Capital Structure Decision, Importance and implementation(The Case of KSE)

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ABSTRACT

Financial management of the capital structure decision is one of the most important decisions. Capital structure decisions in the areas of corporate finance are at the heart of many decisions. These so dividend policies, project financing, the issuance of long-term securities, mergers and financing of copies, and so on. This thesis focuses on the determinants of capital structure for the non-financial firms listed on the Karachi Stock exchange (KSE). The sample period selected for the study was 1993-2002. The effect of five explanatory variables is measured on leverage ratio which is calculated by dividing the total debt by total assets. We first present some descriptive statistics on our selected variables. The most interesting finding of our descriptive statistics is the highest leverage ratio for textile industry whereas the average profitability of textile industry is negative. Our explanation of this fact is the continuous year to year understatement to the profit by family controlled firms in the textile industry in order to deprive government of taxes and minority shareholders of dividend. The profit figure is thus negative on average for all years that brings down the equity figure and raises the debt percentage in overall financing. We used five explanatory variables to measure their effect on leverage ratio. Three of our variables were significantly related to leverage ratio whereas the remaining two variables were not statistically significant in having relationship with the debt ratio. Our results approve the prediction of trade-off theory in case of tangibility variable whereas the growth (GT) variable confirms the agency theory hypothesis. Size (SZ) variable neither confirms to the prediction of trade-off theory nor to asymmetry of information theory.

KEY WORDS; Capital structure, Karachi Stock exchange, Dividend policies

INTRODUCTION

Financial management of the capital structure decision is one of the most important decisions. Capital structure decisions in the areas of corporate finance is at the heart of many decisions. These so dividend policy, project financing, the issuance of long-term securities, mergers and financing of copies, and so on.

Corporate Finance Manager One of the goals of the different costs of capital guarantees and, therefore, is to maximize shareholder wealth. Capital structure, cost of capital that can be managed and effective management is one of the tools. Optimal capital structure, cost of capital, the minimum point is reached. The optimal capital structure exists whether or not? It determines the optimal capital structure is the potential? These studies to answer questions.

In other words, given the work of researchers, institutional, industrial and / or equity in the capital structure of the market is to identify potential determinants. Corporate Finance Manager, thus minimizing the cost of capital

in order to make the best combination of debt and equity can benefit from this for. A large body of theoretical and empirical studies published in 1958 by Modigliani and Miller capital structure, capital structure, because the path breaking paper focuses on the area. However, most of the research work in the developing world in the company's capital structure, little work has been carried out in developed countries.

Pakistan one Stock Exchange, Karachi Stock Exchange is the largest one (KSE) and emerging markets. More than 700 companies are listed on the Stock Exchange. Little experience in the area of capital structure research has been done in Pakistan. There is limited research in this area. For example, Booth (2001), 10 developing countries, including Pakistan, were studied. However, this study was limited to a maximum 100 Index companies. For the period 1997-2001 that are not traded on the stock exchange in any financial institution, including Shah and Hijazi (2005), another study by the improvements made in the first. They are not traded on any exchange, including financial institutions, and also in the capital markets of Pakistan to explore the determinants of capital structure, superior econometric methodology significantly Shah and Hijazi (2001) improved on previous work by Shah and Khan (2007) of the study. The purpose of this paper to various sectors of the economy of Pakistan, including the determinants of capital structure in more detail to explore.

UNDERSTANDING CAPITAL STRUCTURE

Overview

The capital structure of the source of funding and long-term retention and a variety of interests, including the company's surplus means the mixture. It affects investment decisions, almost all of the structure elements as well as a complex quantitative and qualitative characteristics are not. Net income approach, under certain assumptions the weighted average cost of capital, and an inverse relationship between the total value of the company to assume utilization of net operating income, even if you change the approach to diving, a clear relationship between these two can not be visualized. existing view of the emergence of the debt equity resulting optimal capital structure has a smart combination.

