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The Effect of Corporate Financial Performance on Growth Potential: Perspectives from the Listed Non-Financial Firms in Egypt Exchange

Abstract

This paper examines the effect of firm financial performance on growth potential for the non-financial firms listed in Egypt stock exchange. The annual data covers the years 2010 – 2020. The total number of firms included in the study was 193 of non-financial firms listed in the Egyptian stock exchange (EGX). Overall, the results revealed that the robust determinants of firm growth potential are related only to (Cash ratio, inventory to current assets ratio), debt financing (long-term debt to total assets ratio, fixed assets to total debt ratio) and profitability (Net Operating Profits/Total Assets). Thus, there is a significant and positive association between the liquidity ratios, leverage ratios, and the firm growth potential. However, there is a negative and significant relationship between dividends and age and the growth potential.

Key Words: firm growth Potential, liquidity ratio, leverage ratio, profitability ratio, dividends.

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تأثير الأداء المالي للشركات على إمكانات النمو: دراسة الشركات غير المالية المدرجة في البورصة المصرية

ملخص البحث

يبحث هذا المقال في تأثير الأداء المالي للشركات على إمكانات النمو. يتضمن المقال الشركات غير المالية المدرجة في بورصة مصر. تم جمع البيانات للفترة 2010–2020. بشكل عام. العدد الإجمالي للشركات المدرجة في الدراسة كان 193 شركة غير مالية مدرجة في البورصة المصرية. كشفت النتائج أن هناك ارتباطًا إيجابيًا وفعال بين نسب السيولة (نسبة النقد إلى الأصول المتداولة، نسبة المخزون إلى الأصول المتداولة)، ونسب الرافعة المالية (نسبة الدين طويل الأجل إلى إجمالي الاصول، نسبة الأصول الثابتة إلى إجمالي الدين)، ونسب الربحية (نسبة الأرباح التشغيلية إلى إجمالي الاصول). ومع ذلك، هناك علاقة سلبية وذات دلالة إحصائية بين الأرباح (نسبة التوزيعات إلى الأرباح)ونمو الشركات.

الكلمات المفتاحية: نمو الشركات، معدل السيولة، معدل الدين، معدل الربحية، نسبة التوزيعات.

1- Introduction

The study of corporate growth and its determinants has been a long-standing focus in academic research. It remains a challenging and relevant topic for many scholars. Successful companies typically progress through distinct growth stages, namely expansion, peak, contraction, and trough. However, not all companies successfully transition through these phases, and there are varying perspectives discussed by the researchers in literatures. Some researchers show that a company's growth pattern follows a linear and predictable path, while others argue that it is characterized by opportunistic and unpredictable shifts (Gupta et al., 2013). Some have identified a negative relationship between a company's growth and its size, while others have shown the insignificant relationship between the growth and the firm size. Some even suggest that smaller companies experience positive significant rapid growth. Thus, there is a mixed results with regards to the relationship between the growth of firms and its size.

The growth rates of companies often vary throughout each stage of their business cycles. Initial stages are typically characterized by high growth rates, as companies are essentially starting from scratch and reaching a new audience. As a business matures, its growth rate tends to stabilize, even as it continues to expand. Some companies may experience multiple phases of rapid growth when introducing new products or undertaking branding initiatives. Conversely, declining businesses exhibit low or negative growth rates. The growth of companies is influenced by a variety of external and internal factors. External factors primarily include industry-related aspects, the macroeconomic environment, business cycle phases, inflation, interest rates, the development of financial markets, access to capital, resource availability (both financial and material), government policies, fiscal and monetary measures, and policies designed to support corporate development, such as growth grants. In addition, internal factors play a significant role in shaping a company's growth potential. These factors include management quality, corporate governance, strategic planning, organizational structure, innovation, strategic partnerships, human resource management, workforce quality, operational performance, and financial policies. A company's historical success generates the necessary resources for future growth through in-

ternally generated means. Company growth can be measured in different ways, through sales growth, assets growth, growth in the number of employees, value growth, business volume growth, and so on. The most used measure is sales growth. In this paper we investigate firm-specific financial determinants on corporate growth in the case of companies listed in Egyptian stock exchange. Based on the data from their financial statements for the period 2010 to 2020.

1-1 Objectives

This paper aims at fulfilling the objectives that follow.

