Capital Structure and Profitability of Nepalese Hotel Industry

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Abstract

Employing a descriptive and analytical quantitative research design, this study examines the influence of capital structure on the profitability of hotels in Nepal. The secondary data utilized in the research is obtained from the official websites of a limited number of hotels in Nepal. As independent variables, the Debt Ratio (DR), Short Term Debt Ratio (STDR), Liquidity Ratio (LR), and Firm Size (Size) are examined, while Return on Assets (ROA) and Return on Equity (ROE) are used as dependent variables. The relationship between these capital structure components and profitability metrics is analyzed using a multiple linear regression model. The study confirms the presumptions of the regression model as the residuals show homoscedasticity, independence and a normal distribution. Particularly the histogram of regression standardized residuals shows a bell-shaped curve, the Normal P-P Plot tightly aligns residuals with the diagonal line; and the scatterplot of residuals versus anticipated values shows a random distribution around the horizontal axis. These results validate the reliability and accuracy of the findings and support the use of linear regression in the research. Studies show that keeping the right balance between debt and equity may significantly increase a hotel's profitability. Larger companies may exploit their varied financial structures and have easier access to capital. The research contributes to the existing literature by offering practical insights for hotel managers and financial planners to make informed decisions about capital structure in order to achieve sustainable profitability and financial stability. It also provides empirical evidence from the Nepalese hotel industry.

Keywords: Debt Ratio, Firm Size, Liquidity Ratio, Return on Assets, Return on Equity, Short Term Debt Ratio

Introduction

The hotel business is vital to Nepal's GDP and jobs (Bhandari, 2019). This industry's development and profitability depend on understanding its financial dynamics. Leverage ratio has become a popular financial statistic. Leverage is when a firm borrows money to fund its assets. Thus, the leverage ratio measures how much debt a corporation employs to increase equity and earnings.

Leverage impacts company profitability in several ways. According to the Modigliani-Miller (1958) theorem, a leveraged enterprise may have the same value as an unleveraged one. It presupposes ideal capital markets, no taxes and no bankruptcy fees, which are unusual in practice. Interest tax shields, bankruptcy expenses and agency charges affect leverage and profitability (Jensen & Meckling, 1976).

Hotel operations are capital-intensive; thus, leverage is crucial. High leverage may improve equity returns if asset returns exceed borrowing expenses. However, excessive leverage increases financial risk, which may impair profitability, especially during economic downturns when revenues are unpredictable (Titman & Wessels, 1988). Given this dual effect, the appropriate leverage level that enhances profitability without compromising financial stability is critical.

The impact of leverage on profitability has shown inconsistent results in empirical research. Abor (2005) discovered that Ghanaian enterprises with more leverage are more profitable. However, Ebaid (2009) found a negative link among Egyptian enterprises, suggesting that high debt levels might hurt profitability. The differences in findings emphasize context-specific analysis. Tourism and hospitality investments have grown Nepal's hotel business. However, there is little empirical data on leverage and Nepali hotel profitability. This research analyzes Nepalese hotel leverage ratios and profitability measures to address this gap. This link is examined to determine optimum capital structure methods

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for the Nepalese hotel business, adding to academic research and practical financial management. This study examines that the leverage ratio affects hotel profitability in Nepalese hotel.

