



## INTERNATIONAL JOURNAL OF RESEARCH IN COMMERCE, ECONOMICS AND MANAGEMENT

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**STUDY OF LINKAGE OF DIVERSIFICATION STRATEGY AND CAPITAL STRUCTURE OF FIRMS: A SURVEY**

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**ABSTRACT**

*The role of strategic factors in capital structure decisions is well established in the studies of linkages between corporate strategy and capital structure. Diversification being one of the important strategies of management, establishes obvious linkage with the capital structure. The research around diversification and capital structure has gone a long way in last three decades and has shown varied results, however with some well-established findings during earlier phase. There is dual or reciprocal relationship between the two with predictions based on two distinct theoretical explanations i.e. Agency Cost Theory and Transaction Cost Theory. The studies have also explored the impact of combination strategy of product and international diversification on capital structure. The area has been practically unexplored with respect to Indian environment. However, the significance lies with the growth and liberalization of the Indian economy. This paper attempts to review the research so far on linkage between diversification strategy and capital structure decision in general and further provides the direction to explore the field in Indian context. Taking India IT sector as a case, the paper attempts a preliminary study in taking Indian IT sector as the case. The preliminary results indicate that the leverage of the firm goes down with international diversification with typical low debt structure for Indian IT firms and are in line with the previous studies. The results also support the agency cost theory with increase of agency costs with lower diversification.*

**KEYWORDS**

Diversification Strategy, Capital Structure, Indian Firms

**INTRODUCTION**

Theory of Capital Structure by Modigliani and Miller (1958, 1963) has faced criticism over the period of time especially in their assumptions of perfect markets. Their theory stresses that under certain assumptions, the choice between debt and equity in a firm will not affect the firm value and therefore the decision is irrelevant. Time and again, the assumptions around this theory are questioned and subsequent research (Harris and Raviv 1991; Myers 1984) has pointed out that on relaxing the assumptions, the newer perspective of capital structure decisions emerges. The imperfections in the market play an important role and the choice of capital structure does affect the performance of the firm.

Research around Capital Structure decision in an organization has evolved with multidimensional perspectives over the years and has also explored the behavioral dimension along with the traditional financial paradigm. It has been found that the capital structure decisions are based on various strategic factors like management's values and goals, their risk taking ability, external and internal financial factors (Barton and Gordon 1987, 1988).

Further research has delved into the linkage of diversification strategy and capital structure decision. The role of strategic factors in capital structure decisions is well established in the studies of linkages between corporate strategy and capital structure. Diversification being one of the important strategies of management, establishes obvious linkage with the capital structure. Researchers have tried to establish a two-way relationship between the two. The studies have ranged from understanding the impact of nature of diversification, mode of entry, product or international diversification and many other areas in the field. The debate has been around two possible explanations based on agency theory and transaction cost economics.

The research around diversification and capital structure has gone a long way in last three decades and has shown varied results, however with some well-established findings during earlier phase. The studies have also explored the impact of combined strategy of product and international diversification on capital structure.

The area has been practically unexplored with respect to Indian environment. However, its significance lies with the growth and liberalization of the Indian economy. In Indian context, the diversification is happened both ways where in Indian companies are diversifying internationally and with Indian economy opening up across sectors, many multinational firms are penetrating either independently or jointly with Indian firms.

There have been very few studies in Indian context in the related area. Most of the studies have focused separately on determinants of capital structure and diversification but not established the relation between the two. These studies have been done for pre-liberalization period and India has gone through drastic change after that. The globalization has dominated Indian corporate world and the factors related to diversification and capital structure need study with respect to Indian environment.

This study primarily attempts to review the literature in the area to understand the direction as well as the gaps prevalent and also highlights the importance of context encompassing country specific factors to explain the linkage between diversification strategy and capital structure of any firm. Additionally, the paper attempts to explore this linkage in the Indian context, specifically comparing relationship between IT multinational firms with Non-IT multinational and domestic firms.

The initial finding in the paper gives an opportunity to explore the relationship in an exhaustive manner in a larger context with a possible comparison with developed and developing markets.

