© *The Pakistan Development Review*
46 : 4 Part II (Winter 2007) pp. 465–478

Corporate Debt Policy—Pre- and Post-financial Market Reforms: The Case of the Textile Industry of Pakistan

S. M. AMIR SHAH

1. INTRODUCTION

The literature provides evidence that the capital structure of a firm is often a combination of several securities; it can arrange (1) Bank loan (2) issue debentures/bonds, (3) issue shares (4) lease financing, or (5) utilise its retained earnings. Eventually number of ideas and theories has been developed to discuss the optimal capital structure. Optimum is the trade-off between the benefit of tax and costs of financial distress; a firm faces due to the borrowed money. Although extensive research work has been done on the capital structure but still it remains one of the unsettled topics in finance. Optimal capital structure has an impact on corporate profits. Debt is considered as the cheapest source of financing due to tax shield, higher the firm's tax bracket more the debt is advantageous to a firm. The trade off theory states that higher debt is associated with higher profitability. Three reasons support this theory; one debt allow tax shield. Second, more trust is built on profitable companies considering more sustainable and less prone to bankruptcy; hence high profitable companies are able to seek more debt. Third, agency cost, for the profitable firms, lenders/creditors give relaxation in monitoring charges, which reduces the debt cost. This motivates profitable firms to go for more debt.

If firms follow pecking order theory then it base financial decision on the availability of internally generated funds. Profitable firms prefer internal financing. External finance is only used when internally generated funds are not sufficient.

Number of studies worldwide shows different results. Textile industry is the largest sector of Pakistan, which has major share in exports. Hence this sector has a major impact on the national economy. This sector major financing depend on bank loan. In mid 1990s Government of Pakistan started financial sector reforms and in 1997 it was strengthened when the government issued three amended ordinances that are, State Bank of Pakistan Act, 1956, Banking Companies Ordinance, 1962, and Banks Nationalisation Act, 1974. These amended ordinances further strengthened the State Bank of Pakistan in regulating banking sector. Furthermore, Securities and Exchange Commission of Pakistan (SECP) was established under the Act of Parliament in 1997 as an autonomous body. It started operations from January 1999 as regulator of Non-banking financial institutions. This study examines the debt and its determinants in the light of capital structure theories in the pre and post financial sector reforms.

S. M. Amir Shah <syedamir84@hotmail.com> is Lecturer, Department of Commerce, AIOU, Islamabad.

2. LITERATURE REVIEW

Capital Structure Theories

Static trade off theory: Finance managers often think of the firm's debt-equity decision as a trade off between interest tax shield and the cost of financial distress. Trade off theory of capital structure recognises that target debt ratios may vary from industry to industry. Industries where assets are mostly tangible, borrow heavily because their assets are collateral and relatively safe, however, the trade off capital structure advocates moderate debt ratio.

Rajan and Zingales (1995) compared leverage and its determinates across G-7 countries that are united states, Germany, Canada, Italy, France, Japan and united kingdom. They analysed there was a positive relationship of leverage and profitability only in Germany. Tangibility is positively correlated in all countries. Size is positively correlated with leverage except Germany.

Jose (n.d.) have studied the relationship between capital structure and profitability of the Brazilian firms. They have concluded that in short run there was a positive relationship between debt and profitability. However, in the long urn there was inverse relationship between debt and profitability.

Antonoiu, Guney, and Paudyal (2002) investigated determinants of capital structure and leverage ratio of French, German and British firms with the help of penal data. Their results suggested that size of the firm positively affect the leverage ratio. They analyse relation of profitability, size of firms, fixed assets. This study identifies a positive impact on firm's size on leverage. While the relationship between fixed asset ratio and level of leverage was mixed means positive in Germany but negative in France and UK. This shows that tangibility of assets is more significant in bank borrowing in Germany. The effect of all these factors on leverage depends on financial environment and tradition of the country in which firm operates.

