

Analyzing Significance Of Financial Leverage On Financial Performance In Manufacturing Sector Of Pakistan

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Abstract

This present research is conducted to probe the impact of company's' Financial-Leverage on its Performance, the research-data pursued and collected for listed manufacturing sector of Pakistan from State Bank of Pakistan via Financial-Statements analysis. Time- series-data is collected from 2009-2019. The research is based upon Ratio and Return on Assets , Return on Equity are as Independent-Variable and Net-Profit margin are Dependent-Variable, the research is mechanized by applying the Regression-Model by using SPSS. Manufacturing sector is performing a crucial function in the Developing and Developed-Economies. It offered maintain for Economic-Development of country by depicting encouraging trends for growth towards the sector, helping as a control for the growth of firm's various working areas like; textile, cement and iron. It offers extensive contribution for production, trade and service. Generally, perceived the financial leverage is helpful to boost up the Financial-Performance of the Company. The study is aimed at checking the Hypothesis and to comprehend the contact of Financial-Leverage on the Firm

Financial outcomes of the manufacturing sector of Pakistan. The study's core objective is to observe that the entities acquire work with high profits may be leads to choice High-Leverage by using different statistical techniques and tools. The study highlights Financial-Leverage positively affects the company Financial Performance. By affirming the alternate hypothesis H1 and Ho is rejected. Further, analysis substantiates High-Profit earning entities make sure of feasible liquidity situation s to acquire significant Financial-Performance of entity. This orientation has significant impact on the manufacturing sector in Pakistan in Financial- Leverage on its sustainability and significance.

Keywords: Financial Leverage, Financial Performance, Financial Ratios, manufacturing sector, KSE.

Introduction

Financial Leverage can be called as leverage or trading on equity, shows the use of debt to get access to extra funds in form of assets. By using portion of debt financing as leverage to control ample quantity of funds (by acquiring some funds as debt) that would be one of the main reason of returns on the owners' investing projects. There are various factors that can impact a companies' financial performance and their profits. Economic models are being designed to examine the dependency of one on another. Financial performance and its functions are dependent on many factors such as debt, inflation, interest rate, and monetary policy of country. Financial leverage has become a significant feature of building capital in under developing countries around the world. During the 21st century financial leverage is believed to be the most significant component that contributes extensively in companies' funding requirements of under developing and developing countries. Capital structuring is the most perplexing subjects in financial management literature. The conception of capital-mixture is mainly portrayed as fraction of long-term Debt and Equity build up a company's total capital. Percentage of DOE ratios nice-alternative for financial managers (Kajanathan, 2012). Correspondingly, long term debt and equity choice is an important administrative decision because it effects shareholder's return and risk (Enekwe et al., 2014)Therefore, market-value of a stock might get influenced via capital-structuring decision, and firm will to plan capital mixture in start. Therefore, when resources are raised to finance investments, Debt and Equity Decision is concerned (Abubakar, A., 2016) added optional term 'trade on Equity' is resulting from the fact that Owners' Equity under practice be as foundation to augment Debt. The Debt-Lender (Creditor) acquires' limited input in allocation of Firms Earnings leading to inflict certain boundaries (protecting covenants) on the enterprise (Okoye, 2019). Financial leverage evaluation is a unique as it directly inclined by such decision, so, fund-managers should trade with vigilance when making Debt-Equity Mix Decision. Since, the contemplation results in the statements of Perfect-Markets, having Taxes, unavailability of Transaction and bankruptcy costs, the Debt inappropriateness is hardly rational. (Miller, 1988) moderated a Non-Tax preposition and postulated a hypotheses that concerns with tax advantages of liability. Pakistan is one of the under developing country with Low-Economic growth, lack of Capital, Lack

of Savings along with low level of Industrialization, High Population-Growth, High External Debt, Lack of Managerial and Technical-Skills and Deficit-Budget regularly. It is argued that Profitable Entities were less probably dependency on Debt in capital mixture than less Gainful Entities, and that entities having more growth rates possess more DOE ratios (Onaolapo et al., 2015). Managers use free-cash flows of the concern for investing in profitable and uphold cash on hand. But if the entity is not devoted to some set payments such as interest expenses, managers may have incentives to “waste” extra free cash flows in sustaining discipline managers, shareholders pull towards you in fund in form of liabilities. (Long & Malitz, 1983) corollary working on Dividend policy and financial-leverage-management. According to (Hussan, 2016) "The degree to which an entity materialized Debt-Financing, or Financial-Leverage, contains three crucial inferences: (1) By escalating Funds through Debt, Shareholders can control a company with a limited investment. (2) Creditors appear to the Equity or Owner-Supplied-Funds, to provide a margin of security so if the stockholders have provided only a small percentage of the Total-Financing, the Risks of the entity are borne mainly by its lenders. (3) If the entity gaining more on investments-financed with borrowed funds than it gives interest, the rate of return on owners' capital is magnified, or Leveraged."

