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Determinants of Firms' Profitability across Diverse Groups

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Abstract

We develop a methodology that explains firms' profitability, based on their performance patterns and selected financial ratios. We use the Greek retail sector as a case study (a sample of 122 firms, large, SMEs, and micro) covering the period 2014-2017. We investigate the effect of four groups of performance indicators (liquidity, efficiency, financial leverage, and managerial performance) on two profitability proxies (net profit margin and gross profit margin). In our approach, we use cluster analysis to capture the factors influencing firms' profitability in heterogeneous groups. We examine the two profitability proxies as trajectories over time. We check and confirm the effects – in terms of signs and statistical significance – of selected performance indicators on profitability by using Random Effects (RE) or Fixed Effects (FE) models. Our empirical findings indicate that the selected financial indicators explain more satisfactorily the proxy of net profit margin rather than the gross profit margin. Managerial performance, short-term solvency, and effective use of total assets seem to be decisive factors for firms' profitability. However, some effects seem to vary – in terms of magnitude and statistical significance – across three clusters of analysis. The proposed methodology may serve as a diagnostic tool to assess the determinants of profitability, especially during periods of financial distress. Since "one size does not fit all", we contribute to the investigation of firms' profitability by introducing a novel framework that allows patterns' recognition in diverse profitability groups and the identification of main determinants.

Keywords: cluster analysis, econometric analysis, financial ratios, Greece, retail sector