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Capital Structure and Profitability – A Study of selected Companies in Nifty

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Abstract:

Capital structure decisions are critical for every business organization as maximization of firm value is a complex task and involves the selection of debt and equity securities in a balanced proportion, keeping in view the different costs and benefits attached to these securities. This empirical study aims to explore the factors that affect the capital structure in Indian firms and to know which capital structure theory—whether the pecking order theory or the trade-off theory—justifies the findings of the study. The investigation is performed using panel data procedures on Indian firms during 2011-2020. The dependent variables used are short-term debt, long-term debt and total debt. Profitability, firm's size, growth rate, tangibility, business risk, interest coverage ratio, non-debt tax shield, tax rate and liquidity are taken as the independent variables. The results suggest that variables such as profitability, firm's size, liquidity, risk and tax rate affect the capital structure of the Indian firms, and short-term debt is found to be an essential financing source of the Indian firms. This study has laid some groundwork to explore the determinants of the capital structure of the Indian firms upon which a more detailed evaluation could be based.

Keywords: - Capital structure, Firm's value, Profitability, Panel Data, Empirical Study, NIFTY.

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INTRODUCTION

In the wake of globalization and liberalization of economic policies across the world, investment opportunities have expanded, financing options have widened, and above all, dependence on capital markets has increased. A new business requires capital and the firm will require even more capital as it grows. The requisite finance can come from different sources and in different forms as well. Firms can finance their assets using either debt or equity capital, but the appropriate choice is a combination of both **Azhagaiah and Gavoury, (2011)[1].** One of the most mystified issues faced by financial managers is the relationship between debt and equity financing (capital structure). Another important aspect of the finance literature is that of the capital structure which indicates how corporations finance their assets. Capital structure decisions are one of the most valuable decisions in corporate finance. The study of capital structure aims to characterize the mix of various sources of finance to fund an organization's strategic plan which includes debt, equity, and preferred stock. The capital structure reveals the firm's financing strategy, for instance, its overall desired ratio, the design and timing of a specific debt issue, and also its financing tactics. One of the most important decisions that managers make is how to finance their projects. Therefore, financial structure choice is one of the vital issues among financing decisions. It is explained by the mix or proportion of a firm's financing represented by debt or equity.

The firm can issue a variety of definite securities in different combinations. A rational attempt is to determine the specific blend that will increase the firm's overall market value (**Cheng and Chien, 2010)[2]**. Capital structure however, has been a contentious topic in corporate finance, since the distinguished study of(**Jaros and Bartosova, 2015)[3]** has elaborated the capital structure as "one of the seven most outstanding ideas in finance". It has been an essential issue from the perspective of strategic management standpoint since it is linked with a firm's ability to meet the demands of various stakeholders. Capital structure is a related

[1]Azhagaiah, R., & Gavoury, C. (2011). The Impact of Capital Structure on Profitability with Special Reference to IT Industry in India. *Managing Global Transitions: International Research Journal*, *9*(4), 371-392

[2]Cheng, Y. S., Liu, Y. P., & Chien, C. Y. (2010). Capital structure and firm value in China: A panel threshold regression analysis. *African Journal of Business Management*, *4*(12), 2500-2507.
[3]Jaros, J., & Bartosova, V. (2015). To the capital structure choice: Miller and Modigliani model. *Procedia Economics and Finance*, *26*, 351-358.

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strategic decision that ultimately affects the value of a firm **Cheng et al., (2010)**[4]. Consequently, various theories have been developed to examine the determinants of capital structure.However, none of these theories provide a complete description of capital structure because they are conditional as each works under its own assumptions and propositions.

Literature Review

The review of literature comprises key modern theories of capital structure and examples of empirical evidence from all around the globe.