Research Questions:

1. How much important financial leverage is in determining firms 'performance?
2. What is the impact of leverage on return of companies' in manufacturing sector in Pakistan?
3. Which of the financial leverage factors impact more on firm's performance non- financial sector of Pakistan?

Research Objectives

The core objective of current study is to identify impact of Financial-Leverage on -Performance of manufacturing sector firms of Pakistan.

1. To conclude influence of debt to equity ratios on Financial-Performance in manufacturing sector of Pakistan listed on KSE.
2. To describe the consequence of gearing ratio on Financial-Performance (ROA, ROE, NPM).
3. To test consequence of gearing ratio on Financial-Performance of manufacturing sector of Pakistan.

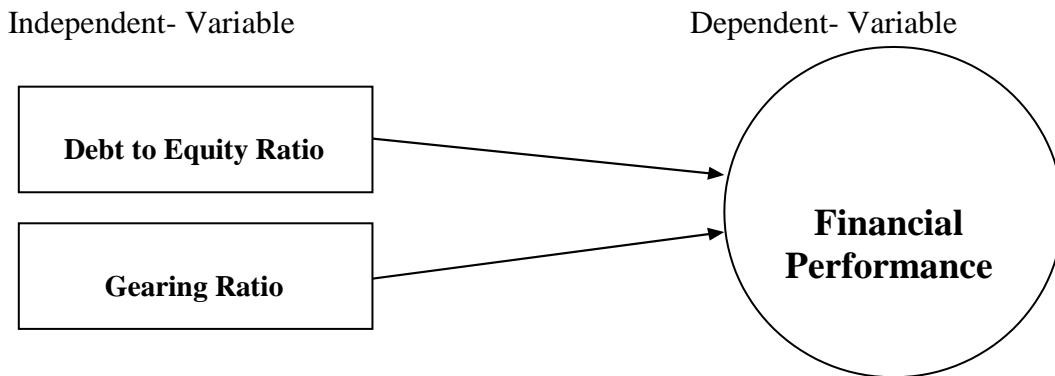
Literature Review

Financial leverage is general term, which expresses in different forms. (Ali,2014) in a study, revealed that the consequence of Financial-Leverage on the Financial-Performance is positive as alternate hypothesis was accepted however, the Null-Hypothesis was rejected. Further, the study is carried out on the firms in fuel and energy sector in Pakistan, for creating correlation between

