

The Impact of Capital Structure On Firm Performance: Evidence From Pakistan

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Abstract

The purpose of this study was to investigate the impact of capital structure on firm performance. A whole population of 155 Non-financial textile sector companies listed at Karachi Stock Exchange (KSE) were taken as census for data analysis for the period 2007-2012. For this purpose, data was collected through Financial Statement Analysis (FSA) report given on the SBP website. After the collection of Time series, Panel data two different tests correlation and regression analysis were run as a statistical tool for data analysis. Correlation test was conducted to check the percentage of association between dependent and independent variables. While regression analysis was conducted to check the impact of capital structure on firm performance. Econometrics model was run through regression. In the model, dependent variable return on assets was regressed on two independent variables debt and equity, Data analysis was done through SPSS. Results showed a statistical significant association between independent variables debt and equity with dependent variable return on assets. Hence, it was concluded that capital structure is linked firm performance.

1. Introduction

In the modern era, firm's objective is to achieve the maximum level of profit, consistency and stability in their operations. Thus, firms require huge capital to finance their operations so that profits are maximized. One of the dilemma is to decide about desired capital and the source of capital. Capital structure is the combination of debt and equity. Companies use both source of financing in their capital structure. Debt is the cheaper source of financing as interest payments are related to the debt financing and treated as expense while in equity financing payment of dividends to the shareholders are not deductible (Modigliani & Miller, 1963). Debt financing influence companies to use more debt in their capital

structure as a cheaper source but there is also a drawback related to debt financing which is insolvency/bankruptcy cost. If a source of financing is debt, then the chances of insolvency are higher because the firm will be unable to meet their obligations. On the other hand, equity financing is a source where companies generate profits through dividends and capital gains. Capital structure policy involves a trade-off between risk and return. Using huge amount of debt increases the risk of firm's earning tributary, but also clues to a higher expected return rate and the higher risk linked with larger debt inclines to lesser the price of stock and narrow down the performance of the firm. While making financial choices, the firms have the main decision to make. (i) Designing the best structure for capital. Capital structure may be only based on debt or equity or it may be any combination of debt and equity.

Problem Statement

There has been lots of researches directing on association among capital structure and firm performance, but there is quiet disparity concerning whether capital structure effect performance of firm or not. Current study attempts to inspect the impact of capital structure on firm performance in an organized way and delivers applied and pertinent guidelines for someone who desires to have understanding of the topic. In general it shelters each and every facet of the theme but specifically it is linked to capital structure and firm performance of non-financial firms of textile sector listed in Pakistan Stock Exchange.

Research Questions

The study attempt to identify that the capital structure has impact on firm performance or not?

Research Objectives

The intent of the research work is to propose an integrated theory of capital structure which empirically predicts their impact on performance of the firm.

Scope of the Study

This study was limited to textile sector non-financial firms only stated on State bank of Pakistan website. 122 out of 155 firms were taken in this study and data is collected for six years from the time period 2007-2012. 33 firms were excluded from data analysis having incomplete data.

Significance of the Study

This study will convey about the comparative implications of firm's capital structure as replicated in firm performance. Firm's capital structure is reflected through debt and equity proportions of the firm. However, requisites of capital structure such as debt and equity impact positively or negatively on firm performance as supposed by each balanced investor in the stock market.

In developing countries like Pakistan this study will be beneficial for practical field persons to better design their structure of capital for achieving higher firm performance.

2. Literature Review

Background

Value-based management is as a management approach that is based on the decisions relating basic drivers of value. The goal of any firm is to maximize shareholder's wealth. Thus, it becomes the responsibility of a manager to make certain decisions that are fruitful for profit maximization. Hence, the value-based management becomes of importance as it improves the decision-making process (Sharman, 1999).

According to Friedl (2013) most of the companies may choose several factors for choosing debt or equity. One of the factors is the benefit of tax shield from interest payments may result in higher Firm Performance. Another factor is the risk of financial distress that boosts a balance between benefits and costs of debt of financing. Agency cost is one of the factors that arise due to the conflicts between shareholders and managers depending on the capital structure. Asymmetric information is one of the factors for the companies choosing debt or equity as it serves as a signal for capital structure.

Value based management strategies can be helpful for companies in their operations which leads them to the peak of success, the factors which can be helpful in determining firm's operations and performance are discussed below.

Capital structure

Background

It is the primary objective of every firm to stable their financial position in the industry, which is always a tough job. It is not possible to establish firms easily because it requires huge investment to make huge sales. For that purpose, they need funds, which can be elevated by the mixture of debt & equity financing. A company's debt, equity mixture is recognized as their capital structure. The proportions of debt and equity may differ time to time, so firms attempt to retain their target capital structure within the optimal capital range.