Frank and Vidhan (2005) investigated that there are a large number of variables that appear to be related to debt ratio of the firm but only few factors have significant effect on debt ratio. They found that relation between leverage and size of firm is positive. For tangibility of assets Empirical results showed a positive relation among leverage and tangibility of assets of firm.

On the basis above literature review on static trade off theory, following hypothesis can be developed and tested whether static trade off theory is relevant in Pakistan textile sector.

H1: There is a positive relationship between leverage ratios and profitability.
H2: There is positive relationship between leverage ratios and tangibility.
H3: There is positive relationship between leverage rations and size.

Pecking Order Theory

Asymmetric information affects the choice between internal and external financing and between new issues of debt and equity securities, this lead to pecking order theory. Myers and Majluf (1984) suggested that retained earning is better than debt but on the other hand debt is better than equity if external financing is used. Hence profitability

should have inverse relationship with leverage. Managers use private information about the characteristics of firm's return on investment or investment opportunities which is not known to common investors.

Antonios, Guney, and Paudyal (2002) investigated determinants of capital structure and leverage ratio of French, German and British firms with the help of penal data. This study identifies a positive impact on firm's size on leverage. They also find an inverse relationship among profitability and leverage only in France and UK, which supports pecking order theory in these countries. While the relationship between fixed asset ratio and level of leverage was mixed means positive in Germany but negative in France and UK. This shows that tangibility of assets is more significant in bank borrowing in Germany. The effect of all these factors on leverage depends on financial environment and tradition of the country in which firm operates.

Frank and Vidhan (2005) found that relation between leverage and size of firm is positive. For tangibility of assets empirical results showed a positive relation among leverage and tangibility of assets of firm. The results showed a negative relation between profitability and leverage.

Hijazi and Tariq (2006) analysed determinants of capital structure of cement industry of Pakistan with the help of OLS regression. They found that size of firms and profitability were negatively correlated with leverage. Hence this rejects the static trade off theory, which showed a positive relation between size of the firm and profitability. This shows that firms in cement industry use more equity and less debt. Tangibility of assets and growth found to be positively correlated with leverage. All the results were significant except the size of the firm. Their results with Shah and Hijazi (2005) were found to be different in terms of growth and size of the firm. They concluded that in developing countries like Pakistan, cement industry usage of short term financing is higher than long term financing.

Spuma, Waters, and Payne (1995**)** concerned with those variables that indicate the level of leverage in firm. It shows that there is a negative relation among growth and leverage of the firm. Size of the firm is negatively correlated with the leverage of the firm hence smaller firms are accepted to increase the profitability of going private.

Scot (1976) stated that firm will issue secured debt to the possible extent in order to attain the optimal capital structure. He argues the agency costs of secured debt as lower as compared to unsecured debt. Thus, firms with fixed assets issue more debt.

Keister (2000) stated that in the economic transition times, shortage of finance in companies affect the capital structure of companies.

Titman and Wessels (1988**)** argues that size has an affect on financial leverage across countries. Research carried out on U.S. U.K, Japan, France, and Israel data. It concluded that there was more variation in financial leverage across countries.

Korajczyk and Levy (2003) highlighted the affect of macroeconomic conditions and firm specific factors and stated that both have an effect on firms financing choices.

Antonios, *et al.* (2002) argued that surrounding environment has impact on the capital structure decisions of firms besides it own characteristics. There may be different reasons; the environment affects the company's capital structure like the improvement in the state of economy, the existence of a stock market and/or the size of banks sector. Leverage can be changed due to an active decision of the firm to issue repurchase

securities. Leverage can also be changed when the firms circumstances changes or when its stock prices changes.

Rajan and Zingales (1995) concluded profitability is negatively correlated in all G-7 countries except Germany and analysed that size is positively correlated with leverage except Germany. Tangiblity is positively correlated with leverage in all countries.

Wolfgang and Fix (2003) concluded that firms with less investment opportunities apply more leverage that is in accordance to both theories and leverage has a direct relation with the tangibility of assets. They also suggest that more profitable firms use less leverage.