1- Examine the effect of liquidity ratios on growth potential of firms for the 1st quartile of fixed assets ratio.

2- Examine the effect of leverage ratios on growth potential of firms for the 1st quartile of fixed assets ratio.

3- Examine the effect of profitability ratios on growth potential of firms for the 1st quartile of fixed assets ratio.

4- Examine the effect of dividends on the growth potential of firms for the 1st quartile of fixed assets ratio.

1-2 Research Problem

This paper examines a gap in the current literature about firm growth that the current determinants of firm growth include all levels of growth. In this regard, this paper examines firm growth potential (the 1st quartile of fixed assets ratio) as a realistic objective of a firms by using the following variables of firm growth potential: liquidity ratios, leverage ratios, profitability ratios and dividends ratios. That is, firms are usually looking at reaching higher growth rate.

2-Literature review

This section reviews the substantive theoretical and methodological contributions regarding the relationship between firm-specific financial indicators and the firm growth. It consists of three sections: a general review of the firm growth literature, a general review of the independent indicators and a review of each indicator and the firm growth.

2-1 Firm Growth

The problem of finding an appropriate measure of firm growth has been empirically examined by many scholars. Delmar (1997) and Ardishvili et al. (1998) identified the following commonly used growth indicators: growth in assets, sales, employment, market share, profit, and physical output.

However, the use of market share and physical output is not feasible because they can only be used within the same industry, and data on them is difficult to obtain. Delmar et al. (2003) also argue that profit is not a reliable measure of firm growth because it is only evident over long-term horizons and can vary depending on a company's variable expenses from one period to the next. The remaining three measures of firm growth, namely sales, assets, and employment, are widely used in empirical studies. Kirchhoff and Norton (1992) found that these three measures are interchangeable, as they produced similar results over a seven-year period. Hart (1995) considers growth in assets to be an appropriate measure of firm growth. He defines a firm as a group of tangible assets and property rights that are under the same ownership and control. However, the use of assets as a growth indicator is not without its drawbacks. For example, service companies do not rely on the number of assets they possess, so the use of assets as a growth indicator is not reliable for all types of industries. The last and most widely accepted proxy for measuring firm growth is sales growth, according to Hoy, McDougall, and Dsouza (1992) and Ardishvili et al. (1998). Sales growth is the preferred indicator for entrepreneurs, and it is a highly suitable indicator across various dimensions of firms, according to Davidsson and Wiklund (2000). Flamholtz (1986) argues that sales growth is a natural choice for measuring growth because it reflects growing demand.

2-2 Firm Financial Indicators

Firm-specific factors are typically operationalized by variables such as liquidity, leverage, profitability, and dividend distributions. These indicators are used as proxies for firm-specific factors in prior research (Asimakopoulos et al., 2009; Dang et al., 2018; Dietrich & Wanzenried, 2010; Pattitoni et al., 2014; Eldomiaty et al., 2019). Therefore, an understanding of (Liquidity, Leverage, Profitability, and dividends distributions) is used to analyse the impact of firm-specific

factors on firm growth potential. Studies have found that the relationship between liquidity and firm growth may vary with the business cycle. Omoregie et al. (2019) found that liquidity and debt ratios are negatively correlated during recessions. This suggests that during economic downturns, companies with lower liquidity may be more likely to experience financial distress. In contrast, Amith and Gabriele (2017) examined a sample of 1905 manufacturing firms of India between 2010 and 2014 and according to the study's findings, the liquidity ratio is a significant predictor of firm growth, suggesting that a better liquidity position can reflect higher growth and lower the probability of default.

Berman (2008) discusses profitability ratios as financial metrics used to evaluate a company's ability to generate earnings, profits, and cash flows relative to its sales, assets, and equity. He emphasizes that profitability ratios provide valuable insights into a company's financial health and performance, highlighting how effectively its profitability is being managed. According to several theoretical studies, firm profitability is a significant factor in determining firm growth (Anton (2016); Demirguc-Kunt and Maksimovic (1998). Robu et al., (2023) studied the effect of profitability on firm growth in a sample of Romanian non-financial firms listed on the Bucharest Stock Exchange and found a positive relationship between ROA and firm growth, suggesting that firm growth in Romania is financed by increasing firm profitability.