Chowdhury and Chowdhury (2010) in their study conclude that a firm has to adopt ideal proportions of debt and equity, however, Weighted Average Cost of Capital (WAAC) has a negative relationship with Firm Performance so the firm has to maintain WAAC as low as possible. They postulate that managers should prepare optimal capital structure to maximize their firm's value. Further arguing that combination of debt and equity can be utilized by the firm's to funding its operations. Also, firm's value depends upon the actual resources of the firm not on the debt and equity percentage.

Debt financing has an advantage of low cost after paying low interest by lessening tax amount while equity financing contains high cost (Elkharashy, 2016). According to San and Heng (2011) in their research conclude an association between capital structure and selected performance of the corporations.

Zeitun and Tian (2014) in their study posit that if firm Performance is impacted by capital structure then there must exist a strong relation between performance of a firm and capital

structure. Furthermore, they dispute that performance of firm is associated negatively with short-term debt. This is because short-term debt leads firms to the threat of refinancing.

Green, Kimuyu, Manos & Murinde (2002) stated that company decides to retain huge debt volume, the other external source of financing may not be needed and vice versa. However, this choice rest with the firm's management and it varies from company to company.

Miller (1977) and Frank & Goyal (2007) stated that debt financing influence companies to use more debt in their capital structure as a cheaper source but there is also a drawback related to debt financing which is insolvency/bankruptcy cost. If a source of financing is debt, then the chances of insolvency are higher because the firm will be unable to meet their obligations. On the other hand, equity financing is a source where companies generate profits through dividends and capital gains.

Abor (2005) in his paperwork check the association among capital structure and firm's financial performance quoted in Ghana. He conclude that total liabilities to total assets and current liabilities to total assets have positive impact on firm's profitability while Return on earnings have positive, and long term liabilities to total assets have negative impact on firm's profitability.

Theoretical Literature

Capital structure is the combination of firm's equity and debt proportions they used to finance their operations. Most of the researches have contributed a lot in relating a connection among capital structure and Firm Performance. There are some of the theories, which can support in creating the connection among capital structure and Firm Performance.

No Bankruptcy Cost (Trade-off Theory)

Modigliani & Miller (1977) postulates in their paperwork that debt is valuable because interest is treated as expense and tax deductible, but there is also a fear of bankruptcy cost. Gaud et al., (2005) in addition to MM theory presents their views that to achieve optimal capital structure by cost and benefit analysis of debt financing is the theory analysis. Furthermore, proper debt and equity mixture leads to maximum Firm Performance. Hence, concludes a relationship among capital structure and Firm Performance.

Above theory concludes in favor of capital structure and its impact on Firm Performance if firms utilize the debt and equity mixture in an appropriate manner.

There is another theory of capital structure is pecking order theory which is related to internal and external sources of finance firms use to meet their operations. The deep explanation regarding pecking order theory is discussed below.

Pecking Order Theory

Myers and Majluf (1984) presents a theory explaining that Firm Performance is associated with capital structure. This is due to the fact because if Firm Performance can be maximized if they properly use correct form of capital. This theory further prevails that firm do prefer internal

equity instead of external equity to meet their financial operations. After the diminution of internal equity, they prefer debt due to the advantages of taxation, low transaction cost, and further benefits attached to it. Hence, this theory concludes an association between capital structure and Firm Performance.

From the above theory we can conclude that firms prefer internal equity firstly to meet their deficiency in operations, if they can accomplish their deficiency problems through internal equity, they go for the debt.

Firm Performance

Firm performance is the combination of firm's present and prospect profits that are expected to be earned. Firms that are wishing their profits to be maximized in future are in fact wants the value to be maximized. Furthermore, Firm Performance is the present value of projected potential cash flows plus present cash flows (Baye & Beil, 2006).

Ross (1977) and Jenson (2001) stated in their researches that managers are considered as backbone of the company as always busy in maximizing Firm Performance; they can maximize the value through exploiting the greatest capital structure of a firm. Active firms need generous class indication to the marketplace, whereas fewer energetic firms' managers try to remove it at any cost.

Modigliani & Miller (1963) about corporate taxes conclude that, if a firm using debt in their capital structure can increase firm's performance because debt adds discipline to the market. They concluded that increasing debt proportion leads to reduction in cost of capital and resulted in increased Firm Performance and stock price; also originate an association among capital structure and firm performance.

