



A Study on Impact of Capital Structure on Firm Performance: Evidence from Indian Manufacturing Industry

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ABSTRACT

A capital structure decision plays an important role in the performance of a firm. Consequently, numerous research have examined the relationship between a firm's performance and its capital structure; nevertheless, the results of these studies have yielded conflicting results. Furthermore, comparatively few empirical research have been conducted to investigate the relationship between capital structure and the performance of Indian listed companies. Capital structure variables include long-term debt to assets ratio, short-term debt to assets ratio, and total debt to assets ratio. Return on assets, return on equity, and earnings per share are the primary metrics used to assess success. A positive correlation between capital structure determinants and company performance was confirmed by the study's findings. important area of corporate finance is the relationship between capital structure and business performance, which affects a company's profitability, efficiency, and market value.

Keywords: capital structure and business performance.

I. INTRODUCTION

It impacts on the wealth of the shareholder's and an excessive debt level in the capital structure and it aims at two important concern they are the first is to maximizing the value of the firm and the second is to minimizing the overall cost of capital. Some of the impact of capital structure firm projects by issuing debts in the form of short-term debt & long-term debt, loans payable, notes payable, bonds debentures etc.

In this project there is no fixed commitment of paying interest and principal payments and the company has to make a choice of between the debt & equity financing has its own merits & demerits and also taking in to consideration the maximization of a firm value and minimization of the overall cost of capital. According to Modigliani and Miller theory (1958) the firm performance Of capital structure under the perfect capital market with no transaction and agency cost, and there is a perfect disclosure of all the credible information. Trade-off theory states that states that the optimal capital structure where a firm value is maximized can be attained by developing a balance or trade-off between and the tax-free of debt and the distress cost of the debt. As per Myers and Majluf (1984) explained the firms prioritize their sources of funding starting from internal financing or retained earnings to debt insurance and finally equity as a last resort to meet their funding needs. In developed markets capital structure are more efficient and suffer less from information asymmetry compared to other emerging economies.

METHODOLOGY

RESEARCH GAP

Even while the connection between capital structure and company performance has been well studied, there are still a number of important gaps in the literature. First and foremost, a more thorough study is required, one that takes into account the dynamic nature of capital structure choices and how they affect various aspects of a firm's performance over time. Furthermore, research frequently concentrates on broad metrics of company performance, such profitability or stock returns, but is less detailed when evaluating particular operational or strategic outcomes impacted by capital structure decisions. Furthermore, there is a lack of knowledge regarding the ways in which contextual elements including macroeconomic conditions, industry dynamics, and regulatory frameworks affect the association between capital structure and business performance. Investigating these disparities will offer insightful information to practitioners and scholars who want to maximize capital structure choices to improve overall company performance.

NEED OF THE STUDY

For a number of reasons, it is essential to research how capital structure affects the performance of businesses. First of all, managers and investors may make more educated financing decisions if they have a clear grasp of how capital structure decisions impact firm performance. Organizations can optimize their capital structure to meet their strategic objectives by examining the relationship between debt, equity, and firm performance criteria like profitability, growth, and shareholder value.

Second, studies in this field can shed light on the processes by which company performance is impacted by capital structure. For instance, does increased debt limit operational efficiency and flexibility or does it increase financial risk and possibly yield higher returns? Decisions about capital allocation and risk management can be influenced by an understanding of these mechanisms.

Additionally, researching how capital structure affects firm performance adds to the body of knowledge in the fields of financial economics and corporate finance. Our knowledge of capital structure theories and how they relate to actual business operations can be improved by researchers by finding empirical regularities and putting theoretical models to the test.

Furthermore, the relationship between capital structure and company performance becomes even more crucial in an era of economic volatility and unpredictability. By navigating financial obstacles and optimizing their capital structure to survive market swings, research in this field can help organizations become more resilient and competitive.

All things considered, research on how capital structure affects business performance is crucial for developing finance theory as well as having real-world applications for financial management and corporate decision-making.

OBJECTIVES OF THE STUDY

To conduct an empirical investigation of how capital structure or financial leverage affects a company's financial performance in a particular Indian manufacturing firm

Give managers and investors useful information so they may decide how to optimize the capital structure for long-term business performance.

RESEARCH DESIGN

The research design comprises defining variables (firm performance, capital structure), utilizing a quantitative methodology, gathering financial data, applying statistical tools to analyse relationships, and coming to conclusions that will guide the choice of the best capital structure. It includes calculating the debt and equity components, evaluating growth and profitability measures, and obtaining business financial statements for information gathering. Thorough investigation looks at correlations and other moderating factors, offering information for investment and management plans.

