

## IMPACT OF CAPITAL STRUCTURE ON INVESTOR BEHAVIOR AND PERFORMANCE OF FIRMS IN PAKISTAN

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### ABSTRACT

*The purpose of this article is to find out that capital structure which has a positive impact on the investor behaviour and firm's performance. This article explains the impact of capital structure on investor behaviour and performance of firms in Pakistan. Study on capital structure proves that an organization Capital structure plays a vital role in determining financial performance, sustainability and future growth of the organization. In this paper impact of capital structure has been shown through a conceptual framework. This study provides guidelines for developing countries that capital structure increases performance of firms and create a positivity in investor behaviour. It is also seen that different choices of capital structure influences behaviour of investors. In other words investor behaviour has been changed due to changes in pattern of capital structure. That's why investors should have the correct knowledge regarding combination of debt and equity of a firm. This research is useful for Pakistani firms and by using these guidelines firms can develop a good capital structure.*

*Keywords: Capital, Capital structure, Investor behaviour, weighted average cost of capital, Return on asset, Return on equity, Earning per share, Profitability ratio.*

### INTRODUCTION

The Capital structure is the combination of different source of capital. In this combination every firm decides the portion of debt and equity. Selection of a right capital structure is a serious decision for any firm. This decision is important not only due to need of make increase in rate of return but also its necessary for the purpose of maximizing the firm ability to face the challenges of its competitive environment. Researches in Business, Economics and Finance always analysed the processes of economic value creation as their main area of studies. Capital structure has become one of the main factors which are essential in determining value. The division of equity is important in explaining the overall capital structure. The variable associated with the collateral value of assets shows a considerably positive relationship with debt. Capital structure refers to the way a firm finance its assets through some mixture of equity, debt, or hybrid securities. A firm's capital structure is then composed of 'structure' of its liabilities. For example, a firm that sells \$20 billion in equity and \$80 billion in debt is said to be 20% equity financed and 80% debt financed. The firm's ratio of debt to total finance is 80% in this example is known as the firm's leverage. Actually, capital structure may be extremely complex and include dozens of sources. Gearing Ratio is the percentage of the capital employed of the firm which come from outside of the business finance, e.g. by taking a short term loan etc.

Managers try to adjust the capital structure of firms according to changes in the agency cost structure in a versatile manner. The structure of equity ownership is important in describing the overall capital structure of the firm. Both source of finance debt and equity has the advantages and disadvantages. In Pakistani economy come many variations from the time of independence 1947. These changes in the economy come due to the political and socioeconomic problems. According to Modigliani and Miller (1958) capital structure is unconnected in the perfect market condition characterized by the capital market with no taxes, no transaction cost and homogeneous anticipations. According to corporate tax study organizations must use debt as much as possible in order to utilize tax savings. (Modigliani and Miller, 1963). In developing countries like Pakistan debt market is small and underdeveloped that's why organizations are dependents largely on the banking sector in obtaining debt to finance their operations. A large portion of the banking sector in Pakistan is privatized and they don't offer debt finance on easy terms. Those organizations which involve in risky operations are restricted to borrowing less in these markets. The importance of this study is that it will provide help to construct that structure of capital that bring an increase in the profit and also makes the investor behaviour positive towards the investment in the firms. It will also tell how the pattern of capital structure affects the performance of firms in Pakistan.

