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   STATEMENT OF THE PROBLEM

   OBJECTIVES

   HYPOTHESES

   RESEARCH METHODOLOGY

   RESULTS & DISCUSSION

   FINDINGS

   RECOMMENDATIONS/SUGGESTIONS

   CONCLUSIONS

   SCOPE FOR FURTHER RESEARCH

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THE CAPITAL STRUCTURE PUZZLE

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ABSTRACT

This paper is an attempt to analyze the important determinants of capital structure in Indian manufacturing industries in India in last decade. Over the past several years, financial economists and researchers have worked to bring more of scientific and predictive understanding in Corporate finance, this has been done by preparing formal theories that can be tested by empirical studies of corporate and stock market behavior. But this brings us to the most important issue to developing a well defined and exhaustive theory of capital structure which also find its applicability in actual market scenario and designing empirical tests that are powerful enough to provide a basis for choosing among the various theories. Several competing theories have reserchers have given there perspective in the form of theories, since Modigliani and Miller's famous propositions on the capital structure, to test the ground realities of capital market imperfections such as taxes, bankruptcy costs, agency costs, and information asymmetries. Therefore, the determinants of the capital structure of companies have been debated for long in corporate finance. To bring more clarity on it, this research attempts to test the important determinants of the capital structure of companies.

KEYWORDS
Capital Structure, Leverages, Debt –Equity ratio

INTRODUCTION
Some questions in finance-economics have not received there definitive answers, inspite of Corporate finance being discussed and taught in management schools for a century now. One of such are is "What determines the capital structure of a company". Miller-Modigliani (MM) arbitrage theorems on capital structure is considers to be milestone in this field. The actual financial market is far away from the assumptions of finance& economics assumptions of market imperfections and their effect on the share price of the firm. Most of the researchers in this have found that firms try to maintain a definitive debt ratio, to some extent which is affected by the market leaders of the specific sector. According to Myers, finance managers of a firm have a short term perspective while taking decisions related to sources of raising funds, they take the path of least resistance and choose what at the time appears to be the lowest-cost financing without considering its strategic results. Brander and Lewis (1986) and Maksimovic (1988)have found relation between capital structure and market performance. Contrary to the researchers who believe that the main objective of business is profit maximization objective, these theories, like the corporate finance theory, assume that the firm's objective is to maximize the wealth of shareholders, and show that market structure affects capital structure by influencing the competitive behavior and strategies of firms. Researchers' have developed models which have predicted a negative relationship between capital structure and market structure. As discussed in Myers (1984), it predicts a cross sectional relation between debt ratios and asset risk, size, profitability, tax status and asset type. Such have determined similar type of, risk characteristics and tax status, having similar leverage ratios. Bowen (1982) and Kim and Sorensen (1986) provide a negative relationship between non-debt tax shields and leverage. Conversely, Bradley (1984), Titman and Wessels (1988) and Homaifarl. (1994) have found a positive relationship between them. Ferri and Jones (1979), Kim and Sorensen (1986), and Chung (1993) show that there is no systematic association between firm size and capital structure. On the other hand Homaifar. (1994) and Titman and Wessels (1988) report results which are consistent with the notion that larger firms have higher debt ratios. Jaiilvand and Harris (1984) look at the determinants of speeds of adjustment to long term financial targets where the speed of adjustment is allowed to vary across companies and over time. Their results suggest that firm size, interest rates and stock price levels affect speeds of adjustment. In the UK firms, research on related topic has been notably done by Bennett and Donnelly (1993), Lasfer (1995), and Walsh and Ryan (1997). Bennett and Donnelly (1993) provide an examination of cross sectional determinants of leverage decisions among non-financial UK firms. They find that non-debt tax shields, asset structure, size and profitability are important determinants of capital structure of companies uneder study. The agency theory assumes that equity-controlled firms have a tendency to invest sub optimally to expropriate wealth from bondholders and the cost associated with this agency relationship is likely to be higher for growing firms. Ozkan (2001) presented further evidence on the negative and statistically significant relationship between growth opportunities and leverage. Nevertheless, Ozkan (2001) found a positive and statistically significant relationship between the lagged growth and leverage. He argues that the positive effect may happen because growth has a transitory effect on leverage ratios. Study done by T. Mallikarjunappa (2001) has found that Profitability, Collateral value of assets , Growth, Size, Tax, and Uniqueness do not have a significant influence on the capital structure of companies in the pharmaceutical industry in India. On the other hand, the variables Debt service capacity, non-debt tax shield, and Business risk emerge as the significant factors but their signs are in a different direction than what is hypothesized. Sahu (1997) study debt financing in the Indian corporate sector for 170 companies from 1979-80 to 1990-91 and report that, in the case of the total sample in 11 out of 12 years under study, the quantum of debt funds exceeded the volume of net worth. Besides, on an average debt funds constituted 71.5% of total fund sources of sample companies during 1979-91. Thus, heavy reliance by the total sample companies on debt funds is observed throughout the period under study.

