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   STATEMENT OF THE PROBLEM

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   HYPOTHESES

   RESEARCH METHODOLOGY

   RESULTS & DISCUSSION

   FINDINGS

   RECOMMENDATIONS/SUGGESTIONS

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RELATIONSHIP BETWEEN CAPITAL STRUCTURE AND FINANCIAL PERFORMANCE: EVIDENCE FROM INDIAN STOCK MARKET

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ABSTRACT

The purpose of this study was to understand the relationship between capital structure and financial performance of the companies. For this purpose, the study used definition of capital structure in scope of book value to market value and measures were assumed for financial performance. In this paper, I applied the data of 200 companies listed on National Stock Exchange (NSE) of India in a 5 year time horizon (2008-2012). Results of my study demonstrated that capital structure influences financial performance. The significance of the influence of capital structure on performance is respectively belonged to measures of adjusted value, market value and book value.

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KEYWORDS
Capital structure, Financial performance, Market Value

1. INTRODUCTION

Financial performance is a subjective measure of how well a firm can use its' assets from its' primary business to generate revenues. Erasmus, (2008) noted that financial performance measures like profitability and liquidity among others provided a valuable tool to stakeholders to evaluate the past financial performance and the current position of a firm. Brigham and Gapenski (1996) argued that in theory, the Modigliani and Miller model was valid however in practice, bankruptcy costs did exist and that these costs were directly proportional to the debt levels in a firm. This conclusion implied a direct relationship between capital structure and financial performance of a firm.

Berger & di Patti, (2006) concluded that more efficient firms were more likely to earn a higher return from a given capital structure, and that higher returns can act as a cushion against portfolio risk so that more efficient firms are in a better position to substitute equity for debt in their capital structure. This is an incidental of the trade-off theory of capital structure where differences in efficiency enable firms to alter their optimal capital structure either upward or downwards. In addition, Singh & Hamid, (1992) in their research, used data on the largest companies in selected developing countries and found that firms in developing countries used more of debt finance in financing their growth than was the case in industrialized countries. Abor, (2005a) also found a positive relationship between total assets and return on equity and that profitable firms in Ghana depended more on debt as a main financing option due to a perceived low financial risk.

Financing decisions are one of the most critical areas for finance managers. It has direct impact on capital structure and financial performance of the companies. It is a topic that continues to keep researchers pondering. Capital structure is directly related with the financing decision of the company. Primarily, it consists of the debt and equity used to finance the firm. Researchers continue to analyze capital structures and try to determine whether optimal capital structures exist. An optimal capital structure is usually defined as one that will minimize a firm's cost of capital, while maximizing shareholder's wealth. Hence, capital structure decisions have great impact on the financial performance of the firm. Exactly how firms choose the amount of debt and equity in their capital structures remains an enigma. Are firms mostly influenced by the traditional capital structures of their industries or are there other reasons behind their actions? The answers to these questions are very important, because the actions of managers will affect the performance of the firm, as well as will influence how investors perceive the firm. Much of the theory in corporate sector is based on the assumption that the goal of a firm should be to maximize the wealth of its current shareholders. One of the major cornerstones of determining this goal is financial ratios. Financial ratios are commonly used to measure firm's performance. Generally, corporations include these in their annual reports to stakeholders. Investment analysts provide these to investors who are considering the purchase of a firm's securities.

2. REVIEW OF LITERATURE

2.1 CAPITAL STRUCTURE THEORY

Capital structure puts into perspective the way in which a firm finances its operations Brigham,(2004), this can either be through debt or equity capital or a combination of both David, (1979). Capital structure theory as attributed to Modigliani and Miller concluded that it doesn't matter how a firm finances its' operations and that the value of a firm is independent of its' capital structure making capital structure irrelevant. The study was based on the assumption that there were no brokerage costs, earnings before interest and tax were not affected by the use of debt and that investors could borrow at the same rate as corporations and lastly there was no information asymmetry. Although this statement didn't reject the possible preference of a firm's owner to a certain type of financing over others, it did affect the irrelevance of the value of the firm to the means of financing it given a perfect market (Fischer, Heinkel, & Zechner, 1989). A number of theories were from then onward advanced to explain capital structure notable among which are the pecking order theory and trade off theory which have been often than not a centre of debate.