Modigliani and Miller (1958) state that the firm's value is independent of its capital structure under perfect capital markets with no corporate taxes, no transaction, and agency cost, and there is a perfect disclosure of all the credible information. Kraus and Litzenberger (1973) state that the optimal capital structure reveals a trade-off between the tax benefits of debt and the cost of financial distress associated with the debt. In other words, as per the trade-off theory, the optimal leverage is attained by developing a balance between the tax-free benefit of debt and the distress cost of debt. Myers and Majluf (1984) explained the pecking order priority of firms: funding starts from internal financing or retained earnings to debt issuance and finally, equity as a last resort to meet their funding needs. Jensen and Meckling (1976) explained the agency cost that includes monitoring expenditures by the principal, bonding expenditure by the agent, and residual loss. This theory is based on the assumption that agents may not always act in the best interest of the principals; this leads to a conflict of interest between agents and principals, resulting in a loss in return to the principals.

Donaldson (1985) argues that the dependence on debt or equity changes as the firm's stock ownership changes and results in changes in firm's financial goals. Harris and Raviv (1991) and Rajan and Zingales (1995) summarized many studies and suggested that most studies are sharing the following variables for determination of capital structure: tangibility of assets, non-debt tax shields (NDTSs), investment opportunities, firm size, volatility, advertisement expenses, R&D expenses, probability of bankruptcy, profitability, uniqueness, etc. Graham and Harvey (2001) argue that firms consider price increase before issuing stock and credit

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rating before issuing debt. Cook and Tang (2010) state that firms adjust their capital structure to their target structure quickly in good macroeconomic conditions.

Mishra (2011) argues that leverage is affected by profitability, asset structure and tax. Bhayani (2006) studies the impact of leverage on shareholders' return in the Indian cement industry. De Wet (2006) studies the relationship between firm value and optimal gearing level. Fama and French (2002) find a positive relationship between leverage and profitability. Leland and Toft (1996) find a positive relationship between leverage and debt maturity. Mukherjee and Mahakud (2012) find market to book ratio as a proxy for growth prospects and a significant factor for determining the capital structure of Indian manufacturing companies. Bhaduri (2002) argues that optimal capital structure is determined by variables such as cash flow, growth, size, restructuring costs, products and industry characteristics.

Rasoolpur (2012) argues that uniqueness and liquidity determine the capital structure of the Indian corporate sector. Adhegaonkar and Indi (2012) find that tangibility, NDTS, and interest coverage ratio are significant determinants of capital structure. Majumdar (2012) argues that tangibility, growth, profitability, and risk are significant determinants of capital structure. Mukherjee and Mahakud (2010) find that market to book ratio, size, profitability and tangibility are significant determinants. Sinha and Ghosh (2010) argue that default spread, growth, size and profitability are significant determinants. Rajagopal (2009) argues that fixed asset ratio, size, profitability, market-to-book ratio, NDTSs, and earnings volatility are determinants of capital structure. Bhole and Mahakud (2004) argue that debt cost, equity cost, size, the collateral value of assets, liquidity and NDTS are significant determinants of capital structure in India. Bayrakdaroglu et al. (2013) find that size, profitability, tangibility, NDTS, inflation and tax are significant determinants of the Turkish capital structure.

Purohit and Khanna (2012) argue that growth, collateral value of assets and R&D expenditure are significant determinants of capital structure. Akhtar (2005) argues that growth, profitability, size, collateral value of assets, bankruptcy cost and level of geographical diversification are determinants of capital structure in Australia. Chen and Strange (2005) argue that profitability, size and risk are determinants of capital structure for Chinese listed companies. Lim (2012) finds that profitability, size, NDTSs, earnings volatility and non-circulating shares are major determinants of capital structure. According to Cortez and Susanto (2012), tangibility, profitability and NDTS are significant factors that affect the

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capital structure, while, Kouki and Said (2012) find that size, profitability, growth opportunities and NDTS are important capital structure determinants.

To sum up, empirical evidence provides varied and contradictory results regarding the determinants of capital structure and their statistical significance and relationship. Also, there are very few studies that empirically study this relationship in developing economies like India. The present study extends the literature on the determinants of capital structure by empirically evaluating the determinants of capital structure in the Indian companies listed on the National Stock Exchange. Table 1 shows the predictions made by trade-off as well as the pecking order theories regarding various determinants of capital structure.