Chandra and Nayar (2008) Conclude in their study that firms may have to finance their business with low debt portion to take advantages of high growth in sales and profits. Antwi (2012) in his paperwork conclude that Firm Performance is determined by equity capital and long-term debt, the components of capital structure. Firm Performance will increase as debt portion of company increases up to some boundary that is the boundary of liquidation variable, a company financed 100 percent with debt has an anxiety that the firm will go insolvent(Akintoye, 2008).

According to Tanni (2013); Johannes and Dhanraj (2007); Messbacher (2004) postulates that weighted average cost of capital is helpful in defining Firm Performance through discounting future cash flows. They conclude that Firm Performance is maximized by decreasing weighted average cost of capital. Hence, conclude that performance of firm has a relation with capital structure.

Aggarwal and Kyaw (2006) discuss that Firm Performance is effected both positively and negatively by debt so firms have to manage their optimal debt structure by balances their under or over speculation hurdles and other debt relating costs.

From the above discussion by different authors we come to know that Firm Performance can be increased by making such bold and helpful decisions regarding structuring capital. Most of the scholars show pertinent connection between Firm Performance and capital structure. Some of the evidences from Pakistan regarding capital structure and its impact on firm value have been discussed below.

Studies Conducted in Pakistan

Khan (2012) in his paperwork inspect the association among capital structure decision and firm's performance of 36 engineering sector firms quoted on KSE for the period 2003-2009. His findings reveal significantly negative association between capital structure and firm performance. Negative but insignificant association lies between financial leverage and Return on Earnings as measure of firm performance. In addition, insignificant association is found between Capital Structure and firm performance.

Saeed, Gull, and Rasheed (2013) observe an association among Capital structure and Performance of Pakistani banks quoted on KSE for the period 2007-2011. They conclude a positive association between banks performance and capital structure.

According to Mumtaz, Rauf, Ahmad, and Nooren (2013) there is a significant association among capital structure and financial performance of the 83 companies selected from KSE 100 index.

Amara and Aziz (2014) analyze an association among capital structure and performance of the quoted companies from food sector of Pakistan. Their results reveal a negative connection among capital structure and companies' performance whereas only debt to equity ratio has a significant association with performance of the companies. It can be concluded from the above studies that food sector is not properly utilizing debt in their capital structure while leads them to low performance.

By reviewing above literature it was observed that most of the authors check the association of capital structure with firm value/performance in different sectors of Pakistan. In this research the author consider textile sector as the biggest sector of Pakistan as well as its huge contribution towards economy.

Theoretical Framework

The Theoretical framework was design by the researcher from the previous researches discussed with an addition of few new variables. This framework shows how firm performance depends upon the independent variable Capital Structure. Return on assets was the proxy of firm performance while Debt & Equity were the proxies of Capital structure.

INDEPENDENT VARIABLES

DEPENDENT VARIABLE

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CAPITAL STRUCTURE

- DEBT
- EQUITY

FIRM PERFORMANCE

ROA

Hypothesis

- There is an effect of debt on return on assets.
- There is an effect of equity on return on assets.

Variables of the Study

This study will have only two set of variables i.e. dependent and independent.

Dependent Variable

Firm performance is dependent variable and it will be determined by taking Return on assets as given in the financial statement analysis of the firms.

Independent Variable

Capital structure as independent variable (as suggested by literature) is considered and its effect will be checked on the dependent variable.

Capital Structure

Capital structure is the mixture of debt and equity firms normally uses to finance their operations and meeting working capital requirements.

Description of the Variables

Name of the Variables	Proxies	Calculations
Firm Performance	Return on Assets (LnROA)	ROA values are given in the Balance sheet analysis of the companies
Capital Structure	Debt Value (LnDB)	Current Liabilities + Non-Current Liabilities
	Equity Value (LnEQ)	Shareholder's Equity

3. Research Methodology

This section of the research gives a complete outline regarding the selection of the sector under study and procedural facets of the research work. Textile sector was selected as this sector is the biggest sector having 155 out of 397 non-financial companies in Pakistan. One reason for selecting textile sector was the contribution towards economy of Pakistan. The

easy availability of the data was the other reason for selection of this sector and time window for the period 2007-2012. Furthermore, this segment discusses the population of the research and techniques through which the data were gathered, the variables of the research, and statistics regarding methods that were engaged for data analysis.

Source of Data

This study was based on time series, panel data. Data was collected through Financial Statement Analysis (FSA) report of Non-financial companies listed at Pakistan Stock Exchange (PSX) for the period 2007-2012 as full complete data was available for this period.

