

MACROECONOMICS AND FIRM-LEVEL DETERMINANTS OF MARKET TO BOOK RATIO: EVIDENCE FROM PAKISTAN TEXTILE INDUSTRY

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ABSTRACT

This research aims at assessing the determinants of the M/B ratio of eighty textile firms in Pakistan collected from 2011 to 2020, giving a total of 800 observations. Specifically, conforming to a theoretical base and employing four empirical strategies, including Ordinary Least Squares (OLS), Fixed Effect (FE), Random Effect (RE), the study identifies both firm and macroeconomic factors influencing the M/B ratio. Further, the findings establish that there is an inflation regime which is positively and significantly associated with the M/B ratio; systematic risk (beta) has a positive influence on the M/B ratio; interest rates have a negative influence on the M/B and leverage also appears to have a negative effect on the M/B. On the other hand, we do not have evidence that firm growth proxied by GDP, firm age and profitability having any impact on market valuation, Thus as is evident firm specific and macroeconomic factors may not impact firm's market valuation in the same way. This study highlights the significance of applying panel data regression analysis in establishing the changes over time and cross-sectional ones when analyzing the M/B ratio. This research contributes information and insights to investors, managers and policymakers about the state of value investing and ways in which strategies for valuing equities should be better suited in relation to macroeconomic factors and firm characteristics. Therefore, this work extends the knowledge of firm valuation in emerging markets especially the textile industry by questioning dominant theories that assume firms focus on profits and maturity.

Keywords: Firm performance, Inflation, GDP growth rate, Interest Rate.

INTRODUCTION

Firm performance refers to a complex construct which depends on a combination of micro and macro factors. Elements like leadership, the quality of its products, culture, and business efficiency are the microeconomic factors of a firm that has close relations with the firm's capabilities to adjust with the dissimilar environments (Broadstock et al., 2011;

Adidu & Olanye, 2006). On the other hand, inflation, interest rate, GDP, growth rate and the government policies among others are factors that exist beyond the control of the firm. The external factors many a time poses threats and opportunities that define the general flow of business performance (Adidu & Olanye, 2006). Uniquely understanding the complex

relationships of these micro and macro factors is important for firms to continue competitive and maintain development.

It will also be seen that the distinction between micro and macro factors is especially clear during economic transformations. A noble example of these shocks is the 2007/2008 Global Economic Crisis and regional shocks such as the case of Africa have revealed how firms are susceptible to macroeconomic shocks (Issah & Antwi, 2017). In many developing economies macroeconomic factors are even more influential because of structural issues such as instability in the exchange rate, high levels of inflation, and inconsistencies in policy regimes (Zeitun et al., 2007). Nonetheless, the resource-based view (RBV) pays significant attention to the internal resources, including human capital, organizational capabilities, and tangible resources as sources allowing firms to cope with external volatility (Barney, 1991; Denizel & Özdemir, 2006). Organization's internal competencies and external forces on which they operate business activity are two cornerstones to analyse corporate performance enhancers.

The market-to-book (M/B) ratio is one of the most common measures for firm valuation, and through the lens of this measure, we examine firms' responses to internal and external conditions. This ratio provides the investors with the perception ratio between the prospects of growth and Book value of a firm. According to prior research, macroeconomic variables such as inflation, interest rate and GDP are strongly related to the M/B ratio due to the effects they have on investors' expectation and firm operating outlook (Mohd & Siddiqui, 2020). At the same time, internal factors include firm age, leverage, and profitability take significant roles on the firm value and market performance (Kuntluru et al., 2008; Pavelková & Knápková, 2009). However, the level and type of these influences differ from case to case, and from industry to industry and from region to region, requiring further investigation of their interactions.

Textiles are one of Pakistan's most important industries and the largest source of export income: about 60% of total exports are textiles; 40% plus of the industrial labor force. This segment includes cotton ginning, spinning, weaving, apparel and home textiles which take advantages of Pakistan as fifth

largest producer of cotton internationally. That is why it is not only of significant importance to study the industry in terms of purely economic indicators, but also because the main result of the activity of these companies is the fight against poverty and the development of rural areas due to employment. But, the textile industry has many problems such as; outdated infrastructure, energy crises, high cost of production which makes the textile sector an insignificant competitor internationally. Volatility of the exchange rate, inflation and other inconsistent fiscal policies make these challenges worse at the macroeconomic level. variations in the exchange rate for example, make the cost of imported machinery and raw materials to be high, and inflation decreases the overall profit made by organization since costs have risen. Nevertheless, the sector is hurdled by certain barriers which is a preferential trade that allows the sector to gain duty free market access to Europe. However, to ensure continued operation and remain profitable the industry requires reinventing its process, embrace sustainable practices and conform to international best practice.

