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A STUDY OF CAPITAL STRUCTURE ON PERFORMANCE OF CORPORATE SECTORFIRMS

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ABSTRACT

When it comes to managing finances and succeeding as an organization, capital structure considerations are important. The purpose of this research was to learn more about capital structure decision-making in the Indian business sector and the factors that influence it. This study's overarching goal is to shed light on financial planning in the Indian context by investigating the variables that play a role in determining the optimal capital structure. A large dataset of Indian firms from diverse industries and fields is used for the quantitative study. The factors that influence a company's decision on how to allocate its funds are dissected using financial statistics including the debt-to-equity ratio, the interest coverage ratio, measures of profitability, and the characteristics of the company itself. Many variables influence a nation's capital structure. This is because the political, legal, and economic environments in various nations are different from one another. So, different patterns have had an impact on developing economies than they have on advanced ones.

KEYWORDS: Capital Structure, Corporate Sector Firms, Indian business sector, financial planning, economic environments

INTRODUCTION

Companies have had to deal with capital structure problems for over 40 years. Companies have had trouble accumulating adequate liquidity during times of credit expansion to weather future contractions, particularly those with variable cash flow sources that rack up more debt during economic downturns. Both returning surplus cash to shareholders and investing it, and taking on additional debt or raising money via stock offerings, are viable choices for CFOs to consider when managing company balance sheets. Experts and practitioners alike have found it challenging to determine the best debt-to-equity ratio at which a firm could operate and invest. While many companies maintain sizable cash reserves and weigh their alternatives, others choose debt due to the common tax advantage of interest. When choosing on a capital structure, businesses confront perhaps the most crucial choice in their whole financial basis. Methods of financing assets are a primary determinant of the ownership structure and corporate governance practices of publicly listed organizations.

For over 40 years, businesses have struggled with issues related to their financial structure. Companies, particularly those with unstable cash flow sources and a propensity to take on additional debt during economic downturns, have historically had a hard time amassing sufficient liquidity during times of credit boom to weather subsequent contractions. To finance new

projects, CFOs must constantly weigh the pros and cons of increasing debt against raising money from shareholders, as well as the merits of reinvesting any cash excess vs returning it to shareholders. It has been difficult for both academics and business owners to zero in on the optimal debt-to- equity ratio for a company's operations and investments. Some businesses choose debt because of the common tax advantage of interest, while others keep significant cash reserves and assess their choices. Businesses confront possibly the most important decision in their whole financial foundation when choosing on a capital structure. The ownership structure and the norms of governance of publicly listed firms are based on the methods through which the companies get funding for their operations. The term "capital structure" is often used to refer to a company's method of financing its assets and investments. The success, growth, and profitability of a business depend on maintaining an appropriate level of debt in relation to its equity. Leverage or trading on equity, the company's growth, the nature and size of the business, the concept of retaining control, the requirements of investors, the cost of floatation of new securities, the timing of issue, the corporate tax rate, and legal requirements are just a few of the factors that can affect a company's capital structure. It is difficult to rate them because of the unique nature of each component and the dynamic nature of their impact on a company.

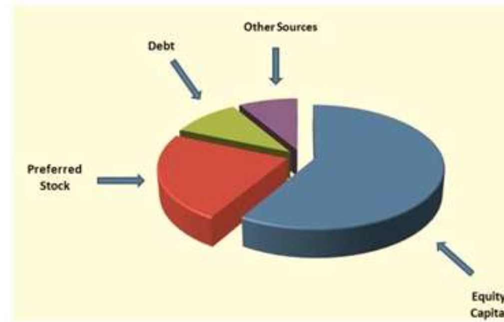

Figure 1.1: Components of Capital structure

CAPITAL STRUCTURE

Debenture, preference share capital, and equity capital including reserves and surplus are all examples of long-term financing that make up a company's capital structure. Despite any similarities in their nature, activities, etc., no two businesses can have the same capital structure, and the same capital structure won't work for the same business in every situation. Asset financing is a critical issue for every company, and a good rule of thumb is to use a combination of loan and equity. To maximize the return on its shareholders' equity, businesses often resort to long-term fixed interest loans. The capital structure of a company is one of the most important decisions it will ever make. The stakes are high not just because of the requirement to maximize profits, but also because of the effect that a choice like this may have on an organization's ability to navigate the competitive landscape.

