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Impact of Profitability, Leverage and Corporate Governance on Value Creation: Empirical Study of Saudi Real Estate Companies

Soumaya Hechmi[1*], Imen Ben Saanoun[2]

[1]Department of Finance, Imam Mohammad Ibn Saud Islamic University (IMSIU), Riyadh, Saudi Arabia
[2]Department of Finance, Shaqra University (SU), Riyadh, Saudi Arabia
Email: *sbhechmi@imamu.edu.sa, isaanoun@su.edu.sa

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Abstract

This study analyzes the impact of profitability (ROA), leverage (LEV) and corporate governance (DUAL and BS) on value creation of Real estate companies listed in the Saudi financial market (Tadawul). The study is carried out for the period 2015-2022. The panel data regression method is used to examine the impact of the aforementioned factors on value creation. Data consisting of a sample of 10 companies for the entire eight-year period represent the database for this study. Results obtained showed a strong significant positive relationship between leverage and board size on the one hand and value creation of a firm on the other hand. However, Profitability and CEO duality have a significant negative impact on value creation. Finally, firm size, as a control variable, negatively and significantly affects value creation. The findings are expected to have practical implications for directors and shareholders of firms operating in real estate sector and can help them in their decisions regarding financial performance and value creation.

Keywords

Value Creation, Profitability, Leverage, Corporate Governance

1. Introduction

Today, the value creation has become one of the concerns of finance. The question that arises is: why it is necessary to take value creation into consideration when evaluating the company?

Creating value is not just about satisfying shareholders. It is also the way to ensure the company's ability to ensure its sustainability and finance its growth.

The company will not be able to attract new capital if it destroys value.

The fundamental idea behind the different measures of value creation by a company is to say that a company creates value for its shareholders when the return on capital invested is greater than the cost of the different financing sources used or the cost of capital.

Value based management deploys around value creation indicators (EVA, economic profit, etc.) rigid systems and procedures whose objective is to supervise management decisions and partially remunerate managers based on compliance with financial rules imposed.

It is necessary to measure value, because the manager must maximize the value of the firm with the aim of creating value for shareholders and stakeholders (employees, state, customers, suppliers, creditors and society in general).

The goal of this study is to develop a factor-based model that may foretell a company's value creation.

The rest of the article is organized as follows. Section 2 reviews the relevant literature and presents the hypotheses of this study. Section 3 outlines the research methodology. Section 4 presents results and discusses them. Section 5 concludes.

2. Literature Review and Hypothesis Building

Creating value for the company means calculating a certain number of performance measurement indicators, while the latter should not go beyond the stage of a tool to help create value. But once we have measured these indicators and therefore the creation of value, have we done anything more or different to ensure that this value creation exists, is sustained and grows?

To do this, we must first transform value creation into a real tool for management, decision-making, action, in short, management that is both strategic and daily.

2.1. The Leverage

For Ross (1977), the financial structure of the firm can be a variable of signaling, on condition that we adopt a system of incentive and penalties leading to a balance. This system should be as the managers are encouraged to deliver good information.

They must be penalized when they seek to emit a false signal, i.e. when they emit a signal tending to the belief that the firm they manage is good whereas it is bad. On the other hand, if they say the truth, they must be rewarded.

Thus, the managers communicate the characteristics of their firm by the means of the firm structure.

H1: The leverage has a significant positive effect on value creation

2.2. The Profitability

Profitability value measures the company's ability to invest its assets to generate profits, and the more profitable the company is, the better the company's performance will be and thus its value will increase.

H2: Profitability has a significant positive effect on value creation

2.3. The Corporate Governance

Interest in the concept of corporate governance has increased as it is one of the means of controlling management behavior within companies in various countries of the world, and one of the most important means used to complete financial and administrative reform processes, and spare the company agency costs by enhancing the principles of disclosure, transparency, accountability, justice, and clarity, and defining the responsibilities and relationships of all parties clearly, which helps to better exploit the company's resources, thereby maximizing its market value.

H3: Corporate Governance has a significant positive effect on value creation

H3.1: The CEO Duality, as measure of Corporate Governance, has a significant positive effect on value creation

H3.2: The Board Size, as measure of Corporate Governance, has a significant positive effect on value creation

Although value creation is not a recent topic addressed by researchers, there is a literature gap in studying the mixed effect of profitability, financial leverage, and corporate governance on value creation. This paper will attempt to fill this gap and contribute to current knowledge by using a cross-sectional time series analysis methodology to identify the determinants of value creation in the Saudi real estate sector.

3. Research Methodology

This study aims to empirically test and prove the effect some factors on value creation. The independent variables in this study are profitability (ROA), leverage (LEV) and corporate governance (DUAL & BS). The dependent variable in this study is a company value creation, as measured by using the ratio of Tobin's Q. Control variable includes firm size (SIZE measured by Log Total assets). The study utilized a sample of public companies listed on Saudi stock exchange and operating on real estate sector from 2015-2022. This study used a panel data regression model to test the research hypothesis that the independent variables affect the dependent variable.