Population

The study focuses only on textile sector companies listed on Karachi Stock Exchange (KSE). All 155 textile sector companies were taken as population of the study. However, when the data collection stage started, it was observed that some of the company's data set for the year 2007-2012 was incomplete. Therefore, those companies were omitted from the list. At the end a total of 122 firm's data which is 78.70% of the whole population was complete in all respects.

Analytical Techniques

Descriptive analysis, Correlation and Regression Analysis were used as techniques for data analysis. Descriptive analysis show the normality of the data, Correlation analysis shows a percentage association between dependent and independent variables, while regression analysis shows the impact of independent variables on dependent variable.

Econometric Models

The econometrics model was designed by reviewing the above literature. Returns on invested capital values were available in percentage in the financial analysis report (FSA). The explanatory variables debt and equity were transformed to percentages to stream line the model as dependent variable ROA was already available in log form and the second reason for transformation was the remedy of multicollinearity.

$$\text{LnROA} = B_0 + B_1 \text{LnDebt} + B_2 \text{LnEquity} \text{----- (Model -1)}$$

Where

LnROA= Return on Assets

LnDB = Debt Value in Percentage

LnEQ = Equity Value in Percentage

4. Results and Discussion

This section gives an outline of research findings and results conducted through different analytical techniques used by the researcher. First of all descriptive analysis is conducted to know whether the data is normal or not. Secondly, correlation test is conducted to check the

association between dependent and independent variables. At the end, multiply regression is used to check whether independent variables are contributing towards dependent variable or not. Following tests used for data analysis are discussed below.

Descriptive Information of Variables

	N	Minimum	Maximum	Mean	Std. Deviation
LnROA	122	-11.74	14.85	2.1175	5.57630
LnDEBT	122	10.18	17.18	13.9561	1.34424
LnEQUITY	122	10.14	17.22	13.3575	1.38408
Valid N (listwise)	122				

The above table displays the data features including total number of observations, means, Standard Deviation and their respective minimum and maximum values of all Karachi Stock Exchange non-financial listed textile sector firms for the study period of 2007 to 2012.

There are total 122 firms having 6 years data constructing 732 observations. In the results, LnDEBT standard deviation 1.34424 signifies that LnDEBT representing that Pakistani firm’s capital structure preferences are typically common in symbolic nature. By linking LnROA mean with its SD, it is decided that maximum of LnROA measurement fall above or below 5.57630 of 2.1175. LnEQUITY is having high inconsistency ranging from 13.3575 to 1.38408.

Correlation Analysis

		LnROA	LnDebt	LnEquity
LnROA	Pearson Correlation	1	.031	.243
	Sig. (2-tailed)		.734	.007
	N	122	122	122
LnDebt	Pearson Correlation	.031	1	.853**
	Sig. (2-tailed)	.734		.000
	N	122	122	122
LnEquity	Pearson Correlation	.243**	.853**	1
	Sig. (2-tailed)	.007	.000	
	N	122	122	122

**** . Correlation is significant at the 0.01 level (2-tailed).**

The above Correlation analysis table shows percentage association between dependent and independent variables. The threshold for correlation is 0.30 to 0.50 percent for moderate results and 0.50 to 0.70 percent good results, and any observation above 0.70 percent shows powerful

results. Any observation lies below 0.30 percent prevails weaker results and association with each other. Our results show that LnDebt is weakly and positively associated with LnROA, but insignificant at $P = .734$, LnEquity and LnROA are weakly and positively associated with each other and significant at $P = .007$.

Regression Analysis

Variables	Beta	P-values	R-Square	Adj R²	F-Statistics
Constant	-3.191	.516			
LnDebt	-2.684	.000	.173	.159	12.420 at $P < (0.000)$
LnEquity	3.202	.000			

Dependent Variable: LnROA

The above table shows regression analysis on the basis of beta, P-values, R², Adjusted R², and F statistics. Beta shows contribution of each independent variable towards dependent variable. LnDebt contributes -2.684 percent towards LnROA, while LnEquity contributes 3.202percent towards LnROA. P-values show significance level of each variable which in our case is significant at 1%. R-square known as coefficient of determination shows variation in dependent variable explained by variations in independent variables included. Our result shows 17.30 percent variations in LnROA explained by variations in LnDebt and LnEquity. Adjusted R² shows model’s variability which in our case is 15.90%. F-statistics shows the whole models significance level which in our case is significant at 1%.

$$\text{LnROA} = B_0 + B_1\text{LnDebt} + B_2\text{LnEquity} \text{ ----- (Model -1)}$$

$$\text{LnROA} = -3.191 - 2.684\text{LnDB} + 3.202\text{LnEQ}$$

(.516) (.000) (.000) ----- (P-value)

$$R^2 = .173 \quad R^2_{\text{adjusted}} = .159$$

$$F = 12.420 \text{ (P-value} = .000) \quad N = 122$$

- The one facet of Equity contributes positively and significantly towards dependent variable Return on assets, while Debt contributes negatively but significantly towards Return on assets. One percent change in LnDB brings -2.684 percent changes in LnROA, while 3.202 percent change in LnROA occurs due to one percent change in LnEQ.