Review of Literature

Theoretical Review

The correlation between leverage and bottom-line results has been the subject of much investigation by academics in the field of corporate finance. According to the most fundamental theories of capital structure, such as the Modigliani-Miller theorem (1958), a company's capital structure does not affect its value under certain conditions of ideal markets. With no obstacles or resistance, this theorem essentially grasps the concept that leverage has no effect on a company's value. However, actual factors like agency concerns, bankruptcy costs, and taxes impact the interaction of these assumptions. According to the Trade-off Theory (Kraus & Litzenberger, 1973), businesses should prioritize the benefits of debt above the risks of a potential financial catastrophe. Leverage raises the likelihood of bankruptcy, which serves as a counterweight to the tax refuge that interest deductibility offers, which encourages corporations to use debt. The optimal leverage ratio is achieved when the monetary cost of financial issues is equal to the monetary gain of a tax shield. Myers and Majluf's (1984) Pecking Order Theory suggests that businesses prefer to finance themselves internally and only seek external loans when their internal resources are insufficient. Since it is more costly and has asymmetric knowledge, it stays away from issuing stocks. This theory implies that companies with lower leverage ratios are more successful ones with higher internal capital. Agency theory (Jensen & Meckling, 1976) introduces the concept of agency costs stemming from conflicts of interest between managers and shareholders. Limiting the free cash flow available to managers helps debt to function as a control mechanism lowering agency costs and maybe improving company performance. In the hotel industry, these theories provide a structure for examining the link between leverage and financial performance indicators such return on assets (ROA) and return on equity (ROE)……..

Empirical Review

Empirical research on leverage and financial performance shows variable outcomes due to different circumstances and methodology. Financial success is positively correlated with leverage in many research. Greater leverage was linked to greater ROE in Ghanaian enterprises (Abor, 2005). This demonstrates that, during prosperous times, leverage could increase shareholders' returns on equity. According to several studies, using too much leverage could impair your financial results (Ebaid, 2009), Egyptian businesses' ROA and ROE suffer when their debt levels are higher. This indicates that leverage may be neutralized by substantial debt expenditures like interest payments and financial troubles.

Return on Assets (ROA)

Its ROA reflects the company's earnings related to total assets. It assesses a company's asset management efficiency to make profits. In Ghanaian firms, leverage boosted ROA, suggesting that debt management may enhance asset usage and profitability (Hongli, Ajorsu & Bakpa, 2019). Ebaid (2009) identified a negative association between leverage and ROA in Egypt, showing that financial stress and interest requirements may affect asset efficiency and profitability. Salim and Yadav (2012) found that Malaysian enterprises' ROA decreased when debt ratios climbed, emphasizing the hazards of over debt. Akinlo and Asaolu (2012) revealed that Nigerian companies were inefficient with assets and unprofitable as they borrowed more.

Return on Equity (ROE)

This variable identifies the company's performance by showing shareholder profits. Measurement of leverage's influence on firm performance is crucial. Abor (2005) found that leverage may enhance shareholder returns in Ghanaian enterprises. ROE shows shareholder investment gains. Leverage has been shown by Abor (2005) to increase shareholder returns in Ghanaian firms. Return on Equity (ROE) measures the profit of shareholder investment in a company. Without it, it is not feasible to

quantify the impact of leverage on business performance. Abor (2005) found that leverage might increase shareholder profits in Ghanaian companies. Ebaid (2009) revealed that leverage impacted ROE in Egyptian companies due to greater financial costs. Due to excessive leverage, Gill et al. (2011) found that American companies with higher debt equity ratios had worse ROE. Chen et al. (2014) found that high debt equity ratios hurt Chinese companies' ROE, demonstrating the negative effects of excessive leverage. Khadka (2017) found that debt management may increase commercial bank ROE by increasing leverage.

Debt to Total Assets ratio (DTA)

The Debt Ratio—a company's amount of debt-backed assets—has been widely examined. Abor (2005) and Ebaid (2009) found corporate performance affected. Ghanaian companies with greater debt were more lucrative (Abor, 2005). In contrast, Ebaid (2009) found a negative correlation between Egyptian firms' debt ratio and profitability, underscoring the consequences of heavy debt. Salim and Yadav (2012) found that Malaysian enterprises' debt ratios negatively affected ROA but positively affected ROE, reflecting leverage dynamics. Akinlo and Asaolu (2012) discovered a negative association between debt ratio and financial performance in Nigerian enterprises, which affected return on assets. After studying Pakistani manufacturing enterprises, Sheikh and Wang (2013) identified a negative link between profitability and debt levels.

