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The Impact of Financing Practices, Firm Growth and Dividend Practices on Firm's Value as Mediated by Profitability

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Keywords:

Financing Practices, Firm Growth, Dividend Policy, Profitability, Firm Value.

ABSTRACT

In this study the mediating role of profitability among financing practices, firm growth, dividend payout and firm value has been examined. The study applies Hayes and Preacher model for mediation and structural equation model to examine the matter. A sample of 15 firms in manufacturing sector who have spent maximum time in Pakistan stock exchange from 2006 to 2016 are selected in the study. The study shows that capital structure and dividend payout are not only two things which can be treated separately but interlinked and profitability is not only dependent on dividend payout and capital structure rather it has an impact on these factors. Therefore when there is high profit the dividend pay out will be high and the retained earnings will be low similarly if the profit is higher the payout will be higher and retained earnings will be low and there will be low equity financing. The results in this study show that profitability taken as ROA and ROE has a mediating role among financing decisions, profitability and firm value. Therefore firm should make its policy by keeping in view the financing practices, firm growth, and dividend payout along with increasing profitability which will

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ultimately enhance the firm value in long run. On the other hand in some cases firm growth has an insignificant impact on firm value. Therefore the mediating role of profitability needs to be studied and explored. Furthermore the association between profitability and firm value is weaker in some situations which might be due to the moderating role of profitability rather than mediation which may be further elaborated in future.

INTRODUCTION

1. Introduction

The utmost important concerns of the literature in finance are to decide an appropriate capital structure consisting of debt and equity finance. Appropriate capital structure will not only enables the stakeholders of the company to perform various analyses before entering into contracts with company but also enables the company to reduce the overall risk including financial distress and variation in the financial institutions and market. Therefore it very important for a company to form a combination of financing decisions which maximize shareholders wealth and ultimately improve firm value by increasing market share price. The sole objective of management and doing business is to maximize companies value (Fama & French, 2002). This issue of great importance in developing economies like Pakistan because the growing development of financial markets is creating possibilities of financing for companies to achieve sustainability over times and becoming attractive for investors.

In stock market investors are interested to allocate and invest their asset most probably because of firm's value (Dincer et. all, 2016). The sole objective of management and doing business is to maximize companies value (Fama & French, 2002). This is achieved by generating profit more than firm weighted average capital cost.The growth and profitability and their interrelation have attracted the interest of researchers over a decade which is still continued. The business operations of a firm result in binomial growth-profitability which is mostly used as an indicator for measuring firm performance and competitive advantage over times (Fitzsimmons, Steffens, & Douglas, 2005). However most of the times growth is not sustainable for a long time and it is not accompanied by profitability of the firm because the firm is forced to finance its activities from debt financing instead of using only profit. Although a lot of research work has been carried out to study the relationship between growth and profitability however it is not yet confirmed that what are their key parameters and pre-requisites along with their sustainability over times.

Dividend policy is consist of decisions regarding the profits earned during the year which will be distributed among the shareholders of the company as a dividend as well as it will be used for issuing right shares to increase capital. The Bird in the Hand Theory (Gordon and Lintner, 1963), suggest that it is better to receive dividend on shares rather than capital gain because it bears less risk. Therefore the companies can maximize their share price by offering high dividend yield and maintaining high dividend pay-out ratio. Profitability can also affect the value of the company because the main objective of company formation is earning profit which ultimately enhances the value of the company's Share capital. The research conducted by (Antoro & Hermuningsih, 2018) shows that profitability have a significant positive effect on the firm value which is supported by the research of Rochmah & Fitria (2017) and Sisca (2016). On the other hand Wulandari & Wiksuana (2017) argue that profitability have a significant negative effect on the firm value.

In this study we are trying to investigate the relationship among Financing Practices, firm growth and dividend practices and its impact on the firm profitability and firm value of listed firms at Pakistan Stock Exchange. The overall relationship and impact of these factors on firm value with mediating role of profitability has not been discussed before. The study is focusing on recent years' data and the time period is comparatively prolonged (2006 to 2016). More variables are added in the study to explore in more detail that how financing Practices, firm growth and dividend practices influence the profitability and value of listed firms in Pakistani setting. New findings are expected in this sector due to global financial crises and subsequent flight of capital. The political instability and new political set up of 2013 is also considered for the study because various governments had a different view towards internal and external debts and Continuous changes are adopted in monetary policy and fiscal policy over times.

