A STUDY ON

"CAPITAL STRUCTURE"

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ABSTRACT:

Abstract Capital form is the mixture of debt financing and fairness financing. Its desire and determinants related to many extremely good factors. This paper endeavour's to answer the very questions of what determines the capital form of Pakistani listed cement organizations. This paper gives several traditional theories discussed on capital form, which includes trade-off idea, corporation value concept and principle of pecking-order. The information of 20 organizations for three financial years 2007, 2008, 2009 is taken. The have a look at shows that besides size, all other variables have exquisite dating with leverage and may be used for making decisions by businesses in cement industry. The correlation evaluation is used to degree the effects of various variables at the leverage & so, locating out the determinants of the capital shape in cement industry. The take a look at permits the manage in choice making at the same time as putting their leverage ratio, as they may be capable of recognize that as a lot as what extent profitability, growth & tangibility will be tormented by decrease or growth in leverage.

KEYWORDS: *Capital structure, Pecking-order theory, Agency costs, Tangibility, Growth opportunity.*

INTRODUCTION:

The have a examine of capital shape attempts to provide an explanation for how listed corporations utilise the combination of various sorts of securities that lets in you to finance investment. Modigliani and Miller (1958: 201) established that capital form is irrelevant under high quality restrictive assumptions. Ever when you consider that then, many researchers have approached the examiner of business enterprise capital shape under much much less restrictive assumptions. This has led to the confirmation of a existence of the top of the line preference of capital structure. Unfortunately, there has been little consensus amongst researchers on what the simplest capital shape is. However, it is important to synthesise the literature on capital shape and wherein possible, to relate the literature to recognised empirical evidence.

Capital structure stays a challenge, even though many theorists have attempted to provide an explanation for the debt ratio variation across companies. Pioneering research on capital shape based totally their hypotheses on perfect capital market conditions that lead to rather theoretical assumptions. Campbell and Rogers (2018) discussed approximately the Corporate Finance Trilemma that happens since organizations would love to determine on their debt, coins holdings, and equity pay-out policies at the equal time, but firms cannot. Nevertheless, Ardalan (2018) proved that there prevails an top of the line capital shape for the firm. However, for groups based totally inside the fundamental markets of United Kingdom,

Germany, France, and PIIGS (Portugal, Italy, Ireland, Greece, and Spain) considerable discrepancy was set up in their capital systems among 2006 and 2016 (Campbell and Rogers 2018). As well, DeAngelo and Roll (2015) noticed for U.S. groups, capital shape stability is the exception, no longer the rule.

Modigliani and Miller provided direction and guidelines for the researchers to examine the financing styles and later numerous hypotheses were put forward or good sized paintings has been completed by researchers to examine the determinants of capital shape. In 1963, Modigliani and Miller wrapped up the company tax assumption and meant that the fee of the company or fee of capital varied with the variation in the usage of debt capital because of tax benefits (Baral 1996). MM considered the corporate taxes and concluded that due to tax deductibility of interest; the usage of debt increases the price of the company. So the companies can use 100�bt. Because of the unrealistic assumptions in MM irrelevance idea, research on capital structure gave birth to different theories: the static trade-off, the pecking order theory, signalling concept and the business enterprise principle.

REVIEW OF LITERATURE:

The work of Modigliani and Miller (1958) (henceforth "MM") and the preceding theoretical contributions—amongst which must be noted Durand (1952); Guthmann and Dougall (1955)—have struggled with numerous inconsistencies. If the traditional thesis inconveniences stemmed from assuming the knowledge of the market structure and interest rates, the MM criticisms are especially caused by the indebtedness risk. Summarizing, MM's initial theory stated that the price of a organization couldn't be suffering from amending the debt–capital ratio.

The effects of various explanatory variables on capital structure have been targeted by an awful lot theoretical and empirical studies for decades and in exclusive environments. In this section, it's far proposed to review existing literature in the discipline of capital structure. For this purpose, the research studies of different countries are reviewed below.

Modigliani and Miller (1958) have a principle of "capital shape irrelevance" in which argue that monetary leverage does no longer have an effect on the firm's market price with assumptions associated with homogenous expectations, ideal capital markets and no taxes.

