Capital Structure Composition Demeanour towards Corporate Financial Performance Potential

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ABSTRACT: The optimal amalgam of debt and equity subject to various crucial considerations is potentially influenced by the availability of the financial sources that upshot corporate financial performance. The study accounts for the effect capital structure composition (CSC) implies upon corporate financial performance potential (CFPP) of 151 textile companies listed at Karachi Stock Exchange Pakistan using time series data during 2008-2014 compiled from the annual reports of respective concerns. E-Views has been used as analytical tool to regress the secondary data and empirical findings reveal that capital structure composition has adverse impact upon corporate financial performance of textile industry of Pakistan because of high fixed financial charges. Policy makers and management are suggested to take financing decision with utmost care and reliance upon equity financing would be more lucrative rather debt financing.

KEYWORDS: Capital Structure Composition, Corporate Financial Performance Potential, Return on Assets, Return on Capital Employed. Return on Equity.

1 INTRODUCTION

Profitability is the prime objective of all business ventures, as the long run survival depends upon profitable operations besides other measures and it is measured in terms of revenues and outlays of funds to yield such revenues. Whether profitability is recorded for past or projecting for foreseeable future, its measurement is most noteworthy measure for success of business unit. Increasing profitability is one of the most important tasks of the business managers. Managers constantly look for ways to change the business to improve profitability. These potential changes can be analyzed with reference to all those critical factors those trigger the profitably either positively or adversely and leverage is one of them. Leverage results from the employment of debt capital to meet the varying financial requirements of business operations. Leverage can be defined as "the use borrowed capital for (an investment), expecting the profits made to be greater than the

interest payable"1. The choice to raise funds either through equity or debt in maintaining an appropriate capital structure is an imperative decision to be wisely taken by financial managers because each source of financing has embedded features. Complexity of financial decisions varies with respect to nature of business, capacity of transactions, management policies and the aptitude of finance managers towards risk.

According to reference [1] "leveraged finance is funding a company or business unit with more debt than would be considered normal for that company or industry. More-than-normal debt implies that the funding is riskier, and therefore more costly, than normal borrowing. As a result, levered finance is commonly employed to achieve a specific, often temporary, objective: to make an acquisition, to effect a buy-out, to repurchase shares or fund a one-time dividend, or to invest in a self-sustaining cash-generating asset." Reference [2] investigated the connotation between the ownership and control structure and innovation and found that innovation is significantly and negatively related to the level of agency problems while as the innovation is lower for firms whose controlling owner is also either the chief executive officer or the chair of the board of directors.

Determination the optimal amalgam of debt and equity subject to various crucial consideration is potentially influenced by the availability of the financial sources. Keeping high debt proportion in capital structure opens up an avenue for interest outflows but provides tax relief at other front besides amassed financial leverage and demanding defray potentials. Although it deteriorates the ownership control over management affairs but it is sometimes beneficial as it does not result in ownership dilutions to existing equity holders. At the other front, with the view to have lesser external claims on corporate holdings management may decide to opt high equity capital to cultivate funds over long run, handicaps smooth governance as cumulative voting power of shareholder empowers to influence preferential managerial decisions regarding capital budgeting and optimistic dividend pay-out expectations. Pakistani textile industry is the largest one among all manufacturing sector industries. It comprised upon 155 identifiable separate entities. According to Trade Development Authority of Pakistan (TDAP) during 2012-13 the textile group has been the prominent export sector accounted 10,570,585,000 US dollar with 5.68 percent annual growth2. Deciding which combination of debt and equity is optimum for a given situation has an ultimate impact upon profitability of the venture that affects variety of useful decisions of stakeholders.

1.1 OBJECTIVES OF THE STUDY

The study focused to:

- Gauge the effect capital structure composition (CSC) implies upon corporate financial performance potential (CFPP) of textile industry of Pakistan.
- Offer policy recommendations for improvement for financial performance of textile industry of Pakistan.
- Offer recommendations for suitable composition of capital structure.

2 PREVIOUS RESEARCH

This important section accounts for the views of researchers pertaining to the capital structure and profitability relationship. According to reference [3] investment decision narrates the choice of assets in which a firm will invest the funds and assortment of appropriate mix of equity and debt in forming capital structure is governed in finance decision. The study of 167 Jordanian companies during 1990s demonstrated significant negative impact of capital structure on financial performance however, short term sources have positive significant influence on the performance [4].

Reference [5] has employed regression to investigate the impact of leverage ratio on liquidity, size, growth rate, profit, and tangibility of Jordanian listed companies. The results reveal that in industrial sector that liquidity and tangibly have significant relationship with leverage, whereas the results for the services sector discovered that the growth rate, liquidity, and tangibility are significantly related with leverage. According to reference [6] the regression analysis demonstrated that immense debt financing has positive significant impact upon return on equity of the firms listed on Bucharest Stock Exchange. However it is also pointed out that profitability and capital structure are not solely geared by debt financing, there might be the role of some other factors.