This work aims to examine the M/B ratio with reference to macroeconomic factors such as inflation rate, interest rate, and economic growth while using microeconomic parameters such as firm age, leverage and firm profitability. In this vein, the present study identifies those factors in a Pakistani setting in order to highlight how all these factors jointly contribute to firm performance in a developing country context. The factors that made Pakistan relevant include that it is in the developing country era; it is mainly relying on sectors like textiles that involve high contribution to the GDP and employment; the problems of energy shortages, high production cost, and heavy destined external trade continue to haunt Pakistan.

1.1 Significance of the Study

This research on macro and micro antecedents of performance has great emphasis in developing countries. Previous studies identify the internal factors that influence performance, including operational efficiency and leverage ratios as imperative determinants of performance (Barney, 1991; Kuntluru, Wang, & Zhou, 2008). Also, micro factors that influence the overall price of firms and overall market activity include; inflation rates,

interest rates, and GDP growth rates (Robson, 1996; Zeitun et al., 2007). Analyze the relationship between these factors is vital for policymakers, investors, and managers at the company level to get the approaches that will build firm robustness and flexibility.

Although a lot of work has investigated the effects of macroeconomic variables on the performance of firms, few studies have examined the interaction of internal and external factors within the context of Pakistan. This gap is especially evident in industries such as the textiles industry where global factors as well as local factors have significant influence in the industry performance. In this regard, the study fills a research gap in the understanding of corporate finance and performance in the context of emerging Asian markets as well as sheds light on the antecedents of the overall firm valuation.

1.2 Research Objectives

Therefore, the primary purpose of the present research is to investigate core macroeconomic and microeconomic variables with the M/B ratio of firms listed in Pakistan. Specifically, the study aims to:

1. Determining inflation, interest rates, and GDP, the efficiency of firm valuation.
2. Assess how elements like firm age, leverage, and profitability, internal to the firms affects the given M/B ratio.
3. Give the values of these variables in the manufacturing sector, especially the textile sector, so as to know how they counterpoint in a high VOGM but unfavorable environment.

By so doing, the study aims at creating awareness to the stakeholders regarding the drivers of the firm performance and give guidance on how to sharpen competitiveness in developing economies. It is therefore expected that the study findings will have implications on policy formulation, investment decisions, and strategic management which will add value in the existing literature concerning corporate performance in emerging markets.

1. Review of Literature

Efficiency of firm performance has been a major focus of financial research and understanding its determinants are crucial. The economic factors such as the growth rate in Gross Domestic Product, the rate of interest and inflation affect the operations of

businesses, as do other aspects relating to the firm such as its size, leverage and profitability. The influences of macroeconomic factors are presented in this article through a review of prior empirical research to present an understanding of the interactions between the macroeconomic factors, firm characteristic, and performance measures. This research study sought to examine the effects of macroeconomic factors on Firm performance. Several papers underline the importance of macroeconomic factors in firm performance. Issah and Antwi (2017) used the following factors crucial for the UK context, including unemployment, real GDP, and exchange rates. Analyzing their research, the authors found out the adjusted R² value of 0.91, which points at a high predictive ability of these variables. According to Mwangi and Wekesa (2017) the interest rates and taxation had a positive effect on the operation of Kenya Airways. For instance, Kiganda (2014) noted that gdp, inflation and exchange rate showed no relatedness with the measure of profitability for Equity Bank Ltd, Kenya.

There are works, where researchers use both, macroeconomic and firm level variables to determine their impact on performance. For example, Rani and Zergaw (2017) studied the impact of capital adequacy and management efficiencies on Ethiopian banks and realized macroeconomic variables have positive but statistically insignificant relations. Similarly, Ghareli and Mohammadi found that exchange rates, interest rates and leverage had positive significant impact on Iranian firms while GDP and inflation had both insignificant positive and negative impact. These findings are supported by evidence from Pakistan. The correlation between inflation, economic growth, as well as the mechanization variables such as liquidity and debts for performance was another finding by Mirza and Javed (2013). Similarly Kanwal and Nadeem (2013) revealed that interest rate appeared sensitive and determining tool in banking performance for public commercial while inflation was the negative factor affecting the performance.