The study has a main research question of whether profitability mediates the relationship among financing practices, firm growth, dividend payout and firm value. Likewise the objectives of the study are examining the mediating role of profitability among financing practices, firm growth, dividend payout and firm value.

2. Literature review

The relationship of financing Practices with the firm value is one of the most debatable area of corporate finance. The studies of corporate structure and firm value along with other related variables become more attractive for researchers and scholars of this area after the global financial crises of 2008.The seminal work of Lintner (1956); Hirshleifer (1958) and Modigliani & miller (1958)was also brought under discussion due to its relatedness with this area. MM theory stated that debt to equity choice have no relation with the firm value when the market is efficient. The theory excluded tax shield, inflation rate and cost of borrowing leading to bankruptcy in the assumption of perfect competition. Later on after the emergence of theories like trade-off-theory, picking order theory and agency theory. Modigliani & Miller (1963) assumed conditions and found that in the imperfect capital market if interest expense is used to reduce tax burden then firm value will increases because of higher financial leverage. According to Kraus & Litzenberger (1973)static trade-off theory hypothesized that the firm trade-off the benefits, cost of debt, equity financing and establishes an optimal capital structure after identifying that the market is imperfect due to taxes, agency cost and bankruptcy costs.

Myers &Majluf (1984) however, stated that picking order theory explains how firm should minimize imbalances of information between parties by following a particular financing hierarchy. They further added that a firm should utilize its retained earnings for meeting its financial requirements before opting for debt or equity choices. In this case those firms will preferably use debt finance who are more profitable and generate high cash flows as compared to firms who do not generate high cash flows. It means picking order theory support the assumption of firm's preference for debt financing over equity financing (Rajan & Zingales, 1995; Wald, 1999; Fama & French, 2002; and Karadeniz et. al, 2009). On the other hand some of the researchers are of the opinion that there is no specific limit for debt, however, financing practices are mostly based on requirements and availability of sufficient funds (Arosa, Richie, &Schuhmann, 2014; Hovakimian, 2004; Lee, Su, & Lin, 2012).

Denise & Robert (2009) found that the investment strategy based on equity capital have positive relationship with the profitability of firm. Therefore if the output from loans is greater than interest paid by firms then the dividends for shareholders will be high.Kusumasari, et al. (2009) have argued that financing practices have no significant impact on the firm's financial performance.On the other hand Safieddine& Titman (1997) have noticed an increase in the leverage recapitalization as a result of

increase in the financial performance of firms.

Stulz (1990) have argued in his research that in low growth opportunity the debt ratio of a firm will have positive impact on its value.However if there is high growth opportunity for a firm, there will be a negative impact of its debt ratio on the value of that particular firm. Therefore the impact of debt ratio on firm value strongly depends upon availability of growth opportunity.Greiner (1972) have argued that the growth and profitability of a firm can be positively or negatively correlated. He further added that due to positive impact ofemployee's motivation become more appealing as compared to employees' relation it will cause a negative impact and the growth of firm will increase its profitability. However if there is less motivation and change in the employees' relation then the firm's growth can reduce its profitability.Brigham & Houston (2011) stated that Miller & Modigliani (1961) have shown irrelevance between firm value and dividend policy in the perfect market, certainty and rationale behavior, however Hamidy et al (2018) have stated that capital structure have a positive effect on the firm value.According to Bird-in-the-hand theory the stock risk will decrease when the dividend payout increases (Ehrhardt& Brigham, 2009).Due to higher payout ratio the required rate of return will decrease which will cause an increase in the value of firm (Al-Malkawi, 2007).

The relationship between dividend policy and firms profitability is also discussed by Researchers like Lee, et al. (2012).These researchers have discussed the relationship between changes in the current dividend payout and changes in the future earnings of firms listed from 1998 to 2007 in the Malaysian stock exchange. They have further explained that the dividend payout of firm will change significantly with the contemporary changes in the profit. Although there is a weak association between current dividend payout and changes in the profit of firm initially however in the second and third year mostly they are not correlated with the earnings of firms. They further added that there is a weak correlation of future earnings with the size and stability of dividend.