## REVIEW OF LITERATURE

A most essential and fresh area of strategy has been observed which show the relationship among a company capital structure and elements related to the ability of companies to compete (Balakishnan and Fox, 1993; Barton and Gordon, 1988; Porter, 1992). The Capital structure is a significant matter according to the financial economic viewpoint which has a strong relation to firm's capacity to full fill the demand of stakeholders (Modigliani and Miller, 1958, 1963). Strategic research tells us different ways, those ways provide help in the development of a firm capital structure (Hitt, Hoskisson, and Harroson, 1991). In current years according to Hitt, Hoskisson and Hill, (1988) and Porter, (S1992) the relationship among the choices of capital structure and the competitive competencies of the firms has gained significance. According to Beck and Kunt, (2006) firm size can be affected due to financial and institutional weaknesses. Capital is a vital resource for all firms, the supply of which is in doubt. This doubt enables the suppliers of finance to put control over the firm (Stearns, 1986; Stearns and Mizru- chi, 1993). The two major classes of financial liabilities-debt and equity-are linked with different levels of benefits and control. Questions linked to the choice of financing have increasingly attained importance in strategic management research. It has been recommended that the capital structure of firm results from managerial risk taking propensity (Barton and Gordon, 1987, 1988), is affected by corporate governance mechanisms (Chaganti and Damanpour, 1991; Stearns and Mizruchi, 1993), and influences the diversification strategy of a firm (Chatterjee, 1990; Chatterjee and The Wernerfelt, 1991). A wide-ranging variety of theoretical approaches are included in the recent situation in readings of capital structure but still no particular theory/reading of capital structure is commonly accepted and applied around the globe (Myers, 2001; Harris and Raviv, 1991). According to Myers, (2001, p.81) there is no general or common theory which provides help in choosing the optimum capital structure, also there is no authentic reason to expect one. There are different useful conditional theories however.

Some major reasons why we want to finance our firm operations through different source of capital are following:

1. For Tax saving
2. Differences in information
3. To reduce Agency cost
4. Huge volume of required capital.
5. The Lengthy time period for which money is required.
6. To achieve weighted average cost of capital.
7. Due to Involvement of risk in business operations
8. Because of long Business life cycle.
9. Due to Financial flexibility.

The several theories of ideal capital structure depend on some economic aspect and also on firm characteristic. At this point we can explain above discussed the concept with the help of an example, the trade-off theory emphasizes on taxes, the free cash flow theory put emphasis on agency cost and the pecking order theory make focus on difference in information. Financing choices are relevant to different theories on the base of taxes, information and agency cost. According to Myers (2001) still no theory provides us a general explanation of financing strategy.

There are three basic theories which are related to capital structure:

### ❖ Trade-off theory

Trade-off theory of capital structure allows the bankruptcy cost to exist. It explains that there is a benefit to financing with debt named as the tax benefits of debt and that there is a cost of financing with debt. The marginal advantage of further increases in debt decreases as the debt goes on increasing, while the marginal cost increases so that a firm that is trying to optimize it on the whole value will focus on this trade-off when selecting how much debt and equity to use for financing. This theory may explain differences in Debt to Equity ratios between industries, but it doesn't explain the differences within the same type of industry.

❖ **Pecking order theory**

Pecking Order theory tries to confine the costs of asymmetric information. It explains that companies prioritize their sources of financing from internal financing to equity. According to the law of least effort, or of least resistance, favour to raise equity as a financing resource “of last resort”. So the internal mean of financing is used first when that is worn-out then debt is issued; and when it is no longer appropriate to issue any more debt than equity is issued. This theory maintains that businesses remain to a hierarchy of financing sources and favour internal financing when available, and debt is preferable over equity if external financing is needed. Equity would mean to issue shares which intended to 'bring external ownership' into the company. So, the form of debt a firm chooses can act as a signal of its need for external finance. The pecking order theory was popularized by Myers (1984).when he argues that equity is a less preferable means to raise capital because when managers issue new equity, investor's trust that managers think that the firm is glorified and managers are taking benefit of this over-valuation. As a result, investors will place a least value to the new equity issuance.

❖ **Agency Costs Theory**

There are basically three types of agency cost which can help to explain the relevance of capital structure.

- a) **Asset substitution effect:** As Debt to Equity increases then management has an increased incentive to undertake risk even on negative NPV projects. This is because if the project is flourishing then shareholders will get all the upside but if it is unsuccessful then debt holders will get all the downside. If the projects are undertaken then there is a probability of firm value decreasing and a wealth transfer from debt holders to shareholders.
- b) **Underinvestment problem or Debt overhang problem:** If debt is risky then the gain from the project will transferred to debt holders rather than shareholders. So, management has an incentive to reject positive NPV projects, even when they have the potential to increase firm value.
- c) **Free cash flow:** If free cash flow is given back to investors ,then management has an incentive to destroy firm value through empire building and perks.. Increase in leverage imposes financial discipline on management.