Most of the empirical work on capital structure theory to observations about the characteristics of the multiple regression analysis using a proxy in Pakistan and abroad and is represented by many constraints. On several characteristics unique expression does not rule, but often more than one proxy to describe a particular property. In addition, many properties associated with plausible proxies May release information. The absence of well-defined guidelines, including financial economists econometric model to be limited. Works well in terms of goodness of fit criteria, but proxy. Selection bias in the collection of data, in addition to select the ambiguous relationship between the presence of variable coefficients is often rendered fake. These restrictions on the capital structure of regression due to shed light on the impact of specific variables, and arrive at near optimal capital structure, not their mutual relations.

1.1.2   Types of Capital

•   Current liabilities

•   Long term debt

1.1.3   Equity Capital

•   Stock holders equity

•   Preferred stock

1.1.4   Common Stock Equity

- Common stock

- Retained earning

FINANCIAL LEVERAGE;

These fixed payments, such as debt and preferred the use of funds from the financial leverage magnifies the risk and returns the result. Debt-to-equity ratio, financial leverage of companies large. Liabilities related to the company's ability to meet fixed payments and a fixed payment coverage ratio of the measured ratio times interest earned is available. This ratio indirectly provides information and financial leverage.

FIRM VALUE AND CAPITAL STRUCTURE

Enterprise value and capital structure selection this context, the relationship between the times that change in response to the economic impact on the business value of their capital structure to take action to change the incentives of companies in quantifying Review. This paper introduces a dynamic capital structure choice to extend the existing static model contributes to the growing recent literature. The market value of the company itself, as well as by endogenous choice of investment companies in the market of the product is determined by the exogenous price changes on performance is determined by the investment choices as well as the endogenous product prices, companies are determined endogenously in the model the capital structure is determined by

Company's capital structure, dynamics and potentially affect the characteristics of the company. In particular, we are very levered cost of financial distress companies to take action to reduce the debt-to-equity ratio shows an important role in induction. Compared to the direct cost of bankruptcy, financial distress costs are very levered companies to take measures to reduce the debt-to-equity ratio plays an important role in induction. Financially distressed companies to bankruptcy and, therefore, in response to the adverse consequences of the shares to pay the debt to encourage companies to maximize profits even if you have to experience it directly reduced the cost compared to bankruptcy, financial distress costs to be borne by the shareholders directly can. Therefore, the cost of capital to maximize financial distress companies maximize the total value of the selections made by the company closer to the capital structure, it is recommended that you select a result, the cost of financial distress costs and the agents observing history to reduce the impact of capital structure tend to

About the Karachi Stock Exchange;

Karachi Stock Exchange (KSE) 500 002 515 and U.S. $ 54.28 billion manjugwa average trading value of the market capitalization of the biggest and most liquid exchange in Pakistan, and is an international magazine "Business Week" in 2002, the best performing stock market in the world exchange announced. Since then, exchanges continued reputation as one of the world's best performing market has maintained.

Since 1991, foreign investors in the Karachi Stock Exchange in order to operate in the capital market investors may have an equal chance with. Foreign investors in Pakistan and the establishment of a new policy on privatization started in 2006, 663 companies were listed on the exchange also is accelerating the development of. Have a ready market and a lower listing requirements and over-the-counter (OTC) market - also, a company registered in one of the two markets are available. Corporate Rupee ready market listing must be paid to minimum capital of $ 2,000,000 (UK how? 1.8 square meters), 100 rupees, but at least the company can be traded on the OTC market.

The purpose of this study focus on the determinants of capital structure by taking the non-financial industrial firms (Textile, Cement, Sugar, Paper, Power, Engineering and Chemical) listed on the Karachi Stock Exchange. These firms produce goods and services.

