INTERNATIONAL JOURNAL OF RESEARCH IN COMMERCE, ECONOMICS & MANAGEMENT

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   STATEMENT OF THE PROBLEM

   OBJECTIVES

   HYPOTHESES

   RESEARCH METHODOLOGY

   RESULTS & DISCUSSION

   FINDINGS

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CAPITAL STRUCTURE AND ITS IMPACT ON PROFITABILITY: EVIDENCE FROM SRI LANKAN LISTED BANKS

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ABSTRACT

The purpose of this study were to determine relationship between two capital structure mechanisms (debt to equity and debt to total funds) and three profitability measures (ROCE, ROE and NIM) of a sample of ten Sri Lankan listed banks from financial year 2008-2012.the data have been analyzed by using descriptive statistics and correlation analysis to find out the association between the variables. The results show that there is a significant impact of capital structure on ROCE while insignificant with ROE. The results also show that NIM is negatively correlated with debt to total funds. These results are consistent with prior empirical studies. Further recommendations are also put forwarded in the research.

KEYWORDS

Capital structure, profitability ratios, banking industry.

INTRODUCTION

Capital structure is one of the most puzzling issues in corporate finance literature (Brounen & Eichholtz, 2001). The relationship between capital structure and profitability is one that receives considerable attention in the finance literature. Each and every business organizations need adequate fund to run its business effectively and efficiently. A firm can raise fund from different sources and take different forms. However, the capital can mainly be categorized into two debt and equity. How a firm financed? Either with all debt or all equity or mix of both. What is the optimum mix that leads to the maximum value of a firm? Capital structure theory deals with it. Thus the proportion of debt to equity is a strategic choice of corporate managers. In finance, the most debatable topic is capital structure. The main issue of debate revolves around the optimal capital structure. So capital structure refers to the way a firm finances its assets through some combination of equity, debt, or hybrid securities. A firm's capital structure is then the composition or 'structure' of its liabilities.

Profitability is the ability of a firm to generate net income on a consistent basis. Ratios are used as a benchmark for evaluating the performance of a firm. Ratios help to summarize large quantities of financial data and to make qualitative judgment about the firm's profitability. So Capital structure decision is the vital one since the profitability of an enterprise is directly affected by such decision. Hence, proper care and attention need to be given while determining capital structure decision.

Basically, banks engage in financial intermediation to ensure efficient mobilization & disbursement of funds to the real sector of the economy. Though other financial institutions exist to engage in the intermediation process banks are considered the most important financial intermediaries. The board of directors of the bank should develop an appropriate capital structure, which is most advantageous to the bank. This can be done only when all those factors, which are relevant to the bank's capital structure decision, are properly analyzed and balanced.

This study analysis the impacts of capital structure on profitability of listed banks in Sri Lanka. The relationship between capital structure and profitability is one that received considerable attention in the finance literature. The modern industrial firm must conduct its business in a highly complex and competitive business environment. Therefore, these types of research findings will be benefited in selecting the capital structure to achieve the optimum level of firm's profitability. This study shows the statistical analysis carried out seeking to discover is there any relationship between capital structure and profitability of the listed banks in Sri Lanka.

RESEARCH PROBLEM

The capital structure decision of a bank is similar to that of a non financial firm. Although there are considerable inter industry differences in the capital structure of firms due to the unique nature of each industry's business, the intra-firm variations are attributed to the business and financial risk of individual firms. From the foregoing discussions based on the available empirical literature, it is crystal clear that results from investigations into the relationship between capital structure and profitability are inconclusive and requires more empirical work.

An important question facing companies in need of new finance is whether to raise debt or equity. In spite of the continuing theoretical debate on capital structure, there is relatively little empirical evidence on how companies actually select between financing instruments at a given point of time in order to attain optimum profitability. Hence, the main problem of this research is to what extent the capital structure impacts on profitability of listed banks in Sri Lanka?

OBJECTIVES OF THE STUDY

The objectives of this research are geared towards the following:

- To identify the relationship between capital structure and profitability of listed banks in Sri Lanka.
- To find an optimal capital structure that would be associated with the best performance.
- To find out the impact of capital structure on profitability.