Where total cost of capital is minimized and company value is maximized, an optimal capital structure has been achieved. A company's financial structure should strike a healthy balance between debt and equity funding. If not, it may have trouble attracting investment in the future, which might hamper its ability to finance growth initiatives. However, in practice, designing and achieving a perfect

capital structure for a business is quite challenging. Capital structure rules vary considerably not just across sectors but even between enterprises within the same industry. When two otherwise identical businesses have different decision-makers, their capital structures may vary. Capital structure is determined by a variety of characteristics that are not always predictable by standard theories since they are psychological, complex, and qualitative in nature. Therefore, determining the optimal capital structure requires not only academic grounding but also actual knowledge and experiences.

The theory of capital structure examines how different sources of money affect a company's worth. A company's worth may change if its capital structure alters its predicted profits or its cost of capital. The theory also looks at the question of whether or not there is an ideal structure for a company's capitalization. There may be divided into two main camps. The cost of capital, according to certain academic institutions, is independent of the financing mix's components. This school rejects the idea that an optimum capital structure can be determined. This means that the capital structure makes no difference to the value of the company. The adherents of the competing school argue that the cost of capital is established by the capital structure's composition. When leverage is used, the cost of capital shifts. The goal is to find the optimum capital structure where the total cost of capital is lowest. They conclude that the firm's worth is set by the capital structure. Choosing the best financing structure for your company is crucial. Not only would such a choice have a significant effect on the organization's capacity to cope with the competitive environment, but it is also important because of the requirement to maximize returns to different organizational implications. Classical work "The cost of capital, Corporation Finance & the theory of Investment" by France Modigliani and Merton Miller from 1958 is widely regarded as the starting point for contemporary thinking on capital structure. According to the Modigliani-Miller theorem, a company's stock price has nothing to do with how it raises money for investments or how much of a dividend it pays out.

Importance Of Capital Structure

Debentures, preference shares, and common stock are all examples of long-term financing options that make up what is known as a company's "capital structure." Asset financing is a critical issue for every company, and it's important to strike a balance between debt and equity funding while doing so. Financial leverage, often known as trading on equity, is the practice of using equity shares in conjunction with long-term fixed-interest bearing debt or preference share capital. A company will utilize long-term, fixed-interest debt to boost its return on equity if it can generate profits in excess of the interest it pays on the loan. Although capital structure cannot change a company's overall profit, it may change the proportion of profit that goes to equity investors.

Optimal capital structures are those that reduce the weighted average cost of capital and maximize company value via the allocation of debt, preferred stock, and common equity. To rephrase, the debt equity ratio is a common metric used to describe the mix of debt and equity that makes up a company's capital structure.

Since it will affect the company's performance for the foreseeable future, the CFO must give careful consideration to the capital structure design. The chief financial officer's focus is on the optimal capital structure or leverage for the company. The dilemma facing the management is whether or not to incorporate or grow debt in the current capital structure, since the choice would influence the risk and value of the organization.

Nevertheless, debt or leverage is a double-edged sword. Interest paid on debt is tax deductible, therefore including it in a company's capital structure may help reduce its taxable income. It is unrealistic for a business to expect to reap the advantages of interest payments being tax deductible without incurring additional expenditures. The advantage of debt financing may be outweighed by the expense of financial distress if debt levels are elevated to the point that financial distress (bankruptcy) is a persistent concern for the business. Therefore, leverage (the use of debt in capital structure) impacts a company's liquidity since more debt results in higher cash outflow for meeting fixed financial commitments. The absence of fixed payments and the addition of cash flows from equity financing seem to be positive aspects. However, the company's profitability would be negatively impacted if it opts to be debt-free. It's also common knowledge that the cost of equity is greater than the cost of debt. As a result, it is very difficult to determine what level of debt will best increase the value of the company's shares. Although an ideal capital structure exists in principle, it is challenging to create in reality. This is because the capital structure is determined by a wide range of qualitative and quantitative elements, including the financial manager's own subjective judgment.