On the basis of above literature review on Pecking order theory, following hypothesis can be developed and tested whether Pecking order theory is relevant in Pakistan textile sector.

H4: There is a negative relationship between leverage ratios and profitability.
H5: There is positive relationship between leverage ratios and tangibility.
H6: There is positive relationship between leverage rations and growth.

3. METHODOLOGY

Data

The data used in empirical analysis are sourced from the State Bank of Pakistan Publications "Balance Sheet Analysis of Listed companies on KSE" for the period from 1995 to 2004 (10 years), 176 firms from textile industry included in this analysis.

Model Specification

Most of the studies used OLS model for analysis but this model has very strong assumption of constant intercept and slope coefficients. In this study Fixed effect model has been used on a panel data set considering different intercepts for different companies to capture firm's special features. Time dummies have not been used as there is only one industry, time effects during this period were common for all firms.

Following is the model specification:

$$Y_{it} = \alpha + \sum_{i=1}^{175} \alpha_{1i} D_i + \lambda_1 MRD_t + \sum_{i=1}^{4} \beta_1 X_{it} + \mu_{it}$$

Where:

Y_{it} = Leverage ratio of individual firm over time.
X_{it} = Independent variables (as mentioned below) of individual firms over the time.
D_i = Dummy for each company.
MRD = Market Reform Dummy.
μ_{it} = Residual of individual firm over the time.

Leverage (Dependent Variables)

Academic literature suggests various definitions of leverage. Finance literature give more recognition to the debt ratio, defined as the ratio of total debt divided by the total assets of the firm. Rajan and Zingales (1995) defines of leverage as "the ratio of debt to total assets." This study uses leverage as defined as used by Rajan in his study.

Leverage= Total Debt/ Total Assets

Independent Variables

Profitability

Profitability is important determinant of business performance. Managers have to put efforts to earn profit to pay off business liabilities and provide return to owners and expand business. Static trade off theory and pecking order theory consider profitability as one of the determinants of debt of a company. Literature provides the ratio of profitability as profit after taxed to the book value of total assets; the same is used in this study.
Profitability = NPAT / Total Assets.

Size

Static trade off theory establishes a direct link of the size of the firm to debt of a company. Small size companies are normally closely held and company information is asymmetry where as large companies have dispersed ownership and more exposed to public. Being information symmetry, large companies can raise debt from public more easily and can reduce transaction costs associated with debt issuance. In this way leverage of larger firms is more. Literature provides the evidence of using Log of sales as measure of size of firms.

Size = LN (total sales)

Tangibility of Assets

Static trade off theory and Pecking order theory make link between tangible assets and debt. Rajan and Zingales (1995) states "Tangibility of assets is an important determinant of leverage" On this analogy companies having more tangible assets have the greater ability to take debt as compared to smaller companies. Lender considers secure in dealing with companies having more tangible assets.

Tangibility of Assets = Fixed Assets / Total Assets

Analysis

Descriptive Statistics

Table 1 shows that on average this industry finance 82 percent of its assets through debt with the variation of 43 percent that means in some cases its debt is more than assets. Profitability shows on average industry earned nothing as a return to its investors with the variation of 15 percent that means loss may reach to 15 percent. This study

shows on average, the industry in the last ten years earned nothing rather generated losses. Equity financing on average in this industry is 18 percent. Growth on average found to be 15 percent with a variation of 92 percent. This shows high volatility in growth. Tangible assets on average in this industry are 59 percent with the variation of 20 percent. This percentage seems reasonable for this industry.

The industry must realise that the cost associated to debt is the reason of financial distress. This cost of distress increases when firm uses more debt and is unable to meet interest and principle payments.

Table1

Descriptive Statistics for the Period 1995-2004

Variables	Observations	Mean	SD	Minimum	Maximum
Leverage	1760	0.82	0.43	0	4.79*
Tangible Assets	1760	0.59	0.20	0	1.0
Size (LN Sales)	1760	6.20	1.40	–1.6	10.6
Growth	1760	0.15	0.92	–0.99	13.89
Profitability	1760	0.00	0.15	–1.87	1.51

Note: * Theoretically, debt ratio should be less than one or equal to one, but we have find that most of the firms have negative equity that shows why ratio is more than one.