Fuel & Energy Sectors, the method of Linear- Regressions by using Ordinary Least Square is applied (Akintoye, 2008). It is indispensable that dependent variable of under study research is normally dispersed. In this connection, Jarque-Bera test is materialized. So, the firms which belong to fuel and Energy-Sector should boost their Financial-Performance by focusing, strengthening their Financial-Leverage to the optimal level. It was also exposed in the study that by a proper capital structure, company can get higher returns and profits. Did research on the relationship between Financial-Leverage & Financial-Performance. The study was done on place money banks in Nigeria. Descriptive statistics used for central tendency and dispersion of the data. Also correlation Pearson test used for relationship testing between leverage and ROA of chosen deposit money banks in Nigeria correspondingly. Eleven Banks were selected for sampling in this study. Financial leverage of Money Deposit Banks in Nigeria is very high. The main findings of this study describe that the relationship between Debt-Equity is negative however there was no considerable correlation revealed in Debt-Ratios and ROE through this study (Abubakar, 2015). (Akhtar et al., 2012), conducted a study on the correlation between Financial-Leverage & Financial-Performance. Generally, the relationship usually is positive between Financial-leverage and Financial-performance. Though the study, the mixed results were discovered. According to results, there is a positive relationship between Debt-Equity ratio and Return on Assets and Sales-Growth whereas there is a negative relationship between Debt-Equity ratio and ROE. (GWEYI&Karanja, 2014) conducted the study for examining the correlation between Financial-Performance and Financial-Leverage. The sample size of the study was Forty Savings and Credit Co-operative Societies (Saccos). The study is based on secondary data which was taken from different SACCOS statements. The result of study shows that there a strong positive correlation between Financial-Leverage & Financial- Performance of SACCOS in Kenya. (Ali,2014) investigated the contact of Financial-Liquidity & Leverage on Financial-Performance of Real-Estate and Property enterprises in Indonesia. There is just one variable whose (Ali, 2014) investigated on the impact of Financial-Liquidity & Leverage correlation on the Financial-Performance of Property and Real-estate. There is only one variable which is significant, and it is between times interest earned ratio and return on assets of property and real estate enterprises. Whereas, the correlation between current ratio and Debt-Assets was not considerable. The Liquidity ratios' correlation was not significant with the Return on Assets. (Al Nimer et al., 2015) carried upon research on impact of Working-Capital Management & Financial-Leverage on the Financial-Performance of listed companies in Stock-Exchange in Amman, Jordan. The findings of study depicts that correlation of Working-Capital management and Financial-Leverage with Financial-performance is significant as the ANNOVA, F-Test and T-Test are less than 0.05. (Perinpanathan, 2014), Enquired the impact of Financial-leverage on Financial-performance of John Keells Holdings plc in Sri Lanka. Pearson's Rank Correlation test, ANOVA F- test, and Multiple-Regression analysis were materialized on Forty five firms included in the industrial-sector in Jordan ranked in terms of Gross-Revenues. The study conclusion depicts the correlations between Financial- Leverage & Financial-Performance of John Keells Holdings plc is negative. (KANGOGO, 2021) , study explores the significance of cause of three types of the Degree of

Leverage, Degree of Operating-Leverage, (DOL), Degree of Financial-leverage, (DFL), & Degree of Combined-Leverage on the Financial-performance of the entities of Food & Fertilizer-Sector registered under Pakistan Stock-Exchange (PSE). In study, Nine-Year-Data have been materialized covering the period from 2008 -2015. The data were analyzed by applying the model of E-Views version 8. And for testing the impact of Degree of Operating Leverage, (DOL), Degree of Financial Leverage, (DFL), Degree of Combined Leverage (DCL) & the Firm's'-Size.

.Conceptual Model



Research Hypotheses

H1A= Debt and Equity ratio has significant relationship with ROA in manufacturing industries of Pakistan.

H1B= Debt and Equity ratio has significant relationship with ROE in manufacturing industries of Pakistan.

H1C= Debt and Equity ratio has significant correlation with NPM in manufacturing industries of Pakistan.

H2A= Gearing-Ratio has significant correlation with ROA in manufacturing industries of Pakistan.

H2B= Gearing-Ratio has significant correlations with ROE in manufacturing industries of Pakistan.

H2C= Gearing-Ratio has significant correlation with NPM in manufacturing industries of Pakistan.

Research Design & Methodology

Nature of Research study: The Research is carried on quantitative methods. Data have been collected for analysis from nonfinancial sector financial statements analysis state bank of Pakistan for 11 years from 2009 -2019. Research is based on manufacturing sector of Pakistan.

Research Design

Present research considered the exploratory, descriptive and explanatory research in to clustering (Brynjolfsson & Saunders, 2009)

Data Description

Various studies have been conducted to know the impact of leverage on financial performance of manufacturing sector of Pakistan. The dependent variables studied in this research include financial performance (return on assets, return on equity and net profit margin) and independent variables which studied are financial leverage ratios (gearing ratio, debt to equity ratio).

Data Collection

The research is secondary data based and accumulated from of State Bank of Pakistan, SBP listed on the Karachi stock exchange publications from, (2009 to 2019). This publication provides the industrial ratios from consolidated financial statements of 32 manufacturing and other sector industrial chemicals, engineering, tobacco, leather, fuel and energy, transportation and communication. Here in this research researcher focuses on manufacturing sector which comprises on 32 firms.

Research-Sampling

The number of companies in this manufacturing sector is 32, but for this study researchers selected whole manufacturing sector from the consolidated Financial Statements of the State Bank of Pakistan about 32 firms for sample period 2009 to 2019.

