Does the financial leverage have an impact on investment decisions in Jordanian industrial firms?

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Abstract

This paper primarily focuses on the impact of financial leverage on investment decisions of industrial Firms and it is an attempt to explore the impact of financial leverage on investment levels using industrial Firms-level panel data in JORDAN. We expect to contribute to the existing literature by bringing evidence from a panel data set, which comprises 19 industrial Firms, all listed on the Stock Exchange of JORDAN ,sampled over a 10 year-period (i.e. from 2000 to 2009).

In Jordan corporate firms play a significant role in contributing to economic growth. In order to attain their objectives, firms need to efficiently manage their funds. To respond to global competition firms need to make massive capital investment in modern technologies, infrastructure, product development and product promotion and so on. Such investments may promote productivity and efficiency. There are several sources of financing those investments. Financial leverage is one of them. In its simplest form, financial leverage is the amount of debt used to finance a firm's assets and projects. It is good to note that during the great depression and throughout the 1930s and 1940s, financial leverage was predominantly viewed as a clear evil. It was perceived that huge amount of debt leads to financial distress. However, such a view point is no more universal. Nowadays, financial leverage is seen as important resource for the production of goods and services as well as for their distribution. Financial leverage is an important component in capital structure along with equity and retained earnings. One of the main debates in Corporate Finance is the impact of financial leverage on a firm's investment.

1. Background

The global economy is considered to be changing in terms of size and form. One important change according to Webber (1996) is that the total output growth and accumulation rates have slowed. In accordance with the constant changes, firms try to continuously review in managing and financing their investments to build their right investment decisions. Therefore, firms must concentrate their attention on their capital structure.Awan, Bhatti, Ali and Qureshi (2010) have defined the capital structure as the relationship between firm's debt and its equity, while Eckert and Engelhard (1999) have defined it comprehensively as the combination of financing contracts that have chosen by the firm to finance its investments.Generally, according to their capital structure, firms have been *categorized into two types. The first is unlevered firms in which firms raise their capital only from retained earnings, common stock and other sources (i.e. equity). The second is levered firms in which a mix of equity/ retained earnings and debt is used, where debt could be taken in different forms such as bank loans, term finance certificates, marketable bonds and debentures (Awan et al., 2010).Lang, Ofck and Stulz (1996) argued that when the firms have good projects, they will grow no matter how their balance sheet looks. This is due to that they can always find funding. Since firm's ability to finance growth has been influenced by financial leverage through a liquidity effect (Bernanke, Gertler, and Gilchrist, 1993), it might influences firms investment decisions.Khrawish and Khrawish (2010) refer to that the analysis of financing patterns has been theoretically and empirically extended to include additional factors. In prior research, leverage or capital structure has been found to be containing complex associations with a number of factors. Therefore, managers have to; consider the target capital structure (leverage ratio) and detect and analyze the practical factors that might influence managing of leverage. The important determinants of leverage in a firm are fixed assets, growth rate/opportunities, sales, profitability, cash flow and liquidity.*

Lang et al. (1996) and Aivaziana, Ge and Qiu (2005) referred to that the central issue in corporate finance is the influence of financial leverage on firm investment decision. Therefore, a study on measuring the impact of financial leverage on the investment decisions is important due to that it is related to investment opportunities and profitability which influence return and growth in economy. The current study examines the impact of financial leverage on investment decisions for Jordanian industrial companies listed in Amman Stock exchange (hereafter ASE) for the period from 2004 to 2008.

2. Problem statement

The impact of financial leverage on investment decisions has been researched by many authors and conflicted conclusions using various approaches have been conducted (Odit and Chittoo, 2008). Modigliani and Miller (1958) stated that the researchers' limaited worrying capacity must not be wasted on largely self-corrected problems like the financial leveraging. If this irrelevant proposition is right, firms should depend on other factors in their investment decisions. These factors could be future state of demand, firms production technology and market interest rate as fundamental determinants of profitability, cash flows and net worth (Aivaziana et al., 2005).

As mentioned before, conflicted conclusions for the impact of financial leverage on the investment decisions have been conducted. While many studies (Stephen Ross, 1986; Titman & Wessels, 1988) found no impact for leverage on the investment decisions, other studies (Schall & Haley, 1979; Neveu, 1981; Brigham and Gapenski, 1993) found significant impact for leverage on investment decisions.

Since the conflicting conclusions remained in literature and it is unclear whether financial leverage influences the investment decisions, there is a need to provide further evidence indicating the impact of financial leverage on investment decisions using similar approach.

While a lot of work on the impact of the financial leverage on the investment decisions has been done in developed countries, developing countries have been research by few studies. So, there is a need to trace the impact of financial leverage on investment decisions in these developing countries to present evidence that might or might not support the results of prior studies. In spite of the fact that Jordanian economics has grown in the last two decades, limited studies on the impact of financial leverage on investment decisions have been conducted in this country. Thus, to fill this gap, the current study attempts to find whether Jordanian industrial firms' investment decisions could be influenced by their financial leverage.