To find the affect of leverage on firms financial value including

- Tangibility of Assets (TG)

- Size (SZ)

STATEMENT OF THE PROBLEM;

The problem of this study was focuses on the determinants of capital structure by taking the non-financial industrial firms listed in the Karachi Stock Exchange. The study was mainly deal with determinants of capital structure in general, by selecting various firms from different sectors of the economy.

LITERATURE REVIEW

This chapter discusses in detail both the theoretical and empirical studies on capital structure.

MILLER AND MODIGLIANI (MM) IRRELEVANCE THEORY OF CAPITAL STRUCTURE

MM in concept to demonstrate in the capital structure decisions do not depend on the company's value. This theory is based on several assumptions: the absence of information asymmetry, where, for example, does not have any taxes, facing a perfectly competitive market, there is no more transaction costs, no contracts no problem, personal and corporate risk You can rent paid attention to.

MM first suggested the company's enterprise value at a constant rate based on the hazard class (KSU) Net operating profit expected from (EBIT) is determined by the capital letters:

$$V_L = V_U \frac{EBIT}{WACC} = \frac{EBIT}{K_{sU}}$$

In the above equation, the subscripts L and U levered company means the company represents the slope. KSU or all of the slopes, Inc. for the company's required rate of return. Thus, in the absence of tax, levered company, and the slope value of the company is the same.

Companies increase the use of debt, the cost of capital to rise MM Proposition 11 weeks. Thus, the required rate of capital:

$$V_L = V_U \frac{EBIT}{WACC} = \frac{EBIT}{K_{sU}}$$

D is the market value of the firm's debt, S is the market value of firm's equity and Kd is the constant cost of debt.

TRADE OFF THEORY

Off-trade theory of optimal utilization of corporate control, the three elements that tax, financial distress and agency costs refers to the cost of the impact.

Financial stress financial obligations a company can not meet some or all of the time to failure for the company is to increase corporate debt in the capital structure will increase the likelihood of financial pain. Firms fall into financial difficulties, if faced with certain costs can. These costs can be direct or indirect. Court direct costs, accountants, lawyers, consultants, administrative costs and expenses paid to the bankruptcy proceedings include the company is large, only a small percentage of these costs to configure the company. However small, these make up a high percentage of fixed costs determine the level of debt is considered to be an active variable.

AGENCY THEORY;

Jensen and Meckling (1976), corporate executives and shareholders, and the company's management and conflicts of interest between creditors and confirmed the possibility of conflicts of interest. Conflict of interest appears in the form of cost is known as agency costs.

Jensen and Meckling (1976) was the first to identify a cost. For the first form of agency costs, management perquisites they will try to indulge in the company that owns less than 100% in the case said. Perquisites and benefits such as management style and cost of moving to a fully managed more information about the shareholders and management of the fall because less may be tempted to indulge. If you manage to increase ownership in the company this type of agency costs can be reduced to increase the cost of ownership and more to share perquisites will be managed. Management's stake one way to increase the size of the company and never managed investment companies, while maintaining a constant is the use of debt financing. In this way, debt financing to replace the capital. Financial management of the absolute reduction in capital investment to maintain the same amount of total capital ratio increased management of organization.

Methodology

SOURCE OF DATA

The thesis used the data taken from the State Bank of Pakistan publications "Balance Sheet Analysis of Joint Stock Companies Listed on the Karachi Stock Exchange Volume-11 1993-1999" and volume-1 1997-2002 and Volume-11 1997-2002.

THE SAMPLE SIZE

The sample was consist of non-financial firms listed on Karachi Stock Exchange from 1993 to 2002.We excluded all firms in financial sector from our analysis as the capital structures of these firms are not comparable to the capital structures of firms in non-financial sector. Specifically, we excluded banks, insurance companies, and investment companies.