5. Summary, Conclusion & Recommendations

Summary

All work of the study was to portray the capital structure effect on firm performance in the context of Pakistan's economy. This paper will support to recognize the overall practices of capital structure in Pakistan spoiling the sympathy of effect on every sector.

The definitive objective of the study is to discover the relation among firm performance and capital structure. To attain the objective, secondary data of all non-financial listed textile firms (155) on KSE from 2007 to 2012 are considered as a population of the study, but only certain of the firm's financial data satisfying the criteria which slimed the whole population to 122 firms. SPSS is used for data analysis. LnROA is considered as a proxy for firm performance, while LnDebt and LnEquity are the capital structure proxies.

The study uses descriptive statistics to identify the nature of data on hand (like No. of observations, their respective minimum, maximum, average and standard deviation values) of all the variables. Moreover, the study employ correlation test to know the fair connection among different dependent and independent variables. Furthermore under regression analysis, the proxies of capital structure regressed on proxy of firm performance to check whether it effect each other or not.

The results of the study support the perception of trade off theory and pecking order theory. The trade off and pecking order theory postulations are approved by the firm's LnDebt value that contributes negatively but significantly towards firm performance in Pakistan, which posits that by increasing the debt ratio, company's should boost up their values accordingly. LnEquity contributes positively and significantly towards firm performance (supporting the pecking order theory assumptions). The study concluded that under Pakistani setting, firm's capital structure has significant impact on firm's value (consistent with prior researches like Chandra and Nayar (2008), Tanni (2013), Johannes and Dhanraj (2007), Messsbacher (2004), Aggarwal and Kyaw (2006), San and Heng (2011), Zeitun and Tian (2014), Ebrati, Farzad, Saadati, and Ghorban (2013), Saeed, Gull, and Rasheed (2013), Skopljak (2012), Khan (2012), Muritala (2012), Antwi, Mills, and Zhao (2012), Oliver, Iniver, and Daniel (2016), Honarbaksh, Birjandi, and Birjandi (2013), Hasan, Zaman, and Karim (2013), Hoque, Hossain, and Hossain (2014), Maxwell and Kehindi (2012), Chinaemerem and Anthony (2012), Zeitun and Tian (2014), Hasan, Shenwari, Afshan, Islam, and Kabbir (2016), Nirajini and Priya (2013), Mumtaz, Rauf, Ahmad, and Nooren (2013). It means investor's interest area under Pakistani setting is the firm's earning on each share.

Conclusion

This research was conducted to check the relationship among Capital structure and Firm Performance of textile sector in Pakistan. After collecting data and running different statistical tests, we conclude some findings. Based on our first hypothesis, we experience that debt as proxy of capital structure has a negative and significant association with firm performance measured by ROA of listed textile firms in Pakistan. This means using high level of debt in capital structure may negatively affects firm's ROA. The same results were concluded by Nassar (2016), Javed, Rao, Akram and Nazir (2015), Chinaemerem & Anthony (2012) & Mumtaz, Rauf, Ahmed and Noreen (2013). While based on our second hypothesis, we experience that equity as proxy of capital structure has a positive and significant association with firm performance measured by

ROA of listed textile firms in Pakistan. This means firms practicing equity financing instead of debt in their capital structure policies.

Recommendations

The current research recommends that textile sector of Pakistan should improve their capital structure policy through highlighting.

- The importance of the debt financing is to boost up the slow development of bond market in Pakistan to fast growing bond market that will help in increased Firm Performance.

The study also provides ideas to the corporate manager to recognize the manipulating factors under capital structure that has substantial effect on performance of the firm.

- Firm Performance can also be shaped by identifying flaws in investment because it displays in what way the firm takes its financial choices.

Further study can be conducted by adding more variables for measuring Firm Performance may be useful. Data of long time series could also be used for reliability of results. Future research can be processed by comparing the capital structure and Firm Performance of small and large firms.

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