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FACTORS INFLUENCING THE CAPITAL STRUCTURE DECISIONS: A STUDY OF PHARMACEUTICAL INDUSTRY, INDIA

SHIVA T
STUDENT
DEPARTMENT OF COMMERCE
CHRIST UNIVERSITY
BANGALORE

GIRISH S
ASST. PROFESSOR
DEPARTMENT OF COMMERCE
CHRIST UNIVERSITY
BANGALORE

ABSTRACT

Capital structure is one of the major determinants of the performance of the companies as it states about the usage of leveraging of different sources of funds by the company. There have been many theories based upon the capital structure like, Miller and Modigliani, Pecking order theory, Agency cost theory and Trade off theory. In this study, we have taken the data of five companies from the pharmaceutical sector of NSE, India based upon the highest market cap. The data is collected from various secondary resources and is for the period ranging from 2012 to 2016. The variables used herein are the firm specific characters like the profitability, growth, liquidity, size and tax shield. We have used the regression analysis and the results we have found, liquidity has no influence on the capital structure as the company with the liquid funds can invest by itself in the projects it owns and therefore it does not affect its capital structure decisions. And in the profitability, the company with more profits will employ them for its further operations and so it also exhibits negative relationship with the capital structure. The study also further found that the growth of the company, its size and tax shield also has negative relation with the capital structure. The study considers only a few factors which are firm specific and the number of firms as well the time frame of the data collected can also prove to be the limitations of this research.

KEYWORDS

determinants, capital structure, pharmaceutical industry.

INTRODUCTION

Capital structure is one of the major determinants of the performance of the companies as it states about the usage of leveraging of different sources of funds by the company. There have been many theories based upon the capital structure like, Miller and Modigliani, Pecking order theory, Agency cost theory and Trade off theory. These theories mention about the optimal combination of various sources of funds that a company employs as because the capital structure not only speaks about the financial stability but also looks into the enhancement of the firm's wealth. These theories majorly focus upon the industry specific characters but does not take any account of the firm specific characters.

Now we know about why the capital structure is important and also the above mentioned theories too make it clear regarding the calculation of the optimal combination of various sources of funds in formulating the capital structure. In knowing the factors that determine the capital structure decisions, in this paper we are analyzing the internal and firm specific characters like profitability, liquidity, growth, size and tax shield. Along with the external factors like country specific factors and industry specific factors, it is known that even the firm specific factors make an influence on the determination of optimal capital structure (Masnoon & Anwar, 2012).

LITERATURE REVIEW

The focus of this paper is in the changed scenario of the pharmaceutical industry with advent of the biotechnology in Italy. Firm's size, its diversification in business, propensity in collaboration lowers the leverage and also the profitability implies lower leverage ratio on the sustainable debt. (Zambuto, Billitteri, & Nigro, 2011).

(Hossain & Ali, 2012) This paper reveals that a few of the firm specific characters have a negative impact on the leverage and also dividend and volatility does not impact the capital structure decisions. Also reveals that the DTA ratios differ from one industry to other industry. The data was collected from Dhaka Stock Exchange over 39 nonfinancial firms. Yet in another research done on the pharmaceutical industry alone taking into account 17 firms, this paper (Lima) says that the capital structure is best described by using agency cost theory and trade-off model.

(Mohammadzadeh, Rahimi, & Rahimi, 2013) This paper mainly focuses on the effect of capital structure on profitability and is conducted on the top 30 companies of the Iranian pharmaceutical industry, Tehran Stock Exchange (TSE). The findings are, companies with long term debt financing and short term debt financing does not help in the profitability of the company. It concludes that, the firms follow pecking order theory. And also the capital structure is negatively related to profitability.

The companies prefer for equity in order to do business at the time of economic crisis as well as where there is unstable institutional environment. It is also saying that, the firm-specific characteristics are negatively related to the debt-total assets ratio. (ShEluntcova, 2014)

(Saeed, Munir, Lodhi, Riyaz, & Iqbal, 2014) The following paper deals with the capital structure determinants of the pharmaceutical companies listed in Karachi Stock Exchange (KSE), Pakistan. The paper is unique in its own nature as it also involves corporate governance along with the internal firm specific characteristics. The findings of the study are, all the firm specific characteristics like profitability, growth, tax shields, liquidity and earning volatility does influence the capital structure decisions along with a few factors of corporate governance has influence on debt ratio, which is considered as a proxy for the capital structure.

(Yuxuan & Wenlin, 2014) This paper is about the optimization of the capital structure. It takes into consideration the data from 119 companies. The researcher uses the regression model, Hausman test and F test. The result of the study is, a few factors like size and capital guarantee are positively correlated whereas the profitability and ownership concentration has a negative correlation with the capital structure. This paper suggests promotion of distribution of equity among the shareholders as the individual big shareholder has negative correlation with the capital structure, it also states that the company should also improve the bond financing as it helps in optimizing the capital structure.

