THE EFFECT OF FINANCIAL LEVERAGE ON THE FINANCIAL PERFORMANCE OF KENYAN ENERGY AND PETROLEUM FIRMS LISTED ON THE NSE.

BY

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UNITED STATES INTERNATIONAL UNIVERSITY

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BY

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A Project Report Submitted to the Chandaria School of Business in Partial Fulfillment of the Requirement for the Degree in Masters of Business Administration (MBA)

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STUDENT’S DECLARATION

I, the undersigned, declare that this is my original work and has not been submitted to any other college, institution or university other than the United States International University in Nairobi for academic credit.

Signed: _________________________  Date: ______________________

Nanteza Aziidah (ID 646004)

This project has been presented for examination with my approval as the appointed supervisor.

Signed: _________________________  Date: ______________________

Dr. Amos Njuguna

Signed: _________________________  Date: ______________________

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ABSTRACT

The purpose of this study was to examine the effect of financial leverage on financial performance of Kenyan Energy and Petroleum firms listed on the NSE. The study analyzed the effect of financial leverage on profitability and liquidity management. A descriptive research design was used. Data was collected from the annual financial statements of the Kenyan Energy and Petroleum firms listed on the Nairobi Securities Exchange for a five year period, from 2012-2016.

The study was done on a census scale since data was collected from all the 4 Kenyan Energy and Petroleum firms listed on the Nairobi Securities Exchange. Data was then entered into Microsoft Excel and analyzed for descriptive statistics on profitability, dividend payout ratio, liquidity management and financial leverage. Ratios were used to analyze the profitability, dividend payout ratio, liquidity management and level of financial leverage on the select firms.

Correlation and regression analysis were used to establish the effect of financial leverage on the financial performance of the select firms. Profitability (ROA), dividend payout ratio (DPR) and liquidity management (QR) were used as proxies for financial performance while debt to equity ratio was used a measure of financial leverage. The data was presented in tables.

On the effect of financial leverage on profitability, the study indicated that most of firms increased or maintained their level of profitability throughout the period. The results of the study found that there was a strong negative relationship between profitability and financial leverage, as those firms that relied more on debt had lower profits while those relied more on equity had higher profits.

On the effect of financial leverage on dividend payout ratio, the study indicated that most of the firms paid dividends to their shareholders annually during the period under study. Dividends were slightly reduced as financial leverage levels increased. The results of the study indicated that there was a weak negative relationship between financial leverage and dividend payout ratio.

On the effect of financial leverage on liquidity management, the study indicated that most of the firms efficiently managed their liquidity levels. The study also showed that most firms were able to cover their short term liabilities with their short term assets. The results indicated that there was a weak negative relationship between liquidity management and financial performance.
The study recommended that firms should rely on less costly sources of finance to avoid exhausting funds in loan repayments, increase firms’ value so that shareholders can reinvest their earnings instead of demanding for dividends and that finance managers should match their borrowing needs with the available assets so as to ensure effective utilization of company assets. The study also recommended that firms’ put into consideration the industry specific factors affecting their financial performance as these differ from one industry to another.
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DEDICATION

This project report is dedicated to my grandmother and best friend Hajjat Aziidah Basajjabalaba and to my Uncle, Hajj Hassan Basajjabalaba for being the best support system on this journey. May Allah grant you all your hearts’ desires.
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CHAPTER ONE

1.0 INTRODUCTION

1.1 Background of the Study

The performance of a firm is primarily affected by a number of factors, one of the most important ones being its capital structure (Salman and Yazdanfar, 2012). Capital structure is one of the most noteworthy decisions made by a firm as it is concerned with the ascertaining the optimum capital structure for the firm (Chadha and Sharma, 2015). Capital structure integrates the firm’s long term debt, specific short term debt, common equity and retained earnings, which are all essential in financing the firm’s overall operations and growth (Hasan, Ahsan, Rahaman, and Alam, 2014). Quoting Weston and Brigham (1979), they define capital structure as “the permanent financing of the firm represented by long term debt, preferred stock and net worth”.

Capital structure primarily merges equity and long term debt but doesn’t generally consider short term debt (Hasan, Ahsan, Rahaman and Alam, 2014). Chadha and Sharma (2015) note that the capital structure is a continuous decision making process that is essential when a firm needs funds for its projects. They add that capital structure can only reach its optimum point when it boosts the firm’s market value. Adding to that, Hasan, Ahsan, Rahaman and Alam (2014), suggest that an optimal capital structure is one that maximizes the value of the firm while reducing the cost of capital, thereby balancing the firm’s risk and return. The challenge is that it is still impossible to ascertain a specific approach for determining the firm’s optimal capital structure (Chadha and Sharma, 2015).

The study of capital structure has been of interest to financial economists after Modigliani and Miller’s irrelevance theory of capital structure in 1958 (Hasan et al., 2014). According to this theory, Modigliani and Miller argue that under perfect market conditions, a firm’s capital structure has no impact on its value. However, this theory was challenged by many researchers on grounds that there are no perfect markets in reality (Hasan et al., 2014). MM later revised their earlier theory to include tax benefits, arguing that under imperfect market conditions where interest payments are tax deductible, a firm’s value increases with the increase in financial leverage (Modigliani and Miller, 1963).
Chadha and Sharma (2015) define financial leverage as “the ratio of debt and equity, which states the relationship between borrowed funds and owner’s funds in the capital structure of the firm”. They define that firms that rely on only equity are referred to as unlevered firms while those that rely on both debt and equity are referred to as levered firms. Financial leverage is a measure of how much firms use equity and debt to finance their assets (Enekwe, Agu, & Eziedo, 2014). Financial leverage has also been defined as the degree to which a company uses fixed income securities such as debt and preferred equity (Rajkumar, 2014). He adds that the higher the financial leverage, the higher the interest payments leading to low earnings per share.

Previous studies about whether there is a relationship between financial leverage and the financial performance of a firm have been inconclusive. In his study, Rajkumar (2014), concluded that though there was a negative relationship between financial leverage and the financial performance of a firm, 54.8% of a firm’s financial performance was affected by its financial leverage, attributing the remaining 45.2% to other factors. In their study, Innocent et al. (2014), concluded that the debt to equity ratio has a negative relationship with the firm’s return of assets while the interest coverage ratio of financial leverage has a positive relationship with the return on assets. Salim and Yadav (2012) concluded that total debt has a weak positive relationship with a firm’s financial performance measured by earnings per share.

The global financial crisis affected the capital structures of a number of firms globally, especially the highly levered firms despite the difference in the magnitude of the impact due to differences in financial market development and other factors (Zarebski and Dimovski, 2012). They explain that during the economic boom, most firms were highly liquid, leading to high rates of lending, refinancing and underwriting by financial institutions. This was halted by the real estate market crash in the US which led to the loss of value of many assets, leading to the highly levered firms to default their debts (Zarebski and Dimovski, 2012). In their study, Iqbal and Kume (2014), found that the overall leverage ratios were high before the crisis and low after the crisis in the UK, France and Germany. They also found that firms with lower than average capital structure ratios before the gradually increased their leverage during and after the crisis, and vice versa.
The impact of financial leverage on the value of firms varies across countries due to the difference in tax laws and tax brackets (Obradovich and Gill, 2012). Their study concluded that the value of American firms was positively impacted by financial leverage, among other factors. In their study, Cole, Yan and Hemley (2015), showed that taking on more debt had a negative impact on the ROA and operating return of firms in the healthcare sector. The same study indicated that there was no impact on the profit margins of healthcare firms from taking on more debt. Cole, Yan and Hemley (2015) also found that taking on more debt negatively impact the ROA, operating return and profit margin of US firms in the energy sector. However, their study showed that financial leverage had no impact on the firms’ stock prices.

Because of the historic reliance of Swedish firms on bank loans to fund their operations, the national regulations in Sweden have helped firms avoid abrupt and widespread bankruptcies (Öhman and Wallerstedt, 2012). Yazdanfar and Öhman (2015) show that 31% of the sampled Swedish SMEs were financed by short term debt while 9% by long term debt, indicating a higher preference for internal financing (Equity and Retained earnings). The results indicated a negative relationship between profitability, measured by ROA and accounts payable, short term debt and long term debt.

Some studies conducted in Asian countries show that debt financing has a negative impact on the performance of the firm (Pathak, 2011; Salim and Yadav, 2012). Jensen and Meckling (1976) argue that financial leverage affects the financial performance of the firm by restricting managers’ efficiency to act in the interests of the shareholders, hence increasing agency costs. However, Khan (2011), conducted a study in India, which indicated no significant impact of financial leverage on the level of efficiency.

For large Malaysian construction companies, return on capital has a strong positive relationship with financial leverage measured by the debt to equity ratio while for small construction companies, financial leverage has a negative impact on the companies’ profitability (San and Heng, 2011). Ramachandran and Candasamy (2011) found that the use of debt had no impact on the ROA of low income IT firms in India while debt financing had a negative on the profitability of high income IT firms in India.
Chadha and Sharma (2015) found that higher debt results into low ROE for shareholders. Mireku, Mensah and Ogoe (2014) found that a higher percentage of Ghanaian companies preferred short-term debt to long-term debt as a source of funds to finance their assets and operations. They attribute this to the inaccessibility to long term debt due to the high lending rates offered by banks and the immaturity of the Ghanaian capital market. Ojo (2012) shows that financial leverage has a significant negative effect on the performance of firms in Nigeria. He however adds that firms are likely to opt for more debt financing in case of poor performance. Enekwe et al. (2014) on the other hand concludes that financial leverage has no significant impact on the performance of pharmaceutical firms in Nigeria.