Basic Factors that Influence a Company's Capital Structure Decision:

The basic factors that influence a company's capital-structure decision are:

**Business Risk**

Excluding debt, business risk is the necessary risk of the firm's operations. The greater the business risk, the minimum is the optimal debt ratio. For an instance, let's evaluate a utility company with a retail apparel company. A utility company usually has more stability in incomes. The company has less risk in its business given its stable income stream. However, a retail apparel company has the prospective for a bit more variability in its incomes. Since the sales of retail apparel company are motivated mostly by changes in the industry of fashion. The business risk of a retail apparel company is high so, a retail apparel company would have a minimum optimal debt ratio so that investors feel comfortable with the company's ability to meet its responsibilities with the capital Structure in both good times and bad.

**Company's Tax Exposure**

All Debt payments are tax deductible. As such, if a company's tax rate is more, using debt as a means of financing a project is smart because the tax deductibility of the debt expenses protects some income from taxes.

**Financial Flexibility**

In bad times this is essentially the firm's capability to raise capital. It should come as no surprise that companies normally have no problem raising capital when sales are growing and earnings are strong. But given a company's strong cash flow in the good times, raising capital is not as hard. In good times Companies should make an effort to be careful when raising capital, not to stretch its capabilities too far. The minimum a company's debt level, the maximum financial flexibility a company has. The industry of the airline is a good example. In good times, the industry makes important amounts of sales and thus cash flow but, in bad times that situation is changed and the industry is in a position where it is in a

need to borrow funds. If an airline becomes too much in debt, it may have a decreased ability to raise debt capital during these bad times because investors may be uncertain about the airline's ability to service its existing debt when it has new debt loaded on top.

### **Management Style**

Management styles range from aggressive to traditional. The more traditional a management approach is, the less inclined it is to use debt to maximize its profits. An aggressive management may try to grow the firm quickly by using important amounts of debt to ramp up the growth of the Company's earnings per share (EPS).

### **Growth Rate**

Firms that are in the growth stage of their cycle normally finance that growth through debt, borrowing money to grow quicker. The conflict that arises with this method is that the earnings of growth firms are typically unstable and unproven. As such, a high debt load is mostly not suitable. More stable firms typically need less debt to finance growth as its revenues are stable and proven. These firms also produce cash flow which can be used to finance projects when they arise.

### **Market Conditions**

Market conditions can have an important impact on a company's capital-structure condition. Assume a firm needs to borrow funds for a new plant. If the market is struggling means investors are limiting company's access to capital because of market concerns, the interest rate to borrow may be more than a company would want to pay. In that particular situation, it may be prudent for a company to wait until market situations return to a more normal state before the company tries to access funds for the plant.

Some other important factors are:

- Total volume of required capital.
- The length of time period for which money is required.
- Estimation of interest rate.
- Estimation of cost of equity which firm will pay in future.
- Estimation of Weighted Average Cost of Capital.
- Estimation of future cash flow and their future value.
- Involvement of risk.
- Business life cycle