**CORPORATE STRATEGY AND CAPITAL STRUCTURE DECISION**

Strategic management is a process of aligning firm's internal resources with external environmental factors like economic, technological and socio political (Kracaw, Lewellen, Woo 1992). One of the important decisions for a firm is the financing decision for optimal capital structure, which however has been debated time and again. The researchers, lately, have started looking at the strategic influence on capital structure decision. It has been studied that behavior is a key element for understanding the debt-equity mix in the company (Carleton and Silberman 1977, Findlay and Whitmore 1974). The manager of the firm decides on any investments based on the debt they issued, that enables the equity holders to pursue risky strategies (Jensen and Meckling 1976). While considering the role of capital structure on firm's liquidation decision, Titman (1984) later explained that the customer would prefer low leveraged firm in the interest of ongoing service of goods. The game theory approach (Brander and Lewis, 1986) with two-stage sequential duopoly game explains that if a firm decides on a capital structure in first stage and then decides on an output strategy in second stage, then it tends to choose high debt to signal their competitor of high output in the second stage which will enable both the firms for output levels. Most of the research recognized the role of risk taking ability as an important element for choosing the capital structure.

A more formal framework (Barton and Gordon 1987, 1988) lays out that the capital structure decision in a firm is dependent on the goals and values of the management along with other internal and external factors highlighting a complex relationship between corporate strategy and capital structure in a firm (Kocchar and Hitt 1998). While using Andrew's dimensions of corporate strategy, the framework proposes that the variables like managers' risk taking ability, their goals, their preference for internally generated funds, external investors' willingness to lend and financial variables affect the top management's decisions on having debt or equity in a firm. This framework has established the basis for further studies on linkage of diversification strategy to capital structure of the firm.

## DIVERSIFICATION STRATEGY AND CAPITAL STRUCTURE

The pioneer in this area of research is the strategy taxonomy (Rumelt 1974, 1989) categorizing the diversification strategy of the firm based on specialization ratio and relatedness ratio. While the specialization ratio defines the proportion of business based on one or more product lines, the relatedness ratio groups the business based on core skills or resources. The nine-level taxonomy was refined to four-levels (Wrigley 1970; Barton and Gordon 1987) as Single, Dominant, Related and Unrelated diversification based on number of variables with leverage as one of them. The earlier studies focused on the effect of diversification strategy on corporate growth (Berry 1971) and profitability (Rumelt 1974), while the later ones became more specific to establish the linkage between the diversification strategy and capital structure decision of the firm.

The significant findings based on five financial contextual variables as size of the firm, sales growth rate, profitability, higher capital intensity and high earnings risk, indicated that undiversified firms have lower debt levels compared to diversified firms with unrelated diversification leading to highest leverage, however only profitability and growth being the significant influencing factors (Barton and Gordon, 1987). Although the role of strategic factors on capital structure was well established, the later studies explored more contextual variables like cash-flow, highlighting that it gives the ability for firms to arrange for funds internally in accordance with pecking order theory (Myers and Majluf 1984). The later studies moved from US based firms to other countries like Australia (Lowe and Naughton 1995) using more specific terms to define the capital structure and newer contextual variables like effective tax rate. However, these studies did not establish the same results to define the linkage suggesting a more complex relationship depending on country specific factors along with extent and nature of diversification. Many studies further suggested that firms need to have greater leverage for maximizing the firm value (Kaplan and Weisbach 1992; Singh et al. 2003).

The study by Kocchar and Hitt (1998), establishes a bi-directional or reciprocal relationship between diversification strategy and capital structure. On one hand, the nature of diversification affects the capital structure of the firm which alters the resource profile, while the firm's capital structure affects the diversification strategy decision by any firm on the other.

## THEORETICAL UNDERPINNINGS

This linkage analyzes multiple dimensions like nature of diversification, mode of entry, product and international diversification, the underlying reason for this relationship is being explained through two divergent theories – agency theory and transaction cost economics.

Agency Theory (Jensen 1988) explains the conflict of interests between managers and shareholders restricting the free cash flow to the managers in lieu of payouts to the shareholders and therefore former losing control on pursuing new projects. With their compensation tied up to the growth, managers are inclined to pursue new projects in haste going for uneconomical projects. The usage of debt becomes a control mechanism for managers', who become apprehensive of the bankruptcy costs, and therefore helping to curb their risk taking ability and consequently reducing the agency costs. The debt plays an important role in withholding the managers in their pursuit of diversification especially an unrelated one. The agency costs are the function of risk taking ability of the managers, uncertainty of their efforts and incentive intensity and costs are determined before the contract is established (Kocchar 1998). The theory leads to significant findings (Kocchar 1998) like

- The ratio of debt / equity of a firm increases with the relatedness of the business.
- The firms with high leverage would go for less restructuring or refocusing of their business.
- An increase in debt / equity ratio of a firm will lead to more related diversification.