The model used in this study is as follows:

$$\text{Tobins Q}_{it} = a_0 + a_1\text{LEV}_{it} + a_2\text{ROA}_{it} + a_3\text{DUAL}_{it} + a_4\text{BS}_{it} + a_5\text{SIZE}_{it} + \varepsilon_{it}$$

Explanation:

Tobin's Q: Firm value creation

LEV: Leverage

ROA: Return on Assets as a measure of profitability

DUAL: is a dummy variable that takes the value 1 if the manager of the firm is at once a Chief Executive Officer and a chairman of the board, and 0 otherwise

BS: Board Size

SIZE: Firm Size

ε: error term

The conceptual framework for this research is as follows in Figure 1.

4. Result and Discussion

4.1. Descriptive Statistics

Based on Table 1, the average value of Tobin's Q is greater than the standard deviation. The highest or maximum value is 0.00304, which shows that the value of a company is more significant than its assets, and it shows the company's market value. LEV, DUAL, BS, and SIZE data are homogeneous because the mean values exceed the standard deviation. The highest ROA value is 13.08%. The lowest ROA value is −15.56% which is negative.

4.2. Panel Data Regression

According to results of fixed effects and random effects models in Table 2 and Table 3 and based on Table 4, the test statistic Hausman showed that the models were appropriate to model the panel data on research of this is to do with the approach Fixed Effect (Prob. Chi-Square < 5%).

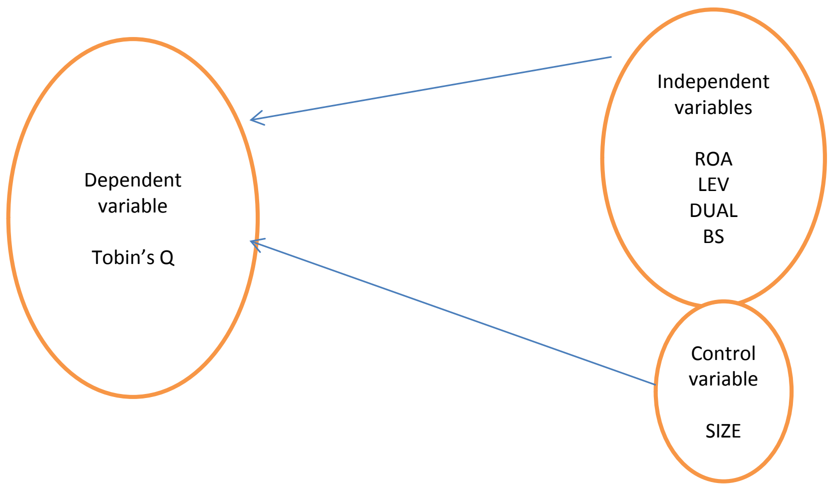

Figure 1. Conceptual framework, Source: Researcher own construct, 2023.

Table 1. Descriptive statistics.

	Min	Max	Mean	Std. Deviation
Tobin's Q	0	0.00304	0.00094	0.00064
ROA	−0.15555	0.13076	0.01601	0.05413
LEV	0.02018	2.01692	0.41049	0.34718
DUAL	0	1	0.55	0.50063
BS	8	12	9.825	1.28058
SIZE	13.76629	17.28005	15.65039	1.11745

Source: Proceed data by EViews 10.

Table 2. Fixed effects model results.

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	0.002859	0.001021	2.801115	0.0065*
LEV	0.005820	0.001557	3.738351	0.0004*
ROA	−0.002847	0.001229	−2.316538	0.0233**
DUAL	−0.0004280	0.000129	−3.317708	0.0014*
BS	0.000147	5.99E−05	2.455913	0.0164**
SIZE	−0.000212	6.79E−05	−3.121909	0.0026*

R-squared	0.384308	Mean dependent var	0.000626
Adjusted R-squared	0.342708	S.D. dependent var	0.000530
S.E. of regression	0.000430	Sum squared resid	1.37E−05
F-statistic	9.238008	Durbin-Watson stat	0.846280
Prob (F-statistic)	0.000001	Total panel observations	80

Source: Proceed data by EViews 10. *relationships are significant at $p < 1\%$; **relationships are significant at $p < 5\%$.

Table 3. Random effects model results.