Adesina, Nwidiobie and Adesin (2015) suggest that management of quoted banks in Nigeria consistently use debt and equity as a way of improving earnings, an indication of a significant relationship between capital structure and financial performance of firms. South African firms are characterized by ownership structures that display a top down chain of command, where the owner of the firm is at the top of the pyramid (Fosu, 2013). He adds that this kind of structure distinguishes the kind of agency problems faced by South African firms from those of other countries because they exist between minority and majority shareholders. This top down structure primarily depends on equity as a source of funds and debt contracts may only be adopted as a measure of mitigating the agency problem (Fosu, 2013).

His findings suggest that financial leverage has a significantly positive effect on firm performance, which is enhanced by the compaction in product markets. This contradicts the earlier findings of Abor (2007), who found a significant negative impact of financial leverage on the performance of a firm. Githira and Nasieku (2015) show a negative relationship between financial leverage and the growth of East African Companies, adding that companies need to boost their operations and maximize profits so as to avoid relying on debt. Their research also showed that increase in financial leverage reduces the firms cost of capital, as argued by Modigliani and Miller (MM, 1958).
In Kenya, Yegon, Cheruiyot, and Cheruiyot (2014), show that there is a negative relationship between long term debt and profitability and a positive relationship between short term debt and firm profitability. They attribute this to the fact that short term debt is cheaper than long term debt hence, increasing short term debt will lead to increased profitability. However, overall debt has no significant impact on the firm’s performance due the distinctive features of both short term and long term debt (Yegon et al., 2014).

1.2 Statement of the Problem

One of the significant roles of a financial manager of a firm is the formulation of financial policies that are intended to maximize the profitability of the firm, among them being the capital structure or leverage decision (Mueni and Muturi, 2015). They add that these decisions have an effect the company’s retained earnings, which in turn influences the company’s future growth, investment potential and working capital. Therefore, it is important for firms in developing countries to find optimum levels of their capital structure so as to fund their activities and grow enough to generate income and employment opportunities (Wachilonga, 2013). However, due a limited availability of company resources, finance managers have to work hard to ensure proper working capital management so as to avoid the opportunity cost of foregoing the resources held in current assets, hence lowering the firm’s returns (Mueni and Muturi, 2015).

A firm’s capital structure generally consists of debt and equity and the choice between the two is significant to a firm (Musina, Ngala, and Okaka, 2015). Mule and Mukras (2015) for example found that an average Kenyan firm employs only 0.258 Kshs of long term debt for every 1 Kshs of capital employed, indicating a clear preference for equity capital. Their results showed a negative relationship between financial leverage and ROE and ROA. Consequently, the use of financial leverage is like a “double-edged sword” as it has the ability to boost the firm’s potential losses or gains (Khan, 2012; Pandey, 2010). The option to use both debt and equity comes with costs while relying on debts only leads to cost savings since debt interest is tax deductible, thereby reducing the overall cost of capital (Mueni and Muturi, 2015).
All in all, a firm’s financial leverage choices are explained by a number of theories (Mule and Mukras, 2015). According to Mule and Mukras (2015), the trade-off theory underlies the fact that the use of leverage in a firm’s capital structure is beneficial up to the point where the optimum capital structure, which is determined by the trade-off between the bankruptcy costs and the tax benefits of borrowing (Owolabi and Inyang, 2013).

The Pecking order theory explains that firms’ preference for different finance sources is based on the ease of accessibility and the associated costs (Myers and Majluf, 1984), adding that debt is considered less expensive and more flexible (Mule and Mukras, 2015). The MM theory underlies the assumption that in a perfect market with no transaction costs, taxes and bankruptcy costs, the capital structure of a firm is irrelevant to its value and that what matters is the ability of the firm’s assets to generate earnings (MM, 1958).

A number of empirical studies have been carried out about the effect of financial leverage on the financial performance of firms in Kenya. Mueni and Muturi (2015) found that there was a significant negative relationship between financial leverage and the performance of sampled NSE listed firms. This is in support of the findings of (Mule and Mukras, 2015). However, Maniagi, Mwalati, Ondieki, Musiega and Ruto (2013), reported both positive and negative relationships between financial leverage and firm performance.

Therefore, the debate of whether financial leverage has an effect on the performance of a firm has been inconclusive. Because a number of these studies have examined the relationship between financial leverage and financial performance of financial institutions, this study will examine the effect of financial leverage on the financial performance of Kenyan Energy and Petroleum companies.

1.3 Purpose of the Study

The purpose of this is to analyze the effect of financial leverage on the financial performance of a firm.
1.4 Research Questions

1.4.1 What is the effect of financial leverage on profitability?

1.4.2 What is the effect of financial leverage on dividend policy?

1.4.3 What is the effect of financial leverage on liquidity Management?

1.5 Significance of the Study

1.5.1 Shareholders

This study will provide shareholders with measures of evaluating the most favorable level of debt and equity to employ so as to avoid agency costs and achieve their objective of maximizing wealth.

1.5.2 Finance Managers

The study will provide guidance for finance managers to drafting and implementing financial policies that will expand their companies profit potential.

1.5.3 Policy Makers

The research will help policy makers in reviewing and reformulating better monetary policies and reforms so as to make funds more readily available and accessible for firms.

1.5.4 Researchers

This research will guide researchers to investigate the extent to which financial leverage negatively or positively influences the firm’s performance and which other factors are at play.

1.6 Scope of the study

The study analyzed data from financial statements of non-financial firms listed on the Nairobi Securities Exchange. Data was collected during the spring semester of 2017 at USIU-Africa.

1.7 Definition of Terms

1.7.1 Debt

This refers to borrowed funds in the capital structure (Chadha and Sharma, 2015).
1.7.2 Equity

This refers to the owners’ capital in the capital structure (Chadha and Sharma, 2015).

1.7.3 Optimal Capital Structure

The level of financial leverage at which the benefits and costs of debt financing are exactly balanced (Mule and Mukras, 2015).

1.7.4 Tax Deductible

Taken away from the total amount of income you pay tax on (Cambridge Dictionary, retrieved on 26th January, 2017).

1.8 Chapter Summary

This chapter provided background information about the research problem, states the problem statement and lists the research questions. It also covered the significance and scope of the study and the definition of terms.

Chapter two reviewed existing literature on the effects of financial leverage on the financial performance of a firm. It analyzed the effects on financial leverage on the profitability, market value and cost of capital of the firm.

Chapter three covered the research methodology used in the study. It detailed the research design, population and sample design, data collection methods, research procedures and the methods used for data analysis.

Chapter four covered the results and findings of the study.

Chapter five covered the conclusion, discussion and recommendation for improvement and for further study.
CHAPTER TWO

2.0 LITERATURE REVIEW

2.1 Introduction

This chapter reviewed existing literature on the effect of financial leverage on profitability, dividend policy and liquidity management, the moderating effect of firm age and size on the relationship between financial leverage and financial performance.

2.2 Effect of Financial Leverage on Profitability

Tulsian (2014) defined profitability as the ability of a given investment to earn a return from its use. Profitability shows the final results of the business operations (Buvaneshwaran and Bai, 2015). Profitability is a relative measurement of the operational performance of any company (Ali and Imdadul, 2014). The word profitability is made up of two word; profit and ability (Tulsian, 2014). He adds that profit refers to the current operating performance and efficiency of business firms while ability refers to the power of business entity to earn profits, which indicates the business’ earning power or operating performance. According to Lakhtaria (2013), profitability is the capacity of earning profit.

Financially, profitability refers to the earning capacity or capability of a company to earn profit currently and in the future (Lakhtaria, 2013). Though profitability is nearly the same as efficiency, it is considered an index or measurement of efficiency and a guide for management for greater efficiency (Enekwe, Okwo and Ordu, 2013). Though used interchangeably, profit and profitability are different terms (Ali and Imdadul, 2014). Profit is an absolute measurement of operational performance while profitability is a relative measurement of operational performance (Tulsian, 2014; Ali and Imdadul, 2014). Profit is not relevant in comparison of the efficiency of a business while profitability analysis is considered the best technique to measure productivity of capital employed and operational efficiency (Tulsian, 2014).
Profitability is also defined as the earnings generated from revenues after subtracting all expenses incurred during a specific period (Al-Jafari and Al Samman, 2015). They add that profitability is considered as one of the most important goals that the management of a firm works hard to realize because without it, a firm may not continue operations. Profitability is essential to a firm because it enables the smooth running of the business in a competitive setting, influences its performance and contributes to economic development (Sohail, Iqbal, Tariq and Mumtaz, 2013).

Profit is a financial gain which is the difference between the amount earned and the amount spent in buying, operating or producing something while profitability means the ability to make profit from all the activities of an organization, company, firm or enterprise (Shiny and Achalapathi, 2015). They add that profit measures the success or failure of an organization or what the business has accumulated. Profitability is an indicator of how efficient management uses available resources to make profit (Enekwe et al., 2013).

A number of studies have been conducted to establish the relationship between profitability and financial leverage. Alkhatib (2012) investigated the determinants of leverage of companies in the industrial and services sectors listed on the Jordanian Stock Exchange. The results indicated a lack of a significant relationship between profitability and financial leverage of companies in both industries. Duca (2012) examined the impact of the usage of debt on the profitability of Romanian companies listed on the Bucharest Stock Exchange. The findings indicated that there was a positive relationship between financial leverage the profitability of the selected companies.