Table (Horizontal-Analysis of the complete Manufacturing Sector by SBP, 2009 To 2019).

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
Gearing ratio	23.9	25.8	24.6	27.7	25.4	24.3	26.3	18.8	17.4	18.5	21.4
Debt to equity ratio	1.23	1.29	1.43	1.45	1.34	1.4	1.319	.879	.933	1.048	1.207
ROA	12.19	9.64	4.92	5.38	6.52	6.77	5.66	9.96	10.74	9.13	5.73
ROE	28.1	21.81	11.64	13.12	15.55	16.05	13.35	20.56	20.49	18.2	12.21
NPM	9.924	7.63	4.61	4.96	6.03	6.32	5.5	9.9	10.6	8.6	5.6

The aim of the study is to find out how leverage influences on financial performance of manufacturing sector and, to know the various factors that impact on financial performance of manufacturing sector. Researcher uses quantitative methods for the data collection.

Choice of Research method:

Researcher uses quantitative method for data collection due to authenticity of results of quantitative method as compared with qualitative method, quantitative research based

Description of the sample

Sampling is generally used because of limited time and data access, here due to availability of data researcher has selected the overall manufacturing sector and data of 32 companies listed at Pakistan Stock Exchange.

Description of analysis:

In this research researcher uses the techniques like correlation analysis, regression analysis, coefficient, autocorrelation.

Population and Sample Selection

In this research data have been collected from state bank of Pakistan. The sample of the study includes the non-financial companies which are listed on Pakistan Stock Exchange form the year 2009 to 2019. The selection of companies to be a part of sample is done on sectorial basis, the data requisite for the analysis is extracted from financial statements Analysis of companies published by State Bank of Pakistan. Following criteria is used to select the companies from the non-financial sector.

- I. Non-Financial firms which are listed on Pakistan Stock Exchange(PSX).
- II. Firms which remain listed on the PSX for the period of 2009 to2019.

The Financial sector is not included, because the capital mix and all other decisions of a financial sector are well regulated and considerably distinguished from the companies in non-financial sectors (Michaels, Chittenden and Poutziouris, 1999). Simultaneously this study can be used for the financial Sector too, by making some basic changes.

Financial leverage

$ROA = \beta_0 + \beta_1 \text{ Debt to equity} + \beta_2 \text{ Gearing ratio} + u_{it}$
 $ROE = \beta_0 + \beta_1 \text{ Debt to equity} + \beta_2 \text{ Gearing ratio} + u_{it}$
 $NPM = \beta_0 + \beta_1 \text{ Debt to equity} + \beta_2 \text{ Gearing ratio} + u_{it}$

In above model, the dependent variable is Lev, which defines the leverage or capital structure of the firm, means how much equity and debt is used to finance the firm. The independent variables included are the return on assets, return on equity and net profit margin of the firm through level of its total assets value. Return on assets explains the earnings of overall manufacturing sector in Pakistan; return on equity describes how much earnings are generated from the shareholders' investments in manufacturing sector. It is worth declaring that two of the alternatives of leverage are utilized to test the Reliability of results. The alternatives include total debt to total equity ratio and Long term debt to total equity and long term debt

The Core variables in table

core variable	type	proxies	acronyms	formula
Financial performance	Dependent	Return on assets Return on equity Net profit margin	ROA ROE NPM	Net income/Total assets Net income/Total equity Net profit/Revenue Net profit/ total revenue
Financial leverage	Independent	Debt to equity Gearing ratio	DER GR	Total debt/total equity Long term debt/total equity+ long term debt

Results & Discussions

This portion is related to results and discussions of this research study, it is important

Descriptive Analysis:

	Debt to Equity Ratio	Gearing Ratio	Return on Assests	Return on Equity	Net Profit Margin
N Valid	11	11	11	11	11
Missing	0	0	0	0	0
Mean	1.2296	23.1000	7.8764	17.3709	7.2431
Std. Deviation	.19646	3.51198	2.51766	5.04165	2.18435
Skewness	-.794	-.563	.415	.868	.422
Std. Error of Skewness	.661	.661	.661	.661	.661

Above given table is representing the descriptive analysis of debt and equity ratio, gearing ratio, return on assets, return on equity and net profit margin, the highest mean for gearing ratio that is 23.10, that representing that gearing ratio is most affected on financial performance of the manufacturing industries in Pakistan, but return on equity has more variation 5.04 while gearing ratio data has been deviated 3.51, Return on Assets mean has 7.87, and standard deviation 2.5, and Net Profit margin has 7.24 mean and standard deviation has 2.