OBJECTIVES

1. To analyze the influence of profitability and liquidity in determining the capital structure of a firm.
2. To examine the impact of growth and size on capital structure of a firm.
3. To determine the effect of tax shield on capital structure of a firm.

RESEARCH METHODOLOGY

- **Hypothesis**
  - The profitability of the firm is not related to the capital structure.
  - Liquidity of the firm is not positively related to the capital structure.
  - Growth of the firm has no impact on the capital structure of the firm.
  - The size of the firm does not influence the capital structure of the firm.
  - There is no relation between the tax shield and the capital structure of the firm.
- **Selection of sample**: The top five companies listed in NSE are considered as sample. The selection criteria is the market capitalization of the firms. The companies selected are Sun Pharma, Lupin, Dr. Reddys Labs, Aurobindo Pharm and Cipla.
- **Data collection**: This study is based on the information obtained through secondary sources. They are, the financial statements of the firms. The data is collected for over a period of 2012-16.
- **Data analysis**: Linear regression is used to find out the influence of significant factors in determining the capital structure of the selected firms.

DATA ANALYSIS AND FINDINGS

Debt equity ratio is used as the proxy variable for the capital structure and is the dependent variables and the rest of them are used as the independent variables. This method was adopted with the help of the review of literature. In this study we have used the regression analysis in the E-Views 8. The significance value used to test the hypothesis is 5% or 0.05. It is assumed that the amounts represented by the annual reports of the companies reveal true information.

TABLE 1

Variable	Coefficient	Std. Error	t-Statistic	Prob.
GROWTH	0.001426	0.001529	0.932256	0.3623
LIQUIDITY	-0.141372	0.080560	-1.754861	0.0946
PROFITABILITY	-2.108075	1.309829	-1.609428	0.1232
SIZE	0.041987	0.031152	1.347795	0.1928
TAXSHIELD	12.53682	8.054608	1.556478	0.1353
R-squared	0.426642	Mean dependent var		0.262400
Adjusted R-squared	0.311971	S.D. dependent var		0.272829
S.E. of regression	0.226305	Akaike info criterion		0.042990
Sum squared resid	1.024278	Schwarz criterion		0.286765
Log likelihood	4.462630	Hannan-Quinn criter.		0.110602
Durbin-Watson stat	0.850913			

ANALYSIS

- Various proxy variables have been used to arrive at the independent variables like natural log of sales for the size, current ratio used for the purpose of liquidity, the ratio of net income before extraordinary items to the total assets is used for the profitability, depreciation to total assets used for the tax shield and the growth percentage in the total assets used as the proxy for the growth.
- As per the regression analysis used at 5% as the significance value, all independent variables do not influence nor they have any positive relationship with the decisions made in setting the capital structure of a company. And it must be kept in mind that these are firm specific characters.
- If a firm is in a very good position, in the sense of good position what we mean is, where it has abundant funds available for itself through the internal sources, and thus does not influence the capital structure decisions.
- If a firm, has greater sales, then we can imply that there is a greater profitability of the firm and henceforth there will be a greater percentage of increase in its revenue and henceforth need not worry on getting the funds from outside and as proved in this case, profitability and size of the firm does not influence its capital structure decisions.
- A total increase in the growth of the assets of the firm, at the same time its liquidity ensures the easy availability of the funds for the firm and further growth of the firm's projects also does not influence its capital structure decisions as the firm can have more of the assets and its projects at a very liquefiable rate and henceforth it proves the null hypotheses. Moreover, in the case of tax shield, if there is a greater availability of the internal funds for the firm in its further expansion and its operations and henceforth the tax shield also does not affect the firm's capital structure decisions.
- The results are in line with our review of literature.

RESEARCH LIMITATIONS

- The research is done only on the companies listed in NSE, it can further be done in the BSE also.
- This paper has taken only 5 companies based upon the market capitalization and therefore further companies can be added based upon the other criteria.
- Further research can be done considering a wider time frame.

CONCLUSIONS

Thus, in this paper we have taken 5 companies based upon their market capitalization and we can make out that these are the top 5 companies in this industry. We have also taken only 5 firm specific characters for analyzing their effect on deciding the capital structure. One of the major drawback what we can find from this paper is, these are the top 5 companies and they perform well in the market and henceforth these factors have either no impact or no relationship with the capital structure (DE ratio) of the firm. The profitability and liquidity are not related to the firm's capital structure. There is no impact of the growth and the size on the firm's capital structure decisions. And finally there is no effect of the tax shield on the capital structure of the firm.

Further research can be carried out including the various other factors and also for a larger time frame and using a larger sample size with more criteria on the selection of the companies. Another drawback is, the data is solely based upon the secondary resources and any errors in the secondary sources may lead to the error in the analyses.

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