As a result, capital structure is more complex than just a single factor. It's the result of a number of factors, not all of which can be influenced by management. The worth of a company may rise if its capital structure is optimized to reduce its cost of capital, allowing for more project acceptability and larger net present values. Serious monetary ramifications may result from closure or takeover if a proper capital structure is not designed. Therefore, capital structure is one of the primary factors that have to be watched carefully in times of rapid changes in the world of corporate finance.

Features of an Ideal Capital Structure

With the use of basic rules of thumb, management can determine what kind of capital structure will work best for the organization. Following are some rules to consider while deciding on a capital structure:

Maximize return and Minimize Cost

This concept states that the optimal capital structure is one that maximizes profits per share while minimizing the cost of borrowing. Payments to capital providers raise the cost of capital because of the interest rate at which they must be paid and the tax treatment of these payments. When the mix of debt and equity yields the highest possible return for equity investors, we say that the firm has the optimal capital structure. For maximum wealth creation, a company's capital structure should provide the lowest possible costs of capital.

Risk principle

There has to be a mix of equity and debt

instruments in the capital structure. This is crucial in order to lessen the danger of borrowing money. The risk principle discourages the use of fixed income bearing instruments in favor of ordinary stock for funding the corporation's capital needs. Investment security should be guaranteed by a robust capital structure. The company's financial framework should be set in a way that ensures it can weather temporary dips in revenue.

Control principle

The financial manager is responsible for ensuring the company's capital structure is optimal while also protecting the residual owners' ability to exert influence. Preferred stock and bonds may be used to fund expansion without giving up voting rights. A corporation's equity owners' voting power should not be weakened by its capital structure. Therefore, issuers of convertible debentures need to exercise extreme prudence.

Flexibility principle

The ability to increase or decrease capital should be facilitated by a well-designed capital structure. When cash flow is low, the firm should be able to raise additional money, and when it's flush with cash, it should be able to pay down all of its obligations. A company's financial structure has to be flexible. It has to be updated often to reflect the realities of the market. If there are extra cash available, the business may use them to minimize its debt and interest payments. According to the flexibility principle, management should work toward generating combinations of securities that make it simpler for management to manipulate sources of money in response to significant shifts in the requirement for funds. Not only does the company have more options for gathering the necessary finances, but it also has more leverage in negotiations with the source of those funds.

Timing principle

The timing of a financial investment is crucial, especially for a developing business. The firm hopes that adhering to the idea of maneuverability in selecting the kinds of financing would allow it to capture market opportunities while keeping the cost of borrowing cash to a minimum. The need for various securities goes up and down with the economy. It is much simpler to sell equities shares when the economy is booming, businesses are expanding, and investors have a strong desire to invest. However, during economic downturns, bond issuance is warranted because investors are understandably wary of putting their money into equities, which are inherently risky. The specifics of such a framework would change from business to business based on factors like the scope and scale of activities, the diversity of funding sources, the effectiveness of management, etc. A company's financial plan has to be driven by a defined purpose. Maximizing shareholder wealth or returns to shareholders are both possible goals.

Guidelines for Capital Structure Planning

Capital structure choices are challenging because of the various tradeoffs that must be made. Some businesses operate without a well-thought-out capital structure because they lack a policy of decision-making. While these businesses may enjoy initial success, they often struggle to get enough funding to sustain their operations

and often waste valuable resources. Therefore, the finance manager's job description should include the planning of an optimum capital structure that optimizes the market value of the firm. While external factors certainly have a part in shaping a company's financial structure, the decision-maker's expertise is essential. The judgment of various decision-makers might cause otherwise comparable businesses to have vastly diverse capital structures. An optimal capital structure, one that serves the firm well, is something the board of directors should work on. Although the interests of equity shareholders—the company's true owners and the source of its risk capital—should take precedence when deciding on the firm's capital structure, the concerns of other stakeholders cannot be ignored. The following criteria should be used to determine the company's capital structure:

Avail the Tax Advantage of Debt

Financial theorists and practitioners are in agreement that interest paid on debt is an expense that may be deducted from taxable income. Since no similar tax break is available on the payment of dividends, the corporation is incentivized to raise additional money via the market. Therefore, most businesses would rather have debt than equity. The company's stock price rises as a result of a lower tax bill. The impact of tax advantage on capital structure may also be inferred from a review of the relevant literature.