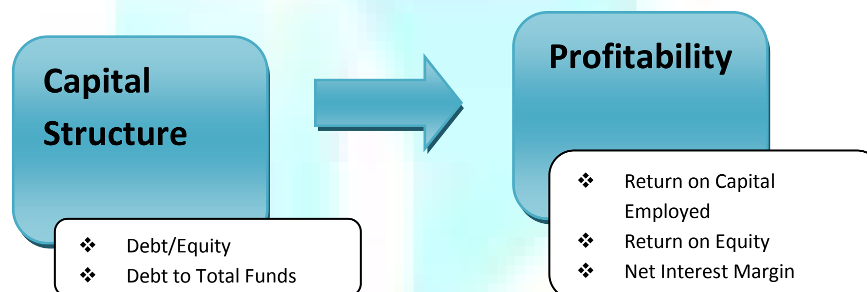
REVIEW OF LITERATURE

One of the most important financial decisions facing companies is the choice between debt and equity capital (Glen & Pinto, 1994). This decision can effectively and efficiently be taken when managers are first of all aware of how capital structure influences firm profitability. This is because; this awareness would enable managers to know how profitable firms make their financing decisions in particular contexts to remain competitive. In the corporate finance literature, it is believed that this decision differs from one economy to another depending on country level characteristics.

Dimitris, M. & Maria, P. (2008) investigated the relationship between capital structure, ownership structure and firm performance across different industries using a sample of French manufacturing firms. They found that a negative relationship between past profitability and leverage and there will be a positive relation between profitability and leverage.
Peterson & Rajan (1994) found a significantly positive association between profitability and debt ratios in a study designed to investigate the relationship. Ooi (1999) argues that profitable firms are more attractive to financial institutions as lending prospects. The reason is that, those firms are expected to have higher tax shields and low bankruptcy costs. According to Scher et al. (1993), start-up firms with higher anticipated profitability have higher debt to equity ratios. In a study developed to investigate the relationship between profitability and firm leverage, Taub (1975) in a regression analysis of four profitability metrics against debt ratio found a significantly positive association between debt and profitability.
According to Bos & Fetherston (1993), capital structure affects both profitability & riskiness of firms. These believe has been held by earlier researchers such as Miller & Modigliani (1963) and Titman & Wessels, (1998). As a result, numerous studies have been conducted by academic writers to examine the impact of capital structure on firm profitability.
According to Champion (1999) & Leibestein (1966), companies can use more debt to enhance their financial performance because of debt's capability to cause managers to improve productivity to avoid bankruptcy. The point here is that, debt must be repaid while dividend payment is not obligatory and can even be postponed if the firm is financially hard up. Furthermore Roden & Lewellen (1995) observed a significantly positive association between profitability and total debt in a study developed to find out the percentage of total debt in leverage buyouts. In a study designed to examine the effect the effect of capital structure on profitability of listed firms on the Ghana Stock Exchange, Abor (2005) has reported a significantly positive relationship between the ratios of short term debt to total assets & profitability but a negative association between the ratio of long term debt to total assets and profitability.
The relationship between capital structure and company profitability is always explained in the corporate finance literature within the framework of "Pecking order theory". Within this framework, firms would always prefer internal sources of finance as opposed to external sources (Myers, 1984; Myers & Majulf, 1984). These authors argue that internal funding which is specifically the use of retained earnings is cheaper as a source of finance relative to external funding which is exclusively the use of debt and equity. This preference is due to the cost that is associated with the information asymmetry that exist between managers and outside market participants thus making external funding expensive. Generally, the investors are of the view that managers would only issue over valued shares and vice versa thereby raising cheap capital. Although this proposition may not always be true, investors often demand higher returns to compensate when there is a new issue thus making external funding relatively expensive (Barclay & Smith, 2005). As a result, astute managers would ignore external funding and use internal sources instead.
Titman & Wessels (1988) contend that firms with high profit levels, all things equal, would maintain relatively lower debt levels since they can realize such funds form internal sources. Furthermore, Cassa & Holmes (2003) and Hall et al. (2004) all found negative relationship between profitability and both long-term debt and short-term debt ratios.
Bourke (1989) reported that capital ratios are positively related to profitability. Bourke explained this by assuming that well capitalized banks may enjoy access to cheaper and less risky sources of funds and better quality asset markets. Alternatively the prudence implied by high capital ratios may also be maintained in their asset portfolio decisions with consequent improvement in loan loss provision and hence profitability.
The effect of the capital structure on profitability is non-trivial, especially for banks subject to regulatory requirements. Fischer, Henkel & Zechner (1989) show that profitability is rather insensitive to the capital structure due to adjustment costs. Since banks are active players on the global capital markets, they face relatively low transaction costs for adjusting their capital structure. Therefore it is likely that a bank's tolerance with respect to deviations in its capital structure from the target capital structure is very limited and that profits react fast to holding an in-efficient capital structure.