Short Term Debt Ratio (STDR)

The short-term debt to total assets ratio is crucial for understanding a firm's liquidity and financial risk. Myers (1977) emphasized the importance of balancing short-term and long-term debt to manage financial risk. Shrestha and Dhungana (2021) found that higher short-term debt ratios in Nepalese firms increase financial risk and liquidity issues. Johnson (1997) observed that U.S. companies with higher short-term debt ratios tend to have lower profitability due to higher interest burdens and refinancing risks. Similarly, Titman and Wessels (1988) reported that firms with higher short-term debt ratios face greater financial distress, impacting profitability.

Liquidity Ratio (LR)

Without factoring a company's liquidity ratio—that is, the ratio of current assets to short-term liabilities—evaluating its financial situation and profitability becomes difficult. Research indicates that liquidity ratios clearly correspond with company success. Studies showing improved corporate performance to higher liquidity ratios indicate that businesses with effective liquidity management are more likely to have a strong financial basis (Smith & Begemann, 1997). Analyzing Indian industrial companies' liquidity ratios, Barua and Mahanty (2020) discovered that corporate profitability was rising. One may also see this link in the Nepalese situation. Examining the financial situation of Nepalese commercial banks, Acharya and Shrestha (2019) found a strong correlation between profitability and liquidity metrics. They came to the conclusion that good liquidity management improves financial performance of a business. This is so because companies could satisfy their immediate needs without sacrificing earnings. These results clearly show that a steady liquidity ratio is a necessary component of any workable capital structure. Long-term financial success depends on prudent liquidity management as it allows companies to maximise their capital structure and preserve a good profit margin.

Firm Size

Financial leverage has computed from the total assets of a corporation, which shows the proportion of equity financing its assets. Titman and Wessels (1988) have indicated that organizations with larger total asset outperformed their rivals; consequently, lowered leverage improves financial performance. Chen and Strange (2005) noted the benefits of equity financing when they discovered a strong relationship between the total assets and profitability in Chinese companies. Higher total asset of UK businesses—especially in stable sectors to be more successful (Baum et al., 2007). Higher total asset US businesses were more lucrative therefore proving the benefits of a solid equity basis (Hovakimian et al., 2001).

This research will examine how leverage ratios impact Nepal's hotel business's financial performance, focusing on ROA and ROE, by reviewing prior studies. This study will help the Nepali hotel sector choose capital structure and financial management methods.

Research Methodology

This research endeavors to examine how leverage effects on the financial performance of Nepalese hotel industry, Solti hotel limited (SHL), Taragaon regency hotel limited (TRH) and Oriental hotel limited (OHL) are traded on the Nepal Stock Exchange (NEPSE). The study has employed a quantitative research design that is both descriptive and analytical, drawing on secondary data collected from sample companies' websites. The sample only includes three of the four hotels Soliti Hotel, Oriental Hotel and Taragaon Regency Hotel from 2014 to 2023, a full decade of data is available that are listed on NEPSE and excluded City Hotel because of data unavailable. The independent variables have been studied Debt to Total Assets Ratio, Short-term Debt to total assets ratio, Liquidity ratio and Total Assets for the firm size. Liquidity ratio and total assets as firm size are taken as control variables. The Return on Assets (ROA) and Return on Equity (ROE) are the dependent variables under consideration. In descriptive analysis, statistical metrics such as minimum, maximum, mean, standard deviation, and correlation coefficients are generated to offer an overview of data distribution and variable correlations.

Regression analysis is used to determine the effect of leverage on ROA and ROE. Two distinct regression models are created, one for ROA and one for ROE, both integrating the previously specified independent variables. The study's extensive research approach attempts to explicate the link between leverage and financial performance in Nepal's hotel business, giving significant insights for sector stakeholders.