Scope of the Study

One of the most significant factors of firm success is capital structure decisions. A large number of firms become bankrupt due to the overburden of their debt or improper capital structure. For an emerging economy like India, it becomes necessary for the Indian firms to

Table 1: Predictive Relationship

Determinants	Code	Trade-off Theory	Pecking Order Theory
Profitability	PROF	Positive	Negative
Firm Size	SIZ	Positive	Negative
Growth Rate	GROW	Negative	Positive
Tangibility	TANG	Positive	Negative
Non-Debt Tax Shield	NDTS	Negative	-
Liquidity	LIQ	Negative	Negative

have an optimal capital structure to minimize the cost of capital and thereby maximize the market value of the firm. For this reason, it becomes important to determine all those factors which help in the attainment of the optimal capital mix. In addition, all the factors that determine the leverage level of a firm may not be within the firm's control. Thus, there is a need to comprehensively study the various factors and analyze their effect on the Indian firms' leverage levels. Also, it is important to know which theory implications are more validating in the Indian scenario, i.e., pecking order or trade-off theory

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Objective

- To study the determinants of capital structure of the Indian companies listed on the NIFTY
- To empirically examine which theory—the trade-off theory or the pecking order theory—is more applicable in the selected NIFTY companies.

Data and Methodology

Sample

This study is based on the secondary data of sample companies taken from the Prowess— Center for Monitoring Indian Economy (CMIE)—database. The annual financial stand-alone results have also been considered for empirical evaluation. The quality and reliability of the study directly depends upon the accuracy, reliability and quality of the Prowess CMIE database. STATA statistical software has been used for applying the required statistical analysis technique like Pooled OLS

The sample used in the present study consists of the data from the year 2011 to 2020 of the Indian pharmaceutical companies listed in Nifty. Out of the total companies listed on NIFTY, financial firms and those firms which have missing values in either the dependent variable or independent variables are excluded. After applying the above filters, with information availability constraints, the final sample consisted of 4 listed companies only. The list of the variables, along with their definitions and measurement, is given in Table 2

Table 2: Definition of Variables

S. No.	Variable	Code	Measurement
1	Debt-Equity Ratio	STD/LTD/TD	(Short-term Debt/Total Assets), (Long-term Debt/Total Assets),(Total Debt/Total Assets)
2	Profitability	PROF	Return on Assets
3	Firm Size	SIZE	Log of Total Assets
4	Growth Rate	GROW	Annual Growth of Total Assets
5	Tangibility	TANG	Fixed Assets/Total Assets
6	Non-Debt Tax Shield	NDTS	Depreciation/Total Assets

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7	Liquidity	LIQ	Current Assets/Current Liabilities

Variables

Dependent Variables

Total Debt Ratio: Total debt ratio is a financial ratio that measures the percentage of a company's assets that are provided in comparison to debt.

Long-Term Debt Ratio: The long-term debt to total assets ratio, at the simplest, measures the portion of a company's total assets that is financed from long-term debt. The value differs from industry to industry and company to company. Comparing the ratio with industry peers is a better benchmark. **Short-Term Debt Ratio**: Short-term debt is shown in the current liabilities of a company's balance sheet. This account comprises any debt or repayments incurred by a company that is due within one year. The debt in this account is usually made up of short-term bank loans taken by a company. The ratio indicates whether a firm will be able to satisfy its immediate financial obligations.

Independent Variables

Profitability: Profitability is the financial benefit that is realized when the amount of revenue gained from a business activity exceeds the expenditure, costs, and taxes needed to sustain the activity. Any profit that is gained goes to the owners of the business, who may or may not decide to spend it on the business.

Size: Large firms are often more diversified and have more stable cash flows; the probability of defaults for large firms is smaller compared to smaller ones. Thus, the financial distress risk can be considered lower for larger firms.

Growth: Firms with growth options are those that have relatively more capacity expansion projects, new product lines, acquisition of other firms and maintenance, and replacement of existing assets. Firms with high growth options and high cash flow volatility have incentives to decrease debt in their capital structure over a period of time.

Tangibility: Asset tangibility refers to the proportion of fixed assets to total assets. It indicates the degree of debt capacity.