Fengju, Fard, Maher and Akhteghan (2013) examined the effect of financial leverage on the profitability of companies listed on the Tehran Stock Exchange. The results indicated a significant relationship between financial leverage and profitability, though there were significant differences in financial leverage and profitability between smoothing and non-smoothing firms. Saleem, Rahman, Sultana and Naseem (2013) analyzed the effect of leverage on the profitability of the oil and gas sector of South Asian Association for Regional Cooperation countries. Profitability was measured by ROE, ROI and ROA. They concluded that there was a significant relationship between leverage and profitability and that the effect of leverage on profitability was positive.
Tayyaba (2013) studied the effect of leverage on the profitability of the oil and gas sector in Pakistan. Results indicated that there was a negative relationship between profitability and financial leverage. Ur Rehman (2013) investigated the influence of financial leverage on the financial performance of listed sugar companies in Pakistan. Findings indicated that there was a positive relationship between debt-equity ratio (financial leverage) and ROA (Profitability), and a negative relationship between debt-equity ratio and EPS, net profit margin and ROE.

Raza (2013) examined the determinants of capital structure of Karachi Stock Exchange listed non-financial firms in Pakistan. The results indicated that there was a negative relationship between leverage and the performance of firms due to the fact that using more debt lowered the profitability of the firms. Tsuji (2013) examined the relationship between capital structure and the profitability of machinery industry firms listed on the Tokyo Stock Exchange. The results indicated that there was a negative relationship between leverage and the profitability of the selected firms.

Shamaileh and Khanfar (2014) carried out a study to identify the effect of financial leverage and ROI on the profitability of Tourism companies in Jordan listed on the Amman Stock Exchange. The results indicated there was a statistically significant relationship between financial leverage and ROI and the profitability of tourism companies in Jordan. Uluyol, Lebe and Akbas (2014) investigated the relationship between financial leverage and the return on equity of firms in the IT, foot, mining, construction and textile industries in Nigeria. The results indicated that there was a negative effect of financial leverage on the return on equity of the firms.

Innocent et al. (2014) analyzed the effect of financial leverage on the financial performance (measured by ROA) of Nigerian pharmaceutical companies. Results indicated that debt ratio, debt-equity ratio had a negative relationship with ROA, while interest coverage ratio had a positive relationship with ROA. Kalpana (2014) investigated the impact of leverage on the profitability of select steel firms in India listed on the Bombay Stock Exchange. EPS was used as an indicator of a company’s profitability. The results indicated that there was a negative relationship between financial leverage and earnings per share (profitability).
Patel (2014) studied the impact of leverage on the profitability of Sabar Diary. The results indicated that there was a significant positive relationship between leverage and earnings per share. Wabwile, Chitiavi, Douglas and Alala (2014) analyzed the relationship between financial leverage and the performance of tier 1 commercial banks listed on the Nairobi Securities Exchange. The findings indicated that there was an insignificant negative relationship between financial leverage and profitability.

Al-Tally (2014) conducted a research to investigate the effect of financial leverage on the performance of publicly listed firms traded listed on the Saudi Arabian stock market. The findings indicated that in stable economic conditions, firms that with lower leverage levels earned higher profits and returns on both equity and assets. Khalid, Ali, Baloch, and Ali, (2014) examined the effect of leverage and adjustment costs on various measures of corporate performance on non-financial firms listed on the Karachi Stock Exchange. The findings indicated that leverage had a negative effect on return on capital employed but a significant positive effect on Earnings per share.

Srivastava (2014) examined the variables determining leverage and risk of Cement companies in India. The results indicated that there was a low degree negative relationship between profitability and leverage. Kumar (2014) examined the relationship between leverage and profitability in Bata India Limited. The results indicated that the level of financial leverage used by the firm had a significant positive relationship with return on investment (profitability).

Abdul and Adelabu (2015) investigated the relationship between financial leverage and financial performance, measured by ROE of oil and gas companies in Nigeria. The results indicated that there was a significant positive relationship between financial leverage and financial performance of companies. The researchers also concluded that more debt enhanced profitability. Ahmad, Salman and Shamsi (2015) analyzed the relationship between financial leverage and profitability of the Cement sector in Pakistan. The findings presented a significant inverse relationship between financial leverage and profitability.
ALghusin (2015) investigated the impact of financial leverage, growth and size on the profitability (ROA) of Jordanian industrial companies listed on the Amman Stock Exchange. The results indicated a significant effect of leverage, growth and profitability. Silambarasan and Azhagaiah (2015) analyzed the determinants of corporate leverage of IT firms listed on the National Stock Exchange in India. The results indicated that there was a significant negative impact of operating leverage and significant positive impact financial leverage on profitability. However, the relationship between combined leverage and profitability was not significant.

Ishuza (2015) investigated the relationship between financial leverage and the profitability of commercial banks in Tanzania. The findings indicated that changing the level of debt used by a firm had a negative impact on its profitability. (Kunga, 2015) investigated the relationship between financial leverage and the profitability of firms listed at the Nairobi Securities Exchange. The results indicated that there was a negative relationship between financial leverage and the profitability if the selected firms.

Nadeem, Ahmed and Ahmad (2015) examined the effect of leverage on the financial health of cement companies in Pakistan listed on the Karachi Stock Exchange. The findings of their study indicated that there was a significant negative relationship between leverage and the profitability of the firms. Raheel and Shah (2015) examined the relationship between financial leverage and firm profitability of oil and gas marketing companies in Pakistan listed on the Karachi Stock Exchange. The results indicated that there was no significant impact of financial leverage on the profitability of the companies.

Chesang and Ayuma (2016) examined the effect of financial leverage on the profitability of agricultural firms listed on the Nairobi Securities Exchange. Financial leverage was measured by debt to equity ratio and long term debt. The findings indicated that debt to equity ratio had a significant effect on profitability while long term debt was statistically unrelated to the profitability of the firms. Duca (2016) carried out a study on the relationship between financial performance and leverage of companies listed on the Bucharest Stock Exchange. The results indicated that there was a significant positive relationship between return on equity (financial performance) and debt to equity (financial leverage).
Muchai (2016) evaluated the effect of corporate leverage on the profitability of manufacturing and allied companies listed on the Nairobi Securities Exchange. The results indicated that there was a significant negative effect of total leverage on the profitability of the selected companies. Nduka and Ucheahara (2016) examined the means of financing corporate organizations for efficient performance of firms listed on the Nigerian Stock Exchange. The results indicated that there was a significant negative relationship between debt ratio and return on equity and return on assets of the firms.

### 2.3 Effect of Financial Leverage on Dividend Policy

Pandey (2001) defines dividend as “that portion of a company’s net earnings which the directors recommend to be distributed to shareholders in proportion to their shareholdings in the company”. Dividend refers to the benefit of shareholders in return for their risk and investment (Uwuigbe, Jafaru and Ajayi, 2012). They add that a firm’s dividend is determined by various factors for example financing limitations, investment chances and choices, firm size, pressure from shareholders and regulatory regimes. Dividends are presented in form of cash flows or as a result of capital gains due to the investors’ view point (Ur Rehman and Hussain, 2013). A firm’s profits can either retained or paid out to the owners of the firm as dividends (Shisia, Sang, Sirma, and Maundu, 2014).

Dividend policy refers to management’s decision to either pay dividends or retain the funds for reinvestment purposes (Priya and Nimalathasan, 2013). They add that dividend policy can either be managed or residual, explaining that in residual dividend policy, the dividend amount is what is left after the firm makes its preferred investments based on NPV. The managed dividend policy is one that the manager believes is important to the investors and positively influences the value of share price. According to Ur Rehman and Hussain (2013), a firm’s dividend policy is a sign of its performance and also a measure of mitigating the agency problem between managers and outside investors.
Shisia et al. (2014), define dividend policy as “a plan of action adopted by a firm whenever a dividend decision is to be made”. They add that dividend policy is helpful in establishing how much of a firm’s earnings are to be allocated to the firm’s owners. A number of dividend theories were put forward by different scholars (Shisia et al., 2014). The dividend irrelevant theory proposed by Modigliani and Miller (1958, 1961), concluded that the firm is dependent on its current and future free cash flow, and that a firm’s dividend policy doesn’t affect firm value if firms maximize their value through investment.

The information content theory argues that firms may pay dividends as a sign of their future prospects, an argument based on the information asymmetry between managers and shareholders (Shisia et al., 2014). The bird in hand theory proposed by Gordon (1963) and Linter (1962) argues that firm owners prefer high dividend policy to uncertain capital gains from future investments. The clientele effect puts forward the fact that investor prefer to invest in firms that suit their factor endowments (Shisia et al., 2014).

The dividend irrelevant theory was developed by Franco Modigliani and Merton Miller in 1961. According to this theory, under perfect market conditions with no taxes, transaction costs, asymmetric information and agency costs, dividend policy is irrelevant to the value of the firm (Luvembe, Njangiru and Mungami, 2014). They add that in such conditions, managers’ actions to change the value of the firm by changing its dividend policy would be impossible. M&M (1958, 1961) also concluded that the value of the firm depends on its current and future free cash flow (Shisia et al., 2014).

The agency cost theory asserts that by increasing dividend payments, the free cash flow and surplus reserves available to managers are decreased, hence reducing their ability to finance their private needs (DeAngelo and DeAngelo, 2006). Managers will also be forced to rely on external sources of finance (Vidhya and Mohanasundari, 2016). Dividends are also helpful in controlling the overinvesting behavior of managers (Luvembe et al., 2014).
The Bird in hand theory was proposed by Myron Gordon (1963) and John Linter (1962), who argued that investors prefer the “bird in hand” (dividends) to the “two in the bush” (future capital gains), due to uncertainty and imperfect market conditions (Luvembe et al., 2014). Gordon and Linter therefore affirm that there exists a relationship between dividend policy and firm value (Simon-Oke and Ologunwa, 2016). Since dividends are less risky than capital gains, firms need to pay high dividends in order to boost the value of the firm’s shares (Luvembe et al., 2014; Vidhya and Mohanasundari, 2016).