Zhang et al. (2017) found that the relationship between financial leverage and firm growth is mediated by financial health. In other words, financial leverage can only have a positive impact on firm growth if the company has strong financial health.. In contrast, Pouraghajan et al. (2012) identified a positive correlation between financial leverage and firm performance in their study. Aivazian et al. (2005) delved into the influence of financial leverage on investment within the context of Canadian companies. Their research indicated a negative effect of financial leverage on investment, with this relationship being more pronounced in companies characterized by lower growth rates, as measured by Tobin's Q.

Bartram et al. (2012) conducted a study to explore the influences of conflicts at both the firm and country levels on the determination of corporate payout poli-

cies. Their research, which involved a substantial dataset comprising 29,610 firms across 43 countries from 2001 to 2006, revealed an inverse relationship between dividend payout and a firm's growth. However, Rozeff (1982) and Bartram et al. (2012) suggested that increasing payout ratios could potentially mitigate agency costs. The body of evidence linking a firm's historical growth and its dividend policy, with the additional factor of agency costs impacting this relationship (Amidu & Abor, 2006; Borokhovich et al., 2005; Skinner & Soltes, 2009), implies that dividend policies may have a bearing on firm growth. The extent of this contribution, however, is contingent upon the presence and magnitude of agency conflicts, whether at the firm-level or within the broader context of the country's regulatory framework (Bartram et al., 2012; La Porta et al., 2000).

Investment decisions represent one of the variables that exhibit a strong and direct relationship with a firm's growth, particularly when assessed in terms of sales expansion. Eldomiaty et al. (2019), show that the investment exerts a positive influence on firm growth. New entrants) seems to be unimportance for the non-acceptance of the randomness of growth. Kayo and Kimura (2011), show that firms often share common characteristics when operating within a specific industry. The inherent structural attributes of an industry naturally impose constraints on the behaviors, encompassing strategies and conduct, of its constituent firms. These constraints, in turn, give rise to industry-specific performance disparities among these firms, as elucidated by Mason (1939). In this conceptual framework, the predominant rationale for elucidating variations in a firm's profitability and, consequently, its growth, is attributed to the industry structure within which the firm is situated, as noted by Hawawini et al. (2002). Thus, in this study industry is used as a control variable.

3- Data and methodology

A complete profile of the methodology that is followed in this paper includes the research hypotheses, the method of data collection, the sampling design, the statistical analysis, the dependent and independent variables used in the research and the econometrics model specifications used to test the research hypotheses are presented.

3-1 Research hypotheses

H1: There is a positive relationship between Liquidity Ratios and Firm Growth.

H2: There is a positive relationship between Leverage Ratios and Firm Growth.

H3: There is a positive relationship between Profitability Ratios and Firm Growth.

H4: There is a negative relationship between Dividend and Firm Growth.

3-2 Data and sample of the test

Data are obtained from the non-financial firm's financial statements published on Egyptian Stock Exchange financial database for the Egyptian firms listed in the Egyptian stock exchange. Corporate financial performance independent variables are obtained from the financial statements of the selected sample firms in the study including balance sheet, income statement, cash-flow statement. The study uses data collected for 11 years starting from 2010 to 2020 for 193 Non-Financial firms listed in Egypt Stock Exchange (Retrieved from https://www.egx.com. eg/en/listedstocks.aspx). The statistical tests include linearity versus non-linearity, Fixed and Random tests, Heteroskedasticity and General Linear Model.

3-3 Dependent variables

The dependent variable examined in this paper is the Growth of Fixed Assets.

3-4 Independent variables

The independent variables include the corporate financial performance indicators: liquidity ratios, profitability ratios, leverage ratios, and dividends ratios.

3-5 statistical tests

Regression analysis: regression analysis aims to select all the independent variables that are believed to have significant effect on the dependent variable to be included in the model. The mathematical representation to the model used to describe the relationship between the dependent variable and other independent variables depends on the nature of the dependent variable.

The Specification of the model in which corporate financial performance indicators of firm growth are examined in the following equation:

$$FG = \beta_0 + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3 + \beta_4 X_4 + \beta_5 X_5 + \beta_6 X_6 + \varepsilon_t$$

FG= growth potential as the 1st quartile of growth of fixed assets

β_1 to β_6= Coefficient of growth X_1= Firm leverage, X_2 = firm profitability, X_3 = Firm liquidity, X_4 = Dividends payout, and ε_t= Random error.

