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Effect of debt on corporate profitability (Listed Hotel Companies Sri Lanka)

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Abstract

The determination of a company's capital structure constitutes a difficult decision, one that involve several and opposed factor, such as risk and return. This study an attempt has been made to find the effect of debt on company's profitability during the 2008 to 2012(05 years). Eleven companies were selected form Hotel companies listed in Colombo stock Exchange as sample companies. Correlation and regression analysis are used to find out the effect of debt on corporate profitability. Accordance with the regression analysis there were no significant relationship between debt and profitability. But based on the correlation analysis, there were strong negative relationship between short term liabilities, ROE and ROA. Further total liabilities to total assets had the strong negative relationship between ROE and ROA. But there was no significant relationship between long term liabilities, ROE and ROA.

Key words: Debt, Return on Assets and Return on Equity

Introduction

According to capital structure theory, capital structure refers to the way an organization finances its assets. A firm can be financed by 100% ordinary shares or with some mix of shares and debt. It is an important decision, how the assets of a firm are financed. Equity shares financing in which investors receive partial ownership in the company in exchange for their funds does not have to be repaid. Debt is borrowing money from an outside source with the promise to return the principal, in addition to an agreed-upon level of interest. Debt allows people and organizations to do things that they would otherwise not be able, or allowed, to do. Debt Financing increase overall risk and return of the company. Debt financing impact on returns of a change in the extent to which the firm's assets are financed with borrowed money. Financial Leverage magnifies risk and adds volatility to returns. So that company used debt financing as a strategy to magnify its profit.

Modigliani Miller (1958) argued that under certain assumptions value of the firm is independent of how its assets are financed. Later in (1963) they revised their famous MM proposition by saying that the existence of tax subsidies on interest payments would cause the value of the firm to rise with the amount of debt financing by the amount of the capitalized value of the tax subsidy. For value of the firm to increase in case of debt financing because of larger cash inflows due to tax subsidy is only possible when EBIT of the firm remains the same no matter how the assets are financed. So, essentially they argued that EBIT of the firm would be independent no matter how the capital is divided among equity and debt. But Jensen and Meckling (1976) argued that Modigliani-Miller theorem is based on the assumption that the probability distribution of the cash flows to the firm is independent of the capital structure. It is now recognized that the existence of positive costs associated with bankruptcy and the presence of tax subsidies on corporate interest payments will invalidate this irrelevance theorem precisely because the probability distribution of future cash flows changes as the probability of the incurrence of the bankruptcy costs changes. Stewart C. Myers (1984) argued that optimal debt ratio in capital structure is determined by tradeoff of benefits and costs of debt financing by holding constant the firm's assets and investment plans. Benefits of debt are interest tax shields whereas costs include various costs of bankruptcy and financial distress.

This paper attempts to study the interactive relationship between debt financing and profitability of listed hotels companies in Sri Lanka.

Research objective

Objective of the study are as follows:

- To find out the relationship between corporate bond and profitability

- ❖ To indentify How extend debt will impact on company's profitability

Research question

Finding of the study would answer the following question;

- ❖ Has it significant impact of corporate debt on profitability of the company?
- ❖ What extend debt will impact on company's profitability?