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[1] Oxford dictionaries, retrieved from: http://oxforddictionaries.com/definition/english/leverage
[2] Retrieved from: http://www.tdap.gov.pk/tdap-statistics.php

Reference [7] used fixed effects regression model on panel data to examine the determinants of leverage of Indian textile firms. It is concluded that size, non-debt tax shields, and tangibility have highly significant positive association with leverage ratio while growth and profitability have highly significant negative relationship with debt ratio. Reference [8] tested the relationship between the financial leverage and the financial performance of the fuel and energy sector in Pakistan by applying correlation and regression, found a progressive connection between financial leverage and financial performance. He believes that firms with high profitability may advance financial performance by devouring high ranks of financial leverage and to sustain future growth. Reference [9] examined the effect of managerial ownership on the cost of debt by using interest rate spread as proxy on corporate bonds for Japanese firms and results revealed that prospective bondholders use managerial ownership information to antedate a firm's prospective agency cost of debt. It is also found that accounting information is advantageous to evaluation cost of debt.

Reference [10] employed ex ante cost-of-equity capital measures based on accounting valuation models to assess the risk relevance of off-balance sheet operating leases. This study finds that a firm's ex ante cost-of-equity capital is positively associated with adjustments in its financial leverage and operating leverage resulting from capitalized off-balance sheet operating leases and that the positive association between the ex-ante cost of capital and the impact of operating leases on a firm's financial leverage is weaker for the operating leases compared with the capital leases. The study results reveal that managerial ownership moderates the relationship between debt and firm performance of Egyptian listed firms [11]. The study of 203 GCC countries using a panel data analysis for the period 2000–2010, examines the effects of financial leverage and risk and results indicate that ownership structure affects firm performance in GCC countries [12].

Reference [13] implied dynamic panel regression to gauge the relationship between leverage and profitability of European and US banks. The findings demonstrate that the performance of banks has adversely affected by leverage. Reference [14] has investigated the effect of leverage and firm size on return on asset from sixty six listed companies at KSE by using regression and found a significant variability in financial performance caused by leverage. Reference [15] claimed that there stand numerous dynamics that can shake the companies' profitability besides debt and they have taken into account operational decision factor, macroeconomics factor, firm size factor, and industry factors to assistance understand the effect of debt on firm's profitability. The empirical results indicate that debt, firm size, and operational decision have positive and significant impact upon profitability while as it is insignificantly influenced by macroeconomics factors. However industry factors drive profitability at a nominal force.

According to Reference [16] leverage can be explained as the relationship between the firm's operational and financial costs respect to the earrings. This relationship is underpinned how debt-equity ratio affects earning per share of the oil and gas sector of Pakistan. The findings of the study did not support the hypothesized positive relationship between financial leverage and firm's profitability. It also opposed the view of other researchers that "high leveraged firms were less risky in both market-based and accounting-based measures", however it is suggested that industry specific factors if considered my help in explaining the underlying association between leverage and profitability.

Reference [17] studied the effect of leverage on the profitability of the oil and gas sector using regression analysis. The study took financial, operating and combined leverage as independent variables to explore their effect on return on asset, return on equity, return on investment and earnings per share that how the earning capability of the sector is affected by operating and fixed financial costs. The relationship between debt and EPS has also been analyzed. The study found not a significant relationship between leverage and profitability indicators which implies that highly leveraged oil and gas companies have lower profitability. Results of the study oppose the belief that there is a positive connection between leverage and profitability.

Reference [18] investigated the relationship between leverage and profitability of Swedish commercial banks during 1870 to 2001 with the help of regression, and findings revealed a positive linear relationship between return on equity and the debt-equity ratio. A strong positive linear relationship was found over the period 1871 to 1980, but not in 1980 to2001. Thus it affirms the positive relationship between leverage and profitability is also reaffirmed. Reference [19] explored the relationship of leverage, profitability and a firm's ownership structure in China for the firms registered on Shanghai and Shenzhen stock exchanges during 1999-2005. The results of regression were recorded significant for foreign holdings pertaining to leverage. Institutional ownership, state ownership and private holdings do not have any significant bearings upon choice of capital structure for the firms in China. The results also propose that certain firm-specific dynamics relevant in explaining firm's leverage in evidences for developed economies are also relevant in case of China.

Reference [20] have probed the relationship between financial leverage and earning per share of selected telecommunication companies in India and the extent of the earning capability of these firms swayed by fixed operating and financial costs. The results of study proposed that leverage has an impact on the profit potential of the firm. Reference [21] applied regression analysis to investigate the effect of profitability and financial leverage of firm on capital structure of the

automobile companies in Pakistan. It is found that the profitability of the firm and its financial leverage have an insignificant impact on the capital structure of the studied firms during the examined period. The study could not found any significant relationship between profitability and financial leverage on the capital structure.