OGBULU, Onyemachi Maxwell and EMENI, Francis Kehinde(2012) have made an attempt on the impact of capital shape on a firm's value. The evaluation became implemented on a pattern of 124 organizations quoted on the Nigerian Stock Exchange (NSE) for the year ended thirty first December 2007. The normal least squares approach of regression become employed in wearing out this evaluation. The end result of the have a look at reveals that in an rising economic system like Nigeria, equity capital as a element of capital shape is beside the point to the price of a firm, while Long-term-debt was located to be the foremost determinant of a firm's fee.

Faiza Saleem (2013) examined the determinants of capital shape in Oil and Gas companies listed on Karachi Stock Exchange of Pakistan on a statistics in the course of 2006 to 2011. Multiple regression approach is used to research the connection between established variable (Leverage) and unbiased variables (Firm Size, Tangibility of Assets, Profitability, and Sales Growth). It is concluded that each one the impartial variables have sizeable effect on the balance of leverage. It is concluding that firm size, tangibility of assets and profitability

having fine relationship with leverage. On the other hand, sales growth has negative courting with leverage.

Despite the tension of its assumptions, the model is useful to determine beneath which conditions the capital structure becomes irrelevant:

- ✓ there are no transaction costs on the capital market;
- ✓ it is possible to lend and borrow money at the risk-free interest rate;
- ✓ there are no bankruptcy costs;
- ✓ firms could issue only two types of securities: free interest risk bonds and common shares;
- ✓ all the companies are included in the same risk class;
- ✓ the cash flows are constant and perpetual;
- ✓ all the agents have the same information (there is no possibility of arbitration by sending market signals);
- ✓ the managers want to maximize shareholders value (there is no agency costs);
- ✓ The cash flows are not affected by the changes in the capital structure.

OBJECTIVES OF THE STUDY:

Capital structure selection is the crucial one because the profitability of an organisation is directly stricken by such decision. The successful selection and use of capital are one of the key elements of the firms' monetary strategy. Hence, proper care and attention want to be given even as determining capital structure choice. In this study, determinants of capital structure in Indian context are examined as regards to capital structure theories. So, the objective of this paper is to check the effect of various explanatory variables of capital shape.

RESEARCH METHODOLOGY:

DATA:

This study is based on the financial facts of 18 firms of cement enterprise from 2006-2010 and has been taken from the State Bank of Pakistan Publications "Balance Sheet Analysis of Joint Stock Companies Listed on the Karachi Stock Exchange 2005-2010".

SAMPLE SIZE:

As this examine has targeted the Cement Sector, so best 18 corporations (which can be indexed at the Karachi Stock Exchange) within the cement sector (who's published was available) are selected even as 3 corporations were no longer taken due to incomplete and insufficient facts. So, there are about ninety firm-years for panel records analysis.

PERIOD OF STUDY:

The study covers a period of ten years starting from 2002-03 to 2011-12.

HYPOTHESIS:

This study has tested the following null hypotheses on relationship between the defined variables and capital structure:

H01: There is no significant relationship between the size and financial leverage.

H02: There is no significant relationship between the business risk and financial leverage.

H03: There is no significant relationship between the earnings and financial leverage.

H04: There is no significant relationship between the Liquidity and financial leverage.

H05: There is no significant relationship between the tangibility and financial leverage.

H06: There is no significant relationship between the debt service capacity and financial leverage.

H07: There is no significant relationship between the Non-debt –Tax Shield and financial leverage.

H08: There is no significant relationship between the operating leverage and financial leverage.

THEORETICAL CONCEPTS:

THE TRADE-OFF THEORY

The trade-off theory of capital structure postulates that managers attempt to stability the benefits of interest tax shields towards the present value of the possible expenses of monetary misery (Myers 2001: 88). This concept originated from the have a look at of Kraus and Litzenberger (1973: 911), who formally introduced the hobby tax shields related to debt and the prices of financial misery into a state desire model. According to Chakraborty (2010: 296), the trade-off theory postulates that some form of premier capital shape should exist pursuant to the balance among the present fee of interest tax shields and the price of bankruptcy. Bankruptcy costs can be classified under direct and indirect charges. As proven in Baxter (1967: 395), direct costs of bankruptcy include, inter alia, the administrative and legal charges incurred by means of a organization that is going bankrupt. On the alternative hand, the indirect prices relate to the reduction within the market price of the firm due to the company's lack of ability to service its debt obligations.