According to Kusumajaya (2011), a study conducted by Yuniasih & Wirakusuma (2006) analyzed that when financial performance is measured through return on assets (ROA), it has a significantly positive impact on firm value. Sari (2005) argued that managerial ownership, investment interaction, leverage ratio, leverage and investment interaction and profitability influence the value of firms. On the other hand Carningsih (2008) has proved that ROA has a negative impact on the firm value and ROE has a positive impact on firm value.

Financing Practices consists and measured mostly by debt and equity financing and by using debt ratio (DR), debt equity ratio (DER) and long term debt to equity ratio (LTDTA). Various studies have been conducted to measure the impact of financing Practices on profitability and firm value individually like Hamidy et al. (2018), Kashkoueyeh et al. (2015), Masidonda et al. (2013) & GarimaDalal (2013). Firm growth can also affect the profitability of the firm because there is a relationship between firm growth and profitability as explained by various researchers. Profitability can be measured through ratios like return on asset (ROA), return on equity (ROE) and net profit margin (NPM) which also have a significant effect on the firm value as mentioned by the previous literature. On the other hand dividend policy is also strongly correlated with the profitability. Dividend policy is mostly measured through dividend payout (DPO) and dividend yield. The researcher is taking firm value as dependent variable and financing Practices, firm growth and dividend policy as independent variables while profitability is treated as mediating variable.

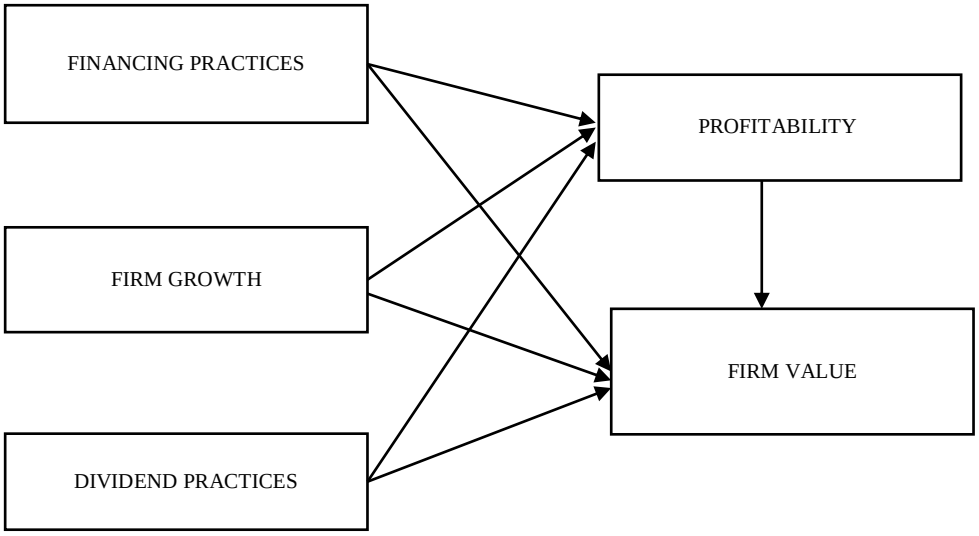

Fig 3.1 Conceptual Framework

Hypothesis

H1: Profitability mediates the relationship of financing practices and firm value.
H2: Profitability mediates the relationship between firm growth and firm value.
H3: Profitability mediates the relationship between dividend payout and firm value.

3. Research methodology

The study is Quantitative in nature and will focus on empirically testing the model of financing practices, firm growth, Dividend policy, profitability and firm value. The research design is confirmatory and exploratory research it means that the research will be done by verifying or testing the relevant theories, particularly the theory of financial and capital markets i. e. trade-off theory, pecking order theory, and the theory of dividend relevance, and the postulates in theories will be tested through hypothesis. The impact of firm growth on profitability and firm value will be analyzed by taking profitability as a mediating variable. The theory of dividend payout is one of the fundamental theories in financial management which will discuss the functional relationship between dividend policy and the firm value.

The irrelevance of dividend proportion states that the dividend payout does not affect the firm value. While the relevance of dividend proportion considers that dividends have relevant impact to the firm value which we will confirm in this study. Another theory to be tested is the Bird in Hand theory introduced by Gordon in 1959, which states that the dividend has an impact on the firm value. Manufacturing firms from different industries listed on Pakistan stock exchange will be our population and at least 15 of those manufacturing firms who have spent more time in hundred indexes will be considered as a sample for a period of 10 years i.e. 2006 to 2016. This study is based on secondary data that will be collected from the annual reports and financial reports of the firms which will be acquired form manual as well as internet sources. The balance sheet analysis of state bank and website will be used for obtaining relevant data of firms. The required data will be analyzed by using appropriate statistical techniques and tests.