CONCEPTUALIZATION

FIG. 1: CONCEPTUALIZATION MODEL



OPERATIONALIZATION

Concept	Variable	Indicator	Measurement
Capital Structure	Role of Debt and Equity	Debt to Equity	Debt x 100 / Equity
	Role of Debt and Total Funds	Debt to Total Funds Ratio	Debt x 100 / Debt + Equity
Profitability	Return on Capital Employed (ROCE)	Profit based on Capital Employed	PBIT x 100 / Capital Employed
	Return on Equity	Profit based on Equity capital	Net profit after interest and tax x 100 / Equity
	Net Interest Margin	Net interest based on Total assets	Interest received – Interest paid x 100 / Total assets

HYPOTHESES OF THE STUDY

The following hypotheses are developed for testing.
H1: There is a positive relationship between debt to equity and ROE
H2: There is a positive relationship between Debt to Equity and ROCE
H3: There is a positive relationship between debt to equity and NIM
H4: There is a positive relationship between debt to Total Funds and ROE
H5: There is a positive relationship between debt to Total Funds and ROCE
H6: There is a positive relationship between debt to Total Funds and NIM

METHODOLOGY

DATA COLLECTION

This study uses secondary data for the analysis. The financial statements which are made up of income statements and balance sheets of the sample banks were the main sources of data for this study. These were obtained from the Hand book of Listed Companies and the annual reports of respective banks. Further, scholarly articles from academic journals, relevant text books on the subject and the internet search engines were also used. Specifically, the financial statements of the banks in the sample are planning to collect for the period 2008-2012 and a balanced panel of ten banks emerged for the study.

SAMPLING DESIGN

The sample of this study composed of ten banks listed in the Colombo Stock Exchange and period of 5 years from 2008 to 2012. Bank Finance & Insurance sector was selected for the present study among the 20 industry sectors. From this sector the following ten listed Sri Lankan banks were selected to carry out the research;Commercial Bank of Ceylon Limited, Hatton National Bank Limited, Housing Development Finance Corporation Bank of Srilanka, Merchant Bank of Srilanka PLC, National Development Bank PLC, Nations Trust Bank Limited, People's Merchant Bank PLC, Sampath Bank Limited, Seylan Bank PLC, Seylan Merchant Bank PLC.

DATA ANALYSIS

The quantitative research approach is employed to find out the findings of the research study. Since numerical and secondary data is used, quantitative approach is considered to be a suitable approach for the study. The upper level of statistical significance for hypotheses testing was set at 5% and 1%. All statistical test results were computed at the 1-tailed level of significance. Descriptive statistics are used to describe and summarize the behavior of the variables in a study. Further, the following Statistical Tools are used in the study Correlation: - To identify the relationship between capital structure and profitability. Regression: - To find out the impact of capital structure on profitability. Data analysis is done by using the SPSS package (Version 16.0).

RESEARCH MODEL

A correlation analysis is used to investigate one variable from one or more other variables. Here also this analysis was performed to identify the impact of capital structure on profitability.

To test the relationship between capital structure and profitability, the following function was considered.

P=ƒ (ROCE, ROE and NIM)

Which shows profitability is the function of capital structure.

Here capital structure is measured with the help of Debt to equity ratio and Debt to total funds ratio. It is important to note that the profitability is measured with the help of three ratios namely Return on Capital employed, Return on equity and net interest margin.

RESULTS AND ANALYSIS

DESCRIPTIVE STATISTICS OF THE VARIABLES

TABLE NO. 01: DESCRIPTIVE STATISTICS

	N	Minimum	Maximam	Mean	Std.deviation
ROCE	10	9.32	25.42	14.8218	5.16101
ROE	10	-25.03	19.48	9.5116	18.51050
Net Interest Margin	10	3.49	8.22	4.9070	1.73385
Debt Equity	10	182.25	1535.88	825.1531	501.59839
Debt to Total Fund	10	77.48	152.39	88.6591	6.84658
Valid N (listwise)	10				

The descriptive statistics above show that over the period under study, the profitability ratios measured by return on capital employed, return on equity and net interest margin averaged 14.8, 9.5 and 4.9 respectively. The debt/equity ratio stood at 825.2 and debt to total funds averaged 88.7. This is an indication that approximately 89% of total assets in the banking sector of Sri Lanka are represented by debt, confirming the fact that banks are highly geared institutions. The maximum and minimum values for debt/equity ratio indicate that the debt/equity composition varies substantially among the listed banks in Sri Lanka