Correlation Analysis:

Correlations

		Debt to Equity Ratio	Gearing Ratio	Return on Assests	Return on Equity	Net Profit Margin
Debt to Equity Ratio	Pearson Correlation	1	.912**	-.673'	-.472	-.837**
	Sig. (2-tailed)		.000	.023	.143	.001
	N	11	11	11	11	11
Gearing Ratio	Pearson Correlation	.912**	1	-.528	-.298	-.714'
	Sig. (2-tailed)	.000		.095	.374	.014
	N	11	11	11	11	11
Return on Assests	Pearson Correlation	-.673'	-.528	1	.963**	.957**
	Sig. (2-tailed)	.023	.095		.000	.000
	N	11	11	11	11	11
Return on Equity	Pearson Correlation	-.472	-.298	.963**	1	.856**
	Sig. (2-tailed)	.143	.374	.000		.001
	N	11	11	11	11	11
Net Profit Margin	Pearson Correlation	-.837**	-.714'	.957**	.856**	1
	Sig. (2-tailed)	.001	.014	.000	.001	
	N	11	11	11	11	11

** . Correlation is significant at the 0.01 level (2-tailed).

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

The above given table is representing the correlation between the independent variables and dependent variables has three like ROA, ROE and NPM. First the relationship between Debt and equity ratio and gearing ratio is Perfect positive 0.91, while debt and equity ratio and ROA has moderate negative relationship 0.67, DER with ROE has also moderate negative relationship 0.47 also DER with NPM indicating perfect negative relationship 0.83, while gearing ratio with ROA has moderate negative relationship between 0.528, while gearing ratio with ROE has also weak negative relationship with 0.298, and gearing ratio with NPM have perfect negative relationship with each other, so according to the co relation analysis the relationship with independent variables and dependent variables are negative. Furthermore, check with the relationship among dependent variables having positive relationship with ROA and ROE and NPM. ROA and ROE has perfect positive relationship between 0.96 with each other and ROA with NPM have also perfect positive relationship 0.95 with each other. Finally, ROE and NPM have also perfect positive relationship 0.87 with each other.

Regression Analysis:

Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.706 ^a	.498	.372	1.99463

a. Predictors: (Constant), Gearing Ratio, Debt to Equity Ratio

ANOVA^b

Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	31.558	2	15.779	3.966	.064 ^a
	Residual	31.828	8	3.979		
	Total	63.386	10			

a. Predictors: (Constant), Gearing Ratio, Debt to Equity Ratio

b. Dependent Variable: Return on Assets

Coefficients^a

Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	17.357	4.211		4.122	.003
	Debt to Equity Ratio	-14.659	7.837	-.144	-1.870	.098
	Gearing Ratio	.370	.438	.516	.844	.423

a. Dependent Variable: Return on Assets

Regression analysis is used to see the impact between independent variables and dependent variable. The above given table is representing the Debt to equity ratio and gearing ratio with respect to ROA, the R square is 0.706, so debt to equity and gearing ratio is 70% explained by Return on Assets. The beta interpretation of this model is if you increase one point of debt to equity ratio than ROA will be decrease by 14%, and if you increase one point of gearing ratio than ROA will be also increase by 37%.

Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.572 ^a	.328	.160	4.62162

a. Predictors: (Constant), Gearing Ratio, Debt to Equity Ratio

ANOVA^b

Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	83.307	2	41.653	1.950	.204 ^a
	Residual	170.875	8	21.359		
	Total	254.182	10			

a. Predictors: (Constant), Gearing Ratio, Debt to Equity Ratio

b. Dependent Variable: Return on Equity

Coefficients^a

Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	28.807	9.757		2.952	.018
	Debt to Equity Ratio	-30.624	18.159	-.193	-1.686	.130
	Gearing Ratio	1.135	1.016	.791	1.117	.296

a. Dependent Variable: Return on Equity

The above given table is representing the Debt to equity ratio and gearing ratio with respect to ROE, the R square is 0.572, so debt to equity and gearing ratio is 57% explained by Return on Equity. The beta interpretation of this model is if you increase one point of debt to equity ratio than ROE will be decrease by 30%, and if you increase one point of gearing ratio than ROA will be also increase by 1.1%.

Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.845 ^a	.714	.643	1.30520

a. Predictors: (Constant), Gearing Ratio, Debt to Equity Ratio

ANOVA^b

Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	34.085	2	17.043	10.004	.007 ^a
	Residual	13.628	8	1.704		
	Total	47.714	10			

a. Predictors: (Constant), Gearing Ratio, Debt to Equity Ratio

b. Dependent Variable: Net Profit Margin

Coefficients^a

Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	18.121	2.756		6.576	.000
	Debt to Equity Ratio	-12.291	5.128	-1.106	-2.397	.043
	Gearing Ratio	.183	.287	.295	.639	.541

a. Dependent Variable: Net Profit Margin

The above given table is representing the Debt to equity ratio and gearing ratio with respect to Net Profit Margin, the R square is 0.572, so debt to equity and gearing ratio is 57% explained by NPM. The beta interpretation of this model is if you increase one point of debt to equity ratio than NPM will be decrease by 12%, and if you increase one point of gearing ratio than NPM will be also increase by 1.8%.

Hypotheses testing results:

Hypotheses	P-Value	Supported / Not Supported
H1A= Debt and Equity-Ratio has significant Relationship with ROA in manufacturing industries of Pakistan.	0.098	Not Supported
H1B= Debt and Equity Ratio has significant Relationship with ROE in manufacturing industries of Pakistan.	0.423	Not Supported
H1C= Debt and Equity Ratio has significant Relationship with NPM in manufacturing industries of Pakistan.	0.130	Not Supported
H2A= Gearing-Ratio has significant co -relation with ROA in manufacturing industries of Pakistan.	0.298	Not Supported
H2B= Gearing-Ratio has significant Co-relation with ROE in manufacturing industries of Pakistan.	0.043	Supported
H2C= Gearing-Ratio has significant Co-relation with NPM in manufacturing industries of Pakistan.	0.541	Not Supported

Conclusion

This study is conducted to ascertain the impact of Financial leverage such as (DER), Gearing ratios financial performance of manufacturing sector of Pakistan from 2009- 2019 almost 11years (secondary data) is taken from State Bank of Pakistan (www.sbp.org.pk). Most of the research articles from literature reviews depict the negative impact of financial leverage on financial performance. For data analysis statistical process for social science (SPSS) multiple regression and correlation techniques have been used to show the relationship among the variables. However, according to the co relation analysis the relationship among independent variables and dependent variables are negative. Furthermore in regression analysis the beta interpretation of this model is if you increase one point of debt to equity ratio than NPM will be decrease by 12% means negative impact on net profit margin, and if you increase one point of gearing ratio than NPM will be also increase by 1.8% means positive impact with the relationship among dependent variables having positive relationship with ROA and ROE and NPM. Most of hypotheses are not supported means null hypotheses are rejected and alternative hypotheses are accepted.

Recommendations

Our result has given an opportunity to develop some policy implications in manufacturing sector

in Pakistan. The regression result shows that financial leverage has negative impact on financial performance of Pakistan; hence manufacturing companies should pay some attention to increase the use of debt in their funding requirements to increase financial performance rate. Manufacturing sector should provide business friendly atmosphere and create ease of doing business to invite ample amount of investments in this sector so to attract more investors and firms to come and start investing in this industry.

To control the impact of interest rate (leverage) in this sector, Pakistan government should manufacture sector of Pakistan in managing interest rate risk through monetary policy by mobilizing state bank of Pakistan. Moreover, there is also needed to improve supply side policy, interest rate policy, and There is need to establish the external debt structure modification, the borrowing decision and planning in order to raise the funds, government policy should maintain according to debt management goals. As we know that the financial performance is dependent on investments in form of increasing assets for the new generation of Pakistan because from our study the hypothesis is proved, and it is creating value in the financial performance ultimately in economic development. Banks and lending institutions of the country must develop country's infrastructure, and create stable loan policies and business environment and should develop domestic market to provide opportunities to domestic investors as well as foreign investors and to domestic entrepreneurs, so that no any avenue could remain unexplored for the financial performance and economic growth of Pakistan.

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