RESEARCH TYPE:

Descriptive in nature

Sampling Technique: For the research's purposes, a simple random sampling technique was used.

DATA COLLECTION METHODS

Primary data:

Primary data on the relationship between capital structure and firm performance is frequently gathered through direct interactions with businesses. This may entail conducting surveys among firm executives or financial officers, interviewing important personnel, and reviewing the company's financial accounts. Primary data collection provides academics with personal insights into how capital structure decisions affect firm performance, including profitability, growth, and risk management.

Secondary data:

Secondary data on capital structure and firm performance is often obtained from existing datasets in financial databases, academic journals, government reports, and corporate filings. Balance sheets, income statements, cash flow statements, and market data are popular sources of information for researchers. They may utilize financial parameters such as the debt-to-equity ratio, interest coverage ratio, return on equity, and earnings per share to evaluate a company's capital structure. Scholars might use qualitative data from case studies or industry reports to better understand how managerial decisions and market trends affect capital structure choices and firm performance.

Population: 100

Sample size: 40

Sample unit: Medchal

QUESTIONNAIRE:

Data is gathered using a well-structured questionnaire with simple questions. The survey consists of multiple-choice, closed-ended, and Likert-scale items.

TOOLS USED:

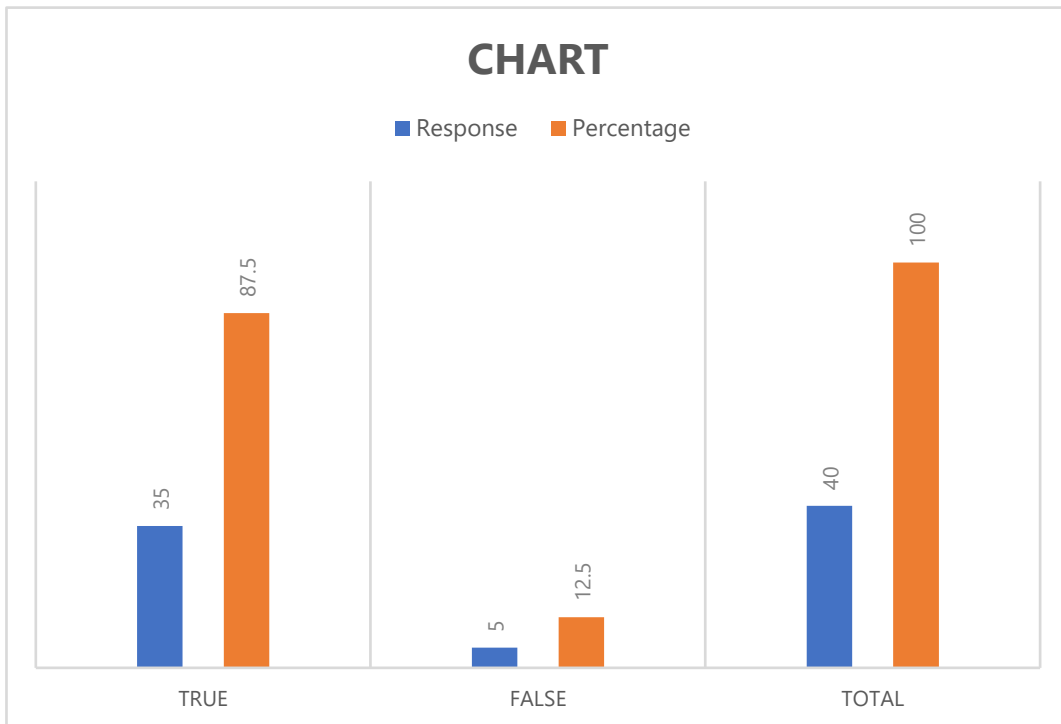
Bar graphs, charts, google forms, chi-square test.

HYPOTHESIS:

H0 : There is no relationship between capital structure and firm performance.

