

Extent of Derivative Usage, Firm Value and Risk: An Empirical Study on Pakistan Non-Financial Firms

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Abstract : Growing liberalisation and intense market competition increase firm's risk exposure and induce corporations to use derivatives extensively as a risk management instrument, which results in decrease in firm's risk, and increase in value. Present study contributes towards existing literature by providing an in-depth analysis regarding the effect of extent of derivative usage on firm's risk and value by using panel data models and seemingly unrelated regression technique. New evidence is established in current literature by dividing the sample data based on firm's Exchange Rate (ER) and Interest Rate (IR) exposure. Analysis is performed for the effect of extent of derivative usage on firm's risk and value and its variation with respect to the ER and IR exposure. Sample data consists of 166 Pakistani firms listed on Pakistan stock exchange for the period of 2004-2010. Results show that extensive usage of derivative instruments significantly increases firm value and reduces firm's risk. Furthermore, comprehensive analysis depicts that Pakistani corporations having higher exchange rate exposure, with respect to foreign sales, and higher interest rate exposure, on the basis of industry adjusted leverage, have higher firm value and lower risk. Findings from seemingly unrelated regression also provide robustness to results obtained through panel data analysis. Study also highlights the role of derivative usage as a risk management instrument in high and low ER and IR risk and helps practitioners in understanding how value increasing effect of extent of derivative usage varies with the intensity of firm's risk exposure.

Keywords : extent of derivative usage, firm value, risk, Pakistan, non-financial firms

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