Since, in general, developed economies1 are considered to be having; more capital structure, which indicates the firms' investments types and levels, more opportunities for corporate/economic growth than developing economies such as Jordan. This fact has to be taken in researchers considerations when examining the impact of financial leverage on the investment decisions in such a country. Therefore, comparing to what extent financial leverage could influence the investment decisions in developing economies with that in developed economies is important in literature depending on growth aspects of each country.

Aivaziana et al. (2005) found out that, management's information about investment opportunities could be simply reflected by financial leverage. This is because it reflects management's information about growth opportunities (Lang et al., 1996) and it could be used as a proxy for those opportunities. Therefore, managers seek for leverage level that

reflects the best opportunities for investment. Since management chooses leverage based on its future firm growth information (Lang et al., 1996), there is a need to examine how managers can relate firms' leverage to their investment decisions.

3. Research questions

This study aims to examine whether firms' investment decisions could be influenced by their financial leverage. This will be done by investigating the impact of Jordanian industrial companies' leverage on their investment decisions. So, the first question of the study will be:

1- Does the financial leverage influence investment decisions in Jordanian industrial firms?

2- Could firms' financial leverage be a determinant for their investments?

3- If no, what among growth opportunities, sales, profitability, cash flow and liquidity is the determinant for firms' investment.

4. Research objectives

Since the purpose of the study is to examine the impact of financial leverage on the investment decisions for Jordanian industrial firms, the study objects:

1- To indicate whether firms financial leverage influences their investment decisions in Jordan.

2- To assist decisions' makers depending on financial leverage in case that the study concludes a significant results and it could be a determinant for firms' investments.

3- To find the determinant for firms' investments (among growth opportunities, sales, profitability, cash flow and liquidity) in case the study concluded insignificant impact for financial leverage on firms' investments.

5. Significance of the study

Since firms' investment decisions are influenced by their financial leverage (Harris and Raviv, 1991), examining this influence is important. As mentioned before, examining the impact of financial leverage on investment decisions produced conflicting conclusions in many studies. Therefore, the study tries to present further evidence indicating the impact of financial leverage on investment decisions in Jordanian industrial companies using similar approach of previous studies.

While managers depend on information about firms' future growth in choosing their leverage, incorrect information might be employed. Since, financial leverage offers information about investment opportunities and it has been used as proxy for growth opportunities in prior studies, the present study tries to provide further evidence relating whether firms' financial leverage influence their investment decisions.

As mentioned before, the study tries to fill the gap in the academic and empirical works related to the effect of financial leverage on the investment decisions in developing country. Jordan as developing country suffers the lack of enough scientific research on this impact. Therefore, the current study tries to extend the literature in this area by including Jordan as developing country. This impact will be examined in Jordanian industrial companies to indicate whether using similar variables and methods can produce similar results in this country. The current study is the first, as far as the researcher is concern, which examines the impact of leverage on the investment decisions in Jordan.

This study attempts to fill the practical gap in literature by providing evidence about the impact of financial leverage on investment decisions in Jordan. Jordan differs from the other developing countries that have been previously researched. Jordanian financial markets (ASE) have been ranked as the best among the other emerging markets. This is according to Standard and Poors (S&P) indexes. With accomplishment of 30% growth, ASE performance was ranked the fifth among the other emerging markets included in (S&P) indexes during 2003 (ASE annual report, 2004).

6. Scope and limitations of the study

The study empirically examines the impact of financial leverage on investment decisions using a sample of Jordanian industrial firms listed in ASE. This sample has been chosen because: (a) the Jordanian industrial firms play an important role in the country's economy and (b) they need a lot of debt at the short-term and long-term aspects. The sample data used is derived from the data base of ASE which includes the published financial statements of the sample firms. In Jordan, the industrial sector is a vital economic one which contributes around 24% from Gross Domestic Product (Central Bank of Jordan, annual report, 2004) and attracts Jordanian investors.

The study examines how the investment decisions in Jordanian industrial firms in ASE can be influenced by the financial leverage within the period from 2005 to 2008. This period has
been selected since many important events have taken place in Jordan such as the privatization programme which was implemented in the year 2000 (Nasser et al., 2002), the establishment of ASE in 1999 and Jordan Securities Commission (JSC) in 2002.

The study faced some limitations including that the target sample is all Jordanian industrial firms listed in ASE within the period from 2000 to 20008 but the incomplete firms financial statements about study's variables and the lack of the continuity of the information limited the study's sample size and period.

7. Organization of the study

This study continues as follows: chapter two reviews the studies related to the topic to build the research framework. Chapter three covers the hypotheses, research design, and data collection. Chapter four presents the findings of the study while these findings will be discussed in chapter five. The last chapter presents the conclusions, contributions and suggestions for future research.

REFERENCES OF THIS STUDY

This study will depend on many references to conclude the information that related to this topic. Theses references (among others) are:

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