Regression model for Return on Assets (ROA):

$$ROA= \alpha +\beta_1 DR+\beta_2 STDR+\beta_3 LR+\beta_4 LnTA +\varepsilon_t \dots \dots \dots \dots \text{(i)}$$

Regression model for Return on Equity (ROE):

$$ROE= \alpha + \beta_1 DR+\beta_2 STDR+\beta_3 LR+\beta_4 LnTA +\varepsilon_t \dots \dots \dots \text{(ii)}$$

ROA= Return on Assets

ROE= Return on Equity

α =Intercept term

ε_t = Error Term

β_1, β_2, β_3, β_4: Coefficients of the independent variables

Result and Discussion

Descriptive Analysis

Table 1

Descriptive Statistics

	Minimum	Maximum	Mean	Std. Deviation	Skewness	Kurtosis
ROA%	-0.644	19.626	8.538	5.165	0.388	-0.191
ROE%	-1.252	26.347	12.750	6.971	0.031	-0.234
DR	18.549	49.767	34.641	7.884	0.306	-0.194
STDR	11.543	28.609	20.107	4.658	-0.114	-0.523
Total Assets	1329065816	5731923033	2977612761	827267148.7	0.972	4.405
LR	0.665	2.749	1.623	0.534	0.039	-0.436

The descriptive statistics table 1 highlights key financial metrics for hotels in Nepal. The ROA has a mean of 8.538 with moderate variability and a slight positive skew. The ROE averages 12.750, showing significant variability and an almost symmetric distribution. The Debt Ratio (DR) averages 34.641%, while the Short-term Debt Ratio (STDR) is 20.107%, both with moderate variability and

slight skewness. Total Assets have a high mean of approximately 2.978 billion and positively skewed distribution. The Liquidity Ratio (LR) averages 1.623, with moderate variability and an almost symmetric distribution. Overall, the metrics display varying degrees of skewness and kurtosis, suggesting generally close-to-normal distributions with some deviations.

Correlation Analysis

Table 2

Correlation Analysis

		ROA	DR	STDR	LR	LnTA
ROA	Pearson Correlation	1				
DR	Pearson Correlation	-.663**	1			
STDR	Pearson Correlation	0.068	0.036	1		
LR	Pearson Correlation	0.315	-.602**	-0.275	1	
LnTA	Pearson Correlation	-.485*	0.34	-0.112	-0.288	1

		ROE	DR	STDR	LR	LnTA
ROE	Pearson Correlation	1				
DR	Pearson Correlation	-.561**	1			
STDR	Pearson Correlation	.093	0.036	1		
LR	Pearson Correlation	0.25	-.602**	-0.275	1	
LnTA	Pearson Correlation	-.486*	0.34	-0.112	-0.288	1

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

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

The correlation reveals significant relationships among the variables. For ROA (Return on Assets), this study shows a strong negative association of Debt Ratio (DR) ($r = -0.663$, $p < .01$), denoted that higher debt ratios are link with lower returns on assets. This indicates that increased debt reduces a company's profitability. Additionally, there is a moderate negative correlation between ROA and Total Assets (LnTA) ($r = -.485$, $p < 0.05$), suggesting that larger asset bases are linked to lower returns on assets. This implies that businesses lose their efficiency in producing profits from their assets as they become bigger. Other variables, such as Short-term Debt Ratio (STDR) and Liquidity Ratio (LR), show no significant correlations with ROA.

For ROE (Return on Equity), similar patterns emerge. This is a significantly negative link of Debt Ratio (DR) ($r = -.561$, $p < .01$), showing that more debt levels are stated with lower equity returns. Total Assets (LnTA) also negatively correlates with ROE ($r = -.486$, $p < .05$), indicating that larger hotels tend to have lower returns on equity. Again, STDR and LR show no significant correlation with ROE.