DATA ANALYSIS, INTERPRETATION & FINDINGS
MODEL 1:KARL PEARSON'S CORRELATION ANALYSIS
DEPENDENT VARIABLES:
In this study Long term Debt-Equity ratio (D-E) is taken as dependent variable.
INDEPENDENT VARIABLE
Profitability (PROF): Earnings before interest and taxes scaled by total assets
Size (SIZ*):* Size is measured as a natural logarithm of sales
Collateral Value Of Assets (COVA): Net fixed assets deflated by total assets Growth (GROW): Growth is measured as a growth rate in yearly total assets.
Tax rate (TAXR): Tax rate is measured as a proportion of tax provision to profit before tax.
Business risk (RISK): It is been measured as the coefficient of variation of EBIT.

STATEMENT OF HYPOTHESES
On the basis of literature review following hypotheses have been formulated.
H_1: There is a positive relationship between PROF & D-E.
H_2: There is a negative relationship between SIZ & D-E.
H_3: There is a positive relationship between COVA & D-E.
H_4: There is a positive relationship between GROW & D-E.
H_5: There is a negative relationship between TAXR & D-E.
H_6: There is a negative relationship between RISK & D-E.

TABLE 1 : CORRELATION MATRIX: LEVERAGE AND DETERMINANTS

VARIABLES	D-E	PROF	SIZ	TANG	GROW	TAXR	RISK
D-E	1						
PROF	-0.4426	1					
SIZ	-0.3687	0.1933	1				
COVA	0.4982	-0.4105	-0.3776	1			
GROW	-0.7017	0.5052	0.6928	-0.6212	1		
TAXR	-0.0527	-0.0991	0.22647	-0.2534	0.1066	1	
RISK	0.7184	-0.2406	-0.0776	0.3971	-0.3457	-0.1058	1

According to the correlation matrix Table 1 the correlation coefficients are significantly different from zero at 95% confidence interval. The coefficients for COVA & RISK have significant positive relationship with D-E, while GROW, PROF & SIZ have significant but negative relationship. TAXR depicts significantly weak and negative relationship. In terms of magnitude highest correlation exists between D-E GROW (-0.68) followed by RISK(0.61), PROF (-0.55),COVA (0.50)& lastly SIZ (-0.37). Other significant relationship exists between SIZ & GROW (0.71), COVA & GROW (-0.62), PROF & GROW (0.49), COVA & RISK (0.41), COVA & SIZ (-0.37) and RISK &GROW (-0.35). Positive relationship between GROW & PROF and SIZ & GROW indicate increase in assets is attributable to increase in net earnings and sales revenue. Negative relationship between GROW & RISK implies increase in sales volume and asset structure decreases the systematic risk.

HYPOTHESIS TESTING

All the six hypotheses have been tested at 5% level of significance or at 95% confidence interval

The summary of critical t and calculated t tests pertinent to all hypotheses and their respective correlation coefficients r are reported at Table 2

INTERPRETATION AND FINDINGS

Result #1

Test statistic t - *2.205* > Critical t *2.201*, calculated t lies in the critical rejection region, the null hypothesis is rejected there is no positive relationship between PROF and D-E. We infer a negative relationship between PROF and D-E as correlation coefficient indicates the same decision.

TABLE 2: DECISION ON HYPOTHESES TESTING

Variables	Critical T	Statistical T	Table r	Statistical r	Null Hypothesis	Null Hypothesis
D-E	-	-	-	-	Accepted	Rejected
PROF	2.2010	-2.2048	0.5530	-0.5536	-	Ho
SIZ	2.2010	-1.3155	0.5530	0.5082	Ho	-
COVA	2.2010	1.9571	0.5530	0.5082	Ho	-
GROW	2.2010	-3.0903	0.5530	-0.6817	-	Ho
TAXR	2.2010	-0.1085	0.5530	-0.0327	Ho	-
RISK	2.2010	2.6099	0.5530	0.6184	-	Ho

NOTE: Indicates significance at 5% level. Degrees of Freedom n - 2. r pertains to Coefficient of Correlation.

Result #2

The hypothesis has been tested at 5% level of significance or at 95% confidence interval Test statistic t = - *1.316* < Critical t = *2.201*, calculated t lies in the acceptance region, the null hypothesis is accepted there is a negative relationship between SIZ and D-E.