Tangibility of Assets (TG)

Much of the fixed assets of the company by providing the creditor's security interest in these assets, the relatively low rate you can borrow. Debt at low interest rates to have a motive, a higher proportion of fixed

assets, fixed assets, less because of the company who has a high cost of borrowing is expected to borrow more than companies. So we take advantage of the type of assets a positive relationship between the sexes is expected. We fixed assets divided by total assets as a percentage of assets, tangibles (TG) is measured. We take the total net fixed assets as the numerator. Using the total net fixed assets minus the cost of fixed assets depreciation means. Our first hypothesis is

Hypothesis 01:

A firm with higher percentage of fixed assets will have higher debt ratio

b.   Size (SZ)

Companies take advantage of the conflicting views on the relationship of the area is the point. First, large companies, these costs total enterprise value fixed by the Constitution, such as configuring a small percentage of utilization to determine the level of active variables are not considered direct bankruptcy costs. In addition, a lower probability of a large corporate bankruptcy (Titman and Wessels 1988 a) has been diversified. The next, one of the company's size and leverage, and you can expect a positive relationship. Second, contrary to the first view, rajagwa Zingales (1995) for a large company claims that less asymmetric information. This is undervalued in the new issue of shares and thus reduce the chances of raising capital for many companies is recommended. Between the size and the use of two companies means that there is a negative relationship. Rajan and Zingales (1995), depending on the size of companies, we take advantage of the relationship between negative expectations. We form size (SZ) measured at the time of the measurement period, a change in the picture, gently taking the natural log of the sale.

Hypothesis 02:

There is negative relationship between size and leverage of the firm.

RESULTS AND DISCUSSION

Table1. Means of selected variables by industries

	Textile	Chem	Eng	Sugar	Paper	Power	Cemnt	Misc:
Leverage (LG)	0.523	0.4.4	0.895	0.526	0.369	0.774	0.359	0.895
Profitability (PF)	-0.022	0.053	-0.031	-0.021	0.030	0.048	-0.032	0.000
size (SZ)	5.920	5.936	4.099	6.369	5.895	8.232	7.238	5.956

Table 1 reports descriptive statistics for various variables used in this study for analyzing the determents of capital structure for the Pakistani firms. The statistic reported in the table 1 indicates that leverage ratio is

highest for textile sector. It is followed by engineering textile industry is relatively more capital intensive. This could be one reason for higher leverage ratio.

Methodology: The study used the following model to analyze the determinants of capital structure for Pakistani firms.

$$LG = \beta_0 + \beta(LG) + \beta_2(SZ) + \beta_5(TG) + \alpha$$

Where as.. (2)

LG   = Leverage

TG   = Tangibility of assets

SZ   = Size

Table 2 reports results for the above regression model as reported in table   the, R shows that only 25.16 % of the variations in leverage ratio are explained by the variations in independent variables. F-statistics shows that the overall model is valid

Table 2.   Regression analysis of the model

Independent Variables	Coefficient	t-Statistic	P-Value
Leverage(LG) Intercept	0.03369	23.2546	0.15
Tangibility(TG)	0.06358	3.2546	0.000
Size(SZ)	00.1000	-1.23695	0.000
R Square	0.3256		
F-statistic	231.32		
Prob(F-statistic)	0.0000		

As shown in table 2, only three of the independent variables are significantly related to leverage. Profitability is negatively related to leverage and confirms fourth hypothesis. Tax rate, being negatively related to debt ratio. Tangibility is positively related to debt ratio and is in conformity with first hypothesis

CONCLUSION

This paper Karachi Stock Exchange (KSE) non-financial companies listed on the determination of the capital structure is focused on. Sample selected for the study period was from 1993 to 2002. The effects of the five variables calculated by dividing total liabilities by total assets leverage ratio is measured from. First, we selected

variables for some of our descriptive statistics are presented. Average profitability of the textile industry is negative, while the most interesting findings of our descriptive statistics, the textile industry is the high leverage ratio. In fact, we have a description of the textile industry of the family controlled corporation tax and dividend to minority shareholders by depriving the government continued profit this year samgaeul years.

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