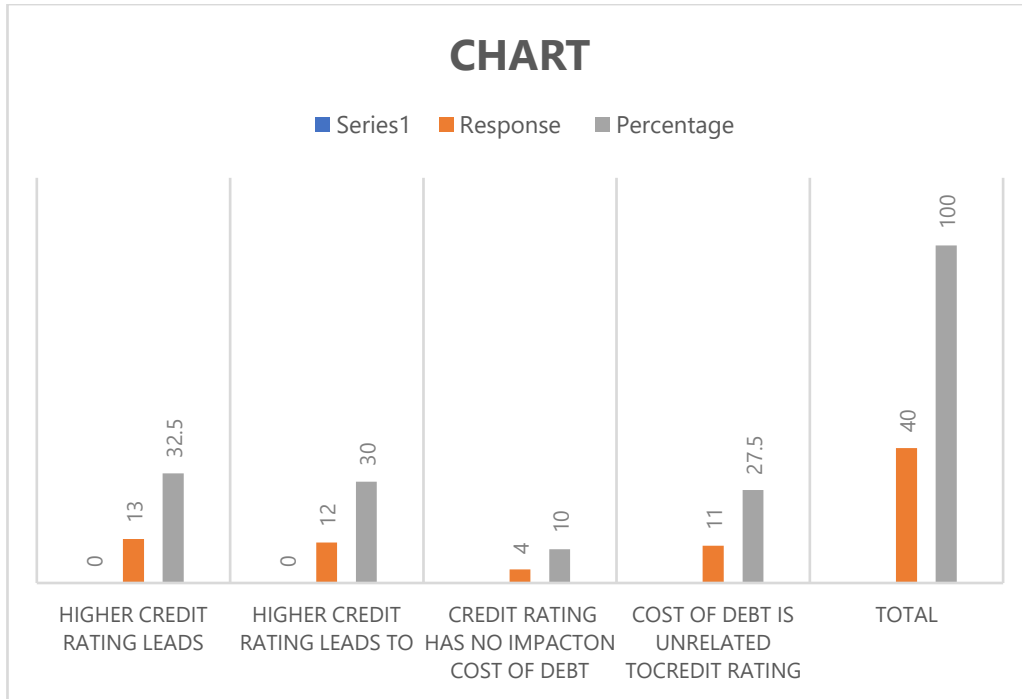
H1 : There is relationship between capital structure and firm performance.

True or False: Modigliani-Miller theorem suggests that, under certain conditions, the value of a company is not affected by its capital structure.	TRUE	FALSE	total
Response	35	5	40
Percentage	87.5	12.5	100



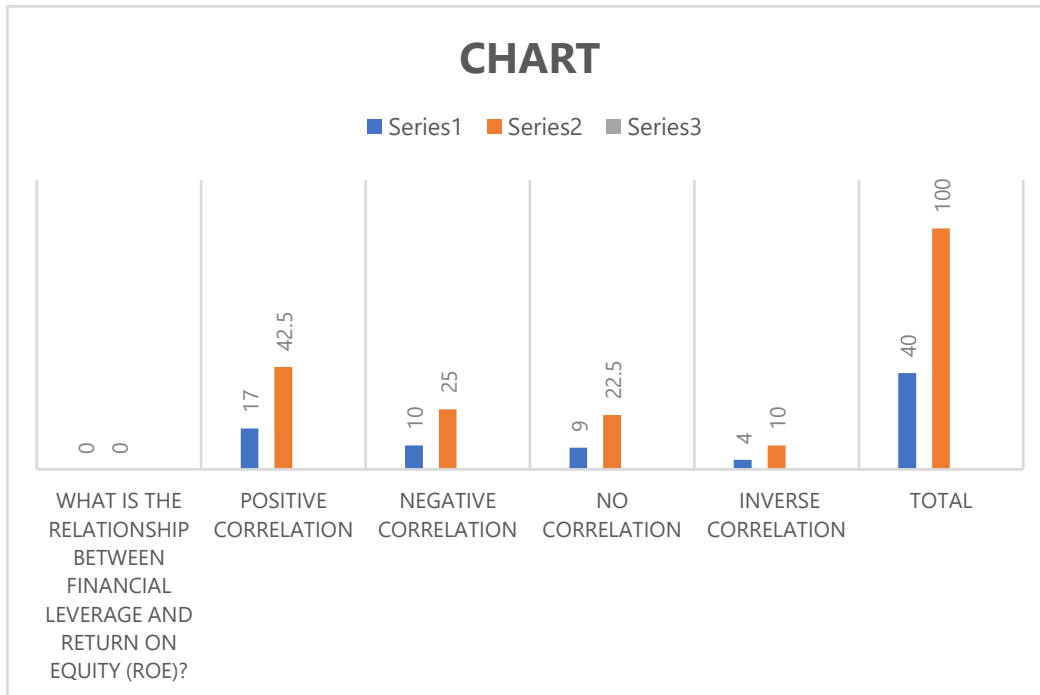
Interpretation: The overwhelming majority of respondents (87.5%) believe it to be true that the Modigliani-Miller theorem suggests that, under certain conditions, the value of a company is not affected by its capital structure, while only a small percentage (12.5%) disagree with this statement.