Level of Control

The equity shareholders have more say in corporate matters than preference shareholders or debt holders since they really control the business. Debt financing is essential for a growing business that needs money for development and growth. Existing shareholders' rights will be diluted if a corporation raises extra capital by issuing new shares of stock. Therefore, no management is going to risk diluting its voting rights by raising capital through shares. Debentures are issued for this purpose of maintaining management of the firm.

Resort to Timing prudently

Though they may not always agree, financial professionals generally acknowledge that the market is not always favorable for raising cash from either stock or debt sources, despite the fact that there may be projections about when such times occur. The corporation may prefer issuing debt if it believes that equity stock prices are low, or it may prefer issuing equity if it believes that equity prices are high. As a result, making sound financial choices necessitates monitoring market trends.

Financial Leverage or Trading on Equity

Using equity capital and debt capital together at a discount is what is meant by financial leverage or trading on equity. It's the gain the business experiences as a result of having both debt and preferred capital on its books. The dividend paid on preferred capital and the interest rate on borrowed capital are both expected to be lower than the total rate of return in the firm since they are considered to be cheaper sources of financing than stock. Therefore, the best mix of debt and preference capital in its capital structure benefits equity owners.

Assurance of Reasonable Exposure of Total Risk

It is the responsibility of the company's management to ensure that the business and financial risks taken on by the equity owners do not exceed acceptable levels.

Leverage is one of the primary causes of financial risk. When a firm relies heavily on debt as part of its financial strategy, it increases the danger of running into financial trouble or even going bankrupt due to the heavy weight of its fixed financial commitments. The stock investors bear the risk associated with these commitments. Therefore, financial managers should organize in a way that reduces costs and risks.

Cost of Capital

A company's cost of capital is the sum total of all the money spent on the different forms of capital it uses. It is the lowest possible rate of return that investors will accept for their money. Capital structure choices are heavily influenced by the cost of capital due to the correlation between it and the value of the firm. A company's goal should be to maximize shareholder value by using a mix of stock and debt that keeps its cost of capital as low as possible.

Size and Operations of Company

The capital structure of a corporation must be tailored to its size and business model. Businesses in the service industry may have a unique financial structure compared to traditional factories. Companies with consistent revenue may choose for more debt, whereas those with erratic revenue streams must seek money via stock and preference capital. When it comes to financing, small businesses may go to banks, financial institutions, and excess earnings, whereas large corporations are more likely to issue shares, debentures, and other forms of equity financing. Since larger companies tend to have more diverse holdings, size may be seen as a countervailing proxy for the likelihood of default and the expenses associated with it, and hence should be positively correlated with debt. Total capitalization expands as size increases.

Norms of Lenders

Companies' primary funding sources, banks and financial organizations, have established guidelines for how they should be used. They are more likely to provide credit to businesses that have substantial amounts of liquid assets rather than intangible ones. Therefore, if a firm has physical assets, it may obtain capital via loans and other external sources, whereas if it has fewer intangible assets, it may have to rely on equity as its primary source of financing. Therefore, a corporation's capital structure is heavily influenced by its asset structure.

Capital market condition

Capital market circumstances in that nation will have an impact on the company's capital structure. Shares of any corporation are sensitive to the state of the capital markets. Debentures and loans make up the bulk of a company's capital structure when the stock market is down, whereas equity shares make up the most of the capital raised during economic booms.

Finance proactively not reactively

According to Warren Buffet, financial managers should "finance proactively, rather than reactively," which implies they should seek funding opportunities rather than wait for them to arise. Smart movements on the financial and investment sides of the firm do not always coincide with one another. No one can see into the future and know what interest rates will be. Therefore, one should borrow money while market circumstances are favorable and look for investment possibilities when the debt market becomes unfavorable.

Growth rate

Companies with rapid expansion tend to depend more on long-term financing from investors. Companies with a rapid pace of expansion require more capital. Companies are more likely to rely on debt financing during expansion since the flotation cost of issuing stock is greater than the issuing cost of debt. At the same time, these businesses are hesitant to employ a lot of debt in their capital structure because of the risk involved.

Period of Financing

The time frame during which the firm will be seeking capital is an important consideration in financial planning. Short-term funding needs may be met by obtaining a loan from a bank or other lending institution, while long-term financing should come through the sale of stock or preference shares.