THE AGENCY THEORY

The organization concept is based totally on the belief that managers will not continually act in the quality interest of the shareholders. Jensen and Meckling (1976: 305) further complex on this idea by figuring out two important conflicts among events to a company, firstly, among the managers and shareholders, and secondly, between the shareholders and the creditors. In the primary instance, managers are tempted to pursue the earnings of the corporations they manage to their own personal advantage at the rate of the shareholders. In the latter instance, debt affords shareholders with the incentive to make investments sub-optimally. Harris and Raviv (1991: 301) argue that if an investment yields returns higher than the face price of the debt, the blessings accrue to the shareholders. Conversely, if the funding fails, the shareholders enjoy restricted liability by exercise their right to stroll away. This leaves the debt holders with a corporation whose market fee is less than the face fee of the extremely good debt.

THE SIGNALLING THEORY

The signalling theory emanates from information asymmetries between organization management and shareholders. If managers agree with that their companies are undervalued, they'll issue debt first and then problem fairness as a closing resort. Conversely, if management believes that their company is overvalued, they will problem equity first. The signalling theory was first coined by means of Ross (1977: 23) who posits that if managers have inside statistics, their preference of capital shape will signal facts to the market. Leverage may well be influenced via the theoretical premise that will increase in debt are a effective sign that managers are assured approximately destiny earnings. Debt contracts are a commitment with the aid of managers to make destiny hobby bills. Failure to repay debt could lead to bankruptcy. This signals self-assurance to the marketplace that the firm will have sufficient coins flows to carrier debt. The shareholders of an organization are the residual claimants to the firm's cash flows. This is due to the fact promised hobby bills are an obligation and have priority over dividends. As a consequence, share prices are extra sensitive to monetary structure announcements than bond prices. If managers are optimistic about their firm's destiny prospects, the corporation's share fee will seem extra undervalued than bond prices.

THE PECKING ORDER THEORY

The pecking order theory takes the signalling theory one step in addition through suggesting that the records expenses are substantial sufficient to warrant managers to trouble the security with the least records fees (Barclay & Smith, 1999: 13). This theory became originated by using Myers and Majluf (1984: 188) who exhibit that a percentage problem is typically perceived negatively by means of the investors. This is due to the fact managers generally tend to problem stocks when they're overpriced. Stated in simple terms, the pecking order theory suggests that in order to avoid the statistics effects of latest share issues, a company is more likely to issue debt than equity. This prediction is conditional at the managers" perception that their corporation's securities are under-priced. The pecking order concept implies that managers will comply with the direction of least resistance, and that they may paintings down a pecking order by using opting to trouble the cheapest form of financing. In this case, corporations will choose retained profits because it has no adverse choice problems. When retained earnings are exhausted, the organization can then difficulty debt. When it does now not make any extra feel to issue more debt, equity can be issued as a financing source of final resort.

THE DIFFICULTIES IN TESTING THE THEORIES OF CAPITAL STRUCTURE

Despite the evidence provided regarding the theories of capital structure, Barclay and Smith (1999: 9) argue that there may be no model that convincingly tests the various competing theories of capital structure due to three reasons. Firstly, with the cutting-edge tests, it is tough to reject one principle in favour of the other. In different words, the theories aren't jointly exclusive. In fact, with respect to the pecking order and trade-off theories, Fama and French (2005: 581) finish that each of these theories has a detail of truth in explaining financing decisions. Secondly, it is not clean to degree many variables that affect the gold standard capital shape, for example, it isn't easy to decide managers" proprietary information, in particular while you are trying out the signalling concept. Finally, rather than being

reducible to a precise mathematical formula, theories of most suitable capital shape culminate in a qualitative prediction, hence less reliable than the asset pricing models.