This is an important area of study because information about the influence of the characteristics of firms on the performance of firms is always very useful especially to the firms themselves. Industry type and its characteristics also affect the

performance indicators, as well as the characteristics of the firm. Dioha et al. (2018) studied 18 Nigerian consumer goods firms, among which firm size, sales growth, and leverage affected only the profitability and the non-performance indicators of age and liquidity had no significant impact on them. This was also supported by Lasisi et al., 2017, who also validated that liquidity and sales growth were significant for Nigerian agricultural firms while leverage was negative. In general, the importance of the influence of firm size is widely recognised. Mohammed and Usman (2016) had affirmed the significant correlation between firm size, leverage, growth and profitability using sample of Nigerian pharmaceutical firms. On the other hand, Bhutta and Hasan (2013) observed an insignificant negative relationship between size and profitability in the food sector in Pakistan, and insisted on industry differences. Scholars on insurance firms also red for many years and cross-country the leverage growth and size. Sambasivam and Ayele (2013) found performance significance of these factors in insurance firms operating in Ethiopia and similarly Sumaira and Amjad (2013) for insurance industry of Pakistan.

The findings of prior empirical research illustrate that the macroeconomic environment and firm factors are

interconnected and show complex associations with performance consequences. Again, some factors such as interest rates and inflation rate have different impacts on different regions and industries while others have universal impacts on firms such as size of the firm, its level of leverage and growth prospects. Knowledge of these dynamics is remarkable for governing bodies as well as corporate managers in a way that will improve firm performance in different economic environments. This article synthesizes results from various studies, providing the reader with a systematic understanding of the sources of varied firm performance in distinct sectors and locations.

3.Data, Variables and Methodology

3.1 Data

This study aims to understand the factors influencing the market-to-book ratio in Pakistan's textile industry. OLS, Fixed Effects (FE), and Random Effects (RE) models are employed in the study, along with panel data regression analysis. 800 observations from 80 cross-sectional units representing different entities within the Pakistani textile industry are included in the panel data, which spans the years 2011 through 2020.

3.2.Variables and its measurement

Table 1 shows the variables and its measurement of the study.

Table 1: Variables and its measurement	
Variables	Measurement
Dependent variable	= (Total outstanding shares plus book equity) / (Total debt plus the number of outstanding shares at the last day of the fiscal year)
Market to book ratio (MBR)	
Independent variables	
Inflation (INF)	Data extracted from trading economies and the World Bank database.
Interest rates(INTR)	Data extracted from trading economies and the World Bank database.
GDP growth rates(GDPG)	Data extracted from trading economies and the World Bank database.
Firm age (AGE)	=Natural log of the years since the company was founded
Profitability(EBIT)	= EBIT/ Total assets
Beta (BETA)	Covariance of market and individual stock return) divided by variance (market return) is equal to β .
Leverage MDR	= (Total debt) divided by (Total debt plus price at the end of the fiscal year \times outstanding shares)

3.3 Estimation method

Panel estimating provides a strong framework for studying longitudinal data since it considers both time-series and cross-sectional variables. Ordinary Least Squares (OLS) regression is used to enhance the basic model to account for differences between businesses and time periods. Fixed effects regression improves the study by utilizing firm-specific fixed effects to identify within-firm differences over time and account for unobserved heterogeneity. Random effects regression, on the other hand, takes into account unobserved heterogeneity across companies

by presuming that firm-specific effects are uncorrelated with the independent variable. By accounting for both within-firm and between-firm changes across time, these methods provide a thorough approach to panel data analysis and provide insights into the connections between independent and dependent variables.