As can be seen from Table 2, the independent variables provide reasonable explanatory power as indicated by R-square value 0.61. Although market reform dummy coefficient is weak positive but is statistically significant that shows financial market reforms have improved the worse situation but as this sector is badly suffering from financial distress, it needs more intra firm management efforts. Firm specific effect has been found in analysis as evident from *t*-value of dummies coefficient. If static trade off theory holds, significant positive slope coefficients are expected for profitability, tangibility and size explanatory variables. Analysis evidences that there is significant negative slope coefficient of profitability, size but positive slope coefficient only for tangibility of assets. There is no support for static trade off theory from textile sector of Pakistan.

If pecking order theory holds, significant negative slope coefficient for profitability is expected and significant positive slope coefficients for growth and tangibility are expected. Analysis show the significant negative slope coefficient for profitability and significant positive slope coefficient for tangibility as expect by theory but significant negative slope coefficient for growth against the theoretical expectations. There is some support for pecking order theory from textile sector of Pakistan. The expected and observed relationships have been shown at Tables 3 and 4.

Table 2

Fixed Effect (Ordinary Least Square Dummy Variable) Model

No. of Observations			1754
R-squared			0.61
Adjusted R-squared			0.58
F(117,1636)=22.10			Prob>F=0.0000
Variables	Coefficient	t-value	P-value
Tangible Assets	.5755544	11.58	0.000
Size Ln(Sales)	–.0625018	–8.99	0.000
Growth	–.0173403	–2.30	0.021
Profitability	–2775967	–5.60	0.000
Market Reform Dummy	.039492	2.89	0.004
αD1	.6121978	6.77	0.000
αD2	–.1461853	–1.62	0.104
αD3	–2719628	–3.04	0.002
αD4	.3592083	4.0	0.00
αD5	.0725621	0.81	0.420
αD6	.22967	2.54	0.011
αD7	–3085304	–3.43	0.001
αD8	–4169538	–4.60	0.000
αD9	.673009	7.54	0.000
αD10	–0542212	–0.61	0.544
αD11	1.586824	17.62	0.000
αD12	.0847772	0.95	0.343
αD13	–.2904446	–3.24	0.001
αD14	–.5024548	–5.53	0.000
αD15	–.0315122	–0.35	0.725
αD16	–.0032141	–0.04	0.972
αD17	.0165131	0.18	0.853
αD18	–.0514177	–0.58	0.565
αD19	–.0932618	–1.04	0.297
αD20	–.0932618	–1.04	0.297
αD21	–.0044418	–0.05	0.960
αD22	–.0535924	–0.60	0.549
αD23	.0249744	0.28	0.781
αD24	–.1028614	–1.15	0.249
αD25	–.0245935	–0.27	0.785
αD26	.2578112	2.85	0.004
αD27	.1141909	1.28	0.202
αD28	1.306758	14.54	0.000
αD29	–.1170848	–1.31	0.190
αD30	–.312008	–3.48	0.001
αD31	–.3085768	–3.26	0.001
αD32	–.2292413	–2.65	0.008
αD33	.1259899	1.32	0.187
αD34	–.2224344	–2.46	0.014
αD35	.1139825	1.28	0.201
αD36	.2240508	2.51	0.012
αD37	–.3614189	–3.96	0.000
αD38	.1360947	1.49	0.137
αD39	.2322271	2.56	0.011
αD40	.1431146	1.58	0.115
αD41	.1431146	1.58	0.115
αD42	–.0718734	–0.80	0.422
αD43	.411755	4.56	0.000
αD44	.0961656	1.07	0.283
αD45	–.2093553	–2.34	0.019
αD46	–.2093553	-2.34	0.019
αD47	–.2093553	–2.34	0.019
αD48	.2654228	2.71	0.007
αD49	.3008151	3.30	0.001
αD50	.2528208	2.80	0.005
αD51	–.2118971	–2.37	0.018
αD52	.0286508	0.32	0.749
αD53	–.0076215	–0.08	0.932
αD54	–.1578637	–1.75	0.081
αD55	–.269576	–2.98	0.003
Cons	0.8079151	14.07	0.00