3-5-1 Descriptive Statistics

Table 1: Descriptive statistics such as mean, standard deviation, minimum, and maximum are presented for all the variables.

Variables	Minimum	Maximum	Mean	Std. Deviation
Growth Potential (1st quartile of growth of fixed assets)	0.0346	4.32	1.39	1.062
Inventory/Current Assets	8.01	17.92	0.721	0.728
Cash Ratio	0.719	1.99	0.1743	0.122
Long Term Debt/Total Assets	0.178	2.916	0.361	0.682
Total Debt / Fixed Assets	0.912	2.712	1.724	22.91
Net Operating Profits/Total Assets	-.0541	0.732	0.0156	0.0381
Return on Assets	-0.719	0.624	0.051	0.0381
Dividend Payout Ratio	0.00	28.213	0.731	7.45
Dividend Yield	0.00	63.77	0.1831	5.77

Table 2: The Results for the Linearity Test

Variable	N	F (3, 2123)	Prob>F
Firm Growth Potential	2123	8.21	0.00012

3-5-2 Hausman Test

The test is run under the hypotheses that follow. Ho: difference in coefficients not systematic; H1: difference in coefficients is systematic.

Table 3: The Results for The Hausman Test

Firm Growth Potential
$\chi^2(15) = 128.11$; Prob > $\chi^2 = 0.0000$

The results reported in table above show that the best model for fitting the data is the fixed effect model as the p-value associated with the test is less than 5%.

3-5-3 Multicollinearity Test (VIF test)

Table 4: The Results for the Multicollinearity Test

Variables	Firm Growth Potential
Inventory/Current Assets	2.232
Cash Ratio	2.114
Long Term Debt/Total Assets	2.425
Fixed Assets/Total Debt	2.271
Net Operating Profits/Total Assets	3.502
Return on Assets	3.338
Dividend Payout Ratio	3.270
Dividend Yield	2.936
Current Assets/ Fixed Assets	2.670
Fixed Assets / Total Assets	2.834
Age	3.371

4- Data Analysis and Discussion

This section discusses and analyzes the results of corporate financial performance indicators on Firm Growth Potential.

Table 5: The corporate financial performance Determinants of Firm Growth Potential

Category of Financial Performance	Independent Variables	Firm Growth Potential
Liquidity Indicators	Inventory/Current Assets	0.381 (4.63)**
	Cash Ratio	0.197 (0.751)
Leverage Indicators	Long-Term Debt/Total Assets	0.892 (4.21)***
	Total Debt / Fixed Assets	0.436 (8.22)***
Profitability Indicators	Net Operating Profits/Total Assets	0.289 (0.216)
	Return On Assets	0.072 (0.077)
Dividends Indicators	Dividend Payout Ratio	-0.0912 (-3.18)***
	Dividend Yield	0.0062 (0.891)
N	2123	
F stat (P-Value)	48.912 (0.00)	
DW	2.59	
$\overline{R}^2$	0.6321	

4-1 Liquidity Ratio and Firm Growth Potential

In table (5), after conducting the analysis, the results show that the relationship is positive at a 95% confidence level for the inventory-to-current assets ratio and show insignificance but positive relationship between cash ratio and firm growth. This means an increase in the inventory-to-current assets ratio leads to an increase in firm growth. The results are consistent with the findings of Amith and Gabriele (2017), who find that liquidity ratios have a positive and significant relationship with firm growth.

4-2 Leverage Ratios and Firm Growth Potential

With regards to the leverage ratio, there is a significantly positive relationship between leverage ratio (proxied by the long-term debt-to-total assets ratio and fixed assets-to-total debt ratio) and growth of firms at the 1% significance level. This result is consistent with Githire and Muturi (2015), that long-term debt has a positive and significant effect on financial performance and thus on firm growth. Furthermore, the total debt-to-fixed assets ratio shows a positive and significant relationship with the growth potential of the firms. The result is consistent with Brealey et al. (2008), who found that the positive relationship may also be seen as a reflection of the risk-reward tradeoff associated with leverage. Higher debt levels entail greater financial risk due to the obligation to service debt payments. However, this risk can incentivize firms to invest more efficiently and pursue growth opportunities that offer higher returns, thus contributing to overall firm growth.

4-3 profitability ratios and firm growth Potential

Table (5) shows that the profitability ratios proxied by Net Operating Profits-to-Total Assets and ROA have an insignificant relationship with firm growth of firms listed in Egypt Stock Exchange.