Panel data techniques have been used in the study because of the nature of data. The correlation among independent variables has been examined and Hayes and Preacher mediation model has been used for measuring the profitability as mediating variable. Tobin Q Model has been used for valuing firms and Structural Equation Model for overall association of variables.

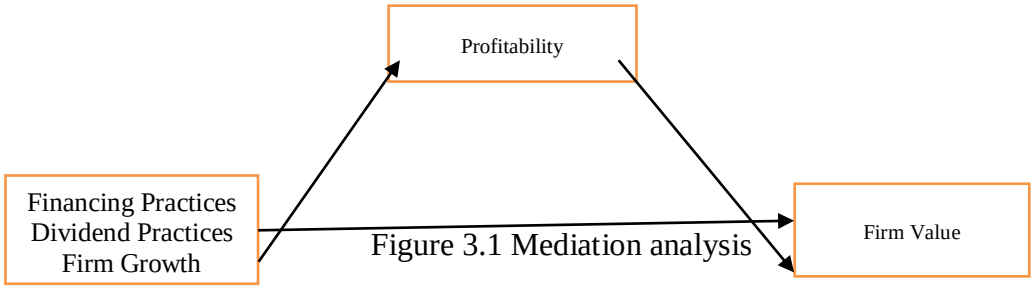

Figure 3.1 Mediation analysis

Econometric Model:

$FV = \alpha_o + \alpha_1 P + \alpha_2 FP + \alpha_3 FG + \alpha_4 DP + U_1$

$P = \beta_o + \beta_1 FP + \beta_2 FG + \beta_3 DP + U_2$
$DP = c_o + c_1 FP$
$FP = d_o + d_1 DP$
Where
FV = Firm Value
P = Profitability
FP =Financing Practices
FG = Firm Growth
DP = Dividend Practices

4. Results and Discussion

The STATA 13 has been used for analysis in the current study. The data is consisting of financial data on yearly basis, which is collected from the annual reports of the selected companies. The empirical results after testing the hypothesis are reported with the help of structural equation model. The Hayes and Preacher Model of mediation is used to assess the relationship among dependent, independent and mediating variables through direct effect and indirect effect.

4.1. Structural Model

	Co-eff.	**Stand. Er.**	**T**	**P|**	**[Confidence In, 95%]**	
Structural						
ROA<-						
Debt ratio	.0177351	.005953	2.98	0.003	.0060675	.0294027
Equity	.0072851	.0057856	1.26	0.208	-.0040544	.0186247
Growth	-.0025289	.0063131	-0.40	0.689	-.0149024	.0098445
Payout ratio	-.0190171	.0202791	-0.94	0.348	-.0587635	.0207293
D. yield	.0127581	.0046589	2.74	0.006	.0036268	.0218894
_Cons	1.394791	.1065901	13.09	0.000	1.185878	1.603704
Next path of structural model						
value <-						
ROA	3.772461	1.042299	3.62	0.000	1.729592	5.81533
Debt ratio	.2762708	.0917962	3.01	0.003	.0963536	.456188
Equity	.2660743	.087717	3.03	0.002	.0941521	.4379965
Growth	.1373688	.0953916	1.44	0.150	-.0495953	.324333
Payout ratio	-.5382168	.306944	-1.75	0.080	-1.139816	.0633823

D. yield	.1345751	.0716152	1.88	0.060	-.0057882	.2749384
_Cons	-2.156674	2.169221	-0.99	0.320	-6.408268	2.094921
Var(e.roa)		.0004561	.0000445		.0003767	.0005523
Var(e.value)		.1040661	.0101558		.085949	.1260022

