

Relationship between Capital Structure and Firms Performance: A Case of Textile Sector in Pakistan

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Abstract

Purpose - This paper investigates the relationship between capital structure, and firm performance in case of textile sector of Pakistan.

Design/methodology/approach - Using regression method we are able to compare the relationship between capital structure and firms performance with the completing hypothesis with different capital structure choices. Throughout this analysis we consider the role of relationship between capital structure and firm performance in case of textile sector of Pakistan. In textile sector 173 companies in which we compare relationship between capital structure and firms performance. In this study three variables are used: two variables dependent and one variable independent.

Findings - In this paper we investigate that what is the relationship between capital structure and firms performance.

Keywords: Capital Structure, Firms Performance, Debt Equity Ratio, Return on Asset, Return on Equity, Regression Analysis

Paper type: Research Paper

Introduction

The capital structure of a business is the mix of types of debt and equity the company has on its balance sheet. The capital structure or ownership of a business can be evaluated by knowing how much of the ownership is in debt and how much in equity. The company's debt might include both short-term debt and long-term debt (such as mortgages), and equity, including common stock, preferred shares, and retained earnings. Capital structure is sometimes referred to as a company's debt to equity. In every business, capital structure is the primary important; this is the company's percentage of money invested in the business. The capital structure of any company shows the large influence and possible outcome of the company's revenues, it also determines the earnings that will go to the shareholders of the business. Generally speaking, it comprises the invested money, purchased land, equipment, buildings, and other materials that are bought in cash to be used in the business. All the things that can be converted into cash or even used as collateral for business loans are considered as part of the capital structure of the business.

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The capital structure is how the company finances its entire operations and expansion by utilizing different financial sources whether it's from equity capital, debt capital, and other form of capital such as vendor financing. Vendor financing is a process of selling goods or products before paying the bill to the vendor. It doesn't cost anything to the company; instead it gives more return of investments.

The capital structure of a company is referred to the way in which the company finances itself through debts, equity and securities; it can therefore be referred to as the capital composition of the company taking into consideration its liabilities, Modigliani and Miller propose the Modigliani Miller theorem of capital structure which states that the value of a company in a perfect market is unaffected by the way the company is financed but through the capital structure it employs. We investigate if firm efficiency has an effect on capital structure and whether this effect is similar or not across different capital structure choices. Throughout these analyses we consider explicitly the role of equity ownership structure on both capital structure and firm efficiency. A mix of a company's long-term debt, specific short-term debt, common equity and preferred equity. The capital structure is how a firm finances its overall operations and growth by using different sources of funds. Debt comes in the form of bond issues or long-term notes payable, while equity is classified as common stock, preferred stock or retained earnings. Short-term debt such as working capital requirements is also considered to be part of the capital. The term capital structure refers to the percentage of capital (money) at work in a business by type. Broadly speaking, there are two forms of capital: equity capital and debt capital. Each has its own benefits and drawbacks and a substantial part of wise corporate stewardship and management is attempting to find the perfect capital structure in terms of risk / reward payoff for shareholders. Equity Capital: This refers to money put up and owned by the shareholders (owners). Typically, equity capital consists of two types: 1) contributed capital, which is the money that was originally invested in the business in exchange for shares of stock or ownership and 2) retained earnings, which represents profits from past years that have been kept by the company and used to strengthen the balance sheet or fund growth, acquisitions, or expansion. Many consider equity capital to be the most expensive type of capital a company can utilize because its "cost" is the return the firm must earn to attract investment. Debt Capital: The debt capital in a company's capital structure refers to borrowed money that is at work in the business. The safest type is generally considered long-term bonds because the company has years, if not decades, to come up with the principal, while paying interest only in the meantime. The cost of debt capital in the capital structure depends on the health of the company's balance sheet. A triple AAA rated firm is going to be able to borrow at extremely low rates versus a speculative company with tons of debt, which may have to pay 15% or more in exchange for debt capital.

Review of Literature

Capital Structure is a mix of debt and equity capital maintained by a firm. Capital Structure is also referred as financial structure of a firm. The capital structure of a firm is very important since it related to the ability of the firm to meet the needs of its stakeholders. Modigliani and Miller (1958) were the first ones to landmark the topic of capital structure and they argued that capital structure was irrelevant in determining the firm's value and its future performance. On the other hand, Lubatkin, M. and Chatterjee, S (1994) as well as many other studies have proved that there exists a relationship between capital structure and firm value. Modigliani and Miller (1963) showed that their model is no more effective if tax was taken into consideration since tax subsidies on debt interest payments will cause arise in firm value when equity is traded for debt. In more recent literatures, authors have showed that they are less interested on how capital structure affects the firm value.