2.2 TRADE-OFF THEORY OF CAPITAL STRUCTURE AND TAXES

Myers, (2001) in his research on capital structure noted that the trade-off theory justifies moderate debt ratios. The purpose of the trade-off theory of capital structure is to explain the strategy a firm uses to finance investments which may be by equity and sometimes by debt. Tradeoff theory predicts that a weak firm will rely exclusively on a bank for debt capital. That is, for weak firms, bank debt dominates any mix of market and bank debt regardless of the priority structure. This result contradicts the notion that small/young firms avoid public debt because they lack access to such markets or face prohibitive costs in so doing (Hackbarth, Hennessy, & Leland, 2007). Within the tradeoff theory, there is a debt "pecking-order" with bank debt being preferred to market debt due to the lower implied bankruptcy costs. When the bank holds all ex post bargaining power, the desired level of debt tax shields can be achieved using only bank debt(Hackbarth *et al.,* 2007).

Myers, (2001) noted that the firm would borrow up to the point where the marginal value of tax shields on additional debt is offset by the increase in the present value of possible costs of financial distress. According to Modigliani & Miller, (1958), the attractiveness of debt decreases with the personal tax on the interest income. A firm experiences financial distress when the firm is unable to cope with the debt holders' obligations. If the firm continues to fail in making payments to the debt holders, the firm can even be insolvent. The theory can be explained by costs of financial distress and agency costs (Pandey, 2005)..

2.3. DETERMINANTS OF CAPITAL STRUCTURE

2.3.1 INTRODUCTION

A number of empirical studies have identified firm level characteristics that affect the capital structure of firms and these include:-

2.3.2 ASSET STRUCTURE

The asset structure of a firm plays a significant role in determining its capital structure. The degree to which the firm's assets are tangible should result in the firm having greater liquidation value Titman & Wessels, (1988a); Harris & Raviv, (1991). Bradley *et al* (1984) assert that firms that invest heavily in tangible assets also have higher financial leverage since they borrow at lower interest rates if their debt is secured with such assets. It is believed that debt may be more readily used if there are durable assets to serve as collateral (Wedig, Sloan, Hassan, & Morrisey, 1988). This will result in firms with assets that have greater liquidation value having relatively easier access to finance at lower cost.

Empirical research done by Bradley *et al* (1984); Wedig *et al.,* (1988); Friend & Lang (1988b); Mackie–Mason, (1990b); Rajan & Zingales, Shyam-Sunder, (1995); and Myers, 1999; Hovakimian *et al.,* (2004b), Kim and Sorensen 1986, suggested a positive relationship between asset structure and leverage for the firms, and a negative coefficient between depreciation expense as a percentage of total assets and financial leverage. In other studies done by Van der Wijst & Thurik, (1993) and Chittenden *et al.,* (1996); Jordan et al., 1998; Michaelas *et al.,* (1999); Cassar *et al.,(* 2003); Hall *et al.,* (2004) suggested a positive relationship between asset structure and long-term debt, and a negative relationship between asset structure and short-term debt. However, Esperanca *et al,* (2003) also found a positive relationship between asset structure and both long-term and short-term debt. The level of tangible fixed assets therefore may help firms to obtain more long-term debt.

2.3.3 FIRM SIZE

Large firms are seen to be more diversified and therefore have lower variance in earnings which gives them an upper hand in tolerating high debt ratios (Castanias, 1983). Smaller firms on the other hand may find it relatively more costly to resolve. Thus lenders to larger firms are more likely to recover their funds than lenders to smaller firms. This simply means that larger firms will have higher debt. Empirical evidence on the relationship between size and capital structure supports a positive relationship. Scholarly works as done by Barclay & Smith, (1996), Al-Sakran, (2001) and Hovakimian *et al.,* (2004a) suggest that smaller firms are likely to use equity finance while larger firms are likely to use debt. Cassar *et al., (* 2003), Esperanca *et al.,* (2003) and Hall *et al.,* (2004) found a positive relationship between firm size and long term debt ratios but a negative relationship between size and short term debt ratios.