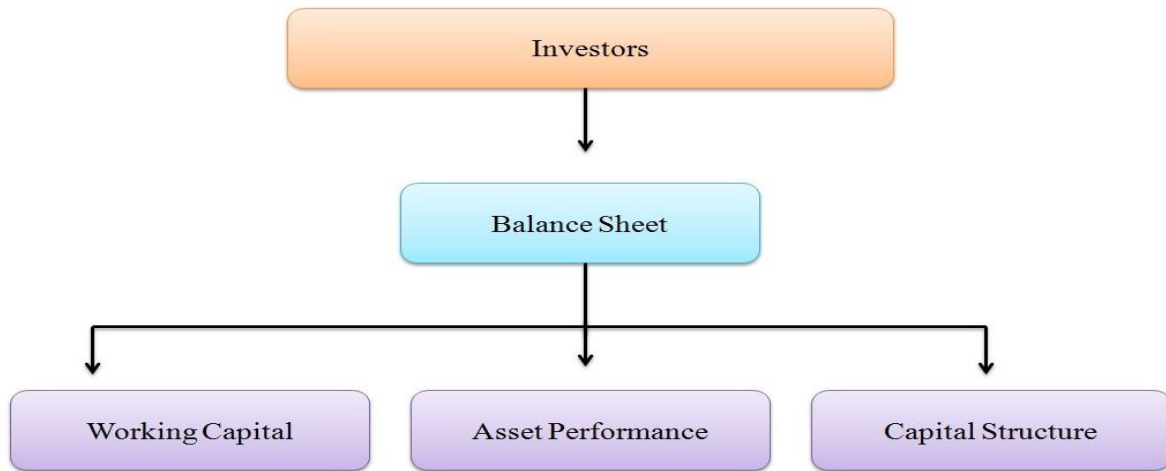
### **DISCUSSION**

The Figure 1 shows that for stock investors a "strong" balance sheet is an important consideration for investments in a firm's stock. The strength of a company's balance sheet can be explained by three broad categories of investment quality measurements.

- a) Working capital adequacy
- b) Asset performance
- c) Capital structure

A firm's capital structure can be found mathematically by calculating its minimum weighted average cost of capital. For instance, if a company uses debt at 4 % to get 30 % of its funds and equity at 10.5 % to get 70 % of its funds, then the firm's weighted average cost of capital is  $(0.30 \times 4\%) + (0.70 \times 10.5\%) = 8.55\%$ . The formula implies that the firm can get a minimum weighted average cost of capital of 4 % by using debt as its sole source of funds, but it would not be the firm's most favorable capital structure as the firm would then face a high risk of bankruptcy.

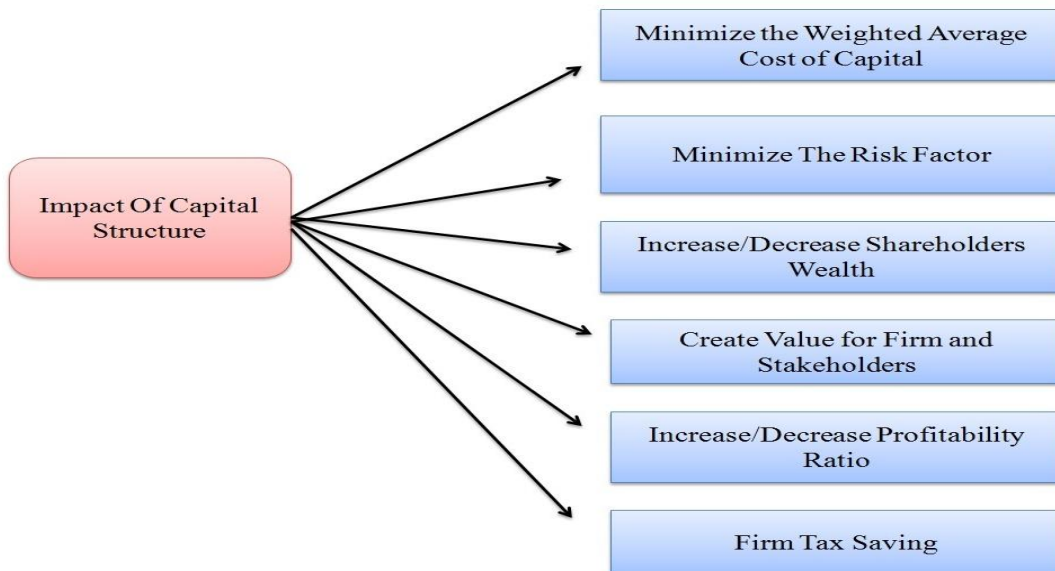
Figure 1:How balance sheet affects different decisions of investor



Impact of Capital Structure (Figure 2):

- a) Minimize the weighted Average Cost of Capital.
- b) Minimize the Risk factor.
- c) Capital Structure increase/Decrease shareholder wealth.

Figure 2: Impact of Capital Structure



1. An optimum Capital Structure used for creating value for firms and stake holders.
2. Good Capital Structure makes an increase in the profitability ratio.
3. Capital Structure makes an impact on the firm tax saving.

## CONCLUSION AND RECOMMENDATIONS

This study provides help to investigate those factors of capital structure which makes impact on firms' performance and behaviour of investors in developing economies like Pakistan. According to findings of research capital structure of firms and investor behaviour in Pakistan has been changed due to these reasons. First, tax shield firms take maximum debt for the purpose of tax saving. Second, investors do not want to transfer ownership that's why they like that capital structure which has a large portion of equity. Third, the firms' capacity of bearing debt is also making impact on the behaviour of investors. Fourth, firms reserve against the debt. Fifth, maximum level of debt which firm can borrow is also making an impact on the firm's capital structure. Results suggest that a large portion of debt in capital structure makes negative effect on return on asset, return on equity and earnings per share. This review paper providing guidelines and help to the stakeholders in the selection of right pattern of capital structure in the Pakistani corporate sector.