DATA ANALYSIS & INTERPRETATION

This study uses panel regression evaluation and descriptive facts for evaluation purposes. Panel facts evaluation enables evaluation of cross-sectional and time series information. The pooled regression type of panel information analysis is used. The pooled regression, also referred to as the Constant Coefficients model, is one where both intercepts and slopes are assumed constant. The cross-segment company data and time series information are pooled collectively in a single column assuming that there's no tremendous cross section or inter temporal effects. Panel statistics follows a given pattern of individuals over time, and therefore presents a couple of observations on each person in the sample. Panel data combines the features of time collection and cross-segment. It gives records on some of statistical gadgets for some of years. Panel information normally presents the researcher a huge quantity of information points, growing the levels of freedom and reducing the co-linearity amongst explanatory variables; hence improving the efficiency of econometric estimates. A Multiple regression model is used on this study.

Model of the Study:

The equation used for the regression model will be:

$LG = \beta_0 + \beta_1(TG) + \beta_2(SZ) + \beta_3(GT) + \beta_4(PF)$

Where;

LG = Leverage

TG = Tangibility of assets

SZ = Firm Size measured by natural log of sales

GT = Growth

PF = Profitability

TOOLS OF DATA ANALYSIS:

This study uses the statistical tools for both its descriptive and quantitative analysis the usage of the SPSS. The Mean, Maximum, Minimum, Range and Standard Deviation are used inside the descriptive portion of the analyses to determine the suggest values of each set of variables and their popular deviation. In the quantitative evaluation portion, a statistical Karl Pearson's correlation evaluation is made to decide the relationship between a particular impartial variables and capital structure for the sample of the study. Similarly, the more than one regression evaluation is also made to evaluate the impact of capital shape variables of the sample firms.

RESULTS AND ANALYSIS:

1 DESCRIPTIVE STATISTICS:

Table#1 offers a summary of the descriptive statistics of the structured and unbiased variables used within the analysis. The facts consists of the 18 companies of Cement Industry listed on

Karachi stock trade from 2006-2010. Table 1 beneath gives summary information of the mean, standard deviation, minimum and maximum. The panel data evaluation is performed for observations of five consecutive years beginning from 2006-2010. In this way, the pattern of the examine consists of 90 firm-yr observations.

Table#1: Descriptive Statistics

	N	MINIMUM	MAXIMUM	MEAN	STD. DEVIATION
Leverage	90	0.23213	1.13812	0.58791	0.17551
Tangibility	90	0.25115	1.55135	0.99560	0.24691
Size	90	0.00000	23.99399	2.15045	3.42977
Growth	90	-0.70738	8.47271	0.38459	1.00954
profitability	90	-0.24777	0.43828	0.010019	0.12421

The suggest of leverage of firms was 0.58791 respectively. Tangibility measured as the percent of fixed assets to total belongings had a median of 0.99560 this shows that, on average, fixed belongings accounted for 99.56% of total assets of the firms sampled. While, size, determined as the herbal logarithm of total income had a median of 2.15045. Growth, given because the ratio of the percentage trade in total assets, registered a median fee of 0.38459 indicating a increase of 38.45 % at some point of a five-12 months period. Profitability, given because the ratio of pre-tax income to total property, registered a mean price of 0.010019 indicating a go back on belongings of 1.00% at some point of a five-12 months period. Table shows, there are minimum values which are much less than zero because of inclusion of the observations that even include poor figures in net earnings for calculating profit.

2 REGRESSION ANALYSIS:

Using pooled regression technique, regression take a look at was finished in order to test the effect of leverage (structured variable) on unbiased variables; tangibility, size, growth and profitability of the corporations of the Cement Industry with the aim to analyze what relationship those variables keep and whether or not these variables have considerable explanatory strength or not. The envisioned effects of 90 years records are reported through the subsequent tables:

Table#2: Regression Model Summary

R	R Square	Adjusted R Square	Std. Error of the Estimate
0.640A	0.410	0.382	0.138009

R square and altered R square indicates the summary of goodness of fit. The price of R rectangular inside the above table-2.1 is 41%. It indicates that size, profitability, tangibility, and boom display round 41% variation within the leverage. The ultimate variability within the leverage is because of some other elements which are not included in the model. The R rectangular of the Yasir and Hijazi (2006) changed into round 74% which shows that these variables are capable to show 74% variant on the leverage of the Cement Industry of Pakistan. In their paper, they have recommended that those variables are predicting the major

impact on leverage. However, the result of this have a look at indicates much less version this means that that with the passage of time the selection of capital shape of the firms of cement zone has modified and now it is predicated on some other factors too together with those four variables. Adjusted R rectangular is slightly under the R rectangular.