2.3.4 FIRM AGE

As a firm continues in business, it establishes itself as a going concern thereby increasing its capacity to take on more debt. This therefore makes age positively related to debt. Age of the firm is a standard measure of reputation in capital structure models because as a firm continues longer in business, it establishes itself as a going concern and therefore increases its capacity to take on more debt making age positively related to debt. Hall *et al.,* (2004) concurred to the above aspect of capital structure noting that age is positively related to long-term debt but negatively related to short-term debt. Esperanca *et al.,* (2003), however, found that age is negatively related to both long-term and short-term debt. Green, (2002.) also found that age has a negative influence on the probability of incurring debt in the initial capital equation, and no impact in the additional capital equation.

2.3.5 FIRM GROWTH

Growth is likely to place a greater demand on internally generated funds and push the firm into borrowing (Hall et al., 2004). According to Marsh, (1982), firms with high growth will capture relatively higher debt ratios. In the case of small firms with more concentrated ownership, it is expected that high growth firms will require more external financing and should display higher leverage (Heshmati, 2002). Aryeetey, (1994) noted that growing Medium Sized Enterprises appear more likely to use external finance although it is difficult to determine whether finance induces growth or the opposite or both. As enterprises grow through different stages, they are also expected to shift financing sources. They may probably move from internal sources to external sources Aryeetey, (1994). Myers, (1977) however, holds the view that firms with growth opportunities will have a smaller proportion of debt in their capital structure.

2.3.6 FIRM RISK

Risk levels are one of the primary determinants of a firm's capital structure Kale *et al.* ,(1991). If a firm's operating risk is more volatile than the firm's earnings stream, the chance of the firm defaulting and being exposed to bankruptcy and agency costs is high. According to Johnson (1997), firms with more volatile earnings growth may experience more situations in which cash flows are too low for debt service.

Inspite of the above studies advanced, a number of studies have indicated an inverse relationship between risk and debt ratio Bradley *et al.,* (1984); Titman *et al.*,(1988a); Friend *et al,* (1988a); Mackie- Mason, (1990a); Kale *et al.,* (1991). Other studies suggest a positive relationship Jordan *et al.,* 1998; Michaelas *et al.,(1* 999). Esperanca *et al.,* (2003.) also found a positive relationship between firm risk and both long-term and short-term debt.

2.4 COMPONENTS OF CAPITAL STRUCTURE

2.4.1 EQUITY FINANCING

If a firm doesn't use debt financing, it's referred to as an un levered firm (Brigham 2004). This brings about what is referred to as business risk which is defined as riskiness inherent in the firm's operations if it doesn't use debt. If a firm doesn't use debt then its return on invested capital shall be measured by return on equity which is denoted by net income to common stock holders divided by common equity.

$$ROE = \frac{\text{Net income to common stock holders}}{\text{Common equity}}$$

This simply means that the business risk of a leverage free firm will be measured by the standard deviation of its Return on equity Brigham & Houston, (2007). The question is if a firm's Return on capital is measured using Return on equity in the absence of debt will the efficiency ratios exert a significant effect on leverage?

2.4.2 DEBT FINANCING

When a firm decides to use debt financing for its operations it's faced with a financial risk and it's referred to as a levered firm. Brigham & Houston, (2007) defined financial risk as that additional risk placed on common stock holders as a result of the decision to finance using debt. Financing risk is the probability that the earnings of the firm will not be as projected because of the method of financing. He also continues by saying that financing risk arises because debt has a fixed financing obligation usually in the form of interest which must be met when the obligation falls due before the shareholders can share in the retained earnings.

3. IMPORTANCE OF THE STUDY

Financing decisions are one of the most critical areas for finance managers. It has direct impact on capital structure and financial performance of the companies. It has always been an area for interest for researchers to understand the relationship between capital structure and financial performance of the company. This study provides a unique opportunity to examine the validity of the above statement and whether the financial performance of India firms can be explained by finance theory. Survival and growth needs resources but financing of these resources has limitation. Therefore, application of these should be in a way that creates an appropriate share of value for both providers and users of resources. Providers of resources are related with different levels of risk, benefit and control. Consequently, their expected returns are not the same. Use of debt leads to tax savings but on-time interest payments is a risk–taking way. On the other hand, lavishing stock holders wealth increases the value of expected returns of share holders so financing expenses will also be high. Thus a capital structure that means a merger of sources of finance minimizes the average costs of capital and leads to good performance is considered optimized one. The objective of this paper is to investigate the impact of financial leverage on the performance of publicly traded Indian companies.