## FOLLOWINGS ARE THE SOME RECOMMENDATIONS FOR THE STAKEHOLDERS OF PAKISTANI FIRMS

The right mix of debt products continues to be entirely according to organization type, depending on the organization's bond ratings, liquidity, investment policy, changing interest rates, and approach toward risk. With fixed rate debt mostly the borrower is insulated from most major risks which include changing interest rates, credit quality deterioration and worldwide events impacting marketability of fixed rate bonds. Variable rate debt exposes the borrower to more risks, including increasing interest rates, credit risk, remarketing risk, bank renewal risk, and others. But, traditionally, variable-rate debt has provided borrowers with a minimum total cost of capital. In times of changing market conditions a firm's board members and management teams should add impetus to ensure that they are fully informed of factors that increase risk, have a clear definition of the level of risk the organization can assume given its financial position, and proactively manage to achieve the right level of risk. Executives must be actively reshaping their firm's capital structure. Given the new risk environment, the optimal, "right" balance of fixed-rate and variable-rate debt has changed for most organizations. Generally it can be accessed only by hospitals with strong credit ratings through a highly rated bank or based on a hospital's own credit and liquidity. Other variable-rate options exist, such as direct private placement with banks and fixed-receiver swaps, and should be considered depending on market conditions and availability.

The limited ability to diversify variable-rate debt has significantly increased firm's risk and cost associated with such debt. As a result, many firms are now rebalancing their debt portfolios by deleveraging from uncommitted, underlying variable-rate capital structures and moving their debt into natural fixed-rate products. As some firms reshape their debt mix to balance risks, higher interest costs will have a material impact on operating expenses. As executives reshape the firm's debt mix, the borrowing and operating plans should reflect the expected higher costs of capital from the greater proportion of committed, fixed-rate debt. Executives must ensure that operating plans include the impact of all such costs. Firms' leaders should be considering all sources of available capital, both traditional and non-traditional including direct bank lending (or private placements), and operating leases. Some lower-rated category credits may wish to consider federal housing administration supported financing. In essence, it provides an insurance policy on fixed-rate debt. Firms' leaders are closely watching their bond and bank as a result of declining financial performance due to operating deterioration, investment losses, defined-benefit pension funding requirements, swap collateral postings, and other calls on capital. Many organizations are in danger of breaching such covenants. Some have already done so and remediation needs are increasing. Bond and bank covenant expectations are much higher in today's market and compliance risk is becoming a major concern. If a firm is close to breaking its covenants, early conversations with the relevant creditors are a very good idea. Covenant violations are not as difficult to remediate if the firm's operational performance is solid. When a firm has technical covenant violations and operating problems, remediation can be very complicated, requiring new forecasts and other documentation. Firms' executives must be very familiar with the definitions in their bond and bank documents, particularly the debt service coverage ratio, and know when a covenant breach could occur. Thorough review of the firm's investment strategy is now more important than ever. At this point firms typically have invested liquid cash reserves in short-term fixed-income securities, bank CDs, and money market funds, which generally were considered safe and liquid. Firms normally invested pension and board-designated unrestricted portfolios in a mix of long term fixed income and equity instruments, with some use of hedge funds and alternate investments. Diversification of investments through the use of a

portfolio approach continues to be a valid risk-reduction strategy. However, as evidenced during the past year, it does not protect against market or event risk created by a severe economic downturn. Asset portfolio allocation decisions must be made with care; products traditionally considered safe, such as fixed income and domestic equity stocks, may now represent an additional risk due to the possible high variability of their returns in a volatile market. Additionally, liquidity of hedge fund and alternate investment vehicles has come under increased scrutiny, and in some cases, is no longer considered part of the board-designated funds. Additionally, investment repositioning could trigger realized losses due to their inclusion in debt service coverage, and run afoul of covenants, thereby raising many problematic issues.

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