Table#3: ANOVA

Model	Sum of Squares	DF	Mean Square	F	Sig.
Regression	1.123	4	.281	14.738	.000a
Residual	1.619	85	.019		
Total	2.742	89			

a. Predictors: (Constant), Profitability, Tangibility, Growth, Size

b. Dependent Variable: Leverage

ANOVA shows that whether the model selected for the observe is match or not. It is confirmed through the significance of the version. The remaining column of this table shows the goodness of in shape of the version. The lower this number, the higher the healthy. So, the significance suggests that the version selected is good enough for this observe. Form the fee of the F-statistic it can be seen that the model is considerable at 1% stage of importance. DF stands for degree of freedom, it shows the scale of sample, which in this case is 90.

Table#4: Regression Coefficients and their Significance

Model	Un- standardized Coefficients		Standardized Coefficients		
	Beta	Std. Error	Beta	t-statistic	Sig.
(Constant)	.468	.119		3.927	.000
Tangibility	.187	.061	.264	3.096	.003
Size	-.002	.004	-.047	-.553	.582
Growth	-.018	.015	-.102	-1.196	.235
Profitability	-.785	.120	-.555	-6.547	.000

a. Dependent Variable: Leverage

From table#4 it could be visible that two variables which are tangibility of property and profitability are statistically tremendous at 1% level of significance while length and growth are determined to be statistically insignificant on this study. The value of Beta suggests the relationship of established variable with impartial variables. From the above table it can be visible that leverage has a superb courting with tangibility of assets and terrible courting with length, growth and profitability.

INTERPRETATION OF RESULTS:

Results obtained from the evaluation for the four variables are interpreted and explained on the subject of the capital shape theories and the connection of leverage with impartial variables is discussed and it is checked that which principle is supported by means of these four relationships of leverage. Three primary theories of capital shape that are static trade-off idea, pecking order concept and agency theory are mentioned in context with the results received from the regression analysis. The following table shows the expected and discovered relationship in evaluation with these three theories:

Table#5: Expected & Observed relationships in comparison with theories

Variable	Definition	Static Trade-off theory	Pecking Order theory	Agency Theory	Expected & Observed Relationship with leverage
Tangibility	Ratio of fixed assets to total assets	Positive	Negative	Positive	Positive
Size	The natural Log of Sales	Positive	Negative	Positive	Negative
Growth	Percentage change in total assets	Negative	Positive (Extended) Negative (Simple)	Negative	Negative
Profitability	Ratio of net income before income tax over total assets	Positive	Negative	Positive	Negative

TANGIBILITY OF ASSETS:

Tangibility of property is seen to be positively associated with leverage with a Beta =0.187. This finding is in line with the findings of previous research together with Titman and Wessels, (1988) and Rajan & Zingales (1995). This result indicates that with a 1 percent growth in the company's fixed assets, relative to total belongings, there is 0.187 percent upward thrust in leverage ratio of a organization. There is a strong giant dating among leverage and asset tangibility at 1% degree of significance. This high quality dating indicates that a corporation with the large portion of fixed belongings can effortlessly increase debt or obtains extra debt at highly lower prices by supplying collaterals of these belongings to creditor. The results for this reason favour the Meckling's (1976) and Myers' (1977) model of the trade-off principle that debt degree should growth with more constant tangible property on the stability sheet. The outcomes are also constant with Yasir and Hijazi (2006). So, this tremendous and nice dating of leverage and tangibility supports the static trade-off idea and

agency concept of capital structure. Therefore, the first hypothesis is standard at 1% stage of significance.

SIZE:

According to the results, size is negatively related with leverage with a beta= -0.002. However, the regression co-green is discovered to be statistically insignificant and it does now not even lie on 10% great level. Based on this insignificant result, no confirmation may be given whether there is a poor relationship between size and leverage or not. On these grounds, the second speculation is rejected that there is bad dating between length and leverage of firms of cement sector. The result is inconsistent with Titman and Wessels (1988), Rajan and Zingales (1995) and Shah and Hijazi (2004) which suggests the proof of substantial direct dating between size and leverage. However, if as compared with the theories, so the path of poor beta supports the pecking order theory, but due to its insignificance the speculation is rejected. Yasir and Hijazi (2006) also observed the identical insignificant dating.