These results highlight that higher debt levels and larger asset bases are detrimental to profitability, as measured by both ROA and ROE, in the hotel industry in Nepal. The significant correlations indicate areas where financial strategies could be adjusted to improve profitability.Regression Analysis

Table 3

Coefficients

Model		Unstandardized Coefficients		Standardized Coefficients			Collinearity Statistics	
		B	Std. Error	β	t value	P value	Tolerance	VIF
1	(Constant)	2.15	0.951		2.26	.035		
	DR	-0.005	0.002	-0.547	-2.578	.018	0.597	1.675
	STDR	0	0.003	0.027	0.151	.881	0.869	1.15
	LnTA	-0.084	0.043	-0.347	-1.946	.065	0.846	1.182
	LR	-0.022	0.029	-0.172	-0.783	.443	0.558	1.792
		R^2 = .435, F value = 4.045, P value = .014						
Dependent Variable: ROE								
2	(Constant)	1.457	0.64		2.275	.033		
	DR	-0.004	0.001	-0.659	-3.417	.003	0.597	1.675
	STDR	0	0.002	0.012	0.072	.943	0.869	1.15
	LnTA	-0.055	0.029	-0.307	-1.897	.072	0.846	1.182
	LR	-0.016	0.019	-0.166	-0.834	.414	0.558	1.792
		R^2 = .534, F value = 6.012, P value = .002						

Dependent Variable: ROA

The first regression model examines the impact of various predictors (Liquidity Ratio, Short-term Debt Ratio, Total Assets, and Debt Ratio) on Return on Equity (ROE). The model summary indicates an R Square of 0.435, meaning that approximately 43.5% of the variability in ROE can be explained by these predictors. The ANOVA table shows that the model is significant (F = 4.045, p = .014), indicating a good fit. Among the predictors, the Debt Ratio (DR) has a significant negative impact on ROE (B = -0.005, p = .018) and Total Assets (LnTA) shows a marginally significant negative effect (B = -0.084, p = .065). The other variables, Short-term Debt Ratio (STDR) and Liquidity Ratio (LR), do not significantly affect ROE. A one-unit increase in the Debt Ratio results in a 0.005 unit decrease in ROE, while a one percent increase in Total Assets reduces ROE by 0.084 percent. ROE has no significant change from the Short-term Debt Ratio or Liquidity Ratio.

The second regression model analyzes the effect of the same predictors on Return on Assets (ROA). This model has an R Square of 0.534, suggesting that 53.4% of the variability in ROA is explained by the predictors. The model is also significant (F = 6.012, p = 0.002), demonstrating a strong fit. In this model, the Debt Ratio (DR) again shows a significant negative relationship with ROA (B = -0.004, p = 0.003). Total Assets (LnTA) also negatively impacts ROA, with marginal significance (B = -0.055, p = 0.072). The other predictors, Short-term Debt Ratio (STDR) and Liquidity Ratio (LR), are not significantly associated with ROA. A one-unit increase in the Debt Ratio results in a 0.004-unit decrease in ROA, while a one-percent increase in Total Assets reduces ROA by 0.055 percent. ROA has no significant change from the Short-term Debt Ratio or Liquidity Ratio.