Sales stability

High debt is manageable for a corporation with consistent revenue, as constant revenue allows for consistent interest payments throughout the year. However, a firm whose revenue is very unpredictable should avoid increasing its capital structure's exposure to debt. Utility firms enjoying consistent customer demand may safely take on more debt than their manufacturing counterparts.

Profitability

Debt capital is inversely related to profitability. Multiple studies have shown that organizations with higher profits employ a lower proportion of debt in their capital structure. A greater rate of return allows a business to meet its own financial obligations via earnings.

Management Attitude

The outlook of management is also crucial to capital structure choices. Capital structure decisions are made based on each management team's unique set of experiences. Conservative management prefers a lower debt-to-equity ratio than the more aggressive management styles, which favor using debt to boost profitability.

Internal condition of company

The capital structure of a firm may be affected by factors both within and external to the business. The rising future profits of the firm are not represented in the stock price since investors do not know about them due to asymmetric information in the company. Debt is now the preferred method of financing, and once profits are realized in the stock price, debt is paid off and equity capital is issued.

Government policies

Government policy also has a role in influencing capital structure choices. Financial choices are heavily influenced by legal constraints imposed by regulatory authorities like SEBI, IRDA, and RBI. Financial institutions are restricted to issuing only share capital and not other forms of security. The same holds true for the debt-to-equity ratio. When seeking investment, no firm may surpass this percentage. The issuance of shares and debentures are governed by rules issued by SEBI.

Issue innovative securities

Financial managers are able to take advantage of the market's novel securities by investing in them. Managers may acquire low-risk funding from the public because of their increased familiarity with recent financial innovations. If a security shifts risk from people who are less able to carry it to those who are more able to take it, it may increase the firm's value. Investors might be encouraged to put money into novel financial products by

shareholders or finance managers.

Capital Structure of Other Companies

When selecting a company's capital structure, it's important to consider the structures of similar businesses. For the simple reason that, under similar conditions, businesses in the same sector tend to adopt very similar capital structure patterns. In addition, SEBI has established varying debt-to-equity ratios for certain sectors. As a result, businesses must weigh these debt ratio standards when making decisions about their financing strategies.

Factors Determining the Capital Structure

Numerous elements influence a company's capital structure. Ranking them would be impossible due to the fact that each component is unique in its impact on a business and that impact fluctuates over time. When money is tight, a financial manager must weigh the benefits and drawbacks of available financing options in order to choose the optimal capital structure. Below, we will examine the elements that contribute to the capital structure as a whole.

Trading on Equity

Trading on Equity refers to the practice of financing a company's operations using a combination of long-term, fixed-interest debt and preference shares and equity share capital. If the return the company generates is more than the cost of debt, then using long-term debt may boost profits per share. Earnings per share rise with the usage of preference share capital as well, but the leverage effect of debt is magnified since interest may be deducted from taxable income. On the other hand, leverage might backfire if the interest rate on the company's long-term borrowing is higher than the rate at which it expects to generate profits.

Sales stability

A corporation with steady revenue can afford to take on more debt and pay greater fixed costs than one with volatile revenue. When revenues are consistent, a company knows it won't have trouble making its regular interest payments on its debt. A company should avoid using debt financing as much as feasible in its capital structure if its revenues are very volatile or falling.

Cost of Capital

The cost of capital is the rate of return at which investors will not invest. The capital structure must be optimized to reduce the total cost of financing. Equity capital, preference share capital, and debt capital are the three most common types of corporate financing. Capital providers anticipate a return on their investment that is proportional to the risk they are taking. The total cost of capital should be kept as low as possible throughout the process of capital structure formulation.

Asset Structure

When deciding on a capital structure, it's important to think about things like liquidity and the mix of assets. A greater capacity to issue long-term debt may be conceivable if fixed assets make up a significant share of the company's overall assets.

Growth Rate

Companies with quicker growth rates need to depend more on outside funding. In addition, the flotation costs associated with selling common stock are higher than the expenses associated with selling debt, which leads fast-growing companies to depend more on debt. However, increased unpredictability is a common reality for

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these businesses, and thus, they are less likely to rely on loans.