The signaling theory contrasts the MM theory and argues that there is asymmetric information between managers and shareholders (Vidhya and Mohanasundari, 2016). Because of this, managers are induced to communicate dividend information to the market as a way of delivering information to the investors or shareholders (M’rabet and Boujjat, 2016). Dividend announcements signal valuable information about the future performance of the firm, which shareholders can used to evaluate the firm’s share value (Luvembe et al., 2014).

The clientele effects theory is an explanation of the objectives of investors to invest only in firms with conditions most favorable to them for example tax bracket (Shisia et al., 2014). According to Black and Scholes (1974), individual investors have individual preferences receiving high cash dividends or retention, depending on their current positions such as tax bracket. Berk and DeMarzo (2013) argue that a firm’s dividend policy has to effectively follow the taxation characteristics of the investor. A number of studies have been conducted to determine the effect of financial leverage on dividend policy.

Jensen, Solberg and Zorn (1992) in their study found out that firms that pay high dividends are less attracted to debt financing which explains why firms with high fixed financial cots are reluctant to pay higher dividends. Asif, Rasool and Kamal (2011) evaluated the impact of financial leverage on the dividend policy of companies listed on the Karachi Stock Exchange. Results indicated that financial leverage negatively impacted the dividend payout policies of these companies. Voluminous studies have been conducted to determine the effect of financial leverage on the dividend policy of a firm.
Alisinaei and Habibi (2012) examined the determinants of dividend payout ratios of listed firms on the Tehran Stock Exchange. The results indicated that financial leverage had a significant positive relationship with the dividend payout ratio. Rehman and Takumi (2012) examined the determinants of dividend payout ratio of Pakistan companies listed on the Karachi Stock Exchange. The results indicated that debt to equity ratio had a positive influence on the dividend payout ratio. Javed (2012) investigated the impact of financial leverage on the dividend policy of Pakistani firms listed on the Karachi Stock Exchange. The results showed that an increase in financial leverage increased the dividend per share paid by the companies.

Mehta (2012) analyzed the determinants of dividend payout for firms in the real estate, energy, construction, telecommunications, healthcare and industrial sectors listed on the Abu Dhabi Stock Exchange. The results indicated that financial leverage had an insignificant effect on the dividend policy of the selected firms. Thi and Trang (2012) investigated the determinants of dividend policy of firms listed on the Hochiminh and Hanoi Stock Exchanges in Vietnam. The results indicated that there was no relationship between the debt ratio (leverage) and the dividend policies of the firms.

Uwuigbe (2013) investigated the determinants of dividend policy of firms listed on the Nigerian Stock Exchange. Results indicated that there was a negative relationship between financial leverage and dividend payout policy. Zameer et al. (2013) investigated the determinants of dividend policy of banks in Pakistani listed on different stock exchanges. The results indicated that leverage had no impact on the dividend payout policy.

Emamalizadeh, Ahmadi and Pouyamanesh (2013) examined the relationship between dividend policy and financial leverage of food companies listed on the Tehran Stock Exchange. Results indicated that financial leverage had no relationship with the dividend payout ratio. However, there was a positive relationship where the debt ratio was less than the dividend yield. Farahani and Jhafari (2013) examined the relationship between dividend policy and financial leverage of firms listed on the Tehran Stock Exchange. The results didn’t indicate any relationship between financial leverage and dividend policy.
Zameer et al. (2013) investigated the determinants of dividend policy of Pakistani banking sector, using data of foreign and domestic banks operating in Islamic and conventional systems and listed on different stock exchanges. The results indicated that leverage had no significant impact on the dividend policy. Azhagaiah and Gejalakshmi (2014) analyzed the determinants of dividend policy of the IT sector in India. The findings indicated that the debt to equity ratio strongly affected the dividend policies of the selected firms.

Nuhu (2014) examined the determinants of dividend payout of firms listed on the Ghana Stock Exchange. The results indicated that there was a significant negative relationship between leverage and dividend payout. Maldajian and El Khoury (2014) investigated the factors determining dividend payout policies of Lebanese banks listed on the Beirut Stock Exchange. The results indicated that financial leverage was insignificant in determining the dividend payout policies of the firms.

Vo and Nguyen, (2014) examined the interrelationship among managerial ownership, leverage and dividend policies. The results indicated that there was a negative relationship between leverage and dividends. Asad and Yousaf (2014) examined the impact of leverage on the dividend payment pattern of Pakistani manufacturing firms. The results indicated that leverage had a significant negative impact on the dividend payment pattern of the sampled firms.

Kaźmierska-Jóźwiak, (2015) examined the cash dividend payments of Polish listed companies. The results indicated that there was a significant negative relationship between dividend payout ratio and leverage. Nuhu, Musah and Senyo (2014) examined the consistency of the determinants of dividend payout decisions of financial and non-financial firms in Ghana listed on the Ghana Stock Exchange. The results indicated that leverage had no consistent effect on the dividend payout decisions of the sampled firms.

Kaźmierska-Jóźwiak (2015) analyzed the cash dividend payments of Polish listed companies. The results showed that there was a significant negative relationship between a firm’s leverage and its dividend payout ratio. Odawo and Ntoiti (2015) examined the determinants of dividend payout policy for CFC Stanbic Bank. The results indicated that there was significant positive relationship between leverage and the dividend payout policy of CFC Stanbic bank.
Dada, Malomo and Ojediran (2015) evaluated the determinants of the dividend policy on Nigerian banks listed on the Nigerian Stock Exchange. The findings indicated that leverage was positively related to the dividend policy of the selected banks. Kuzucu (2015) investigated the firm level factors influencing the dividend decisions of Turkish firms. The results indicated that there was a positive relationship between leverage and dividend payouts.

Kajola, Desu and Agbanike (2015) examined the determinants of dividend policy decisions of non-financial firms listed on the Nigerian Stock Exchange. The results indicated that there was a significant relationship between financial leverage and the dividend policy decisions of the firms. Bisht, Singh and Kavidayal (2015) reexamined the factors affecting the dividend decisions of Indian firms listed on the BSE. The results indicated that there was a negative relationship between financial leverage and the dividend payment decisions of the firms. Labhane and Mahakud (2016) analyzed the trends and determinants of dividend policy of Indian companies. Results indicated that there was a relationship between financial leverage and dividend policy of the sampled companies.

Mohamadi and Amiri (2016) investigated the effect of ownership structure, financial leverage, profitability, firm size and investment opportunity on the dividend policy and firm performance of firms listed on the Tehran Stock Exchange. The results indicated that financial leverage had a negative relationship with dividend policy. Yusof and Ismail (2016) investigated the determinants of dividend policy of publicly listed companies in Malaysia. The results indicated that debt level had a significant negative effect on the dividend policy.

Banerjee (2016) analyzed the determinants of dividend distribution of the top four IT companies in India. The results indicated that there was a significant relationship between leverage and dividend distribution decisions of the selected companies. Hosain (2016) investigated the determinants of dividend payout policy of the listed private commercial banks listed on the Dhaka Stock Exchange in Bangladesh. The findings revealed that financial leverage had a significant negative effect on dividend payout policy.

Hosen and Muhari, (2016) examined the effect of ROA, debt to equity ratio and asset growth on the dividend payout ratio of companies listed on the Jakarta Islamic Index in Indonesia. The results indicated that there was an insignificant effect of the debt to equity ratio on the dividend payout ratio.
Khan and Ahmad (2017) analyzed the impact of profitability, growth opportunities, risk liquidity, firm size, leverage, taxation and audit type on dividend payout decisions of listed pharmaceutical companies in Pakistan. The findings indicated that leverage had an insignificant effect on the dividend payout decisions of the companies.

2.4. Effect of Financial Leverage on Liquidity Management

Liquidity refers to both the time and the costs associated the process of converting a particular asset into cash and from cash into an asset (Brandon and Wang, 2013). Agbada and Osuji (2013) define (bank) liquidity as the “the ability maintain sufficient funds to pay for its maturing obligations”. They add that it refers to the ability (of a bank) to instantly meet its cash, other obligations and permissible loan demands while obliging by its current reserves. Liquidity can also refer to the ability of a business to meet its cash obligations within a specific period of time (Sheikhdon and Kavale, 2016).

Financially, liquidity is defined as the bank’s ability to settle its maturing obligations while avoiding unacceptable losses (Agbada and Osuji, 2013). Liquidity management affects the growth and profitability of a firm to a great extent because inadequate or excess levels of liquidity may disrupt with the smooth operations of a firm (Egbide, Uwuigbe and Uwalomwa, 2013). Liquidity management therefore involves the strategic supply or withdrawal from the market the liquidity amount consistent with the desired current level of reserve money without interrupting the profit making ability and operations of the firm (Agbada and Osuji, 2013).

Therefore, liquidity management refers to the planning and control of liquid assets either as an obligation to the customers’ financial needs or as a measure to oblige to the monetary policies of the Central Bank (Bassey, Tobi, Bassey and Ekwere, 2016). Qin and Dickson (2012) carried out a comparative analysis of commercial banks liquidity position of commercial banks in Tanzania. Results indicated that commercial banks in Tanzania had the strongest liquidity level even though this varied over the years. Davronov (2016) examined the existing mechanisms of liquidity management practiced by commercial banks in Uzbekistan. The results indicated the use of mathematical model of analysis and forecasts of bank cash flows.
Yu-Thompson, Lu-Andrews and Fu (2016) performed an empirical analysis to test whether less severe agency conflict between managers and controlling shareholders may improve family firm’s corporate and stock liquidity, in comparison to non-family firms. Results indicated that family firms are more conservative than non-family firms so as to prevent the underinvestment from external sources of finance. The results also indicate that family firms experience higher levels of stock liquidity and lower liquidity risk.

