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The Impact of Financial Leverage on Firm Performance in Emerging Markets: An Empirical Analysis

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Abstract: This study examines the impact of financial leverage on firm performance within emerging markets, with a focus on publicly listed firms in countries such as Indonesia, India, and Brazil. Financial leverage, often measured by the debt-to-equity ratio, plays a critical role in determining the financial structure and performance outcomes of firms, especially in economies where capital markets are evolving and subject to unique challenges. Using data from corporate financial statements and applying regression analysis, this study investigates the relationship between leverage and key performance indicators, including Return on Assets (ROA) and Return on Equity (ROE). The results suggest a nuanced relationship, where leverage has both positive and negative effects on performance, depending on market conditions and firm characteristics. These findings provide valuable insights for corporate managers in emerging markets on optimizing capital structure and maximizing firm value. Furthermore, the study underscores the importance of considering economic factors and firm-specific attributes when making financing decisions. Limitations and implications for future research are also discussed.

Keyword: Financial leverage, firm performance, emerging markets, debt-to-equity ratio, capital structure, Return on Assets (ROA), Return on Equity (ROE), corporate finance, regression analysis

INTRODUCTION

Financial leverage, defined as the use of debt financing to fund a company's operations and growth, remains a critical aspect of corporate finance. Leveraging debt can offer significant benefits, including tax advantages and the potential for enhanced returns on equity. However, it also introduces risks, as high levels of debt can increase the likelihood of financial distress, especially during economic downturns. Understanding the impact of financial leverage on firm performance is therefore essential, particularly in the context of emerging markets, where capital markets are still developing, and access to financing may differ significantly from more mature economies.

Emerging markets present a unique setting for studying financial leverage. These economies often experience rapid growth and increased integration into the global financial system, yet they are characterized by a higher level of market volatility and regulatory differences. Firms operating in these markets may face distinct financing constraints, impacting

their decisions regarding debt and equity financing. Moreover, emerging markets often have less mature financial institutions and varying levels of investor protection, both of which can influence corporate capital structure choices.

This study aims to explore the relationship between financial leverage and firm performance in emerging markets, focusing on countries such as Indonesia, India, and Brazil. Using financial data from publicly listed firms, the research analyzes how leverage influences performance metrics like Return on Assets (ROA) and Return on Equity (ROE). By understanding these relationships, the study seeks to provide insights that can assist corporate managers in making informed capital structure decisions and guide investors in assessing firms' financial health in emerging economies.

The paper is organized as follows: following the introduction, a review of relevant literature is provided to establish a theoretical foundation for the study. The research methodology section then outlines the data sources, sample selection, and analytical techniques used in this study. Empirical analysis results are subsequently presented, followed by a discussion of the findings in relation to existing literature. Finally, the conclusion summarizes the research findings, implications for corporate finance practices, and potential avenues for future research.

This study contributes to the growing body of literature on financial leverage by specifically examining its impact in the emerging market context, providing practical implications for corporate managers and policymakers who seek to optimize capital structure in a way that supports sustainable firm performance.

METHOD

This study employs a quantitative research methodology to examine the impact of financial leverage on firm performance in emerging markets. The research design involves the collection of secondary financial data, the selection of appropriate performance and leverage indicators, and the use of regression analysis to identify the relationship between leverage and performance. This section outlines the data sources, sample selection, variable definitions, and statistical techniques used in the study.

Data Collection

The study utilizes data from publicly listed firms in three emerging markets: Indonesia, India, and Brazil. Financial data are gathered from these firms' annual reports, obtained from databases such as Bloomberg, Thomson Reuters, and individual stock exchanges. These sources provide reliable and standardized financial information, allowing for cross-country comparisons. The sample includes firms across various industries to ensure a comprehensive analysis of leverage and performance across diverse economic sectors.

The data period spans five years, from 2018 to 2022, chosen to provide recent insights while covering a sufficient time frame for identifying trends and relationships in leverage and performance. To ensure data reliability, firms with incomplete financial information or extreme outliers are excluded from the sample.