4. STATEMENT OF PROBLEM

Although there has been a great deal of research on the subject of capital structure, this study makes a contribution to the literature in this area because it is an attempt to unfold the capital structure practices of companies operating in a unique environment. This is the environment where there are no personal taxes, a lat corporate tax rate, and a financial market system that is not very efficient. However, before looking into the specific of these companies, it would be more appropriate to review the literature available on this subject to see if the results drawn from our analysis are in conformity with the trends in capital structure. The purpose of this paper is to demonstrate the impact of defining the main variables of capital structure and performance on experimental results.

5. RESEARCH METHODOLOGY, HYPOTHESES AND DATA VARIABLES

The purpose of this paper is to demonstrate the impact of defining the main variables of capital structure and performance on experimental results. Therefore, the following hypotheses are extracted:

1) There is a significant relation between capital structure and return on investment (ROI);
2) There is a significant relation between capital structure and Return on equity (ROE);
3) There is a significant relation between capital structure and return on stock (RET);
4) There is a significant relation between capital structure and earnings before tax to sale ratio (EBT / S); and
5) There is a significant relation between capital structure and operational profit to sale ratio (OPR/S).

The starting point of my study is the firms listed at the National Stock Exchange of India. The 200 respondent firms in National Stock Exchange of India constituted the sample in our empirical test of the theoretical model. For these firms we collect data for the five-year period 2008-2012 from Prowess database of CMIE. Moreover, financial firms were excluded due to the peculiarity in terms of operations, structure of assets and liabilities that would hinder analysis and inter-company comparisons.

Internal secondary data was used in order to estimate the value of the dependent variable as well as the values of the independent explanatory variables. Archives, reports and documents are examples of internal secondary data. In the case of missing information, complementary data was collected by using reports available in the library and on the internet. Data was processed by descriptive statistics containing Mean, S.D and inferential statistics containing Pearson Correlation, ANOVA test using Statistical Package for Social Sciences (SPSS).

6. DATA ANALYSIS AND RESULTS

Data analysis is done as mentioned above and the results are drawn thereof.

6.1 DATA ANALYSIS

After gathering necessary data, they were analyzed by Excel and the variables were calculated. Then the variables entered in SPSS software and then correlation between dependent and independent variables were measured by using Pearson correlation coefficient. The difference between variables of capital structure is a result of the way of assessing equity in adjusted debt ratios, average price of selected firms at the end of the terms and average of shares in each of the studying terms has been used. For computing the market value of leverage, we use market value and the number of issued stock at the end of each term. To test the hypotheses, correlation matrix between capital structure and performance is used. Also to show the meaning fullness of the correlation between variables, instead of critical value of student's T test, significance level has been used when significance level is less than %5, H0 (null hypothesis) is rejected. In H0, it is assumed that there is not a link between two variables. Table 1 represents the empirical results from correlation matrix between variables. It is obvious that almost all the correlations (except tow items) are meaningful in level of %1.

TABLE 1: THE RESULTS OF CORRELATION

OPR / S_{it}	*EBT / S_{it}*	*RET_{it}*	*ROE_{it}*	*ROI_{it}*	*Variable*
-0.204	*-0.252*	*0.042**	*0.184*	*-0.329*	*BV_{it}*
-0.423	*-0.536*	*-.0162*	*-0.37*	*-0.604*	*MV_{it}*
0.52	*-0.649*	*-.105*	*-0.438*	*-0.695*	*$AjMV_{it}$*

Correlation in significance level of %95 isn't meaningful (other results are meaningful)

According to obtained results, AJMV v(adjusted market value), MV (market value) and BV (book value) of capital structure respectively have the most correlation with financial performance measures;

rPr,AjMV > **r**Pr,MV > **r**Pr,BV

6.2 RESULTS

Tests on coefficient of correlation demonstrated that there is a meaningful link between tree variables of capital structure and five variables of performance except the link between return on stock and book value of capital structure that is not meaningful in significance level of 95%. This correlation between return on stock and adjusted market value is 95% and among other variables is equal to 99%. Results from tests on correlations and regression revealed that except the link between return on stock (hypothesis 3) in which the correlation between return on stock and market value of capital structure is statistically stronger, in the other correlations, adjusted value has the strongest relationship with performance measures. The negative relationship is consistent with Myers' (1984) notion that in general firms prefer internal to external financing sources. Profits as internal sources reduce the dependency of firms on leverage.