Reference [22] used OLS regression to have an empirical insight into the relationship between return on equity (ROE), financial leverage and size of firms in the restaurant industry during 1998-2003. Evidence reported that size of the firm has relatively greater influence on return on equity than leverage of restaurant firms. Firms with large size have earned significantly higher relative to debt usage comparative to small firms that are more risky and significant regardless of having lower financial leverage.

The literature is inconclusive and conflicting that justifies the scope of this study to provide more evidence on this critical area of capital structure composition and corporate financial performance.

3   RESEARCH METHODOLOGY

3.1   EXPLANATION OF RESEARCH MODEL

The study employed following regression model to measure the bearings leverage have upon financial performance potential of textile industry of Pakistan:

Model: $Y(CFPPPTI) = \alpha_0 + \beta_1 X_1 (CSCPTI) + \varepsilon$ …………………………… (i)
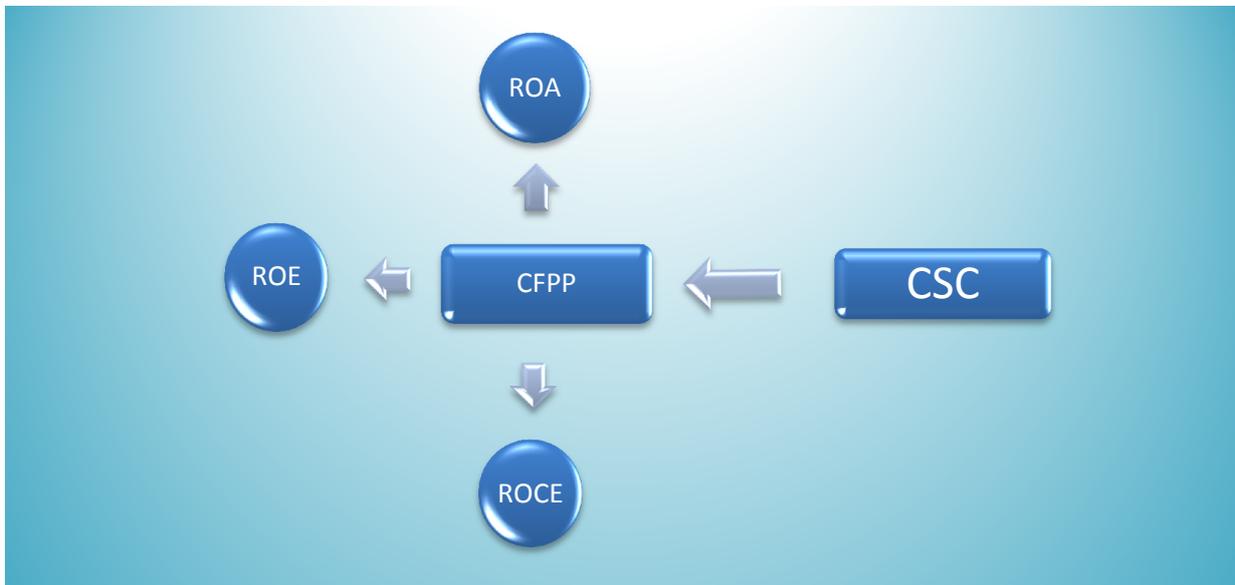

Fig. 1.   Graphical depiction of model

Source: Drawn on literature

Model-A: $Y(ROAPTI) = \alpha_0 + \beta_1 X_1 (CSCPTI) + \varepsilon$ …………………………… (ii)

Model-B: $Y(ROEPTI) = \alpha_0 + \beta_1 X_1 (CSCPTI) + \varepsilon$ …………………………… (iii)

Model-C: $Y(ROCEPTI) = \alpha_0 + \beta_1 X_1 (CSCPTI) + \varepsilon$ …………………………… (iv)

Return on assets (ROA) reflects the relative profitability of a company to its total assets. It is calculated by dividing Net profit before taxes by Average of (Non-Current Assets + Current Assets). Return on equity (ROE) measures firm's efficiency in generating profits from every unit of shareholders' equity and it is captured by dividing Net profit before taxes by Average of Shareholder's equity. While Return on capital employed (ROCE) compares earnings with capital invested in the company, this is calculated by dividing Net profit before taxes with Average of Total capital employed.

3.2 POPULATION AND SAMPLING

This study has taken into account the textile firms from Pakistan textile industry listed at Karachi Stock Exchange (KSE). The sample consists of 151 firms (Spinning, Weaving, Finishing-133; Made-up Textile articles-6 and Other Textiles-12) purposively selected out of 155 listed firms the four firms excluded because they were new in market and data were not sufficient to serve the purpose.