4.1 The structural equation model with ROA as mediating variable

The first structural model of mediation return on assets shows that the coefficient of debt ratio to return on asset is 0.177351 and it is statically significant at 0.003 which is less than 0.05 it suggests that debt to equity had the effect of return on assets and the magnitude of debt is 0.0177351 units if there is a change in the debt ratio. As for as the Z value is higher than 2 which also shows that the relationship is significant. If we talked about equity and return on assets relationship so the coefficient is very minuet that is 0.0072851 as far as the Z value is concerned so it is below then 2 and the P-value suggests that this relationship is insignificant because the P-value is 0.208 which is higher than 0.05. The coefficient of growth is inverse because the negative sign shows that there is an inverse relationship between growth and ROA which is very minute i.e. -.0025289 and its Z value is also less than 2 as for as the P-value of growth is 0.689 which suggest that growth and return on assets have no relationship because it is insignificant at 0.05 level. The payout ratio suggesting that the coefficient is against inverse i.e. -0.190171 while the Z value is again less than 2 and the P-value of payout ratio is higher than 0.05 which is suggesting that the payout ratio and return on the asset have no relationship. The last variable is dividend yield the magnitude of dividend yield is .0127581 and its Z value is greater than 2 and its P-value is less than 0.05 which shows that there is a significant relationship between dividend yield and return on assets.

The second structure model is of value and in this case, the dependent variable is firm value and other variables are independent, including the meditational effect of return on assets. Now if we talked about return on assets and value of firm so they both have a meditational effect and there is a meditational effect return on assert and value because the value of ROA showing a significant relationship because its P-value is less than 0.05 while its Z value is also greater than 2 and the magnitude of ROA is 3.773461 it means that if 1 unit change in ROA it will bring 3.773461 change in the value of the form. And if we talked about the second variable so there is a positive relationship between debt ratio and value of the firm, if debt ration increase by 1 unit it will bring .2762708 units change in the value of firm positively and it is also highly significant as we can see that the P-value is less than 0.05 and its Z statistic is also greater than 2.0 if we talked about equity so equity is also highly significant at 0.05 levels and the Z statistics of equity so it is also greater than 2 and the magnitude is .2660743.

The magnitude of growth is .1373688 but the Z statistics is less than 2 which alarming insignificant relationship and this is confirmed from the P-value which is 0.150 greater than 0.05 so it shows that due to growth there will be no increase in the value of the firm. Now to talk about payout ratio so there is again insignificant relationship between payout ratio and the value of the firm the Z statistic of payout ratio also alarming the level of insignificant and this level of insignificancy was confirmed by the P-value that is 0.080 greater than 0.05. now we have the last variable and that is the dividend yield, so dividend yield has no relationship with the value of the firm because its P-value is also greater than 0.05 and this insignificancy was confirmed by the Z value of dividend yield which is 1.88 less than 2.

The variance of return on assets is .0004561 and it shows that variation between the variables and return on assets is weak. While if we talked about the value so it is .1040661and it suggesting that there is a strong or healthy relationship between the independent variables and the dependent variables. While the Chi value shows that the model is significant.

4.2The Direct,indirect and total effect

Table 4.2.1Direct Effects

	Co-eff.	Stand. Er.	t	P	[95% Confd, Int]	
Structural						
ROA<-						
Debt ratio	.0177351	.005953	2.98	0.003	.0060675	.0294027
Equity	.0072851	.0057856	1.26	0.208	-.0040544	.0186247
Growth	-.0025289	.0063131	-0.40	0.689	-.0149024	.0098445
Payout ratio	-.0190171	.0202791	-0.94	0.348	-.0587635	.0207293
D. yield	.0127581	.0046589	2.74	0.006	.0036268	.0218894
The second path of structural equation model						
value <-						
ROA	3.772461	1.042299	3.62	0.000	1.729592	5.81533
Debt ratio	.2762708	.0917962	3.01	0.003	.0963536	.456188
Equity	.2660743	.087717	3.03	0.002	.0941521	.4379965
Growth	.1373688	.0953916	1.44	0.150	-.0495953	.324333
Payout ratio	-.5382168	.306944	-1.75	0.080	-1.139816	.0633823
D. yield	.1345751	.0716152	1.88	0.060	-.0057882	.2749384

Now we have to check the direct, indirect and total effect of the mediating variables on the dependent variable. In the indirect effect, we directly implement the equation of the dependent variable with the mediating variable along with other independent variables. But it signifies the direct effect of dependent and mediating variables.

The dependent variable is the value of the firm and the mediating variable is the return on assets. So the value of coefficients shows that there is a 3.772461units direct effect of return on assets and value of the firm. It means that return on the asset has a direct relation or it will bring direct change in return on assets by 3.772461units if one unit changes in return on assets and this relationship are highly significant because its P-value is less than 0.005 and its Z value is also very healthy value that is 3.62 far greater than the standard value of Z. so it shows that return on the asset has a direct relationship with a magnitude of 3.772461on value of a firm.