Transaction cost economics is concerned with the governance of contractual relations in transactions between two parties (Williamson 1975, 1985). With the right governance structures, these costs of exchange can be reduced (Williamson 1979). These costs are essentially due to setup and running costs of governance structures and firms seek for reducing the governance mechanisms to curb these costs (Kocchar 1998). With high specificity of assets, these costs can go higher and the firm may look for other forms of governance. In the context of financing, the transactions arise with the contractual obligations of the financier and the firm. The benefits and controls of these transactions vary with debt and equity financing. The debt financiers will get benefits from principal and interest repayments and can exercise control on firm's assets in case of default. However they do not have control over the managers' operations. On the contrary, shareholders only have residual claims of the cash-flows and on liquidation. However, equity holders have greater control over the managers' operations through authority of board of directors and therefore equity financing provides stronger governance in the firm. The choice of debt or equity financing is based on the trade-off between the benefits and governance (Kocchar 1998). The degree of specificity of assets will be the determining factor for making that choice (Williamson 1975). The high specificity of the assets prevents the debt financiers to invest in fear of non-recoverability of funds at the time of liquidation (Kocchar 1998). This leading to equity financiers taking larger control to ensure efficient utilization of the assets with stronger governance, and hence the domination of equity financing. Similarly, R&D, being the specific assets, lead to higher equity financing, in fear of low liquidation value and reconfirms the finding that unique firm specific assets or skills are the most important determinants of capital structure (Balakrishnan and Fox 1993).

The different between the two theories lie in the way debt or equity plays the role of governance mechanism. The agency cost theory takes only the account lender's perspective and ignores the fact that debt holders might not lend with higher risks attached to the investment and making it very costly and therefore considering debt as the only governance mechanism. According to transaction costs theory, the costs arises from market failure to come up with optimal contract with costs related to setup and running of governance mechanisms come out after the contract is established. The assets under governance are firm resources, unlike of free cash flow in agency theory, and therefore consider the role of both debt and equity in governance structure. This particular difference leads to different findings for linkage between diversification strategy and capital structure with transaction cost theory establishing negative relationship between debt-equity ratio and degree of relatedness of the firm, however, finding is quite the opposite based on agency cost theory (Kocchar 1998). There are mixed evidences with respect to both the findings although agency cost theory stands ahead in popularity because of its simplicity in understanding.

## INTERNATIONAL DIVERSIFICATION AND CAPITAL STRUCTURE

With varied evidences across country specific studies, it was evident that the financing policies of any multinational firm will be affected by a few additional factors like country based tax structures and concessional policies, political risk, capital flow barriers and restrictions to fund flows, legal uncertainties and financial market segmentation (Fatemi 1988). Taking agency theory perspective, the multinational firm will have to bear higher agency costs than the domestic firms and therefore will have lower debt-equity ratio. With international firms having an edge on diversification, the effects of agency costs, distress costs and foreign currency denominated debt are higher and therefore the firms will have lower debt) and the firms will go for shorter term debt possibly because of their larger access to global capital markets (Fatemi 1988).

The major study in this regards has been by Lee and Kwok (1988) for comparing the multinational and domestic firms to identify the factors and determinants of capital structure and laying down a framework providing linkage between environmental factors, firm related capital structure determinants and capital structure. According to their study, there are following environmental factors which affect the capital structure of international firms: Political Risk, Complexity of International Operations, Market Imperfections, Opportunities of international diversification, Foreign Exchange Risk, Local factors of the countries and can be categorized based on the agency costs, bankruptcy costs and foreign affiliate's capital structure. Based on the above factors, the different determinants of capital structure are:

- Political risks, complexity of international operations and market imperfections leading to agency costs which in turn decrease the leverage of the firm.
- Opportunities, political risks and foreign exchange risks lead to Bankruptcy costs which increases the debt structure of the company.
- The local country factors resulting in the capital structure of the foreign affiliate company and that increases and decreases the overall leverage accordingly.