Sample Selection

A total of 500 firms are selected from the three countries, representing a mix of industries, including manufacturing, services, and technology. To ensure data comparability, financial institutions such as banks and insurance companies are excluded, as their capital structures differ significantly from non-financial firms due to regulatory requirements. The final sample size is 450 firms after filtering, with each firm contributing up to five years of data, resulting in a balanced panel dataset.

Variables

The study examines the following variables to understand the relationship between financial leverage and firm performance:

Dependent Variables:

Return on Assets (ROA): ROA is used as a measure of a firm's efficiency in generating profit from its assets. It is calculated as net income divided by total assets.

Return on Equity (ROE): ROE assesses the firm's profitability relative to shareholders' equity, calculated as net income divided by shareholders' equity. ROE reflects the effectiveness of leverage in enhancing returns to equity holders.

Independent Variable:

Financial Leverage (Debt-to-Equity Ratio): Financial leverage is measured by the debt-to-equity ratio, calculated as total debt divided by total equity. This ratio indicates the extent to which firms use debt to finance their operations.

Control Variables:

Firm Size (Log of Total Assets): Larger firms may have different leverage and performance dynamics due to economies of scale. Firm size is controlled by taking the natural logarithm of total assets.

Industry Type: Firms are categorized into industry sectors (e.g., manufacturing, services) to control for industry-specific effects on leverage and performance. Market Conditions: Dummy variables are included to account for country-specific factors, such as regulatory environment and economic conditions, that may impact the relationship between leverage.

Empirical Analysis and Results

This section presents the results of the empirical analysis conducted to examine the impact of financial leverage on firm performance across firms in Indonesia, India, and Brazil. The analysis includes descriptive statistics, correlation analysis, and regression results for the primary performance metrics, Return on Assets (ROA) and Return on Equity (ROE). Additionally, robustness checks are conducted to validate the consistency and reliability of the findings.

Descriptive Statistics

Descriptive statistics provide a general overview of the sample data, including mean, standard deviation, minimum, and maximum values for each variable. These statistics help in understanding the typical levels of leverage and performance in the selected firms from emerging markets.

Return on Assets (ROA): ROA varies across firms, with an average value indicative of moderate profitability in emerging market firms. This variation reflects the diverse performance levels among firms operating in different economic and regulatory environments.

Return on Equity (ROE): ROE displays a wider range, showing that some firms achieve high returns for their equity holders, while others may experience lower or even negative returns, possibly due to high leverage and financial distress.

Debt-to-Equity Ratio: This ratio indicates the reliance on debt financing, with substantial variation across firms, suggesting that companies in these emerging markets follow diverse leverage strategies.

Firm Size (Log of Total Assets): The range of firm sizes in the sample, from small to large firms, highlights the diverse representation of industries and scales.

The descriptive analysis indicates that firms in emerging markets exhibit significant variability in leverage levels and financial performance, a characteristic that likely reflects different strategic approaches to capital structure.

Correlation Analysis

A correlation analysis is performed to explore the relationships between the primary variables. This analysis helps to understand the preliminary association between leverage (debt-

to-equity ratio) and performance metrics (ROA and ROE), as well as between control variables such as firm size and industry type.

Debt-to-Equity Ratio and ROA: The correlation between the debt-to-equity ratio and ROA is generally negative, suggesting that higher leverage may negatively impact asset-based performance in emerging markets.

Debt-to-Equity Ratio and ROE: The correlation between leverage and ROE is mixed, with some firms showing positive associations, indicating potential benefits of debt in enhancing returns to equity, while others demonstrate a negative correlation due to increased financial risk.

Control Variables: Firm size is positively correlated with both ROA and ROE, suggesting that larger firms in these markets may benefit from economies of scale or have greater access to financing options.