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Non-Debt Tax Shield: The tax deduction in the firm's income on account of depreciation, expenditure on research and development is called Non-Debt Tax Shields (NDTS) as it is allowed on non-debt items. Firm issues debt so as to get a tax shield on interest. The tax shield motive of issuing debt is weakened by the tax shield availed by the non-debt items. So, firms with larger NDTS are expected to use less debt in their capital structure.

Liquidity: Liquidity is the ability to convert an asset into cash immediately. It is also known as "marketability."

Hypotheses

The following are the proposed hypotheses:

$H_{01:}$ *No significant relationship between Total Debt and Profitability, Size, Growth, Tangibility, NDTS, and Liquidity.*

$H_{02:}$ *No significant relationship between Total Debt and Profitability, Size, Growth, Tangibility, NDTS, and Liquidity.*

$H_{03:}$ *No significant relationship between Total Debt and Profitability, Size, Growth, Tangibility, NDTS, and Liquidity.*

Model Specification

Panel data can also control for individual heterogeneity due to hidden factors, which, if neglected in time-series or cross-section estimations, leads to biased results (Baltagi, 2008). The panel regression equation differs from a regular time-series or cross-section regression by the double subscript attached to each variable. In order to analyze the determinants of capital structure of Indian listed companies, the following pooled OLS method has been utilized. In this study, all the assumptions of OLS are fulfilled and satisfied

Model 1: $$\boldsymbol{TD_{i,t} = \alpha + \beta_1 PROFIT_{i,t} + \beta_2 SIZE_{i,t} + \beta_3 GROW_{i,t} + \beta_4 TANG_{i,t} + \beta_5 NDTS_{i,t} + \beta_6 LIQ_{i,t}} (1)$$

Model 2: $$\boldsymbol{LTD_{i,t} = \alpha + \beta_1 PROFIT_{i,t} + \beta_2 SIZE_{i,t} + \beta_3 GROW_{i,t} + \beta_4 TANG_{i,t} + \beta_5 NDTS_{i,t} + \beta_6 LIQ_{i,t}} \quad (2)$$

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Model 3: $LTD_{i,t} = \alpha + \beta_1 PROFIT_{i,t} + \beta_2 SIZE_{i,t} + \beta_3 GROW_{i,t} + \beta_4 TANG_{i,t} + \beta_5 NDTS_{i,t} + \beta_6 LIQ_{i,t}$ (3)

where *i* represents the companies; *t* represents the time; α stands for model constant; β states the coefficient of independent variables and $\alpha_{I,t}$ represents the error term, which is assumed to have a normal distribution.

Results and Discussion

Descriptive Statistics

Table 3 presents the descriptive statistics of the various variables used in the study. It can be seen from the value of the standard deviation that there is considerable variation in the sample which is manageable for this analysis.

Table 3: Descriptive Statistics

Variable	Obs.	Mean	SD	Min.	Max.
TD	40	0.51	0.18	0.00	1.09
LTD	40	0.18	0.14	-0.16	0.95
STD	40	0.33	0.17	0.00	0.91
PROF	40	8.39	7.93	-35.07	131.04
SIZE	40	4.55	0.65	2.75	6.79
GROW	40	16.65	40.95	-36.43	1352.62
TANG	40	0.27	0.16	0.00	0.79
NDTS	40	0.02	0.02	0.00	0.12
LIQ	40	1.61	2.32	0.11	55.77

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Table 4 represents the correlation matrix of all the independent variables. It was found that there is no statistically high degree of correlation between any of the explanatory variables

Table 4: Matrix of Correlations

Variable	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)
(1) TD	1.00								
(2) LTD	0.482	1.00							
(3) STD	0.666	–0.333	1.00						
(4) PROF	–0.401	–0.327	–0.153	1.00					
(5) GROW	–0.034	–0.017	–0.022	0.330	1.00				
(6) LIQ	–0.375	0.045	–0.266	0.104	0.222	1.00			
(7) NDTS	–0.031	–0.161	–0.133	0.101	–0.090	0.127	1.00		
(8) SIZE	0.144	0.136	0.039	–0.246	–0.105	–0.379	–0.064	1.00	
(9) TANG	–0.016	0.345	–0.310	0.031	–0.067	0.137	–0.132	0.006	1.00

and hence the regression models were free from the problem of multicollinearity. Table 5 lists the empirical findings of the three regression models.