The finding of above study was:

- MNCs have higher agency costs of debt compared to domestic companies irrespective of the size of the firm and the industry it belongs to.
- There was no significant difference between the bankruptcy costs of MNCs and Domestic Companies once the size effect was controlled.
- MNCs have less debt in their capital structure compared to Domestic companies although there was some variation when compared across industries.

The study of linkage of diversification and capital structure has been explored further in recent times for multinational firms. Research tends to suggest that (Burgman 1996; Chen et al.1997) multinational companies have less debt in their capital structure compared to domestic firms inspite of lower cost of debt for multinationals than the domestic firms (Mansi and Reeb 2002). The leverage was positively related to exchange rate risks and political risks asset specific international factors and capital structure can be used a tool to hedge political and exchange rate risk (Burgman, 1996).

Diversification, both product and geographical, plays an important role in the corporate strategy of a firm (Hitt, Hoskinson and Ireland 1994) and tends to improve the financial performance of the firm (Hall and Lee, 1999). The upstream-downstream hypothesis (Kwob and Reeb 2000) explains that the relation between international diversification and capital structure depends upon the relative risk of the home country (of MNC) and the foreign country and the results were similar for the US firms however showing an opposite effect for the emerging countries. With more studies with this comparison (Aviazian, Booth and Coles 2003), considering additional factors such as taxes, agency conflicts, financial distress and informational asymmetries as additional factors, found that the relationship of capital structure and international diversification is same as for developed countries and was dependent on similar variables. However, the additional county specific factors such as GDP growth, inflation and maturity of capital markets also played the role.) Additionally, there was found a non-linear inverted-U relationship between the degree of international diversification and short-term financing (Singh et.al 2004).

With most studies focusing on either product diversification or international diversification, not much has been explored considering the joint effect of the two. Hall and Lee (1999) studied the difference of effect of diversifying strategies between US and Korean firms and found out that the traditional models of diversification i.e. product diversification might not be effective in all the countries, unlike US firms. Although the study was done to understand the impact on performance because of diversification strategies, it also led to further investigation on impact on capital structure because of different combinations of product and international diversification.

Chikr and Cosset (2001) studied the effect on capital structure of multinational companies based on dual diversification strategy i.e. product and international. Their study was based on an event study for comparing the leverage of firms before and after acquisitions of foreign subsidiaries, while isolating the effect of other factors. Their study found that the MNCs with low degree of product diversification are least leveraged and the combination of two enables the companies to achieve higher profitability.

Another similar study by Singh et. al (2003) show that firm following a dual diversification will have higher leverage. The firms that are product diversified do not have different leverage than the domestic firms, however, their international diversification results in lower debt ratios. The results indicate that the usage of leverage due to dual diversification is more due to increased debt capacity with complementary effect of product and international diversification.

A study by Low and Chen (2004) taking a sample of 232 firms across 30 countries with different combination of product and international diversification and industry group, finds negative relation between international diversification and capital structure for US firms but not any significant relationship non-US firms. With respect to product diversification, their study shows higher debt ratios for diversified firms than non-diversified firms.

Overall, the literature indicates that international diversification has different risk-return relationships for different countries especially for the developing or emerging markets as compared to the developed ones and therefore the impact on capital structure of firms in these countries is also different. With different countries, the results have been mixed and do not give any conclusive evidence, however, giving evidences of the effect of more intricate country specific factors determining the capital structure.

## DETERMINANTS OF CAPITAL STRUCTURE

In order to study the linkage between capital structure and the diversification strategy of the firm, the common approach in most of the studies is to compare the determinants of the capital structure across undiversified and diversified firms. There has been extensive research on determinants of capital structure and its relevance to the firm value. Based on the prior literature, it is evident that the factors that determine the capital structure are a combination of multiple variables. This section elaborates on these factors and their relationship with debt based on the past studies.

**Size:** Numerous studies have found Size as the determinant of capital structure, however with contradictory results so far. Larger firms are more diversified and therefore should be positively related to leverage but their preference for equity than debt has a negative impact on leverage. The most common measure of size is Log of total assets or total sales.