Table 4.2.2Indirect Effects

	Co-eff.	Stand. Er.	z	P	[95% Confd, Int]	
Structural value <-						
ROA				0 (no path)		
Debt ratio	.066905	.0290867	2.30	0.021	.0098961	.123914
Equity	.0274829	.0231091	1.19	0.234	-.0178101	.0727759
Growth	-.0095403	.0239613	-0.40	0.691	-.0565036	.0374231
Payout ratio	-.0717412	.0790284	-0.91	0.364	-.2266341	.0831516
D. yield	.0481296	.0220393	2.18	0.029	.0049333	.0913259

In the indirect effect, we checked the relationship between return on asset and value of firm indirectly. All the other variables which are debt ratio, equity, growth, payout ratio and dividend yield they are

affecting the value of the firm but if we checked the significant values so only two variables have a significant value debt ratio and dividend yield debt ratio has a P-value 0.021 while dividend yield has 0.029 which shows that both of variables affecting the value of the firm because their Z values is also greater than 2 while other variables equity, growth, and payout ratio had 0.234, 0.691 and 0.364 P values respectively and these all values are insignificant and if we talked about their Z values so Z value of equity is 1.19, growth has – 0.40 and payout ratio has -0.91 which also alarming that these variables are insignificant. Now if we talked about the return on assets indirect relationship with the value of the firm so there is no coefficient, it means that return on the asset has no indirect effect on the value of the firm it has only a direct effect on the value of the firm

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Table 4.2.3 Total Effects

	Co-eff.	Stand. Er.	T	P|	[95% Confd, Int]	
Structural						
ROA<-						
Debt ratio	.0177351	.005953	2.98	0.003	.0060675	.0294027
Equity	.0072851	.0057856	1.26	0.208	-.0040544	.0186247
Growth	-.0025289	.0063131	-0.40	0.689	-.0149024	.0098445
Payout ratio	-.0190171	.0202791	-0.94	0.348	-.0587635	.0207293
D. yield	.0127581	.0046589	2.74	0.006	.0036268	.0218894
	Second path of structural model					
value <-						
ROA	3.772461	1.042299	3.62	0.000	1.729592	5.81533
Debt ratio	.2762708	.0917962	3.01	0.003	.0963536	.456188
Equity	.2660743	.087717	3.03	0.002	.0941521	.4379965
Growth	.1373688	.0953916	1.44	0.150	-.0495953	.324333
Payout ratio	-.5382168	.306944	-1.75	0.080	-1.139816	.0633823
D. yield	.1345751	.0716152	1.88	0.060	-.0057882	.2749384

If we check the total effect of return on assets on the value of the firm so we have to combine the direct effect with an indirect effect so we will get the total effect. So if we look at the direct effect of return on assets on the value of firm so it is 3.772461 but the indirect effect as we know that there is no indirect effect of return on asset and the value of firm so it is zero so the total effect and direct effect, in this case, are samewhich has a higher magnitude all other variables which is 3.772461 and it is highly significant as P value suggest as well as Z statistics also shows that the value of return on assets with effect to value of a firm is greater than 2, it shows that return on asset had a direct and total effect on the value of firm. If there is one unit change in return on assets or one unit increase in return on assets it will increase the value of a firm by 3.772461 units ultimately.

Conclusion and Recommendations

The results of the study are indicating that debt financing has a significant positive impact on the firm value in both cases, whether ROA or ROE is taken as mediating variable. It is endorsed that ROA and ROE has a mediating role in the association of debt financing and firm value. Similarly financing decisions have a positive impact on firm value through profitability. However, firm growth has an insignificant impact on firm value through profitability. Payment of dividend also has an insignificant impact on firm value through profitability. Similarly, Profitability in some cases have decreased the

impact on firm value which may be an indication that profitability might be moderating variable rather than mediating which needs to be confirmed in future research.The study analyzed the manufacturing sector future study should focus on the trading and services sector. The proxy of the mediating variable may be extended which can further refine the outcome.

Practical Implications

The finding of the current study has significant implications for managers, policymakers and potential investors. In addition, it has an important contribution to the existing body of knowledge since profitability has not been evaluated as a mediating variable in the literature.

Besides, the results of this study also contribute by supporting signalling theory, where the market responds positively to the company's profitability and information is used by investors as a basis for making investment decisions.

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