Profitability

Companies with very high IRR tend to employ minimal debt. Despite the lack of an underlying theoretical rationale, a plausible explanation is that very lucrative companies like Intel, Microsoft, and Coca-Cola do not have access to large amounts of loan funding. Their profitable rates of return allow businesses to rely mostly on their own resources when funding their operations.

Size of a company

While big corporations may arrange long-term loans on acceptable terms and even offer stock and preference shares to the public, small businesses must rely mostly on owned capital since it is so difficult for them to obtain long-term loans at a decent rate of interest.

Cash flow ability to service Debt

A firm with a greater and more consistent capacity for cash flow generation may afford to use a higher proportion of debt in its capital structure than one with a lower capitalization base. When seeking new funding, businesses must predict and account for future cash flows to assure that fixed costs will be met.

Control

Capital structure may be affected by the impact of debt vs equity on management's ability to maintain control. Management with voting authority but limited funds to acquire more shares may choose for cheaper debt financing instead. In contrast, management could choose to employ stock if the company's finances are so precarious that taking on debt would put it at significant danger of default. Since the sort of capital that best safeguards management varies from circumstance to scenario, control concerns might lead to the usage of either debt or equity.

Management Attitude

Management is free to make up its own mind on the optimal capital structure since it is impossible to establish that one capital structure would result in better stock prices than another. While more cautious management teams employ debt at lower rates than their sector peers, more risk-taking teams borrow more money to boost profitability.

Corporate Tax

Companies with high tax rates might benefit the most from interest cost deductions. Therefore, the benefit of debt increases as a company's tax rate rises.

Age of the company

Due to the risk associated with starting a new business, raising initial funding may be challenging. However, obtaining finance is often not a problem for established businesses that have a track record of success.

Ownership Pattern

Foreign equity holders, financial institutions, body corporate, promoters, directors, and their family, and other dispersed shareholders are all examples of ownership patterns. The funding mix will be determined by the relative weight of each of these categories of equity investors, who may have investment requirements that are at odds with one another.

Lenders and rating agency attitudes

It is common for the opinions of lenders and rating agencies to impact choices about capital structure. Typically, a business will consult with lenders and credit rating agencies about its capital structure and pay close attention to their input.

Capital Market Conditions

The state of the financial markets is never static. There might be a slump in the market one day, followed by a boom the next. It would be unwise for the firm to issue equity shares if the stock market is down. However, it makes sense to issue stock shares during prosperous times.

Firm's internal condition

The ideal capital structure of a company may also be affected by the state of the company internally. Let's say a company has recently finished some fruitful R&D efforts and expects to see increased profits soon. Investors are not yet factoring in the new results, therefore the stock price does not reflect them. Instead of issuing shares to raise capital, the corporation would rather use debt until the improved profits are reflected in the stock price.

Financial Flexibility

It's important for a company's capital structure to be adaptable so it can meet the demands of the market over time. It shouldn't be too hard or time-consuming to raise more money. It is important for a business to set up its capital structure so that it can easily switch between different types of funding.

Period of finance

When short-term financing is essential, debentures are preferable over stock. However, equity share capital is preferable if the funds are required on an ongoing basis.

Government Regulations

Government rules on security problems should be taken into account when deciding on a funding mix. The Securities and Exchange Board of India oversees all public company capital raises in the country. The capital structure may be affected by whether or not the SEBI's regulations on capital issuance are followed.

CONCLUSION

This analysis attempts to cost-effectively apply to the many factors, suited for optimum capital structure, in order to create an acceptable capital structure and make themselves competitive. The purpose of this research is to learn how firm size, tangibility, growth, profitability, earning risk, non-debt tax shield, business risk, net worth, equity capital, reserve and surplus, and total borrowings are connected to a corporation's capital structure (Debt Equity Ratio). Because it directly impacts the firm's value, Capital Structure is a crucial decision for any finance manager to make. The goal of any given company, after all, is to maximize shareholder wealth. In finance, "optimal capital structure" refers to a financial setup that maximizes shareholder wealth. In order to optimize returns to equity share holders, this study reveals the core areas that demand close scrutiny when assessing profits. Management will have the information and authority to make constructive choices about the debt- to-equity ratio. In India, rivals come from all over the world. Many economists around the world believe that companies in all countries now operate in an increasingly competitive market.

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