**Agency costs:** Myers' (1977) hypothesis of Underinvestment problem suggests that the value of firm is based on real assets and intangible assets and will depend upon future discretionary investments. However, they pose a conflict between bondholders and shareholders resulting in underinvestment problem and suggesting a negative relationship with debt levels. Since advertisement and R&D are good indicators of growth opportunities of the firm (Titman and Wessels 1988), they have been taken as a measure of agency costs

The different measures that have been used are

- Ratio of sum of R&D and advertisement expenses to Sales (Lee and Kwok 1988; Burgman 1996)
- Titman and Wessel (1988) measure (TW) = Cash and Marketable Securities / 3 Years average of total assets
- Free Cash Flow measure by Lehn and Poulsen (1989)

**Profitability:** Leverage is negatively related to profitability (Myers, 1984) and more profitable firms will prefer internal funds than debt. Other studies (Caesar and Holmes 2003) also support the same and found that more profitable companies will have lower debt levels.

The common variable used to measure the profitability is EBITD/Sales or Net Income / Sales.

**Bankruptcy Risk:** Increase of leverage will increase the possibility of bankruptcy and therefore increase the bankruptcy costs (Kraus & Litzenger 1973). MNCs with increase cash flow and profitability will have lower bankruptcy risk (Burgman 1996; Reeb et. al 1998). Overall the companies with lower default risk should sustain higher debt levels. There have been several measures of bankruptcy risk. Earlier researchers (Lee and Kwok, 1988) have used standard deviation of first difference in EBIT scaled by the mean values of total assets. Akhtar (2005) have used Standard Deviation of first difference in EBIT divided by Interest Expense. Chikr and Cosset (2001) have used multidimensional measure of bankruptcy risk proposed by Alman (1968) which was again refined later. For private firms, this Z-Score is measured as:

$Z' = 0.717T1 + 0.847T2 + 3.107T3 + 0.420T4 + 0.998T5$ , where

$T1 = (\text{Current Assets} - \text{Current Liabilities}) / \text{Total Assets}$

$T2 = \text{Retained Earnings} / \text{Total Assets}$

$T3 = \text{Earnings Before Interest and Taxes} / \text{Total Assets}$

$T4 = \text{Book Value of Equity} / \text{Total Liabilities}$

$T5 = \text{Sales} / \text{Total Assets}$

Higher the Z-score, lower is the bankruptcy risk of the company and therefore higher the leverage.

**Exchange Rate Exposure Risk and Political Risk:** The sensitivity of earnings to foreign exchange fluctuations, lower is the expected level of leverage (Burgman,1996). MNCs with more foreign rate exposure risk should have lower debt. Overall the leverage should have negative relationship with the exchange rate exposure risk.

Earlier researches (Burgman, 1996; He and Ng 1998; Shin and Soenen 1999; Chikr and Cosset 2001) have used exchange rate risk exposure by the time series measured as:

$Rit = \text{Beta}(i0) + \text{Beta}(ix) + \text{Beta}(im)Rmt + \text{Error term}$ , Where



Rit = Rate of Return of ith company common stock

Rxt = Rate of return on the trade weighted exchange rate

Rmt = Rate of return on value weighted market index

The regression coefficient Beta (ix) is the foreign exchange rate risk exposure.

The other measure (Wright, Madura and Wiant 2002; Aktar 2005) that has been used is Total Foreign Subsidiaries Sales / Total Sales.

Political risk measure is the political risk ratings is also a similar measure like exchange rate exposure risk with the same consequences.

**Degree of Multinational Diversification:** There has been conflicting results on relation of multinational diversification and leverage. Degree of multi-nationality has been measured in multiple ways in the past studies. A few common measures are foreign tax ratio / total sales, number of foreign subsidiaries, foreign sales / total sales.

**Debt Measure:** In past studies (Burgman 1996; Chikr and Cosset 2001; Aktar 2005) has been defined as ratio of long term debt to sum of long term debt and market value of equity. Most of the studies have taken a simpler measure of debt-equity ratio.

## RELATED RESEARCH IN INDIAN CONTEXT

There have been scattered studies with respect to developing or emerging markets while the prior studies more focusing either on developed countries specifically or the comparison with the less developed world. There have been very few studies in Indian context in the related area dealing separately on determinants of capital structure and diversification as a strategy with none establishing any linkage between the two.