GROWTH:

According to the results, increase was found to be negatively related with leverage with a beta= -0.018. The dating among leverage and growth in total assets is located to be negative, and is steady with the predictions of static trade-off concept, easy version of pecking order principle and agency theory. This finding is also constant with other studies consisting of Rajan and Zingales (1995), Shah and Hijazi (2004). Yasir and Hijazi (2006) found a widespread high-quality dating. However, the relation in this examine proves to be statistically insignificant which makes the third hypothesis to be rejected. Though, the results obtained here display that there exists no courting between expected boom and leverage that is of financial significance. A reason may be that the degree used here, the proportion alternate in total property, does now not reflect future growth possibilities only past increase. Thus, other more giant results might be obtained by the usage of every other measure for anticipated boom, for instance market-to book ratio, a typically used proxy for expected increase. Also, in the cement sector the connection is bad because of greater usage of short-term debt as an alternative than long time debt, short time period debt has bad dating with leverage Nejla and Sherine (2011). Thus, the third speculation is rejected.

PROFITABILITY:

According to the outcomes, profitability is negatively associated with leverage with a beta= -0.785. Profitability is also statistically widespread on 1% so the ultimate hypothesis is everyday that there is poor relationship between profitability and leverage. The outcomes approximately the relationship among profitability and leverage are same as contributed by using Shah A (2004) and also consistent with the pecking order concept of Myers and Majluf (1984) for a 1 percent boom inside the income earlier than taxes, relative to overall assets, the leverage ratio of firm will decline by approximately 0.785 percent. It means that profitable companies in Pakistani cement sector maintain low debt ratios. This result is regular with implication of Pecking order concept that companies choose to finance first with inner funds earlier than raising external financing. Further this final results is also constant and Titman & Wessels (1988) and Rajan and Zingales (1995). The same consequences were observed by means of Yasir and Hijazi (2006). Thus, the remaining and fourth speculation is normal.

FINDINGS:

1. Regression correlation was used to see the effect of debt- equity ratio on the earning per share, fixed asset ratio and the interest coverage ratio of the pharmaceutical industries.
2. It was observed that EPS, FAR and ICR had no linear effect of DEQR but FAR was affected exponentially by DEQR and the model gave significant results. It indicated that 1 unit rise in DEQR resulted in 63% fall in FAR exponentially.
3. It was seen that the OPM of all the units except Ingersoll ranges from 15% to 20% approximately. The OPM of Elecon & Ingersoll has shown an increasing trend. The OPM of FAG & Bosch has shown a declining trend over the period.
4. In the case of return on investment it was observed that it was higher in the initial year of the study and then there was a great fall in the return in the immediate next year in few companies and then again, a slight rise followed by a fall again.

SUGGESTIONS:

1. From the above study it can be suggested that engineering companies need not necessarily concentrate on the debt-equity ratio to maximize its earnings per share.
2. It is theoretically mentioned that the debt-equity ratio of 2:1 is the ideal one. In the above study it was observed that Elecon Engineering Ltd. had a ratio of 2:1 in 2006 but at the same time it does not have the maximum earnings per share among all the units. So, it can be recommended that in order to maximize the earnings there are factors other than debt-equity ratio which should be considered.
3. From the study, it was seen that the interest coverage ratio in one of the companies had gone negative in one of the years 2007 despite the fact that the company did not have any long-term debt. Thus, it can be suggested that the companies should concentrate on their operational efficiency to improve its interest coverage ratio.

CONCLUSION:

Capital structure decision is the strategic financing choice which entails finding out the most suitable mix of equity and long-term debt finance for an organization. Capital structure policy involves a preference among threat and expected return. The top-rated capital shape strikes a stability among these risks and returns and as a result examines the fee of the stock. The capital structure decision being the strategic selection, ambitions at attaining the simple objective of every company i.e., wealth maximization. The pattern of capital structure of a firm must be planned in such a way that the owner's interest is maximized. It may be concluded from the above study that during exercise the determination of capital structure entails considerations similarly to the worries approximately earning in step with share, value and cash flow.

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