Arif and Anees (2012) define liquidity risk is that is a result of the inability of a bank to settle its obligations as they come while avoiding unacceptable losses. Anam, Hasan, Huda, Uddin and Hossain (2012) refer to it as the excess transaction costs, loss of value and time paid to a third party for allocating liquidity when specified. Iqbal (2012) relate it to solvency, adding that it is when a bank is not able to meet its funding requirements to finance its assets. It is as a result of financing bank’s long term assets by short term liabilities, hence making the liabilities prone to rollover or refinancing risk (Kumar and Yadav, 2013).

Liquidity risk is the risk having inadequate liquid assets to meet its policies, leading to the sale of assets at lower prices, hence losses despite the firm being solvent (Kamau and Njeru, 2016). Managing a bank’s liquidity risk will help ensure a bank’s ability to meet its obligations as they fall due and it reduces the likelihood of facing an unfavorable situation (Kumar and Yadav, 2013). Research on liquidity risk and liquidity risk management is voluminous. Arif and Anees, (2012) examined liquidity risk in Pakistani banks and evaluated its effect on bank’s profitability. The results indicated that liquidity risk had a significant negative effect on bank profitability.

Ramzan and Zafar (2012) identified the institutional elements that significantly determine the liquidity risk of Islamic banks in Pakistan. The results indicated that there was a statistically positive relationship between asset base (size) of the banks and their liquidity. Cucinelli, (2013) analyzed the relationship between liquidity risk and bank structure of Eurozone banks. The results indicated that bigger banks had a higher risk exposure while banks with higher capitalization had a better liquidity in the long term.
Khan and Syed (2013) identified and examined the potential causes of liquidity risk in Pakistani banks and evaluated their effect on bank’s profitability. The results indicated that bank’s profitability was significantly affected by liquidity risk. Farooq et al. (2015) analyzed the relationship between bank liquidity risk and the performance of conventional banks in Pakistan. The results showed that liquidity risk was an internal factor affecting bank performance.

Rahman and Banna (2015) carried out a comparative analysis of liquidity risk management between conventional and Islamic banks in Bangladesh. The results concluded that size and net working capital had an insignificant positive relationship with the liquidity risk of Islamic banks while size had a negative relationship with the liquidity risk of conventional banks. ROA had a positive relationship with the liquidity of conventional banks while the relationship was insignificant for Islamic banks.

Zaghdoudi and Hakimi (2016) carried out a study to identify the key determinants of liquidity risk of Tunisian banks. The results indicated that internal factors like level of capitalization, size, and industry factors like structure of banking market, and the international environment affect liquidity risk. Muriithi and Waweru (2017) examined the effect of liquidity risk on the financial performance of commercial banks in Kenya. The results indicated that liquidity coverage ratio had no significant influence on financial performance while net stable funding ratio had a negative effect on financial performance.

In theory, leverage is considered as a source of risk because the more a firm relies on financial leverage, the higher the risk to the equity shareholders (Alnaif, 2014). He however adds that since financial leverage minimizes agency costs, it boosts profitability and it should therefore have a positive impact on stock liquidity. The relationship between financial leverage and cash holdings of a firm (liquidity) is further supported by both the pecking order and the trade-off theories (Anjum and Malik, 2013). Globally, the relationship between liquidity and leverage remains widely uninvestigated (Sivathaasan, Ali, Liu and Haung, 2016).
Although the current study aimed at investigating the effect of financial leverage on the liquidity management of a firm, some studies have indicated a reverse relationship (effect of liquidity on the financial leverage of a firm). Udomsirikul, Jumreornvong and Jiraporn (2011) examine the impact of liquidity on the capital structure of firms in Thailand. The results indicated that there was a negative effect of liquidity on the leverage levels on the firms. Cekrezi (2013) examined the effect of firm specific factors on the capital structure decisions of non-listed Albanian Firms. The results indicated that there was a significant impact of liquidity on the leverage levels of the firms.

Pervaiz, Zaman, Salam and Bilal (2013) examined the effect of liquidity on the capital structure of textile firms listed on the Karachi Stock Exchange. Results indicated that liquidity had an insignificant impact on the debt levels of the firms. Sharma and Paul (2015) explored the relationship between a firm’s liquid equity and the capital structure of Indian firms listed on the Bombay Stock Exchange. The results indicated that there was no reverse relationship between liquidity and leverage.

Kajananthan and Achchuthan (2013) examined the relationship between liquidity and the capital structure of the Sri Lanka Telecom plc. The results indicated that there was a significant relationship between liquidity and the debt to equity ratios of Sri Lanka Telecom plc. The researchers suggested that firms should consider managing their liquidity efficiently so as to enhance their value.

Mohamed and Seelanatha (2014) investigated the effect of the recent global financial crisis on the relationship between equity market liquidity and the capital structure on firms listed on the Australian Securities Exchange. The results indicated that before the crisis, there was a negative effect of liquidity on the leverage of firms. However, after the crisis this relationship was insignificant.

Ghasemi and Ab Razak (2016) investigated the effect of liquidity on the capital structure of firms in Malaysia. The study employed a sample of 300 firms listed on the Main Market of Bursa Malaysia from 2005 to 2013. Pooled OLS was used to determine the relationship between liquidity and debt ratios. The findings showed that liquidity had a significant effect on all the measures of financial leverage used, that is, debt/equity ratio and Debt/Asset ratio.
Karlsson and Svensson (2016) examined the relationship between liquidity and the capital structure of IT and real estate firms listed on the Nasdaq OMX in Sweden. The results indicated that there was a positive relationship between liquidity and the leverage levels of firms in the IT sector, and a negative relationship for firms in the real estate sector.

Rashid and Mehmood (2017) examined the effect of equity market liquidity on the leverage decisions of listed on-financial Pakistan firms. The results showed that there was significant negative impact of liquidity on the leverage levels of the firms, adding the more liquid the stock of a firm, the more preference to equity and not debt.

According to Lyroudi and Bolek (2012), the relationship between liquidity and financial leverage exists due to the fact that liquidity reduces a firm’s default and bankruptcy risks, and the cost of capital. Šarlija and Harc (2012) note that studies have indicated that liquid assets increased leverage levels in some countries while in others, liquid firms relied less on leverage. Lyroudi and Bolek (2012) add that by increasing the receivables conversion cycle, inventory conversion cycle and by reducing the payment deferral period, a firm can increase its cash conversion cycle (liquidity).

Šarlija and Harc (2012) also suggest that by keeping debt levels regulated and using borrowed funds efficiently, leverage can contribute to higher returns on investment. Citing Williamson (1988), Šarlija & Harc (2012), add that a firm’s liquid assets have an impact on the level of debt used by the firm, concluding that the higher the level of liquidity of a firm, the higher the leverage. However, Akdal (2011), found a negative relationship between leverage and the liquidity listed British companies.

A few studies have examined the effect of financial leverage on the liquidity management of firms. Gill (2011) investigated the factors that influence the working capital requirements of firms in Canada. The study used a sample of 166 firms listed on the Toronto Stock Exchange. The study also employed co-relational and non-experimental research design. The results indicated leverage was one of the factors that influenced working capital requirements. Since the authors interpreted working capital as a measure of liquidity, this indicated that financial leverage influenced the liquidity of the sampled firms.
Owino (2011) investigated the relationship between the liquidity and leverage of firms listed on the Nairobi Securities Exchange. The study employed a sample of 30 companies and analyzed the secondary data of the selected firms between 2006 and 2010. The study also used multivariate regression to estimate the relationship between the variables. The results indicated that there was a weak negative relationship between liquidity and leverage of the selected firms.

Šarlija and Harc (2012) investigated the impact of liquidity on the capital structure of Croatian firms. The study used a sample of 1058 Croatian firms. The authors used Pearson correlation coefficient to establish the relationship between liquidity and debt ratios. The findings revealed that there was a statistically strong relationship between liquidity and leverage, indicating a stronger relationship with short term leverage than with long term leverage.

Khanqah and Ahmadnia (2013) analyzed the impact of capital structure on the on liquidity and growth opportunity of firms listed on the Tehran Stock Exchange. The study used a sample of 75 firms from 2006-2010. The study also employed the least square regression technique to establish the relationship between capital structure (leverage) and liquidity. The findings indicated that financial leverage had a significant impact on the liquidity of the firms.

Hussain, Rao, Akram and Fayyaz (2015) conducted a study to examine the effect of financial leverage on the efficiency of firms in Pakistan. A sample of 154 textile firms was used and the study also employed the ordinary Least squares technique to measure the efficiency of financial leverage. Liquidity was used as a control variable and was measured as a ratio of current assets to the whole property. The results indicated that liquidity was positively related to the total long term debt ratio (financial leverage).

Goel, Chadha and Sharma (2015) analyzed the impact of financial leverage on different measures of operating liquidity. A sample of 151 Indian machinery firms was taken, analyzing their financial statements for a period of 10 years. The study also employed ratio analysis and panel data regression to establish the relationship between the variables. The results indicated that financial leverage had a strong impact of the different measures of operating liquidity.
Githaiga and Kabiru (2015) investigated the effect of long term and short term debt on the financial performance of SMEs. A sample of 50 SMEs was selected from Eldoret, Kenya. The study used quantitative secondary of the selected companies for a period of 3 years. Multiple linear regression analysis was used to establish the relationship between the variables. The results indicated that there was a strong negative relationship between long term and short term debt and liquidity.

Sivathaasan, Ali, Liu and Haung (2016) examined the effect of stock liquidity and corporate governance on the leverage of firms in Australia. The study used secondary data of a sample of 1207 firms. The findings indicated a negative relationship between stock liquidity and financial leverage, concluding that more liquid stock were less leveraged.