Bhaduri (2002) has studied the capital structure issue in India with respect to market oriented reforms presenting a five-factor model for optimal capital structure in dynamic environment with respect to Less developed countries. The results are consistent with the recent theories around the topic indicating costly restructuring in Indian firms and have suggested a model for long-term and short-term borrowing. The results show that the growth opportunities in India increases firm value and therefore increase the long-term debt capacity.

Another study by Majumdar and Chibbir (1997) have analyzed the levels of debt in the capital structure and performance of Indian Firms indicating a negative relationship because of increasing government ownership.

The limitations of above studies are primarily in the context of Indian economic environment. The studies have been done for pre-liberalization period and India has gone through drastic change after that. The globalization has dominated Indian corporate world and the bi-directional flow of diversification necessitates the need for exploring the determinants of capital structure with respect to diversification strategy in the Indian context.

This paper attempts to explore this relationship in the Indian environment, which is influenced by globalization phenomenon. Not only there is explosion of foreign firms in India, but also an extensive diversification of Indian firms with respect to product as well as geography. Based on the literature so far, we establishes few hypothesis that are tested with a small sample of Indian domestic and multinational firms throwing some light on typical debt structure of Indian IT firms.

In the Indian context, both domestic and multinational companies would prefer equity than debt. The hypothesis in this context would be:

**H1: Debt of the company is negatively related to Size of the company.**

**H2: Leverage of companies will have negative relationship with the agency costs**

**H3: Leverage will have negative relationship with profitability of the company.**

**H4: Leverage will have negative relationship with the z-score.**

**H5: Leverage will have negative relationship with Exchange Rate exposure risk.**

**H6: The debt of the company is negatively related to the degree of diversification of the company.**

## METHODOLOGY AND DATA

Based on earlier studies, the relationship of leverage with different determinants can be established through following model:

$Debt = \beta_0 + \beta_1 * Agency\ Costs + \beta_2 * Bankruptcy\ Risk + \beta_3 * Size + \beta_4 * Profitability + \beta_5 * Exchange\ Rate\ Exposure\ Risk + \beta_6 * Degree\ of\ Multinational\ Diversification$

However, in this paper, we do a preliminary analysis through descriptive statistics based on following measures of selected variables:

- Debt = Debt / Equity Ratio
- Agency Costs = AGENCY = (Advertisement + R&D Expense) / Total Sales
- Size = SIZE = Natural Log of Total Sales = Ln(Total Sales)
- Bankruptcy Costs = ZSCORE = Z Score (Altman's measure- as described in the above section)
- Profitability = PROF = EBIT / Total Sales
- Exchange Rate Exposure Risk = EXCHRISK is measured by the following regression equation
- Stock Return of the company =  $\alpha_0 + \alpha_1 * Exchange\ Rate\ Index + \alpha_2 * Weighted\ Stock\ Market\ Index + e$
- The Exchange Rate Exposure Risk is the value  $\alpha_1$
- Degree of Multinational Diversification = DIVER = number of foreign subsidiaries or number of overseas operations or development centers for any company, whichever is higher.

The selection of firms was done from CMIE database. These companies were NSE listed companies. Total 60 companies were taken as the sample with 15 as IT MC firms were selected with data from 2003 – 2009, Similarly 21 Non-IT MC firms and 24 Non-IT domestic firms were selected across different industries. A firm can be called MC if it has operations abroad on its own or through its subsidiaries. Therefore criteria for MC firms were number of foreign subsidiaries or number of development or operation centers overseas with minimum of 3 in number. In case if both are present then higher number is taken assuming there will be an overlap between the two. The subsidiaries or operations information was taken from latest annual reports of the company. The firms which have exports but do not have any overseas operations or subsidiaries or the firms with less than 3 subsidiaries overseas are considered as DC.

The data for other variables from take from CMIE database for 2003 – 2009 and average of 5 years was taken for the firm except for those for those for which the data was available for less than 5 years. The information on diversification status is taken from companies' annual reports for the last five years.