Literature Review

The successful selection and use of capital is one of the key elements of the firms' financial strategy (Kajananthan, 2012).Velnampy &. Aloy Niresh.J made an attempt to find out the Relationship between Capital Structure and profitability of ten listed Sri Lankan banks over the past 8 year period from 2002 to 2009. Results of their analysis show that there is a negative association between capital structure and profitability except the association between debt to equity and return on equity. Further the results suggest that 89% of total assets in the banking sector of Sri Lanka are represented by debt, confirming the fact that banks are highly geared institutions. According to Kajananthan,(2012), Achchuthan, Kajananthan, & Sivathaasan, (2013) and Kajananthan & Achchuthan (2013) Capital structure is related with corporate governance practices liquidity. Profitability is related with corporate governance practices and working capital management (Kajananthan, 2012; Velnampy, 2013; Achchuthan and Kajananthan, 2013; Velnampy and kajananthan, 2013)
Anandasayanan & Subramaniam(2013) are examined Effect of Capital Structure on profitability of Listed Manufacturing Companies in Sri Lanka. Their sample consists of 12 Manufacturing companies listed in Colombo stock Exchange and their results reveal significantly negative relation between debt and profitability.
Balasundaram Nimalathasan and Valeriu Brabete evaluated Capital Structure and Its Impact on Profitability: A Study of Listed Manufacturing Companies in Sri Lanka. In their study an attempt had been made to analyze the capital structure and its impact on profit earning capacity during 2003 to 2007 (05 years) financial year of listed manufacturing companies in Sri Lanka. The results revealed that debt to equity ratio (D/E) ratio is positively and strongly associated to all profitability ratios [gross profit ratio (GPR); operating profit ratio(OPR); and net profit ratio(NPR)] except return on capital employed (ROCE) and return on investment (ROI). Debt to assets (D/A) ratio is positively and strongly associated to OPR, NPR and ROCE. Similarly capital gearing (CG) ratio is also positively correlated to GPR and NPR. Further, interest coverage (IC) ratio is significantly correlates to ROCE and NPR. Further capital structure has a great impact on all profitability ratios except ROCE and ROI.
Nirajini and Priya (2013) have done a research on" impact of Capital structure on financial performance of the Trading companies in Sri Lanka'. They found there was a positive relationship between capital structure and financial performance and also capital structure is significantly affected on gross profit, net profit and ROCE.

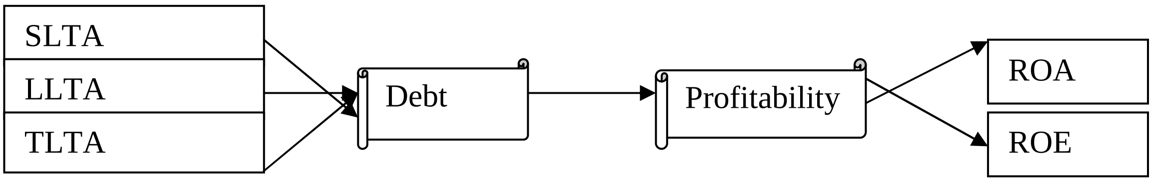
Velnamby &.Nimalathasan initiated to effect of the firm size on profitability of virtually all the branches of Bank of Ceylon (BOC) and Commercial Bank of Ceylon Ltd (CBC) with 10 years accounting period: 1997-2006.Correlation analysis shown that, there was a positive relationship between Firm size and Profitability in Commercial Bank of Ceylon Ltd, but there was no relationship between firm size and profitability in Bank of Ceylon.

Anansasayanan (2013) analyzed "The determinant of leverage of the listed companies in Sri Lanka: An empirical Study. The purpose of present study was to investigate the determinants of leverage (or capital structure) decision of Sri Lankan firms based on a panel data set over a period of five years from 2007-2011 comprising of 60 companies. This study examined the impact of five firm specific factors – firm size, firm growth rate, profitability, and asset tangibility, on the leverage decision of listed companies in Sri Lanka. The results showed that financial leverage of Sri Lankan firms is influenced by firm size, firm growth rate and profitability .This study contributed to the literature on the factors that influence financial leverage of the firm.
Gleason et al., (2000) Using data from retailers in 14 European countries, which are grouped into 4 cultural clusters, it was shown that capital structures for retailers vary by cultural clusters. his result hold in the presence of control variables. Using both financial and operational measures of performance, it was shown that capital structure influences financial performance, although not exclusively. A negative relationship between capital structure and performance suggests that agency issues may lead to use of higher than appropriate levels of debt in the capital structure, thereby producing lower performance.

Based on above literature, we can say that several studies have been done on this area, but a comprehensive study has not yet been conducted, especially in Sri Lankan hotel companies. Hence this study was an attempt to examine the effect of corporate debt on company's performance of the listed hotels in Sri Lanka.

Conceptualization frame work

According to the literature review, following conceptual model are formulated.