Table 3

Expected and Observed Relationship between the Variables, Based on Static Trade-off

Determinants	Expected Relationship with Leverage	Observed Relationship with Leverage	Statistical Significance
Profitability	Positive	Negative	Significant
Tangibility	Positive	Positive	Significant
Size LN (Sales)	Positive	Negative	Significant

Table 4

Expected and Observed Relationship between the Variables, Based on Pecking Order

Determinants	Expected Relationship with Leverage	Observed Relationship with Leverage	Statistical Significance
Profitability	Negative	Negative	Significant
Tangibility	Positive	Positive	Significant
Growth	Positive	Negative	Significant

Theoretically, all companies are exposed to certain risk attached to its operations; this type of risk is known as business risk which remains the concern of lenders. Financial risk is associated with the use of debt by companies. Business risk depends on number of factors as stated by Brigham, Gapenski in his book Financial Management "(1) demand for firm's product (2) sales price variability—firm's product are exposed to highly volatile market (3) input cost variability—firm's input costs are highly uncertain (4) ability to adjust output prices for changes in input costs (5) ability to develop new product in a timely, cost effective manner—the faster the product become obsolete, the greater a firm's business risk. (6) The extent to which costs are fixed-operating leverage." Bradley, Jarrell and Kim, (1984) argue that "business risk of the firm reflects the probability that the firm will go into bankruptcy, with an inverse relationship between the level of business risk of the firm and its leverage" Proxies are usually used to reflect the firm's business risk. Titman and Wessels (1988) uses "standard deviation of the percentage change in operating income" Wiwattanakantang (1999) uses "standard deviation of the first difference in sales, scaled by the average value of the firm's total assets" Financial risk further increases the risk level of firm if it is exposed to debt financing. Upon review of literature it revealed that the operating profits and return on equity of levered firm will decrease either due to decrease in sales or increase in operating expenses, more as compared to unlevelled firm. Financial risk leads to financial distress. In times the company is in financial distress it cannot fulfil promises to creditor, hence financial distress may leads to bankruptcy, may be lower capital investment and Research and Development spending**,** key employees leave companies. Following calculations depicts the business and financial risk of textile industry of Pakistan.

Table 5

Table Showing the Measures for Business and Financial Risks

Title	Gross Sales Rs(000)	(*)Operating. Expenses (Including CGS) to Gross Sales	Percentage Change in Sales	Return on Assets	Leverage
Average	1102.32	1.08	46.09	0.00	0.82
Standard Deviation	448.8	0.56	119.32	0.16	0.43

(*) Data did not allow the separation of operating expenses from CGS.

If we look at Table 5, the average and standard deviation of ROA, Percentage change in sales and operating expense (including cost of goods sold) to gross sales, industrial units are not capable of seeking loan either from bank or market, up to the extent of 82 percent, in some cases even more than that. Despite inefficient utilisation of debt, how it became possible? For that matter, it is necessary to further explore the ways and means of possibility of seeking loan. Upon review of literature of financial markets it revelled that all borrowing is from banks. In seventies, government's decision of nationalisation of Pakistan's banking sector strengthened and helped political control upon the financial institutions. State Bank of Pakistan's regulatory and supervisory role was weaker. Pakistan Banking Council created for operational control of banks. In this scenario Federal government had the right to select the members of the Pakistan Banking Council (PBC) and through the PBC, it controlled over the formation of BOD through nominating board members of individual banks. In this way political control over the banking sector was strengthened. In Pakistan industrialists and land lards have strong political influence. Cheema (1999) argues that "during the 1980s and early 1990s the rate of interest on long-term loans was only 40 percent of the open market price of capital, which constituted a significant subsidy for the industrial firms." Subsidised credit created discrimination became hurdle in corporate efficiency. Government credit subsidies watered down the Pakistani corporation's need to mobilise equity finance and debt through capital markets which in turn might be the reason for underdevelopment of capital markets in Pakistan.