For exchange rate exposure index calculation, monthly NSE stock market returns for each company were taken from 2003 to 2009 except for those where data was available for less. The weighted market return was taken for NSE market return for the period of 2003-2009. The exchange rate return index was taken as Nominal Effective Exchange Rate (NEER) Index maintained by Reserve Bank of India. This index is a 36-currency based Trade weighted index (Base 1993-94 = 100). The index is also taken for the period of 2003 – 2009 on a monthly basis. The regression for each company was done based on the equation below:

Company's Monthly NSE Stock Return =  $\alpha_0 + \alpha_1 * NEER\ Index + \alpha_2 * NSE\ Return$

Significant Coefficient Value of  $\alpha_1$  is taken as the exchange rate exposure index for that company. In case the value is insignificant then 0 is assumed for that company by default.

## ANALYSIS

Table 6.1 depicts the descriptive statistics of all the variables across 5 sets of samples. The results indicate that overall leverage of the sample goes down with the inclusion of IT companies in the sample. Indian IT companies have lowest leverage across the industry which is indicated from the data and also has the maximum diversification ratio. The similar relationship is found with Non-IT MC and DC firms showing lower leverage with more diversification. This supports the general view based on the earlier studies that leverage of the multinational companies is lower compared to the domestic companies. This supports our hypothesis H6 that degree of international diversification decreases the leverage.

When we see the agency costs, the results suggest that agency costs of Non-IT companies are higher compared to all firms for non-IT all firms. The results also show that agency costs are higher for Non-IT MCs compared to DC. This is consistent with the previous studies that multinational companies will have lower leverage and therefore higher agency costs and supports our hypothesis H2. However the same is not true for IT companies with lowest agency costs, explaining the distinct nature of the sector having low marketing and advertising costs.

The relationship with respect to profitability is consistent with earlier studies which say that higher profitable companies will have lower leverage. The IT companies with the lowest leverage are most profitable, followed by Non-IT MCs and then Non-IT DCs. This supports our Hypothesis H3 for profitability.

The exchange rate exposure risk is higher for all Non-IT firms. Exchange rate risk exposure is highest for all Non-IT MC firms compared to DC firms. The result is intuitive as with more international diversification, the exchange rate risk increases, however, this result is contradictory to most of the earlier studies and rejects the hypothesis. Another notable aspect is that IT firms though with highest international diversification do not have the highest exchange risk.

Z-Score is highest for IT MC firms and explains the lowest bankruptcy risk and supports our hypothesis for its relation with diversification. However the relationship is inconsistent with the hypothesis when we compare Non-IT MC and DC firms. The MC firms carry higher bankruptcy risk compared to DC firms although the average Z-Score for both is within safe limits. We think that the results might be biased due to data issues.

The above results are preliminary in nature and do not explain the significance of each of these factors on capital structure with different types of diversification. A more detailed analysis is required with a larger set of data to understand the specific relationships in the area. Our preliminary regression results with this sample of data revealed only firm size and exchange rate risk as the significant factors in this relationship. Moreover, the results also did not find diversification ratio significant for determination of the capital structure. However, we cannot base our results on such a small sample of data.

TABLE 1: DESCRIPTIVE STATISTICS

	Debt / Equity	Agency Costs	Profitability	Exchange Rate Risk	Z Score	Diversification Ratio
<b>All Firms</b>						
Max	4.330	0.765	0.376	4.537	622.408	64.000
Min	0.000	0.000	-0.007	-2.475	0.701	0.000
Average	0.632	0.034	0.160	0.302	22.763	12.167
StdDev	0.744	0.100	0.090	1.081	91.096	15.734
Median	0.492	0.011	0.140	0.000	2.437	6.000
<b>All Non-IT Firms</b>						
Max	4.330	0.765	0.376	4.537	8.361	38.000
Min	0.022	0.000	0.033	-2.475	0.848	0.000
Average	0.780	0.043	0.145	0.334	2.848	8.067
StdDev	0.782	0.115	0.084	1.028	1.898	11.232
Median	0.592	0.016	0.128	0.000	2.160	2.000
<b>All Non-IT MC Firms</b>						
Max	4.330	0.765	0.376	4.537	8.361	38.000
Min	0.048	0.000	0.065	-0.230	0.848	3.000
Average	0.872 (.690)*	0.058	0.160	0.667	2.417	17.800
StdDev	0.942	0.169	0.074	1.331	1.782	10.586
Median	0.643	0.014	0.144	0.152	1.822	16.000
<b>All Non-IT DC Firms</b>						
Max	2.562	0.126	0.344	1.126	7.587	2.000
Min	0.022	0.000	0.033	-2.475	0.996	0.000
Average	0.706	0.031	0.133	0.067	3.193	0.280
StdDev	0.638	0.035	0.091	0.606	1.952	0.678
Median	0.544	0.019	0.109	0.000	2.647	0.000
<b>IT MC Firms</b>						
Max	1.216	0.038	0.323	3.990	622.408	64.000
Min	0.000	0.000	-0.007	-2.440	0.701	3.000
Average	0.200	0.006	0.203	0.188	87.615	22.857
StdDev	0.369	0.010	0.097	1.308	178.150	20.542
Median	0.031	0.004	0.219	0.000	17.609	14.000

