quoted on the NSE did not follow the Pecking Order Hypothesis. Nonfinancial financial firms in Nigeria do not rank their financing behaviour i.e. they exhibit market timing behaviour. This implies that firms issue debt if it is cheap and available and they issue equity if it is over-valued by the market.

3. Objectives

- To analyse the trend of financial leverage,
- To analyse the impact of financial leverage on price-earnings ratio

4. Statement of hypotheses

To determine whether there is a relationship between financial leverage and firms' value, the following hypothesis would be tested:

H_0: There is no significant impact between financial leverage and firms' value.

H_1: There is significant impact between financial leverage and firms' value.

5. The topic for this research has been selected as under:

"ASSESSING THE INFLUENCE OF FINANCIAL LEVERAGE ON FIRM VALUATIONS OF SELECTED INDIAN FMCG FIRMS"

6. Methodology of the study

6.1 Period of the Study:

The present study is made for the period of five years from 2016 to 2020.

6.2 Sample Design:

The total number of FMCG Companies is the universe of the study. At this stage researcher has decided to take five companies for the study. The researcher has selected these five companies randomly.

6.3 Sample of Study:

For this study researcher has selected five companies of the FMCG Industry of India:

1. Colgate Palmolive (India)
2. Emami
3. Tata Global beverages Ltd.
4. Merico
5. Nestle

7. Data Collection:

The present study is totally based on Secondary data. The data has taken from the Annual reports of the selected sample companies, text books, Reference books, magazines, journals, Articles and some data obtained from the Internet. The study would increase the intelligence of the researcher.

8. Data Analysis:

8.1 Tools & Technique of Analysis:

8.1.1 Accounting Tools-Ratio analysis: -

Ratio analysis is a widely used tool of financial analysis. It is defined as the systematic use of ratio to interpret the financial statements so that the strengths and weaknesses of the firm as well as its historical performance and current financial condition can be determined. The term ratio refers to the numerical or quantitative relationship between two variables. “A ratio is the relation of one amount of X, to another amount Y, expressed as the ratio of X to Y, or X: Y, or as a fraction, or number, or a percentage”. A ratio is simply one number expressed in the term of another. It is found by dividing one number, the base into the other.

8.1.2 Statistical Techniques:

(1) Simple Linear Regression

Simple linear regression is a model that assesses the relationship between a dependent variable and an independent variable. The simple linear model is expressed using the following equation:

$Y = a + bX + \epsilon$

Where:

Y – Dependent variable

X – Independent (explanatory) variable

a – Intercept

b – Slope

ϵ – Residual (error)

Analysis of Financial Leverage and Valuation of firm

Table 1: Financial Leverage

Financial leverage						
Company / Year	Colgate palmolive	Emami	Tata	Merico	Nestle	AVG
2016	1.000	1.165	1.173	1.345	1.559	1.2484
2017	1.000	1.218	1.399	1.354	1.501	1.2944
2018	1.000	1.257	1.354	1.328	1.512	1.2902
2019	1.000	1.299	1.402	1.049	1.359	1.2218
2020	1.278	1.168	1.512	1.251	1.351	1.3120

(Source: Annual reports of Companies)

The above table no. 1 shows the calculation of financial leverage of selected five sample companies for the study period of 2016 to 2020. The table also shows average financial leverage for the same. Researcher found that there is highest value of financial leverage in the Nestle i.e., 1.559 in the year 2016 and highest average value found in the year 2020 i.e.,1.3120. whereas, lowest value of financial leverage is represented in the Column of Colgate & Palmolive for four years from 2016 to 2019 i.e., 1.000. the lowest average value of Financial leverage has been found 1.2484 in the year 2016. Financial leverage has been calculated by using the following formula:

$$\text{Financial leverage} = \frac{EBIT}{EBT}$$

Table 2: Price to Earnings Ratio

P/E Ratio						
Company / Year	Colgate palmolive	Emami	Tata	Merico	Nestle	AVG
2016	56.44	52.85	30.48	43.87	26.50	42.028
2017	49.5	70.98	24.52	49.93	36.10	46.206
2018	56.58	74.19	27.91	52.42	23.50	46.92
2019	79.54	67.55	29.47	41.10	24.30	48.392
2020	87.54	44.45	42.02	33.02	24.30	46.266

(Source: https://www.valueresearchonline.com/stocks)

The table of Price to Earnings ratio is the indicator for valuation of selected FMCG companies for the selected time period from 2016 to 2020. The highest value of Price to Earnings ratio can be seen in the year 2020 for company Colgate & Palmolive i.e. 87.54. The highest average value has been found in the year 2019 which is 48.392. The lower value of Price to Earnings ratio has been found in the year 2018 in the Nestle which is 23.50.

Financial leverage has been calculated by using the following formula:

$$\boldsymbol{P/E} = \frac{\text{Shareprice}}{\text{Earnings per share}}$$

Table No. 3 Yearly Average value of financial leverage and Price to earnings ratio

Year	AVG FL	AVG P/E Ratio
2016	1.2484	42.028
2017	1.2944	46.206
2018	1.2902	46.92
2019	1.2218	48.392
2020	1.3120	46.266

Table No.4 A Table Showing Regression Statistics

Multiple R	0.016831288
R Square	0.000283292
Adjusted R Square	-0.33295561
Standard Error	0.042814303
Observations	5

Here, above table of regression statistics shows the value of R Square 0.000283 or in percentage 0028%. That proves there is no relationship between financial leverage and valuation of firms.

Table No.5 A Table Showing Coefficient of Regression Statistics

	Coefficients	*Standard Error*	*t Stat*	*P-value*	*Lower 95%*	*Upper 95%*	*Lower 95.0%*	*Upper 95.0%*
Intercept	1.261251	0.415753	3.033657	0.056148	-0.06186	2.584361	-0.06186	2.584361
Avg. P/E	0.000263	0.009036	0.029157	0.978571	-0.02849	0.02902	-0.02849	0.02902

The above table shows the p – value of regression analysis which is 0.978 that is more than significant value 0.05 which indicates that null hypotheses should not be rejected. So, it proves here that there is no significant Impact of financial leverage on valuation of firm.

Conclusion: -

This paper examines the "Impact of Financial Leverage on Valuation of Firm of Selected FMCG Companies of India" Value is measures by regression analysis. A population of five FMCG companies listed in NSE and the period for the study was 2016-2020. On the basis of the results researchers have concludes that there is no significant impact between financial leverage and firms' value. There is further scope for other industries or different time period. Further there is also scope for different capital structure mix to analyse the same.

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