In mid 1990s Government of Pakistan started financial sector reforms and in 1997 it was strengthened when the government issued three amended ordinances that are, State Bank of Pakistan Act, 1956, Banking Companies Ordinance, 1962, and Banks Nationalisation Act, 1974. These amended ordinances further strengthened the State Bank of Pakistan in regulating banking sector. Furthermore, Securities and Exchange Commission of Pakistan (SECP) was established under the Act of Parliament in 1997 as an autonomous body. It started operations from January 1999 as regulator of Non-banking financial institutions.

Once it is proved statistically that market reforms have impact on determinants of debt policy, it is considered pertinent to further investigate the determinants of debt policy in the context of pre and post financial sector reforms separately by each segment analysis to pinpoint the variables. Hence data is divided into two groups Pre reform 1995-1999 and post reform 2000-2004. (see Table 6).

Table 6

Pre-financial Sector Reforms Analysis
Descriptive Statistics (1995–1999)

Variable	Observations	Mean	Std. Dev	Minimum	Maximum
Leverage	880	82	35	0.01	3.1
Tangible Assets	880	0.59	0.21	0.04	1.0
Size-Ln (Sales)	880	6.09	1.19	0.79	9.15
Growth	880	0.17	1.23	–0.99	13.89
Profitability	880	–0.027	0.13	–1.66	0.7

Descriptive statistics show industry in badly clutched in debt trap where there is on average 81 percent debt ratio with standard deviation of 35 percent. Growth on average is only 17 percent whereas during this period of 1995-99 industry sustained losses on average around 3 percent of total assets.

Table 7

Fixed Effect (Ordinary Least Square Dummy Variable) Model
(1995–1999)

No. of Observations	880
R-squared	0.65
Adjusted R-squared	0.59
F(117 ,757)=11.81	Prob>F=0.0000

Variables	Coefficients	t-values
Tangible	.2965521	4.99
Size	–.0122982	–1.31
Growth	–.0127162	–1.98
Profitability	–.8527885	–11.05
αD1	–.4682897	4.62
αD2	–.0973133	–0.97
αD3	–.2551793	–2.55
αD4	.1626572	1.61
αD5	.1684891	1.68
αD6	.1575624	1.57
αD7	–.2182896	–2.16
αD8	–.3371508	–3.32
αD9	.714361	7.13
αD10	.0107797	0.11
αD11	.7953232	7.86
αD12	.0209118	0.21
αD13	–.2289789	–2.29
αD14	–.2455824	–2.37
αD15	.0256306	0.26
αD16	.0704384	0.70
αD17	.0129102	0.13
αD18	.1330749	1.34
αD19	.0413353	0.41
αD20	.0685582	0.69
αD21	.0248361	0.25
αD22	.2421013	2.41
Cons and More	.6594322	9.36

Profitability coefficient shows strong statistically significant relationship and explain reasonable portion of debt. Negative coefficient (–0.85) between profitability and debt show that debt increases when profitability decreases and 85 percent debt is explained by negative profitability. This is the worst situation of lending to the textile industry.

As can be seen from Table 7, the independent variables provide reasonable explanatory power as indicated by R-square value 0.65. Firm specific effect has been found in analysis as evident from *t*-value of dummies coefficient. If static trade off theory holds, significant positive slope coefficients are expected for profitability, tangibility and size explanatory variables. Analysis evidences that there is significant negative slope coefficient of profitability, size but positive slope coefficient only for tangibility of assets.

There is no support for static trade off theory from textile sector of Pakistan. However, there is some support for pecking order theory from textile sector of Pakistan.