Normality Test

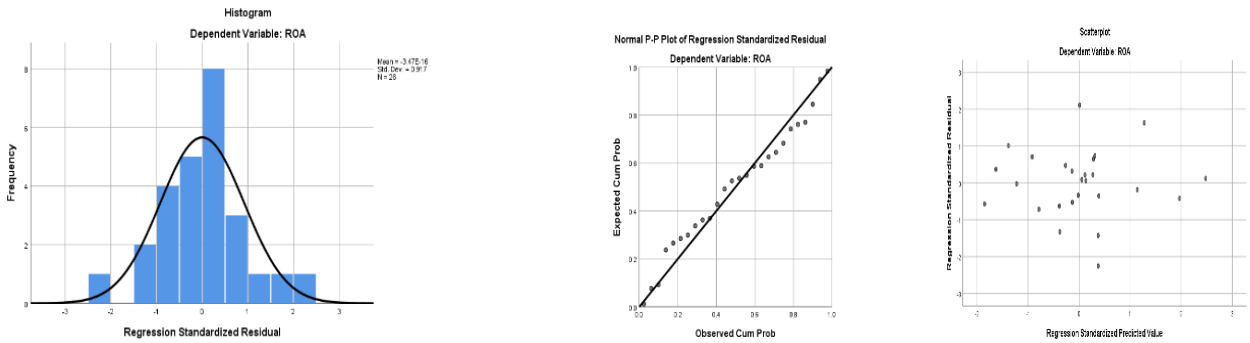

Figure 1: Histogram, P-P Plot and Scatter Plot

The normality assumption for regression analysis in this study on the impact of capital structure on profitability in Nepalese hotels is validated by three graphs. The histogram of regression standardized residuals shows a bell-shaped curve, indicating normal distribution. The Normal P-P Plot of residuals aligns closely with the diagonal, confirming normality. The scatterplot of residuals versus predicted values shows a random distribution around the horizontal axis, indicating independence and homoscedasticity. These tests collectively confirm that the residuals meet key assumptions, validating the use of a linear regression model for your analysis.

Residual Diagnosis

Residual diagnostics and multicollinearity analysis were conducted in this study. The residuals for both ROA and ROE models are symmetrically distributed around zero, with studentized deleted residuals ranging from -2.743 to 2.728 for ROA and -2.618 to 2.591 for ROE, both within the acceptable threshold of ±3, indicating no significant outliers. Cook's Distance values, which range from 0 to 0.403 for ROA and 0 to 0.298 for ROE, are below the threshold of 1, suggesting no undue influence from individual observations. Leverage values, ranging from 0.01 to 0.377 for both models, show no data points disproportionately affecting the results (Fox & Weisberg, 2018). VIF values for all predictors are below the threshold of 5, confirming no significant multicollinearity issues (Hair, Anderson, Babin, & Black, 2019). These results support the validity and robustness of the regression models.

Discussion

The regression analysis reveals that the Debt Ratio (DR) has a significantly negative impact on firm performance, evidenced by a $\beta = -0.659$, $p = .003$. This aligns with Abor (2005), Ebaid (2009) and Saeedi and Mahmoodi (2011), who found that higher debt ratios reduce profitability. With a $\beta = 0.012$, $p = .943$, the Short-Term Debt Ratio (STDR) has a minor impact, in accordance with Myers (1984) and Titman and Wessels (1988). According to Baum et al. (2007) and Hovakimian et al. (2001), there is a somewhat minor negative influence on the Total Assets (LnTA) (β -0.307, $p=.072$). Gill et al. (2010) and Rahman et al. (2019) support the Liquidity Ratio ($\beta = -0.166$, $p = .414$) little influence.

Conclusion and Implications

Conclusion

The research work found that the Debt Rati had a negative impact on corporate performance as evaluated by ROA and ROE and greater levels of debt were associated with worse profitability in Nepalese hotels. The results are consistent with prior studies showing that heavy debt has a negative influence on financial outcomes (Abor, 2005; Ebaid, 2009; Saeedi & Mahmoodi, 2011). Baum et al. (2007) and Hovakimian et al. (2001) identified that LnTA affects profitability marginally, indicating inefficiencies as enterprises grow. However, according to the Pecking Order Theory (Myers, 1984; Titman & Wessels, 1988), the Short-Term Debt Ratio (STDR) has no discernable influence on ROA and ROE. According to Rahman et al. (2019) and Gill et al. (2010), there was little to no effect on the Liquidity Ratio (LR). Overall, the data show that hotels are impossible to increase their profitability without rigorous financial management and an optimum capital structure.

Implications

Financial planners and hotel managers may benefit greatly from the practical insights provided by the study. Making better strategic financial choices, including maximizing the ratio of debt to equity to increase profitability, is made possible by an understanding of the link between capital structure and profitability. This research also emphasizes how crucial it is to have a proper balance between short- and long-term debts in order to successfully manage financial risk. The aforementioned implications have the potential to inform financial strategies that strive for sustainable economic development and performance, ultimately bolstering the financial stability and prosperity of Nepal's hotel industry.

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