Modigliani and Miller (1963) argued that the capital structure of a firm should compose entirely of debt due to tax deduction son interest payments. However, Brigham and Gape ski (1996) said that, in theory, the Modigliani-Miller (MM) model is valid. But, in Practice, bankruptcy costs exist and these costs are directly proportional to the debt level of the firm. Hence, an increase in debt level causes an increase in bankruptcy costs. Therefore, they argue that that an optimal capital structure can only attained if the tax protection benefits provided an increase in debt level is equal to the bankruptcy costs. In this case, managers of the firms should be able to identify when this capital structure is attained and try to maintain it at the same level. Using theoretical models, top Management of firms are able to calculate the optimal capital structure but in real world situations, many researchers found that most firms do not have an optimal capital structure (Simerly and Li, 2000). The reason underlying this argument is that, in general, the performance of a firm is not related to the compensation of the managers of the firm. Accordingly, managers prefer to surround themselves with all sorts of consideration as a key factor to determine the performance of the firm. Jensen and Meckling (1976, p. 308) states that "An agency relationship is a contract under which one or more persons (the principal) engage another person (the agent) to perform some service on their behalf which involves delegating some decision-making authority to the agent". The problem is that the interest of managers and shareholders is not always the same and in this case, the manager who is responsible of running the firm tends to achieve his personal goals rather than maximizing returns to the shareholders.

Firms' Performance and Capital Structure

The agency cost theory is premised on the idea that the interests of the company's Managers and its shareholders are not perfectly aligned. In their seminal paper Jensen and Meckling (1976) emphasized the importance of the agency costs of equity incorporate finance arising from the separation of ownership and control of firms whereby managers tend to maximize their own utility rather than the value of the Firm. Agency costs can also exist from conflicts between debt

and equity investors. These conflicts arise when there is a risk of default. The risk of default may create What Myers (1977) referred to as an “underinvestment” or “debt overhang” problem.

Methodology & Empirical Findings

We use Regression analysis technique for the relationship between independent and dependent variables. In this study we use the simple regression analysis for the relationship between capital structure and firm’s performance and capital structure and firm’s performance. In this part of the study empirical findings have been shown and interpreted. Table presents the regression model which shows the overall picture of the variables.

Data Collection

We collected data 173 companies of textile sector which are listed at the Karachi stock exchange. We collected data for the relationship between capital structure and firm’s performance for 10 year from 2000 to 2009. The number of companies included in the statistical analysis varied from year to year at the Karachi stock exchange. Three variables are collected for this study. Return on asset is used as a dependent variable and return on equity, and debt to equity ratio (indicator of capital structure) as a independent variables.

Selection of Variable

Dependent variable

Debt to equity ratio (indicator of capital structure)

Debt to equity ratio=total liabilities/share holders equity

Independent variable

Return on asset=net income/total asset

Return on equity=net income/shareholder equity

Linear regression analysis

$$Y = \alpha + \beta \text{ROA} + \varepsilon$$

$$Y = \alpha + \beta \text{ROE} + \varepsilon$$

Where epsilon represent the residual of the model

Regression Model on Return on Equity

Model summary

Model	Multiple R	R square	Adjusted r square	Standard error	observation
1	0.85	0.72	0.69	5.34	10

Prediction. Debt equity ratio

ANOVA

Model	Df	Sum square	Mean square	F	Significance F
1 Regression	1	592.89	592.89	20.78	0.00185
Residual	8	228.24	28.53		
Total	9	821.12			

Dependent variable: Return on equity

In this table we study debt equity ratio (indicator of capital structure) in dependent variable and dependent variable (return on equity) which shows the strong relationship between capital structure and firm performance and p value is less than 5% this shows the significant relationship between capital structure and firms performance and here significance level is 5% and level of confidence is 95%.

Model Summary on Return on Asset

Model summary

ANOVA

Model	df	Sum square	Mean square	F	Significance F
1 Regression	1	34.89516191	34.895162	15.18101872	0.004568543
Residual	8	18.38883809	2.2986048		
Total	9	53.284			

Dependent variable: Debt equity ratio (indicator of capital structure)

In this table we study the debt equity ratio (indicator of capital structure) dependent variable and debt equity independent variable and this table shows the strong relationship between capital structure and firms performance and p value shows the significant relationship between capital structure and firms performance and p value is less than 5%. in this model level of confidence is 95% and significance level is 5%.

Conclusion

This paper provides an overview of the Pakistani textile industry and investigates the textiles risk adjusted investment tendency using textile performance relationship with Capital structure. Textiles industry in Pakistan is still in growing phase other than special circumstances regarding macroeconomic factors political instability. Overall results suggest that textiles in Pakistan are able to add more value either Govt. or private level. Whereas results also show some of the companies under perform, these funds are facing the diversification problem with respect to all micro-macro factors. Worldwide there had been a tremendous growth in this industry; this growth in textiles worldwide is because of the overall growth in both the size and maturity of

many foreign markets, we are far behind. The need of an hour is to mobilize saving of the individual investors through the offering of variety of firms (with different situated objectives). The success of this sector depends upon the performance of funds industry and the role of regulatory bodies. Excellent performance and stringent regulations will increase the popularity of textiles in Pakistan. In this paper we analyze the relationship between capital structure and firms performance and debt equity ratio has positive effect on return on asset return on equity and strong relationship between capital structure and firms performance. By conducting this research, the researcher felt many things, which should be done to upgrade the status of textile industry. So, taking full advantage of this platform, the researcher wants to recommend certain things to the people who would like to do some further study upon this topic. There are also some suggestions for the authorities or the people who can do something practically find out the relationship between capital structure and firms performance.

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