Table 8

Post-fnancial Sector Reforms Analysis
Descriptive Statistics 2000-2004

Variable	Observations	Mean	Std. Dev	Minimum	Maximum
Leverage	880	82	0.51	0.04	4.79
Tangible Assets	880	0.58	0.19	0.06	1.0
Size-Ln(Sales)	880	6.32	1.54	0.26	10.61
Growth	880	0.12	0.41	–0.89	8.0
Profitability	880	0.026	0.17	–1.87	1.51

Descriptive statistics show industry in on average still has 81 percent debt burden with standard deviation of 51 percent. Growth on average is only 12 percent whereas during this period of 2000-04 industry improved in assets utilisation and earned a profit on average around 3 percent of total assets. This improvement may be attributed to the financial sector reforms.

As can be seen from Table 9, tangible assets coefficient shows strong statistically significant relationship and explain reasonable portion of debt whereas other independent variables size, growth and profitability do not show strong relationship although they are statistically significant. Positive coefficient (0.61) between tangible assets and debt show that debt increases when tangible assets increase. Thus post reform period analysis improved in a way that debt shifted its strong negative relationship with profitability to a strong positive relationship with tangible assets. Negative coefficient of profitability decreased from 0.85 to 0.23 which changed its strong relationship with debt to weaker relationship with debt and improved its weaker relationship with tangible assets (coefficient 0.29) to strong relationship with debt (0.61). This improvement can be attributed to the financial market reforms.

Table 9

Fixed Effect (Ordinary Least Square Dummy Variable) Model for the Period 2000–2004

No. of Observations		880
R-squared		0.74
Adjusted R-squared		0.70
F(117 ,761)=18.92		Prob>F=0.0000
Variables	Coefficients	*t*-values
Tangible	.6072086	7.93
Size	–.0729014	–8.07
Growth	–.0676245	–2.75
Profitability	–.234893	–3.9
αD1	.7594282	6.03
αD2	–.1519616	–1.21
αD3	–.1966783	–1.57
αD4	.5764206	4.62
αD5	–.0347829	–0.28
αD6	.2801931	2.20
αD7	–.3466631	–2.77
αD8	–.4007325	–3.16
αD9	.6095784	4.89
αD10	–.1327001	–1.06
αD11	2.327363	18.48
αD12	.1333092	1.07
αD13	–.2799682	–2.24
αD14	–.5598994	–4.45
αD15	–.04957	–0.40
αD16	–.0386119	–0.31
αD17	–.0070227	–0.06
αD18	–.2641527	–2.12
αD19	–.1896903	–1.52
αD20	–.0860582	–0.69
αD21	–.1489243	–1.19
Cons and More	.8894734	10.88

The independent variables provide reasonable explanatory power as indicated by R-square value 0.74. Firm specific effect has been found in analysis as evident from *t*-value of dummies coefficient. If static trade off theory holds, significant positive slope coefficients are expected for profitability, tangibility and size explanatory variables. Analysis evidences that there is significant negative slope coefficient of profitability, size but positive slope coefficient only for tangibility of assets.

There is no support for static trade off theory from textile sector of Pakistan. But there is some support for pecking order theory from textile sector of Pakistan.