2.5 Chapter Summary

This chapter reviews literature on profitability, dividend policy, liquidity management and cost of capital. The chapter examines the effect of financial leverage on profitability and dividend policy and also analyzes the effect of liquidity management and cost of capital on the financial performance of firms. The next chapter will cover Research Methodology.
CHAPTER THREE

3.0 RESEARCH METHODOLOGY

3.1 Introduction

This chapter covers the research methodology. It covers the research design, population and sampling design, data collection methods, research procedure, data analysis methods and chapter summary.

3.2 Research Design

According to Yin (2009), research design lays the foundation for carrying out the research. It provided the guidelines for gathering and analyzing data (Bryman and Bell, 2007). Research design is the blue print for the collection, measurement and analysis of data. It can be seen as the logic or master plan of a research that that highlights how the study is to be conducted (Thomas, 2010). The purpose of the research design is to ensure that suitable research methods are applied in the answering of the research questions.

The researcher employed a descriptive research design for the current study. Descriptive studies aim at formulating an understanding of situations, individuals or events (Saunders, Lewis and Thornhill, 2009). Descriptive research provides a detailed information of an event or situation that is studied despite of quantitative, qualitative or a combination of methods (Bryman and Bell, 2007). It is applied to answer the questions in the form of who, what, how, when and where. In quantitative research, the basic goal with a descriptive research design is to investigate relationships between different variables (Dhawan, 2010).

Descriptive studies require the researchers to define the measurement and the population clearly in order to collect and assess the opinion and behaviors of the sample (Dhawan, 2010). “Descriptive studies aim to provide a description of a phenomena in terms of the distribution of relevant variables within a particular population either at a single point in time (cross sectional) or comparatively over time (longitudinal) by using repeat surveys” (Rose, Spinks and Canhoto, 2014). This study will be conducted on a cross sectional basis.
3.3 Population and Sampling Design

3.3.1 Population
Data was collected from a population of the 10 manufacturing and allied firms listed on the Nairobi Stock Exchange.

3.3.2 Sampling Design

3.3.2.1 Sampling Frame
A sampling frame is a set of source materials from which the sample is selected and it provides a way for choosing specific elements of the population from whom data will be collected (Turner, 2003). The sampling frame will be the NSE list of companies trading on the securities market as of March 2017. The sampling units will be the companies listed on the NSE and the sampling elements will be the financial statements of the NSE listed companies.

3.3.2.2 Sampling Technique
Meng (2013) describes sampling as a systematic and cost effective of reducing data size while maintaining the most important components of the data set. Because this study opted for a census survey, a sampling technique was not relevant.

3.3.2.3 Sample Size
This study employed a census survey. A census survey refers to the study that aims at targeting the whole population (Levy and Lemeshow, 2013). Data was collected from all 4 Kenyan firms listed under the Energy and Petroleum sector on the Nairobi Securities Exchange. Census surveys are preferable because they provide high levels of accuracy and are also suitable for heterogeneous units.

3.4 Data Collection Methods
This research was based on secondary data collected from the 2012 to 2016 financial statements and annual reports of all the 4 Kenyan Energy and Petroleum firms listed on the Nairobi Securities Exchange.
3.5 Research Procedure

The research procedure included obtaining financial statements and annual reports from the company websites of the 4 Kenyan firms listed under the Energy and Petroleum sector on the Nairobi Securities Exchange. This was followed by the extraction of information from the annual financial statements and reports of the selected firms. The researcher used annual financial statement information from 2012 to 2016. Data was entered into Microsoft Excel, cleaned and arranged for analysis.

3.6 Data Analysis Methods

The collected data was then entered into Microsoft Excel and analyzed for descriptive statistics on profitability, dividend payout ratio, liquidity management and financial leverage. The study used ratio analysis to analyze the profitability, dividend payout ratio, liquidity management and level of financial leverage on the select firms. One advantage of using ratio analysis is that it takes away the current inconsistencies among the research objects (Abduh, Hasan, & Pananjung, 2013). Ratio analysis also helps the researcher to organize the data and analyze it in an orderly manner, and it is suitable for analyzing financial performance because it verifies the relationship between the variables in the firm’s financial statements (Ali and Imdadul, 2014). Enekwe et al. (2013) note that ratio analysis can be used to summarize large quantities of financial data and to make judgment about the financial performance of the firm.

Simple regression analysis was used to analyze the major determinants of profitability, dividend payout ratio and liquidity management. The study used correlation analysis to determine effect of dividend payout ratio and liquidity management on the financial performance of the selected firms. The study also used Pearson’s correlation to establish the effect of financial leverage on the financial performance of the select firms. Profitability (ROA), dividend payout ratio (DPR) and liquidity management (QR) were used as proxies for financial performance while debt to equity ratio was used a measure of financial leverage. The data was presented in tables.

3.7 Chapter Summary

This chapter will cover the research methodology of the study. This will include the research design, population and sampling design, data collection methods, research procedures and data analysis methods. The next chapter will present the results and findings of the study.
CHAPTER FOUR

4.0 RESULTS AND FINDINGS

4.1 Introduction

This chapter covers the results and findings of the study. The results and findings respond to the questions in chapter two about the effect of financial leverage on profitability and dividend policy on financial performance, and the effect of liquidity management and cost of capital on financial performance.

4.2 General Information

4.2.1 Industry


4.2.2 Sales

Sales were calculated as a natural logarithm of the firms’ annual sales.

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<tbody>
<tr>
<td>KenGen</td>
<td>7.20</td>
<td>7.22</td>
<td>7.24</td>
<td>7.41</td>
<td>7.47</td>
</tr>
<tr>
<td>KenolKobil</td>
<td>8.28</td>
<td>8.04</td>
<td>7.96</td>
<td>7.94</td>
<td>8.01</td>
</tr>
<tr>
<td>KPLC</td>
<td>7.98</td>
<td>7.95</td>
<td>8.02</td>
<td>8.03</td>
<td>8.03</td>
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<tr>
<td>Total Kenya</td>
<td>8.03</td>
<td>8.15</td>
<td>8.19</td>
<td>8.08</td>
<td>7.95</td>
</tr>
</tbody>
</table>

The table indicates that KenolKobil had the highest sales percentage in 2012 out of the four companies while KenGen had the lowest percentage of sales. In 2013 however, KenolKobil’s sales percentage declined and Total Kenya had the highest. KenGen increased its sales values but they were still the lowest. KenolKobil’s sales reduced further between 2014 and 2015 until they picked up again in 2016. KPLC had a steady increase in sales from 2012 to 2016 while Total Kenya had increasing sales between 2012 and 2014 and decreasing sales from 3015 to 2016.
4.2.3 Profit before Tax

Table 4.2: Profit Before Tax for 2012-2016

<table>
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<tbody>
<tr>
<td>KenGen</td>
<td>4,045,190</td>
<td>4,093,074</td>
<td>4,157,948</td>
<td>8,690,012</td>
<td>11,264,044</td>
</tr>
<tr>
<td>KenolKobil</td>
<td>-8,964,664</td>
<td>563,918</td>
<td>1,994,716</td>
<td>2,782,421</td>
<td>3,538,256</td>
</tr>
<tr>
<td>KPLC</td>
<td>8,506,693</td>
<td>6,570,497</td>
<td>10,198,427</td>
<td>12,253,574</td>
<td>12,082,397</td>
</tr>
<tr>
<td>Total Kenya</td>
<td>-64,301</td>
<td>2,084,517</td>
<td>2,276,005</td>
<td>2,618,696</td>
<td>3,935,363</td>
</tr>
</tbody>
</table>

In 2012, KenGen and KPLC had positive results while KenolKobil and Total Kenya had negative results. In 2013, the companies made significant improvement except for KPLC which experienced a 22.74% decline in its PBT. Between 2014 and 2015, all had an increase in their PBT values. While KenGen and KenolKobil experienced an increase (30% and 27% respectively) in 2016, KPLC and Total Kenya both experienced a decline in their PBT (1% and 40% respectively).

4.2.4 Total Assets

Total assets were calculated as a natural logarithm of the firms’ annual total assets.

Table 4.3: Total Assets for 2012-2016

<table>
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<tbody>
<tr>
<td>KenGen</td>
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<td>8.28</td>
<td>8.40</td>
<td>8.53</td>
<td>8.56</td>
</tr>
<tr>
<td>KenolKobil</td>
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<td>7.45</td>
<td>7.38</td>
<td>7.24</td>
<td>7.38</td>
</tr>
<tr>
<td>KPLC</td>
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<td>8.27</td>
<td>8.34</td>
<td>8.44</td>
<td>8.47</td>
</tr>
<tr>
<td>Total Kenya</td>
<td>7.52</td>
<td>7.60</td>
<td>7.51</td>
<td>7.53</td>
<td>7.56</td>
</tr>
</tbody>
</table>

In 2012, KenGen and KPLC had the most total assets compared to KenolKobil and Total Kenya. In 2013, KenGen had a 1.94% decline while KPLC had a 4.49% increase. KenolKobil had a 2.58% while Total Kenya had a slight increase of 0.03%. In 2014, KenGen had an increase of 4.72%, KenolKobil had a decline of 1.84%, KPLC had an increase of 0.01% and Total Kenya had a decline of 2.89%. In 2015, KenGen experienced an increase (3.9%) while KenolKobil, KPLC and Total Kenya all experienced a decline (1.94%, 0.98% and 1.04% respectively). In 2016, KenGen and Total Kenya experienced a decline (0.66% and 0.34% respectively) while KenolKobil and KPLC had an increase in total assets (0.74% and 0.26% respectively).
4.2.5 Return on Assets

Table 4.4: Descriptive Statistics for ROA

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Mean</td>
<td>0.03</td>
</tr>
<tr>
<td>Minimum</td>
<td>-0.19</td>
</tr>
<tr>
<td>Maximum</td>
<td>0.12</td>
</tr>
<tr>
<td>Standard Deviation</td>
<td>0.06</td>
</tr>
</tbody>
</table>

The mean ROA was 0.03 with a minimum of -0.19 and a maximum of 0.12. This shows that there were minimal variations in ROA, represented by the 0.06 standard deviation.