Result #3

There is a positive relationship between COVA and D-E it has been ascertained from the Test statistic t *1.957* which is < Critical t *2.201*, calculated t lies in the acceptance region, therefore the null hypothesis is accepted we infer a positive relationship between COVA and D-E.

Result #4

There is enough evidence to infer a negative relationship between GROW and D-E as Test statistic t - *3.090* > Critical t *2.201*, calculated t lies in the critical rejection region, the null hypothesis stating a positive relationship between GROW and D-E. is rejected. There is a sufficient evidence of a negative relationship between GROW and D-E.

Result # 5

There is enough evidence to infer a negative relationship between TAXR and D-E, as Test statistic t - *0.1085* < Critical t *2.201*, calculated t lies in the acceptance region, the null hypothesis is accepted.

Result # 6

There is a significant evidence of a positive relationship between RISK and D-E. Test statistic t *2.610* > Critical t *2.201*, calculated t lies in the critical rejection region, therefore the null hypothesis is rejected.

Evidence from summarized result table: 2 indicate profitability (PROF) of manufacturing companies has negative relationship with the leverage (D-E). This result is consistent with the implication of pecking order theory . It implies that manufacturing companies that are profitable are less likely to resort to debt financing. The same result obtained by Titman & Wessels (1988) and Rajan & Zingales (1995) in their respective analysis. Size (SIZ) has positive association with the leverage (D-E) ratio. This result is consistent with the implication of trade off theory but is not significant. Research by Remmers et. al. (1974), finds no significant effect of size on capital structure. This result suggests large sized firms have high leverage (D-E) and Pandey et.al. (2000) and Gonenc (2003) have testified positive relationship. Consistent with both pecking order theory and the trade off theory Colletral Value of assets (COVA) is positively associated with the leverage (D-E). Empirical evidence of Titman & Wessels (1988), Rajan & Zingales (1995) Pandey. (2000) also observed positive relationship. Growth (GROW) opportunities as measured by sales growth scaled by corresponding asset growth are found to have a negative relationship with the leverage (D-E) in accordance to pecking order theory. Manufacturing firms experiencing high growth rate resort to less borrowing hence have low leverage (D-E). Myers (1977) indicated leverage to be inversely related to growth opportunities. The magnitude of association of tax rate (TAXR) and leverage (D-E) is negative having correspondingly weak effect. This finding contradicts hypothesized results owing to deferred taxation issue with the sample company. There is a positive relationship business risk (RISK) or volatility and leverage (D-E). The result implies paint manufacturers with high business risk (volatility) have high leverage (D-E). Bradley, Jarell & Kim (1984) and Barclay & Smith (1995) in their argument have stated negative relationship. According to Qian, Tian & Wirjanto (2007) this is attributable to positive relationship between leverage and size. Research studies by Bradley et al. (1984), Kester (1986), Long & Malitz (1985) and Baskin (1985) agree that leverage increase with tangibility while it decreases with profitability. The conclusion of this analysis is that profitability, tangibility and growth are significant determinants in the choice of capital structure by the manufacturing companies.

CONCLUSION

The result shows null hypothesis relating to profitability, growth and business risk are rejected based on t testing despite having statistically significant coefficients (both +ve & ve). The findings are consistent with the predicted hypotheses and the implication of theories. Null hypothesis relating to size, COVA and tax rate is accepted based on t testing only tangibility has statistically significant coefficients whereas size and tax rate denotes significantly weak correlation. The findings are consistent with the predicted hypotheses. Evidence from summarized result table: 2 indicates profitability (PROF) of manufacturing companies has negative relationship with the leverage (D-E). This result is consistent with the implication of pecking order theory . It implies that manufacturing companies that are profitable are less likely to resort to debt financing. Size (SIZ) has positive association with the leverage (D-E) ratio. This result is consistent with the implication of trade off theory but is not significant. Research by Remmers (1974), finds no significant effect of size on capital structure. Consistent with both pecking order theory and the trade off theory Collateral value of assets (COVA) is positively associated with the leverage (D-E). Growth (GROW) opportunities as measured by sales growth scaled by corresponding asset growth are found to have a negative relationship with the leverage (D-E) in accordance to pecking order theory. Manufacturing firms experiencing high growth rate resort to less borrowing hence have low leverage (D-E). The magnitude of association of tax rate (TAXR) and leverage (D-E) is negative having correspondingly weak effect. There is a positive relationship business risk (RISK) or volatility and leverage (D-E). The result implies paint manufacturers with high business risk (volatility) have high leverage (D-E). The conclusion of this analysis is that profitability, tangibility and growth are significant determinants in the choice of capital structure by the manufacturing companies.

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