\*(\*) The average comes down to 0.690 if we remove one outlier data in the sample.

## CONCLUSION

The role of strategic factors in capital structure decisions is well established in the studies of linkages between corporate strategy and capital structure. Diversification being one of the important strategies of the management establishes obvious linkage with the capital structure. The research around diversification and capital structure has gone a long way in last three decades. There have been well established frameworks and theories established to understand the relationship. However, the studies have shown different results in different context and country environment. In less mature markets of developing and emerging countries, the influence of country specific factors have been found significant and have also show contradictory results compared to the developed world. The country specific factors become more significant with international diversification, which was ignored in the earlier studies. Besides, there have been two distinct theoretical basis for explaining this phenomenon giving divergent explanations, however both confirming the linkage. There is no conclusive evidence so far and the results indicate that local risk-return relationship has larger consideration in determining capital structure with diversification.

In India, globalization has led many Indian companies to diversify internationally. There is significant change in the strategic factors in these companies due to globalization. Besides, India is highly exposed to the global capital markets and financing more approachable than before. Research in this field in India has not taken any encouraging path so far and most of the studies have been based on pre-liberalization period. The studies are more focused on determinants of capital structure in general without considering the strategic factors.

The preliminary results in the Indian context, has also indicated of the above relationship of decreasing leverage with more international diversification. The results have also substantiated partially, the earlier studies with respect to other determinants like firm size, agency costs, profitability and z-score. The exchange rate risk shows a positive relationship with leverage in case of Indian firms.

The results with respect to Indian IT firms are consistent for the relationship with diversification strategy, bankruptcy costs, profitability and firm size, however emphasizes the sector specific characteristics for other determinants of leverage like agency costs and exchange rate risks.

This paper is not an extensive analysis of previous studies in Indian context, however emphasizes that the country specific factors are important in determination of this relationship. This study is able to explain the distinct nature of Indian industry and its leverage compared to international studies and the larger objectives of this paper are:

- To understand the existing depth of literature in international context and explore its implications in the Indian context. Consequently, the data for the analysis is small and cannot be considered sufficient to establish firm results.
  - There has been inconsistency in data reporting across companies in reporting number of subsidiaries and number of overseas operations. This could give some inconsistency in our results.
  - The number of listed Indian IT companies are limited and therefore the data points are not enough to get a more accurate model
- It is important to set a direction for the further research in this area considering the dynamic global environment. Following areas can be explored further to bring clarity in understanding the linkage between diversification strategy and capital structure in the Indian context:  
The strategy of any firm will vary with the industry it belongs to. The previous studies were more generic in nature and do not explore the relationship specific to any industry sector.

- In Indian context, one of the areas worth exploring is the IT sector which has shown significant growth in past 2 decades and the international diversification has been quite prominent in the sector.
- With the growth and liberation of Indian economy, the diversification strategy has taken many forms. India corporate sector is influenced by few conglomerates which are diversifying in many ways. They are tying up foreign multinationals within the country and also expanding outside along with diversification in different sectors. This complex relationship needs more study with respect to capital structure.
- A related study in the direction of international diversification is the FDI investments in growing countries like India and China. Increased globalization has led to numerous studies on FDI investments and its determinants with some discussion on its impact on capital structure. The area becomes more important with India opening up its FDI limits in different sectors. The studies can be done with a focus on changing policies and reforms across sectors and their impact on capital structure decisions.

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