4-4 Dividends and Firm Growth Potential

A statistically significant inverse correlation exists between the dividend payout ratio and the growth of positively skewed firms at the 99% confidence level. In practical terms, a one-unit rise in the dividend payout ratio results in a corresponding decrease in the growth of firms by 0.02 units, holding other elements of the financial structure constant. This is consistent with results of Baker and Powell (2000), who shows that when a firm pays out a substantial portion of its earnings as dividends, it leaves less money available for reinvestment in the business. This can hinder the firm's ability to finance growth initiatives, such as research and development, acquisitions, or capital expenditures. As a result, firms with high dividend payout ratios may experience slower growth compared to those that retain more earnings for reinvestment. However, the dividends yield shows an insignificant relationship with firm growth.

4-5 Robustness Test

The authors examine the robustness of the results by dividing the data into two periods, namely from 2010-2015 and 2016 – 2020. The objective is to examine the extent of the coefficients' stability over time. The results are reported in table (6).

Table 6: Testing the Robustness of the Results over Time

Category of Financial Performance	Independent Variables	Firm Growth Potential (2010-2015)	Firm Growth Potential (2016-2020)
Liquidity Indicators	Inventory/Current Assets	0.072 (1.21)	0.81 (3.34) **
	Cash Ratio	0.019 (3.18)***	0.026 (3.15)***
Leverage Indicators	Long-Term Debt/Total Assets	0.813 (4.99) ***	0.491 (6.21) ***
	Total Debt / Fixed Assets	0.088 (5.44)***	-0.091 (-0.764)
Profitability Indicators	Net Operating Profits/Total Assets	0.983 (6.441)***	0.141 (6.053)***
	Return On Assets	-0.0434 (-0.066)	0.079 (0.031)
Dividends Indicators	Dividend Payout Ratio	-0.671 (-4.49)*	0.029 (0.9621)
	Dividend Yield	-0.821 (0.4626)	0.474 (0.9129)
N		1158	965
F stat (P-Value)		36.33 (0.00)	21.487 (0.00)
DW		2.01	2.33
$\bar{R}^2$		0.4107	0.56.63

The results in table (6) show that the robust determinants of firm growth potential are related only to liquidity (Cash ratio), debt financing (Long-Term Debt/Total Assets) and profitability (Net Operating Profits/Total Assets).

5- Conclusion

The paper provides several conclusions that may be drawn from the findings of this paper. This study examines the firm-specific financial determinants of growth potential. The Firm-specific financial determinants used are liquidity ratios, leverage ratios, profitability ratios, and dividends. Further, growth potential is measured by the fixed assets to total assets.

Categories of Financial Performance	Hypothesis
Liquidity Ratios	Positive
Leverage Ratios	Positive
Profitability Ratios	Positive
Dividends	Negative

This paper examines the relationship between financial ratios and growth potential. Notably, the inventory-to-current assets ratio exhibited a positive relationship with growth potential, signifying that an increase in this ratio corresponded to an increase in growth potential of firms. Similarly, the cash ratio displayed a positive but insignificant association with growth potential of firms. These findings align with prior research conducted by Amith and Gabriele (2017), who also discovered a positive and significant relationship between liquidity ratios and growth potential of firms.

The investigation revealed a significant and positive relationship between leverage ratios, proxied by the long-term debt-to-total assets ratio and fixed assets-to-total debt ratio, and the growth of firms. This relationship was observed at a 1% significance level, indicating that an increase in leverage was linked to higher growth potential of firms. These results corroborate the findings of Githire and Muturi (2015), who highlighted the positive and significant impact of long-term debt on financial performance and, by extension, on growth potential of firms. However, when it came to profitability ratios, specifically Net Operating Profits-to-Total Assets and ROA, the study found an insignificant relationship with growth potential of firms among companies listed in the Egyptian stock exchanges. Turning to dividends, a significant inverse correlation was uncovered between the dividend payout ratio and the growth of positively skewed firms. This negative relationship was statistically significant at the 99% confidence level.

In practical terms, a one-unit increase in the dividend payout ratio corresponded to a 0.02-unit decrease in growth potential of firms, holding all other financial structure elements constant. Notably, dividends yield showed an insignificant relationship with the growth potential of firms.

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