4. CONCLUSIONS

This study contributes towards a better understanding of financing behaviour of textile sector of Pakistan in ten years from 1995 to 2004 through investigating the effect of pre and post financial market reforms on determinants of corporate debt policy and explores the evidences for static trade off theory and Pecking order theory in financing decisions of Textile Sector of Pakistan. The Analysis depicts, that reforms have statistically significant effect on debt policy. Findings of this study contribute towards a better understanding of financing behaviour of textile sector of Pakistan in ten years from 1995 to 2004. During the period of 1995-99 industry sustained losses on average around 3 percent of total assets whereas during the period of 2000-04 industry improved in assets utilisation and earned a profit on average around 3 percent of total assets. The post reform period analysis also improved in a way that debt shifted its strong negative relationship with profitability to a strong positive relationship with tangible assets. Negative coefficient of profitability decreased from 0.85 to 0.23 which changed its strong negative relationship with debt to weaker negative relationship with debt and improved its weaker positive relationship with tangible assets (coefficient 0.29) to strong relationship with debt (0.61). Although market reform dummy coefficient is weak positive but is statistically significant that shows financial market reforms have improved the worse situation but as this sector is badly suffering from financial distress, it needs more intra firm management efforts. Results show that on average this industry remained under the debt burden of 82 percent of its assets during the whole period of analysis. This study show on average, the industry in the last ten years earned nothing. This study explored the evidences for static trade off theory and Pecking order theory. On the basis of capital structure theories and literature review of existing research work, hypothesis were developed and tested. Analysis gives no support to static trade off theory for textile sector of Pakistan. However, there is some support for pecking order theory. The industry must realise that the cost associated to debt is the reason of financial distress. This cost of distress increases when firm uses more debt and is unable to meet interest and principle payments. Analysis show lending was neither professionally granted by Banks and development Financial Institutions nor debt was professionally employed in the firms. Operating expenses and cost of goods are much higher that is major reasons of financial distress. The performance of this sector has a strong impact on the national economy. Unless such measures are taken which efficiently utilise the resources, reduce the operating expense and cost of good, due success cannot be achieved in the present scenario.

REFERENCES

Antonios, Antonious, Yilmaz Guney, and Krishna Paudyal (2002) Determinants of Corporate Capital Structure: Evidence from European Counties. *Journal of Economics*. March 1.

Cheema, A. (1999) Rent-seeking, Institutional Change and Industrial Performance: The Effect of State Regulation on the Productivity Growth Performance of Pakistan's

Spinning Sector, 1981–1994. Dissertation. University of Cambridge, UK.

Frank, M. Z. and Vidhan K. Goyal (2005) Capital Structure Decisions. University of Minnesota and Hong Kong University of Science and Technology. (Working Paper.)

Hijazi, S. and Y. B. Tariq (2006) Determinants of Capital of Structure: A Case for Pakistani Cement Industry. *The Lahore Journal of Economics* 11:1, 63–80.

Jose, M. C. M. and E. L. Jose (n.d.) Capital structure and Profitability: The Brazilian Case. Center of Postgraduates Studies and Research (CEPEAD) of the Faculty of Business and Economics, University of the State of Minas Gerais (UFMG).

Keister, L. (2000) Capital Structure in Transition: financial Strategy in China's Emerging Economy. The Ohio State University. (Working Paper.)

Korajczyk, R. and A. Levy (2003) Capital Structure Choice: Macroeconomic Conditions and Financial Constraints. *Journal of Financial Economics* 68, 75–109.

Myers, S. C. and N. S. Majluf (1984) Corporate Financing and Investment Decisions When Firms have Information that Investors Do Not Have. *Journal of Financial Economics* 13, 187–221.

Rajan, R. G. and L. Zingales (1995) What Do We Know about Capital Structure: Some Evidence from International Data. *Journal of Finance* 50, 1421–1446.

Scot, J. H. (1976) A Theory of Optimal Capital Structure. *Bell Journal of Economics* 7, 33–54.

Shah, A. and S. T. Hijazi (2004) Determinants of Capital Structure in Pakistanis Listed Non-Financial Firms. *The Pakistan Development Review* 42:4, 605–618.

Spuma, M. Rao, Melissa S. Waters, and Brace Payne (1995) A Financial Profile. *Journal of Financial and Strategic Decisions* 8:3.

Titman, S. and R. Wessels (1988) The Determinants of Capital Structure Choice. *Journal of Finance* 43, 1–19.

Wiwattancekantang, Y. (1999) An Empirical Study on the Determinants of Capital Structure of Thai Firms. *Pacific Basin Finance Journal*.

Wolfgang, Drobetz and Roger Fix (2003) What are the Determinants of the Capital Structure? Some Evidence from Switzerland. Department of Finance. (Working Paper No 4/03.)