Following equation is used to estimate the impact of inflation, interest rates and GDP growth rates on firm performance.

$$MBR_{it} = \alpha + \beta_1 INF_{it} + \beta_2 INTR_{it} + \beta_3 GDPG_{it} + \beta_4 AGE_{it} + \beta_5 EBIT_{it} + \beta_6 BETA_{it} + \beta_7 MDR_{it} + \mu$$

4. Results and discussion

Table 2: Descriptive Statistics

Variable	Obs	Mean	Std. Dev.	Min	Max
MBR	800	0.983754	0.502422	0.501793	2.469812
INF	800	9.894	4.995728	3.77	20.29
GDPG	800	3.91	1.425988	0.4	5.5
INTR	800	10.075	3.100426	5.75	14.5
AGE	800	3.221396	0.472027	2.079442	3.931826
MDR	800	0.655546	0.26024	0.108376	0.965049
EBIT	800	0.092447	0.088566	-0.06804	0.284611
BETA	800	0.468975	0.475205	-0.15173	1.373876

Table 2 shows the descriptive statistics of the study. The mean market-to-book ratio is 0.98 for the textile sector of Pakistan. The average inflation rate is 9.89. The mean GDP growth rate is 3.92. average interest

rates during the study period are 10.07. The mean firm age is 3.22. The average leverage is 0.65. Profitability mean is 0.09. mean of Beta value of textile sector is 0.46.

Table3: Correlation Matrix

	MBR	INF	GDPG	INTR	AGE	MDR	EBIT	BETA
MBR	1							
INF	-0.05	1						
GDPG	0.110*	-0.36***	1					
INTR	-0.09**	0.94***	0.51***	1				
AGE	-0.03	0.21***	0.13***	-0.21***	1			
MDR	0.70***	0.19***	0.19***	0.213***	0.00	1		
EBIT	0.32***	0.15***	0.14***	0.239***	-0.14***	-0.43***	1	
BETA	0.15***	-0.08*	0.0611	-0.0637	-0.15***	-0.14***	0.08*	1

* $p < 0.05$, ** $p < 0.01$, *** $p < 0.001$

Table 3 shows the correlation matrix of the study. Correlation is a test to identify the multi-collinearity between variables. Market to book ratio is positively and significantly correlated with GDP growth rates, profitability and beta. Market to book ratio is

negative and significantly associated with interest rates and leverage. Inflation rates and firm age are negatively & insignificantly related with market to book ratio. Correlation analysis indicates that there is no possible multi-collinearity between variables of this study.

Table 4: Regression Analysis of the study

	OLS	Fixed	Random
	MBR	MBR	MBR
INF	0.0314*** (0.00919)	0.0202** (0.00674)	0.0268*** (0.00603)
GDPG	-0.0170 (0.0115)	0.00652 (0.00797)	-0.00287 (0.00740)
INTR	-0.0433** (0.0164)	-0.0416*** (0.0105)	-0.0441*** (0.0106)
AGE	0.00169 (0.0277)	-0.299 (0.154)	-0.0672 (0.0644)
MDR	-1.346*** (0.0582)	-0.712*** (0.0720)	-0.859*** (0.0659)
EBIT	0.172 (0.176)	0.0757 (0.146)	0.152 (0.143)
BETA	0.0666* (0.0270)	0.0199 (0.0263)	0.0289 (0.0256)
_cons	2.005*** (0.147)	2.591*** (0.515)	1.926*** (0.229)
R ²	0.51	0.35	0.33
N	800	800	800

Standard errors in parentheses, * $p < 0.05$, ** $p < 0.01$, *** $p < 0.001$

Table 4 shows the regression results of the study. Market to book ratio has a positive and significant relationship with inflation and beta. Market to book ratio has a negative relationship with interest rates and leverage. GDP growth rates, firm age and profitability have insignificant relationship with Market to book ratio.

As it has been postulated in the earlier part of this paper, the findings of the study suggest that the M/B ratio is positively correlated with inflation. From this consideration, it can be concluded that firms in inflationary zones get more value than firms within low inflation zones. Inflation may result in a nominal increase of both revenues and asset values and thereby improve expectations of the market in regard to growth prospects. For instance, if industries with inflation adjusted pricing power include commodities or real estate, a situation of inflation lead to high M/B ratios.

On the other hand, the findings indicate that as the M/B ratio decreases the interest rates increases. When the rates of interest rise, borrowing becomes costlier and Using a higher rate of discounting, the present value of expected profit of firms decrease.

This effect can pull down market values, especially so, for a firm that has most of its value in intangible items such as growth expectations.