CORRELATION ANALYSIS

TABLE NO. 02: CORRELATIONS MATRIX FOR CAPITAL STRUCTURE AND PROFITABILITY

		Debt to Equity	Debt to Total Funds Ratio	ROCE	ROE	Net Interest Margin
Debt to Equity	Pearson Correlation	1				
	Sig. (2-tailed)					
Debt to Total Funds Ratio	Pearson Correlation	.357*	1			
	Sig. (2-tailed)	.011				
ROCE	Pearson Correlation	.549**	.407**	1		
	Sig. (2-tailed)	.000	.003			
ROE	Pearson Correlation	.077	.101	-.181	1	
	Sig. (2-tailed)	.595	.487	.208		
Net Interest Margin	Pearson Correlation	.186	-.637**	.114	-.202	1
	Sig. (2-tailed)	.195	.000	.429	.159	
*. Correlation is significant at the 0.05 level (2-tailed).						
**. Correlation is significant at the 0.01 level (2-tailed).						

Correlation analysis was built in order to test the linear relationship between various independent and dependent variables used in this study.

The above mentioned table shows the relationship between debt/equity ratio and return on capital employed. The correlation value is -.181 and which is not significant. Debt/equity ratio shows a weak negative correlation with return on capital employed. The correlation value between debt to total funds and return on capital employed is .549, which is significant at 0.01 levels. This reveals that there is a significant moderately positive relationship between debt to total funds and return on capital employed. The correlation value between debt/equity ratio and return on equity is .077 and which is not significant. This shows that there is a weak positive association between debt/equity ratio and return on equity.

The table mentioned above also illustrates the association between debt to total funds and net interest margin. The correlation value is -.637, which is significant at 0.01 levels. This shows that there is a significant strong negative relationship between debt to total funds and net interest margin.

HYPOTHESIS TESTING

No	Hypotheses	Results	Tools
H1	There is a positive relationship between debt to equity and ROE	Rejected	Correlation
H2	There is a positive relationship between Debt to Equity and ROCE	Accepted	Correlation
H3	There is a positive relationship between debt to equity and NIM	Rejected	Correlation
H4	There is a positive relationship between debt to Total Funds and ROE	Rejected	Correlation
H5	There is a positive relationship between debt to Total Funds and ROCE	Accepted	Correlation
H6	There is a positive relationship between debt to Total Funds and NIM	Rejected	Correlation

CONCLUSION AND RECOMMENDATION

Several studies have been conducted on the examination of the impact of capital structure on bank profitability, but there are mixed results in different conceptual frame work. Banks generally play a crucial role in the economic development of every country. One critical decision banks face is the debt-equity choice. Among others, this choice is necessary for the profit determination of firms. What this means is that banks that are able to make their financing decision prudently would have a competitive advantage in the industry and thus making superior profits. Nonetheless, it is essential for us to recognize that this decision can only be wisely taken if banks know how debt policy influences their profitability.

This study examined the relationship between capital structure and profitability in Sri Lankan banks. The study covered 10 listed banks over the period of 2008 to 2012. The analysis of listed banks shows that debt equity ratio is positively associated with all profitability ratios such as Return on equity, Return on capital employed and Net interest margin. Total debt was found to be significant in determining return on capital employed in the banking industry of Sri Lanka. Debt to total funds ratio is positively associated with ROE and ROCE and it is significantly correlated to ROCE. But with net interest margin it is negatively correlated.

LIMITATIONS AND SCOPE OF FUTURE RESEARCH

The identified limitations of this study are as follows: This study is restricted only to the listed banks in the Banks, Finance & Insurance sector in Sri Lanka, Data representing the period of 2008 to 2013 will be used for the study and this report Preparation is based on the approximate information and data collection.

The current research has compiled a large database of listed bank's accounting data that demonstrate what can be done even with the limitations of currently available data. There is clearly enormous scope for more research that can inform an understanding of how the capital is structured, how it connects with the profitability and what elements of capital structure make a difference. To develop specific policy recommendations author suggest the following further research.

- This study has utilized only standard forms of profitability measures. A more precise measure of profit can be obtained with the help of Economic Value Added (EVA) concept.
- The sample used in this study consisted only ten banks which indicate the sample is relatively small.
- Another research area that could be extended is to examine capital structure and profitability to the non-listed banks.
- A supplementary analysis ought to be conducted to test whether the differences in firm characteristics has an impact on the way firms in Sri Lanka choose to finance their investments.

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