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	0.006386	0.006706	0.952213	0.3445
LEV	0.004867	0.001897	2.565308	0.0126**
ROA	−0.001551	0.002032	−0.763507	0.4479
DUAL	−9.24E−05	0.000187	−0.494725	0.6225
BS	−6.30E−06	0.000119	−0.053184	0.9577
SIZE	−0.000352	0.000434	−0.810964	0.4203

R-squared	0.65626	Mean dependent var	0.000935
Adjusted R-squared	0.582224	S.D. dependent var	0.000638
S.E. of regression	0.000412	Sum squared resid	1.10E−05
F-statistic	8.864026	Durbin-Watson stat	0.976663
Prob (F-statistic)	0.00000	Total panel observations	80

Source: Proceed data by EViews 10. **relationships are significant at $p < 5\%$.

Table 4. Hausman test results.

Chi-Sq. Statistic: 11.570406	Prob.: 0.0412

Source: Proceed data by EViews 10.

4.3. Discussion

Based on Table 2, it can be seen that the leverage, significantly positively affects value creation, which indicates that increasing debt financing positively affects growth opportunities, which is consistent with the Pecking Order Theory given that the company resorts to financing its profitable investment projects using debt when internal financing sources are insufficient, and therefore the more investment opportunities available, the greater the company's need to use debt for financing. This is relevant to the research findings of Palupi (2023); Pham (2020) and Nguyen et al. (2020). On the other side, our results are inconsistent with the findings of Yuwono and Aurelia (2021); Al-Othman and Al-Samaraie (2022) and Kim and Yoon (2022). So, first hypothesis (H1) is accepted.

It can be seen that the profitability, measured by ROA, significantly negatively affects value creation. The lower the ROA, the better the company value. This may be due to the challenges witnessed by the Saudi real estate sector, which are represented by the large number of regulations and legislation that govern this sector, as it may be difficult for investors to understand the laws related to real estate investment and apply them correctly, in addition to the high environmental risks. Consequently, high risks, including high costs, may lead to the value destruction. This result is align with the finding of Kristianti and Foeh (2020) but it is different from Yuwono and Aurelia (2021). So, second hypothesis (H2) is rejected.

The coefficient of the DUAL variable indicates that the dual role of the CEO has a negative and significant effect on the value creation of the company. This may be due to the dual role of the CEO, although it limits the conflict of interests and opportunistic behaviors of management, it has deprived the boards of directors of sufficient knowledge of the company's affairs and the ability to respond to the rapid changes in the contemporary business environment. This means that whenever there is a separation between the positions of CEO and a chairman of the board, this leads to increasing the value of the company, where Duru et al. (2016) see that if the positions of Chairman of the board and CEO are separated, this will positively affect the value of the company, while Gill & Mathur (2011) see that combining the positions of the CEO and the Chairman of the Board has a positive impact on the value of the company because he speeds up the decision-making process and thus improves financial performance. The Sub-hypothesis (H3.1) is rejected.

The Board Size variable has a positive and significant relationship with value creation. This proves that increasing the number of members of the directors' board helps to increase the efficiency of the Board due to the diversity of members' experiences, thus improving the decision-making process and thus achieving an improvement in the performance and company value. Dalton et al. (1999) see that increasing the size of the directors' board provides a benefit to the company through the diversity of its members' experiences and their ability to deal with the surrounding environment better. Dwivedi and Jain (2005) also pointed out that increasing the size of the directors board enhances corporate governance, which leads to reducing agency costs and thus increasing the value of the company. So, the Sub-hypothesis (H3.2) is accepted.

Finally, firm size proved to have a significant negative effect on firm value. It means that the larger the company's size will be a bad signal to decrease its value. Doukas et al. (2000) see that large companies are more vulnerable to the agency problem than small companies, because of the difficulty that investors face in obtaining information about them. However, Berger et al. (2001) concluded that the agency problem increases in small companies due to the increasing problem of information asymmetry, given that large companies are subject to the control of shareholders and analysts and are less susceptible to the problem of information asymmetry. This result is relevant to the research findings of Kim and Yoon (2022). However, our results are inconsistent with the findings of Yuwono and Aurelia (2021); Palupi (2023) and Pham (2020). Ullah and Rahman (2022) found that the size has a significant negative effect on the financial performance of Islamic banks but this effect becomes positive for commercial banks.

5. Conclusion

This research's findings suggest a negative correlation between firm value creation and both the profitability, CEO duality and the firm size. Also, there is a positive correlation between firm value creation and both leverage and board size.

It is hoped that there will be implications for directors and shareholders to use this research in making decisions, primarily related to the necessity to increase the number of board members because of this positive impact on the diversity of board members' experiences and their making of appropriate investment decisions. Also, it is necessary to raising the level of financial leverage of real estate companies to achieve tax savings and solve the agency problem resulting from the separation between management and owners.

The recommendation for further research is to expand the area by applying the study to a number of sectors and years may allow the topic to be covered more broadly, in addition to the possibility of conducting a comparison between sectors to show the difference between them in terms of factors affecting value creation in companies in each sector.

Conflicts of Interest

The authors declare no conflicts of interest regarding the publication of this paper.

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