4.2.6 Dividend Payout Ratio

Table 4.5: Descriptive Statistics for DPR

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Mean</td>
<td>0.25</td>
</tr>
<tr>
<td>Minimum</td>
<td>-0.02</td>
</tr>
<tr>
<td>Maximum</td>
<td>1.46</td>
</tr>
<tr>
<td>Standard Deviation</td>
<td>0.39</td>
</tr>
</tbody>
</table>

The average dividend payout ratio was 0.25 with a standard deviation of 0.39. The minimum quick ratio was -0.02 with a maximum of 1.46. The deviations of the dividends from the mean were 0.39.

4.2.7 Quick Ratio

Table 4.6: Descriptive Statistics for QR

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Mean</td>
<td>0.92</td>
</tr>
<tr>
<td>Minimum</td>
<td>0.53</td>
</tr>
<tr>
<td>Maximum</td>
<td>1.37</td>
</tr>
<tr>
<td>Standard Deviation</td>
<td>0.29</td>
</tr>
</tbody>
</table>

The average quick ratio was 0.92 and the standard deviation was 0.29, showing minimum variations from the average. The minimum ratio was 0.53 while the maximum was 1.37.
4.2.8 Debt to Equity Ratio

Table 4.7: Descriptive Statistics for DE

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Mean</td>
<td>1.99</td>
</tr>
<tr>
<td>Minimum</td>
<td>0.87</td>
</tr>
<tr>
<td>Maximum</td>
<td>4.07</td>
</tr>
<tr>
<td>Standard Deviation</td>
<td>0.99</td>
</tr>
</tbody>
</table>

The mean debt to equity ratio was 1.99 and the standard deviation was 0.99. This also indicated minimal variations from the average. The minimum ratio was 0.87 while the maximum was 4.07.

4.3 Effect of Financial Leverage on Profitability

4.3.1 Profitability Analysis

The researcher analyzed the profitability of the firms across a five year period.

Table 4.8: Profitability Analysis for 2012-2016

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>KenGen</td>
<td>0.02</td>
<td>0.03</td>
<td>0.01</td>
<td>0.03</td>
<td>0.02</td>
</tr>
<tr>
<td>KenolKobil</td>
<td>-0.19</td>
<td>0.02</td>
<td>0.05</td>
<td>0.12</td>
<td>0.10</td>
</tr>
<tr>
<td>KPLC</td>
<td>0.03</td>
<td>0.03</td>
<td>0.03</td>
<td>0.03</td>
<td>0.03</td>
</tr>
<tr>
<td>Total Kenya</td>
<td>-0.01</td>
<td>0.03</td>
<td>0.04</td>
<td>0.05</td>
<td>0.02</td>
</tr>
</tbody>
</table>

In 2012, KPLC had the highest ROA while KenolKobil and Total Kenya had the lowest. KPLC maintained its ROA at 0.03 during the entire period. Total Kenya increased its ROA until 2015, and in 2016 it declined from 0.05 to 0.02.

KenGen’s ROA fluctuated during this period with their highest being 0.03 and their lowest being 0.01 in 2014. KenolKobil reported the greatest improvement from -0.19 in 2012 to 0.12 in 2015, which declines to 0.10 in 2016.
4.3.2 Effect of Financial Leverage on Profitability

Table 4.9: Effect of Financial Leverage on Profitability

<table>
<thead>
<tr>
<th>Pearson's R</th>
<th>58%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Coefficient</td>
<td>-0.03</td>
</tr>
<tr>
<td>P-value</td>
<td>0.01</td>
</tr>
<tr>
<td>N</td>
<td>20</td>
</tr>
</tbody>
</table>

The model summary indicated that there was a strong relationship between ROA and D/E. This was indicated by Pearson’s R = 58%. This means that a 58% change in profitability is as attributed to financial leverage. Although this relationship is not perfect, it is pretty strong.

The anova showed that the relationship between ROA and D/E is very significant indicated by the p-value = 0.01, which is less than alpha 0.05. The regression coefficient indicated that there is a negative relationship between ROA and D/E. Therefore, the results indicated that there was a strong negative relationship between ROA and D/E.

4.4 Effect of Financial Leverage on Dividend Policy

Table 4.10: Effect of Financial Leverage on Dividend Policy

<table>
<thead>
<tr>
<th>Pearson's R</th>
<th>17%</th>
</tr>
</thead>
<tbody>
<tr>
<td>P-value</td>
<td>0.48</td>
</tr>
<tr>
<td>Coefficient</td>
<td>-0.07</td>
</tr>
<tr>
<td>N</td>
<td>20</td>
</tr>
</tbody>
</table>

The model summary indicated that there was a very weak relationship between dividend payout ratio and debt to equity ratio represented by Pearson’s R = 17%. The anova indicated that the relationship between dividend payout ratio and debt to equity ratio was insignificant because p-value = 0.48. The regression coefficients indicate that the relationship between dividend payout ratio and debt to equity ratio is negative (-0.07). Therefore, according to the results, there was a negative relationship between dividend policy and financial leverage. However, this relationship is insignificant.
4.5 Effect of Financial Leverage on Liquidity Management

Table 4.11: Effect of Financial Leverage on Liquidity Management

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Pearson's R</td>
<td>21%</td>
</tr>
<tr>
<td>P-value</td>
<td>0.38</td>
</tr>
<tr>
<td>Coefficient</td>
<td>-0.05</td>
</tr>
<tr>
<td>N</td>
<td>20</td>
</tr>
</tbody>
</table>

The model summary indicated that there was a weak relationship between QR and D/E, indicated by Pearson’s R = 21%. The anova showed that the relationship between liquidity management and financial leverage was insignificant since p-value = 0.38. The regression coefficient indicated that there was a negative relationship between QR and D/E. Therefore, the results indicated that there was a weak negative relationship between liquidity management and financial leverage and that this relationship was insignificant.

4.6 Chapter Summary
This chapter presented the finding from the study, which were guided by the research questions in chapter two. The next chapter covered discussion, conclusion and recommendations.
CHAPTER FIVE

5.0 DISCUSSION, CONCLUSIONS AND RECOMMENDATIONS

5.1 Introduction
This chapter covers the discussion of the major findings of the study as related to the research questions in chapter 2. The findings of the current study were compared to findings of previous literature. The chapter also presents the major conclusions drawn from the study based on the research questions in chapter two. The chapter concludes with the recommendations for improvement and further study.

5.2 Summary of the Study
The purpose of the study was to determine the effect of financial leverage on the financial performance of a firm. The research questions were the effect of financial leverage on profitability, the effect of financial leverage on dividend policy and the effect of financial leverage on liquidity management of a firm. The study employed a descriptive research design to analyze the relationship between variables. Data was collected from the annual financial statements of the selected companies and the researcher analyzed data for a five year period i.e. form 2012-2016. The study was done on a census scale since data was collected from all the 4 Kenyan Energy and Petroleum firms listed on the Nairobi Securities Exchange.

Data was then entered into Microsoft Excel and analyzed for descriptive statistics on profitability, dividend payout ratio, liquidity management and financial leverage. Simple linear regression, correlation analysis and Pearson’s correlation were used to establish the relationship between the variables. The findings of the study indicated that most of firms increased or maintained their level of profitability throughout the period. Working capital management was found to be the main determinant of profitability for the select firms. Both working capital management and firm age had a positive relationship with profitability. However, firm size was found to have a negative relationship with profitability.
The results of the study found that there was a strong negative relationship between profitability and financial leverage, as those firms that relied more on debt had lower profits while those relied more on equity had higher profits. The study also indicated that most of the firms paid dividends to their shareholders annually during the period under study. According to the study, firm size was the major determinant of dividend payout ratio. The study also showed that dividend payout ratio was positively related to financial performance. The results of the study indicated that there was a weak negative relationship between financial leverage and dividend payout ratio.

The study also showed that both firm size and total sales were significant determinants of liquidity management. However, liquidity management was found to have to be a stronger determinant of liquidity management though this relationship was negative. The study also showed that most firms were able to cover their short term liabilities with their short term assets. The study also indicated that liquidity management had a positive relationship with financial performance. The results indicated that there was a weak negative relationship between liquidity management and financial performance.

5.3 Discussion
5.3.1 Effect of Financial Leverage on Profitability.

The study found that there was a strong negative relationship between financial leverage and the profitability of selected firms. This study is supported by a similar study by Ahmad et al. (2015), which aimed at establishing the relationship between financial leverage and the profitability of Cement manufacturing firms in Pakistan. The results indicated there was a significant negative relationship between financial leverage and profitability of the sampled firms.

This study is also supported by ALghusin (2015), who aimed at investigating the effect of financial leverage, growth and size on the profitability of listed Jordanian industrial firms. The results indicated that there was a strong negative relationship between debt ratio (leverage) and profitability. The author advised firm to minimize debt and maximize financial assets so as to enhance their profitability.
The findings are also supported by the results of Enekwe et al. (2014), who investigated the effect of financial leverage on the financial performance of quoted pharmaceutical firms in Nigeria. The results indicated that there was a significant negative relationship between debt ratio and debt to equity ratio (financial leverage), and ROA (profitability). The researchers suggested that firms should keep debt financing at optimal levels for effective utilization of a firm’s assets.