TABLE 2: THE RESULTS FROM TESTS ON HYPOTHESIS

Hypothesis	Relationship between leverage	Result	*α*	Meaningful variables
1	*ROI_{it}*	Confirmed	%5	*BV_{it},3- MV_{it}, 2 – $AjMV_{it}$1–*
2	*ROE_{it}*	Confirmed	%5	*BV_{it},3- MV_{it}, 2 – $AjMV_{it}$1–*
3	*RET_{it}*	Confirmed	%5	*$AjMV_{it}$,2 – MV_{it} 1–*
4	*EBT / S_{it}*	Confirmed	%5	*BV_{it},3- MV_{it}, 2 – $AjMV_{it}$1–*
5	*OPR / S_{it}*	Confirmed	%5	*BV_{it},3- MV_{it}, 2 – $AjMV_{it}$1–*

Rajan and Zingales (1995) found that if return on stock and investments are fixed in a short term, and the main way of external financing is debt, there is a negative correlation between performance and leverage.

7. FINDINGS AND CONCLUSIONS

One of main factors subject to intense debate in capital structure studies is whether to use the market value or the book value of debt and equity as the correct measure of leverage. Those who favor the use of the book value measure present two strong arguments. First, the main cost of borrowing is the expected cost of financial distress in the event of bankruptcy. Financial distress affects the weighted average cost of capital and consequently the optimal leverage. In such a situation, the value of the distressed firm is closer to its book value. Once the debt has been issued, changes in the market value of that debt do not affect the interest tax shield cash savings. Furthermore, if bankruptcy occurs, the accurate measure of debt-holders' liability is the book value of debt and not the market value of debt. Second, previous studies have shown that managers think in terms of book rather than market values. Unlike market values, book values are more easily accessible, more accurately recorded and not subject to market volatility. On the other hand, those who prefer the market value to book value argue that the market value ultimately determines the real value of a firm. They suggest that it is possible for a firm to have a negative book value of equity while simultaneously enjoying a positive market value. This is possible because a negative book value reflects previous losses while a positive market value denotes the expected future cash flows of the firm. In practice, both measures of book and market values are often used. Results of this study demonstrated that market value and adjusted value measures of capital structure in comparison with book value measures have stronger link with performance. This means market value should be taken more into consideration in evaluating capital structure. Many measures of firm performance, such as a firm's profitability, are negatively correlated with financial leverage. This result can be interpreted in this way that high leverages companies would have less profitability. In other words, debt level is over than optimized level and in comparison to advantages of tax shield, incensement of financial distress costs has more significance. There are other evidences for this relationship as following: Informational asymmetry and high costs of external resources and inefficiency of the market. Total liabilities ratio (TL) is used as the main measure of leverage and all the others are employed for robustness checks. Why do we regard total liabilities ratio a more appropriate measure for capital structure? We argue that, firstly, when a firm wants to obtain more debt, the creditor will consider not only how much the firm's long term debt is, but also how much the firm's current debt and total liabilities are. So the portion of other liabilities will affect the debt capacity of a firm. Second, current debt is a quite steady part of total assets. The reasons behind using of debts by Indian companies may be constant interest rate in any level of debt and risk. Totally, with respect to observed link between capital structure and performance, the conclusion is that company that has high profitability and good performance have less debt. These results are consistent with the results of Mayers, Stulz, Rajan and Zingales. On the method side, it would be desirable to investigate the determinants of capital structure over a longer period of time and over a number of economic cycles. Finally, the analysis could be improved by differentiating between types of debt such as long-term and short-term debt.

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