Results of Model 1

R^2 value (0.293) shows the combined effect of Model 1 in explaining the relevant relationship between the Total Debt and select independent variables. The probable F-statistics value accepts the fitness of the model.

In this model, it is found that the estimated coefficient of PROF turns out to be negative and statistically significant with TD, thus associating high debt levels with lower profitability

Table 5: Regression Analysis

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Variables	Model 1 (TD)	Model 2 (LTD)	Model 3 (STD)
PROF	–0.00918***	–0.00659***	–0.00259***
	(0.000495)	(0.000389)	(0.000484)
SIZE	0.0186***	0.0363***	–0.0177***
	(0.00604)	(0.00475)	(0.00591)
GROW	0.000371***	0.000339***	3.20e–05
	(9.20e–05)	(7.24e–05)	(9.00e–05)
TANG	–0.0615**	0.365***	–0.427***
	(0.0279)	(0.0219)	(0.0272)
NDTS	0.170	–0.995***	1.166***
	(0.287)	(0.226)	(0.281)
LIQ	–0.0260***	–0.00436***	–0.0217***
	(0.00153)	(0.00120)	(0.00149)
Constant	0.560***	0.00157	0.558***
	(0.0307)	(0.0242)	(0.0300)
Observations	40	40	40
R^2	0.293	0.301	0.217
Note: Standard errors in parentheses; *** p<0.01, **p<0.05, *p<0.1			

with the implication that the Indian nifty companies are following pecking order theory. SIZE and GROW turn out to be positive and statistically significant. It suggests that larger firms enjoy higher profits as compared to the smaller ones. Next LIQ and TANG turn out to be negative and statistically significant. The remaining variable, i.e., NDTS have no influence on TD.

Results of Model 2

R^2 value (0.301) shows the combined effect of Model 2 in explaining the relevant relationship between long-term debt and the nine independent variables. The probable F-statistics value accepts the fitness of the model.

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In this model, it is found that the coefficient of PROF turns out to be negative and statistically significant with LTD, thus indicating that high debt levels are proportional with lower profitability, with the implication that the Indian listed companies are following pecking order theory. SIZE, GROW, and TANG turn out to be positive and statistically significant. It suggests that larger firms enjoy higher profits as compared to the smaller ones. Next, LIQ and NDTS turn out to be negative and statistically significant.

Results of Model 3

R^2 value (0.217) shows the combined effect of Model 3 in explaining the relevant relationship between the Short-Term Debt and select independent variables. The probable F-statistics value accepts the fitness of the model

In this model, it is found that the PROF is negatively and statistically significant with STD, thus showing that STD is negatively associated with profitability in Indian firms, also underlining the fact that Indian listed companies are following pecking-order theory. NDTS turns out to be positive and statistically significant. Next, LIQ, RISK, SIZE and TANG turn out to be negative and statistically significant. The remaining variables, viz., TAX, GROW and COVER, have no influence on STD

To sum up, from the empirical findings of the above three models, it is found that size, profitability, tangibility, risk, liquidity and NDTS are the key determinants of capital structure in the Indian listed companies. Regarding, trade-off theory vs. pecking order theory validation, in all the three models pecking order theory explains the nature of capital structure in the Indian listed companies.

Conclusion

This paper studies the key determinants of capital structure for Indian listed companies and which theory implications, i.e., trade-off or pecking order, are more applicable in the current Indian nifty companies' scenario. It was empirically found that size, profitability, tangibility, liquidity and NDTS are statistically significantly correlated with firm debt-equity ratio or key determinants of capital structure in the Indian companies. Pecking order theory explains the nature of capital structure in the Indian listed companies. The findings of the study would

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enhance the literature on capital structure and are useful for the Indian companies' finance managers.

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