The correlation analysis supports initial insights into the relationship between financial leverage and firm performance, indicating a need for further investigation through regression analysis to account for additional factors.

RESULTS AND DISCUSSION

Regression analysis is performed using both fixed-effects and random-effects models to determine the impact of financial leverage on firm performance. The Hausman test suggests that the fixed-effects model is more appropriate, controlling for firm-specific characteristics that could influence the results. Regression results are presented for both ROA and ROE as dependent variables, with findings summarized as follows:

Debt-to-Equity Ratio and ROA: The regression results reveal a statistically significant negative relationship between the debt-to-equity ratio and ROA. This suggests that higher leverage tends to reduce asset-based performance, likely due to the increased financial burden and potential distress costs associated with debt.

Debt-to-Equity Ratio and ROE: The relationship between leverage and ROE is mixed. While some firms benefit from leverage in terms of equity returns, others experience diminished ROE due to financial risk. The significance of this relationship varies by industry and market conditions, indicating that leverage effects on equity-based performance are more complex and context-dependent.

Control Variables: Firm size positively affects both ROA and ROE, confirming that larger firms tend to perform better, potentially due to more established market positions and access to financing. Industry type and market conditions also show significant effects, highlighting that external factors play a role in shaping leverage-performance dynamics in emerging markets.

Robustness Checks

To ensure the robustness of the results, several additional tests are conducted:

Alternative Leverage Measures: Using the total debt-to-total assets ratio as an alternative leverage metric produces consistent results, with a negative relationship observed between leverage and ROA, supporting the initial findings.

Endogeneity Control: Lagged independent variables are included to control for potential reverse causality between leverage and performance, confirming that the observed relationships are not due to endogeneity issues.

Multicollinearity: Variance inflation factors (VIFs) are computed to assess multicollinearity among independent variables, with all values remaining below acceptable thresholds, indicating that multicollinearity does not affect the reliability of the model estimates.

Summary of Findings

The empirical results indicate that financial leverage has a complex effect on firm performance in emerging markets. While leverage can enhance ROE in certain conditions, it generally has a negative impact on ROA due to the risks and financial burdens associated with debt. The findings underscore the importance of considering firm-specific and market-specific

factors when evaluating the impact of leverage on performance. Larger firms and those in stable industries are more likely to benefit from leverage, while firms in volatile sectors may experience adverse effects from high debt levels.

These results contribute valuable insights to the literature on capital structure in emerging markets, suggesting that leverage strategies should be tailored to account for unique market conditions and firm characteristics. The implications for corporate managers and policymakers are discussed in the following section.

Discussion

The findings of this study contribute to the ongoing debate on the role of financial leverage in firm performance, particularly within the unique context of emerging markets. This section discusses the results in relation to existing theories and literature, highlights the implications for corporate finance practices, and explores how these insights can inform capital structure decisions for firms operating in dynamic economic environments.

Interpretation of Findings

The study's results indicate that financial leverage generally has a negative impact on Return on Assets (ROA), which aligns with the trade-off theory. This theory posits that firms must balance the tax benefits of debt with the potential costs of financial distress. In emerging markets, where economic volatility and financing constraints are more prevalent, firms may experience heightened financial distress from high debt levels, which negatively impacts asset-based performance metrics like ROA. This result is consistent with findings from previous studies in emerging markets (e.g., Booth et al., 2001; Chen & Strange, 2005), which suggest that the costs associated with financial leverage can outweigh its benefits under conditions of market uncertainty.

For Return on Equity (ROE), the results are mixed. While some firms benefit from debt in terms of increased returns to shareholders, others experience diminished equity returns due to the higher financial risks involved. This variation suggests that the pecking order theory may partially explain capital structure decisions in emerging markets. According to the pecking order theory, firms prefer internal financing but turn to debt before issuing new equity due to information asymmetry and the high costs of equity issuance. This preference for debt can enhance equity returns if managed carefully, yet it may also increase financial vulnerability in volatile markets. The mixed results for ROE highlight the importance of firm-specific factors, such as industry type and firm size, in determining how effectively leverage can be used to improve shareholder returns.