Also, there is a negative correlation with leverage which shows the effect of financial risk is to decrease market value. Companies with high amount of credit are considered to be more risky because they are closer to the possibility of default or indeed, financial pressure. It may mask other good results, thus coming with a low value of M/B ratios. High leverage also limits the firms' capacity to pursue growth opportunities thereby discouraging investors. Also, similar with what is expected, the positive association with beta, a measure of systematic risk suggest that firms with higher systematic risk tend to be valued more highly. This may be as a result of risk-return relation whereby firms with higher beta are thought to possess superior growth prospects of better returns despite the extra risk. Regarding high-beta firms, investors may relate them with industries considered to embrace innovation or economic recuperation thus increasing their market to book value.

This research concludes that advance firm age, current and prior year GDP growth rates, as well as profitability do not have an effect on the M/B ratio.

Although resulting from macroeconomic conditions, insignificant GDP growth could mean that factors influencing the M/B ratio are firm or industry related rather than macroeconomic. In the same way, firm age, a measure of experience and stability might not have a direct bearing on valuation, if firms that are older do not convey innovation or growth prospects. Surprisingly, there is no relationship between profitability, which can be an important determinant of firm value, and M/B ratio. This could happen in situations where investors and industry expectant value added intangible characteristics such as growth opportunities, innovation or positioning in the industry more than current returns. In addition, there may be severe problem of endogeneity since value added, cost, and market profitability may already be reflected in market price hence serving to explain little of the M/B variation.

5. Conclusion

A key objective of this study is to explore the determinants of the M/B ratio in the Pakistani textile industry using both OLS, FE, and RE models based on a large cross-sectional time-series of aggregated data in a logistic panel of 800 obs., of the from 2011–2020. The study offers us valuable information on assembling firm valuation by using both macro and micro factors that are important in the estimation of firms' values that could be of great importance in the decision making of investors, managers and the relevant policymakers.

Regression analysis reveals that inflation and beta (systematic risk) have a positive coefficient implying that firms operating in high inflation countries and those firms that bear high systematic risk are valued more in the market. It improves expectations of growth prospects with nominal revenues and asset values by inflating worth. Likewise, the companies with high beta are viewed as having better growth prospects, risk and consequently receive higher market to book value.

On the other hand, while the interest rates and the leverage ratio demonstrated a negative correlation to the M/B ratio was observed. Increase in the interest rates makes borrowing expensive and lowers the value of anticipated earnings within the present period which incorrect firm values. Hence, growth constraints occasioned by high leverage, which serves as a measure of financial risk, reduces M/B

ratios through concepts of potential default risks that dented investor confidence.

However, ideally, the M/B ratio should have a negative relationship with the GDP growth rates and a positive correlation with firm age and profitability independent of firm size and firm location but remarkably they do not. This sort of evidence points towards the fact that, whereas GDP growth and other similar indicators could be hugely affected, the picture of the firm or, industry-level characteristics might overshadow it much more in terms of market valuation. Likewise, other fundamentals of value such as firm age and profitability most likely have no significant effect on M/B ratios for firms within relatively high-tech industries where growth potential, innovations, and extracontractual variables are viewed as being more important.

From a methodological point of view, this study recommends the use of panel data regression analysis in an attempt capture the time series as well as the cross sectional changes. OLS regression sets a benchmark where FE and RE models then include the effects of unobserved heterogeneity and within-firm and between-firm effects further improving the reliability of the results.

The findings have important implications for a number of groups of stakeholders. Such information can be useful where other than relying on the systematic risk, specific factors such as leverage, macroeconomic factors such as inflation and interest rates can be used to evaluate firms' valuations. Managers are in a position to develop ways to reduce the impact of explicit risk and taking advantage of high growth opportunities due to high inflation or systematic risk.

The authorities can target the creation of a stable macroeconomic environment that should underpin relatively accurate firm evaluations and investment promotion.

- Thus, the m/b ratio is argued to be a multifaceted proxy that incorporates risk, financial and economic aspects of firms. This paper thus contradicts conventional wisdom by demonstrating that variables like profitability and firm maturity, though not successfully constant to zero, do not have a universally significant relationship with the M/B ratio. However, it focuses on contextual and firm-specific factors and contributes fruitful

information for knowing more about the firm valuation in Pakistan's textile sector.

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