3.3 DATA SOURCE AND STATISTICS

Secondary data pertaining to profitability and capital structure indicators for the period 2008-2014 have been compiled from annual audited financial reports of respective firms and the database maintained by statistical division of SBP, that have been analyzed descriptively and inferentially with the help of E-Views.

4 RESULTS AND DISCUSSIONS

4.1 DESCRIPTIVE STATISTICS

Table 1 exhibited the relationship among variables; Pearson Correlation for CSC is negatively correlated with ROA -.072, ROE -.097 and ROEC (-.103) at 1 and 5 percent significant level. ROA is correlated with ROE and ROEC with .545 and .378 respectively while as ROE and ROEC are correlated with .646.

4.2 REGRESSION ANALYSIS

Aggregate regression output generated by E-Views is reported in this section and table 2 represents the fitness of econometric model applied to regress the relationship between CSC and proxies of CFPP. For all three proxies of Corporate financial performance potential the p-value is less than .05 [Model-A ($P<.05<.019$); Model-B ($P<.05<.001$); and Model-C ($P<.05<.002$)] that signifies the explanatory power of these econometric models and their fitness is also observed by the minute difference of R Square and Adjusted R Square values.

The results of coefficients are portrayed in table 3 and p-value for CSC (Model-A) is significant ($p<.05<.019$) and signals that return on assets has significantly been influenced by capital structure composition and beta coefficient (-.357) indicates that CSC has negatively affected the ROA by 36% while as, ROCE is 40% adversely influenced by CSC. The second highest unfavorable translation is implied by CSC on ROE was 50%.

5 CONCLUSION AND POLICY RECOMMENDATION

5.1 CONCUSSION

Empirical findings reveal that capital structure composition has vital impact upon corporate financial performance of textile industry of Pakistan that supports the claim of reference [20]. Results show that most of the textile firms have employed debt financing as prominent part of capital structure that resulted in outflow of reasonable portion of yield in servicing debt financing. The results are consistent with reference [4] and [17] while in contradiction with the findings of reference [18].

Among all financial performance measures the return on equity has suffered more besides return on capital employed and return on assets at second and third respectively.

5.2 POLICY RECOMMENDATIONS

Based upon the empirical findings, following policy recommendations are offered to management and practitioners of Pakistan textile industry:

- Capital structure decision needs to be taken with utmost care as it has significant bearing on financial performance potential of the sector.
- It is therefore rational to rely on equity financing rather debt financing to overcome the massive interest expenses outflow required to service debt capital.

- If at any stage external financing becomes indispensable, manage least cost short term financing so the profitability may not be adversely hampered.
- Before choosing capital structure composition for each firm, industry capital structure analysis would be more fruitful and lucrative.

5.3   FUTURE RESEARCH

The study has contemplated the whole textile industry to gauge the impact of capital structure compassion on corporate financial performance. Analysis of capital structure composition and its effect on firm financial performance at micro level would be a potential scholarly contribution.

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APPENDICES

Table 1. CORRELATIONS AMONG VARIABLES

		CSC	ROA	ROE	ROCE
CSC	Pearson Correlation	1	-.072[*]	-.097[**]	-.103[**]
	Sig. (2-tailed)		.019	.002	.001
	N	1057	1057	1057	1057
ROA	Pearson Correlation		1	.545[**]	.378[**]
	Sig. (2-tailed)			.000	.000
	N			1057	1057
ROE	Pearson Correlation			1	.646[**]
	Sig. (2-tailed)				.000
	N				1057
ROCE	Pearson Correlation				1

*. Correlation is significant at the 0.05 level (2-tailed).
**. Correlation is significant at the 0.01 level (2-tailed).

Source: Estimations by author(s).

Table 2. MODEL SUMMARY AND ANOVA[a,b,c]

	R Square	Adjusted R Square	F	P-value
Model-A	.005	.004	5.539	.019[*]
Model-B	.011	.010	11.393	.001[*]
Model-C	.009	.008	10.014	.002[*]

a,b,c. Dependent Variable: ROA, ROCE and ROE
*Predictors: (Constant), CSC

Source: Estimations by author(s).

Table 3. COEFFICIENTS[a,b,c]

		Unstandardized Coefficients		Standardized Coefficients	t	P-value
		B	Std. Error	Beta		
Model-A	(Constant)	5.390	.913		5.904	.000
	CSC	-.357	.152	-.072	-2.353	.019
Model-B	(Constant)	3.548	.715		4.960	.000
	CSC	-.401	.119	-.103	-3.375	.001
Model-C	(Constant)	6.479	.959		6.757	.000
	CSC	-.504	.159	-.097	-3.164	.002

a,b,c. Dependent Variable: ROA, ROCE and ROE

Source: Estimations by author(s).