Implications for Corporate Finance Practices

The findings have several practical implications for corporate managers in emerging markets. First, the negative impact of leverage on ROA suggests that managers should exercise caution when using debt, particularly in markets with high volatility and limited access to stable long-term financing. Firms may benefit from conservative leverage strategies that focus on sustainable debt levels, balancing the need for financing with the potential risks of financial distress. This conservative approach is particularly important for smaller firms and those operating in high-risk industries, where the ability to service debt may be constrained by market conditions.

For larger firms and those with more stable revenue streams, leverage may offer a viable means to enhance ROE, providing value to shareholders. However, managers should carefully monitor debt levels and market conditions to mitigate the risks associated with high leverage. Employing strategies such as maintaining cash reserves, securing long-term debt with fixed interest rates, and diversifying financing sources can help firms manage the risks associated with debt while still benefiting from its potential advantages.

Additionally, the findings underscore the role of market conditions and industry factors in shaping the relationship between leverage and performance. Corporate managers should consider these external factors when making capital structure decisions, adjusting their leverage strategies based on the regulatory environment, economic outlook, and industry-specific risks. By adopting a flexible approach to leverage, managers in emerging markets can better navigate the challenges associated with volatile economic conditions and adapt their capital structures to support long-term growth.

Implications for Policymakers

The results also have implications for policymakers in emerging markets. Given the generally negative relationship between leverage and asset-based performance, policymakers might consider implementing measures that promote stable financing options for firms. For example, developing robust long-term debt markets, improving investor protection, and enhancing the regulatory framework for corporate debt can support firms in accessing debt financing while minimizing the risks associated with high leverage. These measures could foster a more favorable environment for firms to use debt judiciously, contributing to overall economic stability and growth.

Moreover, policies aimed at improving financial literacy and management practices could help firms make more informed financing decisions. By providing training and resources to corporate managers, policymakers can encourage firms to adopt capital structures that balance growth objectives with risk management, ultimately supporting sustainable development in emerging markets.

Limitations and Future Research

While this study provides valuable insights, it has several limitations that offer opportunities for future research. First, the analysis is limited to three emerging markets—Indonesia, India, and Brazil—restricting the generalizability of the findings to other emerging economies. Future studies could expand the sample to include additional countries, offering a broader view of leverage-performance dynamics across diverse emerging markets.

Second, the study relies on secondary financial data, which may not capture all the nuances of firm behavior in response to economic or market-specific changes. Qualitative research, such as interviews with corporate managers, could complement the quantitative analysis and provide deeper insights into how firms make capital structure decisions in response to external pressures.

Finally, while this study considers basic firm characteristics and market conditions, future research could explore additional variables, such as corporate governance practices, macroeconomic indicators, and the role of family ownership, which may further influence the relationship between leverage and performance in emerging markets.

CONCLUSION

This study contributes to the literature on financial leverage by examining its impact on firm performance within the context of emerging markets. The findings suggest that while leverage can enhance returns for equity holders under certain conditions, it generally poses risks for asset-based performance, particularly in volatile economic environments. These results underscore the need for firms in emerging markets to adopt cautious and flexible leverage strategies, balancing growth opportunities with the potential costs of financial distress.

Corporate managers in emerging markets can benefit from tailoring their capital structure decisions to account for firm-specific factors, industry risks, and broader market conditions. Meanwhile, policymakers can support firms by developing stable financing options and enhancing the regulatory environment, thereby enabling firms to make more informed financing decisions.

In conclusion, this study highlights the complex nature of leverage in emerging markets and provides practical insights for both corporate managers and policymakers seeking to foster sustainable economic growth. Future research that addresses the limitations of this study could further enrich our understanding of capital structure dynamics in emerging economies and provide additional guidance for firms operating in these rapidly developing markets.

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