SLTA: short term liabilities to total assets **ROA**: Return on Assets
LLTA: long term liabilities to total assets **ROE**: Return on equity
TLTA: Total liabilities to total assets

Operationzation

Variable	Indicators	Measurement
Independent variable	SLTA	SL/TA
	LLTA	LL/TA
	TLTA	TL/TA
Dependent variable	ROA	Return /Total Assets
	ROE	Return/Equity

Research Hypothesis

Based on the conceptualization frame work hypotheses are formulated as follows:

H1: there is significant association between short term liabilities to total assets and ROA

H2: there is significant association between long term liabilities to total assets and ROA

H3: there is significant association between total liabilities to total assets and ROA

H4: there is significant association between short term liabilities to total assets and ROE

H5: there is significant association between long term liabilities to total assets and ROE

H6: there is significant association between total liabilities to total assets and ROE

Methodology

Data collection

This study fully focuses on secondary data sources. Five years (2008-2012) eleven hotels data were taken for this study based on random sampling method to find out the relationship between earning per share and share price of the company.

Data analysis and Discussion

Correlation analysis

Table 1

Independent Variable	Return on Equity	Return on assets
Short term liabilities to total Assets	-.627*	-.659*
Long term liabilities to total Assets	-.307	-.306
Total liabilities to total Assets	-.660*	-.639*

*. Correlation is significant at the 0.05 level (2-tailed).

Above table 1 shows the Pearson correlation coefficient and it indicates how various kind of debt variables are correlated with profitability of the firm. Short term liabilities to total assets have strong negative correlation between ROE and ROA -.627* and -.659* respectively at 0.05 significant level. In addition total liabilities to total assets also have strong negative correlation between ROE and ROA (r=0.660* and -0.639* at 0.05 significant level).further long-term liabilities to total assets have negative correlation between ROE and ROA.

Regression analysis

Table 2 Coefficients

Model	Coefficients B	Std. Error	t	Sig.	R^2
(Constant)	.125	.041	3.045	.019	
Short term liabilities to total Assets	-.015	1.496	-.010	.992	
Long term liabilities to total Assets	.224	1.032	.217	.834	
Total liabilities to total Assets	-.491	1.315	-.374	.720	
					.482
a. Dependent Variable: Return on Equity					

The results given in the table 2 above depicted that empirically negative relationship existed between the debt and return on equity. 48.2% return on equity is explained by debt.

From this table we find our estimated line can be written as

ROE= .125+-.015β+.224β+-.491β

In order to test the hypotheses

Table 3 **Coefficients**

Model	Coefficients B	Std. Error	t	Sig.	R^2
(Constant)	.108	.032	3.409	.011	
Short term liabilities to total Assets	.008	1.160	.007	.994	
Long term liabilities to total Assets	.214	.800	.267	.797	
Total liabilities to total Assets	-.437	1.019	-.429	.681	
					.525
a. Dependent Variable: Return on assets					

The above table explores impact of debt on Return on assets. In here both debts that are short term debt and long term debt have positive impact on return on assets. Even though, total liabilities to total assets have negative impact on return on assets. 52.5% return on assets are explained by debt

Hypotheses testing

hypotheses	
H1	Accepted by correlation
H2	Rejected
H3	Accepted by correlation
H4	Accepted by correlation
H5	Rejected
H6	Accepted by correlation

From these study the impact of total debt as the whole contains short term debt had negative impact on ROE and positive impact on ROA and long term debt positive impact on ROE and negative impact on ROA. Even though, total liabilities to total assets had negative impact on ROE and ROA.

Conclusion

This study an attempt to examine the effect of corporate debt on company's profitability using 11 listed hotels in Sri Lanka between 2008 to 2012. Correlation and regression analysis are used to find out the effect of the debt on the company's profitability. Accordance with the regression analysis there were no significant relationship between debt and profitability. But based on the correlation analysis, there were strong negative relationship between short term liabilities, ROE and ROA. Further total liabilities to total assets had the strong negative relationship between ROE and ROA. But there was no significant relationship between long term liabilities, ROE and ROA. This study consistent prior studies (Velnampy & Aloy Niresh,.Anandasayanan & Subramaniam)

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