How does a company's credit rating affect its cost of debt?	Higher credit rating leads to lower cost of debt	Higher credit rating leads to higher cost of debt	Credit rating has no impact on cost of debt	Cost of debt is unrelated to credit rating	total
Response	13	12	4	11	40
Percentage	32.5	30	10	27.5	100



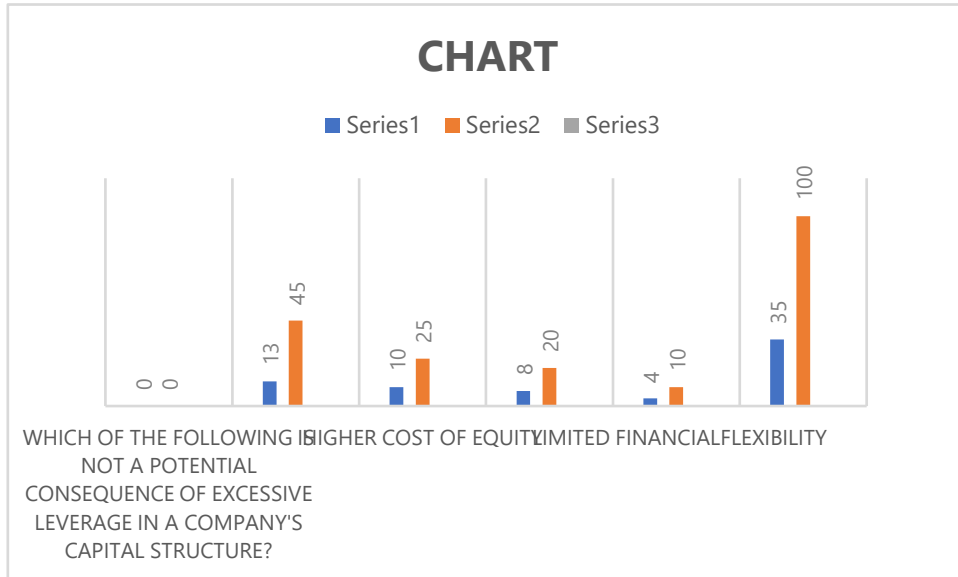
Interpretation: According to the responses, 32.5% believe that a higher credit rating leads to a lower cost of debt, while 30% indicate it leads to a higher cost of debt, with 10% suggesting that credit rating has no impact on the cost of debt, and 27.5% stating that the cost of debt is unrelated to credit rating.

What is the relationship between financial leverage and return on equity (ROE)?	Positive correlation	Negative correlation	No correlation	Inverse correlation	total
Response	17	10	9	4	40
Percentage	42.5	25	22.5	10	100



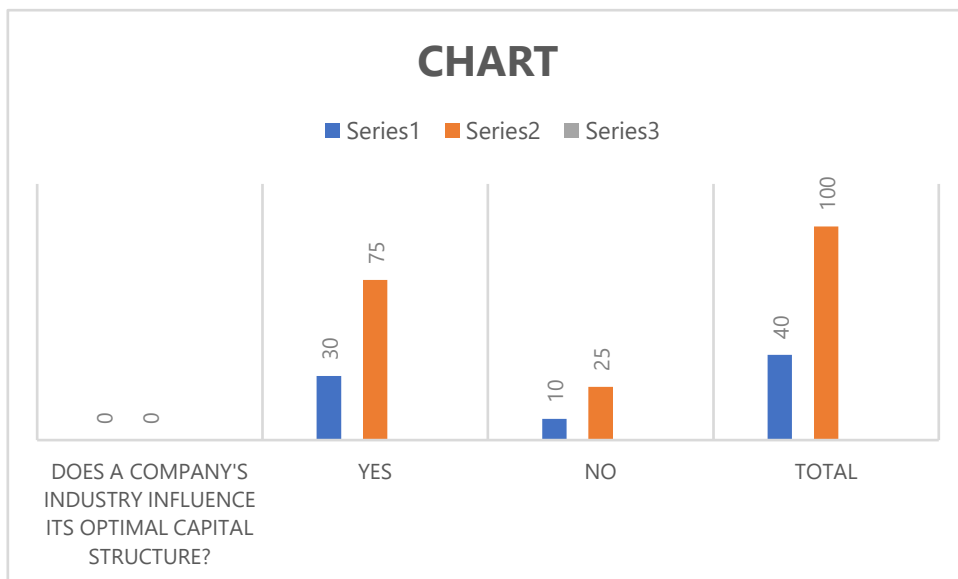
Interpretation: According to the data, the majority of respondents (42.5%) perceive a positive correlation between financial leverage and return on equity (ROE), while 25% indicate a negative correlation, 22.5% suggest no correlation, and 10% describe an inverse correlation between the two variables.