Similar findings were found by Kalpana (2014), who aimed to analyze the impact of leverage on the profitability of selected Steel manufacturing firms listed on the Bombay Stock Exchange in India. The results indicated that there was a negative relationship between financial leverage and the profitability of the findings, adding that the use of debt and fixed cost expenses reduced the profitability of the firms.

The findings of the current study are also supported by Patel (2014), who studied the impact of financial leverage on the profitability of Sabar Diary in India. The results indicated that there was a negative relationship between the degree of financial leverage and ROA (profitability), adding that a higher degree of financial leverage decreased the profitability of the selected firms.

Ur Rehman (2013) aimed at investigating the impact of financial leverage on the financial performance of listed sugar companies in Pakistan. The results indicated that there was a negative relation between financial leverage and EPS, net profit margin and ROE. However, the results were mixed because they indicated that there was a positive relationship between financial leverage and ROA.

The findings are also consistent with the results of Chesang and Ayuma (2016), who examined the effect of financial leverage on the profitability of agricultural firms listed on the Nairobi Securities Exchange. The results indicated the there was no significant relationship between debt to equity and long term ratio (financial leverage) and the profitability of the selected firms.

Abdul and Adelabu (2015) investigated the relationship between financial leverage and the ROE of Oil and Gas firms in Nigeria. The results indicated that there was a positive significant relationship between financial leverage and the financial performance of the selected firms. The results indicated that as leverage increased, so did profitability, adding that firms should take on more debt so as to enhance their profitability.
Moghadam and Jafari (2015) analyzed the role of financial leverage on the performance of Iranian firms listed on the Tehran Stock Exchange. The study used ROA as the dependent variable. The results indicated that there was a positive relationship between financial leverage and ROA (firm performance). The researchers recommended that managers should rely more on external sources of financing than equity.

**5.3.2 Effect of Financial Leverage on Dividend Policy**

The findings indicated that there was an insignificant negative relationship between dividend policy and financial leverage. This is supported by a study by Javed (2012), which aimed at investigating the impact of financial leverage on the dividend policy of Pakistani firms listed on the Karachi Stock Exchange. The results indicated that there was a negative relationship between financial leverage and dividend per share, indicating that the higher the financial leverage, the lower the dividend paid out.

Uwuigbe (2013) investigated the determinants of dividend policy of Nigerian listed firms. The findings indicated that there was a negative relationship between financial leverage and the dividend pay-out ratios of the firms. The results indicated that holding other factors constant, increasing financial leverage had a negative impact on the dividend pay-out ratios. The researchers concluded that more levered firms paid lower dividends than the unlevered firms.

The findings are also supported by Vo and Nguyen (2014), who examined the interrelationship between managerial ownership, leverage and dividend policies of Vietnam listed firms. The results indicated that there was a negative relationship between financial leverage and the dividend policies of the selected firms.

The results are also supported by the findings of Asad and Yousaf (2014), which examined the impact of financial leverage on the dividend payment pattern of Pakistani manufacturing firms. The results indicated that there was a significant negative relationship between financial leverage and the dividend patterns of the selected firms.
Kaźmierska-Jóźwiak (2015) examined the determinants of cash dividend payments of Polish non-financial firms listed on the Warsaw Stock Exchange. The results indicated that there was a significant negative relationship between leverage and the dividend payout ratios of the selected firms. The results indicated that Polish firms with high leverage were less likely to pay dividends. The researchers indicated that this was in support of the agency cost theory of dividend policy.

The results are also supported by Kuzucu (2015), who aimed at investigating the firm-level factors influencing the dividend decisions of Turkish listed firms. The results of this study indicated that there was a negative relationship between leverage and dividends. The researchers concluded that firms with higher debt ratios were less likely to pay dividends and more likely to retain their earnings.

Labhane and Mahakud (2016) analyzed the trends and the determinants of dividend policies of Indian companies. The results indicated that dividend policies of the sampled firms were negatively affected by the firms’ financial leverage ratios. The researchers however noted that the significant of this relationship varied across the different proxies for dividend policy and across time periods.

Yusof and Ismail (2016) investigated the determinants of the dividend policy of public listed companies in Malaysia. The findings indicated that the level of debt in a firm negatively influenced the dividend policy of the selected firms. The researchers concluded by signifying the need for management to decide on the appropriate dividend policy of the firm as this has an effect on the shareholders’ investment decisions. The results are however in contrast to some earlier studies.

Banerjee (2016) analyzed the determinants of dividend distribution of IT companies in India. The results indicated that there was a significant positive relationship between financial leverage and dividend pay-out ratios. The results also indicated that highly levered firm had higher profits, and hence paid higher dividends.

Alisinaei and Habibi (2012) examined the determinants of dividend payout ratios of Iranian companies listed on the Tehran Stock Exchange. The results indicated that there was a significant positive relationship between debt to equity ratio (financial leverage) and dividend payout ratio. The researchers attributed this positive relationship to the fact that banks pressurize management to make profits so as to repay their obligations, hence making more profits and paying more dividends.
5.3.3 Effect of Financial Leverage on Liquidity Management

The results of the current study indicate that there is a weak negative relationship between financial leverage and liquidity management. This is supported by Owino (2011), who examined the relationship between liquidity and leverage of companies listed on the Nairobi Securities Exchange. The results indicated that there was an insignificant negative relationship between liquidity and financial leverage. The researcher added that firms instead adopted better market practices like shorter cash conversion cycles.

The findings are also supported by Khanqah and Ahmadnia (2013), who studied the impact of capital structure on liquidity and growth opportunity of Iranian firms listed on the Tehran Stock Exchange. The results indicated that there was a negative relationship between financial leverage and the liquidity ratios of the sampled firms. The results indicated that the higher the liabilities of the firm, the lower were the liquidity ratios.

Hussain et al. (2015) analyzed the effect of financial leverage on the performance of Pakistani textile firms. Using liquidity as a control variable and long term debt ratio as an independent variable, the results indicated that there was a negative relationship between liquidity and financial leverage. This indicated that the high the degree of leverage, the lower the liquidity management ratios of the firms. This study however contradicts with some earlier studies.

Gill (2011) analyzed the factors that influence the working capital requirements of Canadian firms listed on the Toronto Stock Exchange. Working capital was considered a measure of corporate liquidity. The results indicated that there was a positive relationship between liquidity and financial leverage. The researchers concluded that higher levels of debt required higher levels of working capital hence the need to pay attention to account payables and receivables.

Goel et al. (2015) analyzed the impact of financial leverage on the different measures of operating liquidity machinery firms in India. The results indicated that there was significant positive relationship between financial leverage and various measures of liquidity. According to the researchers, this indicated that as firms obtain more debts, they are able to finance their current assets and also meet their current liabilities.
5.4 Conclusions

5.4.1 Effect of Financial Leverage on Profitability
The results indicated that financial leverage negatively affected the profitability of the selected firms. Therefore, the more a firm relies on debt financing, the lower its profits become. This could be associated with the fact that instead of using the profits for reinvestments in the firm, the profits are instead used to meet the liabilities of the creditors.

5.4.2 Effect of Financial Leverage on Dividend Policy
The results indicated that there was a negative relationship between financial leverage and dividend policy. This implies that as firms use more of debt in their capital structure, they retain their earnings for reinvestment in the firms. It should also be noted however that as some firms pay more dividend, their cash flow reduces hence the need for external sources of finance (financial leverage). Therefore there is an interdependent relationship between financial leverage and dividend payment behavior of a firm.

5.4.3 Effect of Financial Leverage on Liquidity Management
The study indicated that there was a negative relationship between financial leverage and liquidity management. This means that the increase of financial leverage makes it difficult for companies to efficiently and effectively manage their liquidity. This could be attributed to the agency theory assumption that as cash flows in a firm increase, so do the agency problems of maximizing one’s self interests at the expense of the shareholders’ objectives.

5.5 Recommendations

5.5.1 Recommendations for Improvement
The results indicated that there is a negative relationship between financial leverage and different ratios of financial performance, which included profitability, dividend policy and liquidity management. Therefore, financial leverage negatively affects the financial performance of Energy and Petroleum firms in Kenya. This means that as firms rely more on financial gearing, their financial performance measures decline. The researcher recommends the following;
5.5.1.1 Effect of Financial Leverage on Profitability

Research indicates that financial leverage effect on profitability is mainly due to the high cost of borrowed funds. Therefore, the researcher recommended that firms source for less costly sources of finance which don’t exhaust the earnings of the firms. Firms should also negotiate for better and longer credit terms in relation to repayment terms and interest rates.

5.5.1.2 Effect of Financial Leverage on Dividend Policy

Firms should aim at increasing value for their shareholders’ so that instead of them demanding for higher dividends, they would prefer to reinvest their earnings back into the firm. This will increase equity funding and reduce the risks associated with financial leverage.

5.5.1.3 Effect of Financial Leverage on Liquidity Management

Firms should adopt better working capital management techniques to ensure that a firm is able to meet its short term liabilities as they come due with current assets. Firms should also match their borrowing needs with the available assets to ensure effective and efficient utilization of the firm’s and reduce external borrowing.

5.5.2 Recommendations for Further Studies

Financial performance of firms is measured using a number of various proxies. This study only focused on profitability, dividend policy and liquidity management. Other researchers should analyze how financial leverage affects other financial aspects of a firm. This study also used secondary data of Kenyan Energy and Petroleum firms listed on the NSE, which are only 4 in total. Other studies should consider analyzing the effect of financial leverage on the financial performance of firms in other broader sectors e.g. agricultural. Other researchers should also consider the effect of industry specific factors on the financial performance of firms.

5.6 Chapter Summary

This chapter presented the discussion, conclusions and the recommendations for improvement and for further study. The study concluded with the references.
REFERENCES


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