Which of the following is NOT a potential consequence of excessive leverage in a company's capital structure?	Increased financial risk	Higher cost of equity	Reduced bankruptcy risk	Limited financial flexibility	total
Response	13	10	8	4	35
Percentage	45	25	20	10	100



Interpretation: Based on the responses, 45% believe that reduced bankruptcy risk is NOT a potential consequence of excessive leverage in a company's capital structure, while 25% suggest higher cost of equity, 20% indicate limited financial flexibility, and 10% mention increased financial risk.

Does a company's industry influence its optimal capital structure?	yes	no	Total
Response	30	10	40
Percentage	75	25	100



Interpretation: According to the responses, the majority (75%) believe that a company's industry does influence its optimal capital structure, while 25% think otherwise.

STATISTICAL TOOLS FOR ANALYSIS

HYPOTHESIS:

H0 (Null Hypothesis): There is no significant relationship between the financial performance of IBHFL and its share price.

H1 (Alternative Hypothesis): There is significant relationship between the financial performance of IBHFL and its share price.

	High Impact	Low Impact	Marginal Row Totals
Male	35 (36.67) [0.08]	15 (13.33) [0.21]	50
Female	20 (18.33) [0.15]	5 (6.67) [0.42]	25
Marginal Column Totals	55	20	75 (Grand Total)

The chi-square statistic is 0.8523. The p -value is .35591. *Not* significant at $p < .05$.

Results			
	High Impact	Low Impact	Row Totals
20-25	35 (35.28) [0.00]	28 (27.72) [0.00]	63
26-30	3 (2.80) [0.01]	2 (2.20) [0.02]	5
31-35	2 (2.24) [0.03]	2 (1.76) [0.03]	4
36-40	2 (1.68) [0.06]	1 (1.32) [0.08]	3
Column Totals	42	33	75

The chi-square statistic is 0.2345. The p -value is .971839. The result is *not* significant at $p < .05$.

FINDINGS

The overwhelming majority of respondents (87.5%) believe it to be true that the Modigliani-Miller theorem suggests that, under certain conditions, the value of a company is not affected by its capital structure, while only a small percentage (12.5%) disagree with this statement.

According to the responses, 32.5% believe that a higher credit rating leads to a lower cost of debt, while 30% indicate it leads to a higher cost of debt, with 10% suggesting that credit rating has no impact on the cost of debt, and 27.5% stating that the cost of debt is unrelated to credit rating.

According to the data, the majority of respondents (42.5%) perceive a positive correlation between financial leverage and return on equity (ROE), while 25% indicate a negative correlation, 22.5% suggest no correlation, and 10% describe an inverse correlation between the two variables.

Based on the responses, 45% believe that reduced bankruptcy risk is NOT a potential consequence of excessive leverage in a company's capital structure, while 25% suggest higher cost of equity, 20% indicate limited financial flexibility, and 10% mention increased financial risk.

According to the responses, the majority (75%) believe that a company's industry does influence its optimal capital structure, while 25% think otherwise.

SUGGESTIONS

The cost of capital for a company is determined by the combination of debt and equity. By optimizing the capital structure, companies can reduce their overall cost of capital and potentially improve their profitability. Having a balanced capital structure provides companies with financial flexibility, allowing them to pursue growth opportunities and weather economic downturns without having to worry about financial distress. On the other hand, too much leverage can increase financial risk and dilute earnings.

It is important to find the right balance between debt and equity in order to manage risk effectively. Investors often assess the capital structure of a company when making investment decisions, and an optimal capital structure can increase investor confidence and improve stock performance. Debt financing offers tax benefits through interest deductions, but excessive debt can reduce tax benefits and lead to financial instability.

The impact of capital structure decisions on operational efficiency

Operational efficiency refers to the ability of a company to access finance for investment, acquisition, and day to day operations. Companies that have an appropriate combination of equity and debt can improve their operational performance

Competitive position

A company's capital structure can affect its competitive position within an industry. Companies that use leverage effectively can invest in growth, innovation, and remain competitive

Credit Rating

The credit rating of a company has an impact on its ability to borrow money and access the capital markets. Having a strong credit rating is important for securing good financing terms

Long-term sustainability

The long-term sustainability of a company's growth and profitability depends on the ability of the company to regularly evaluate and adjust its capital structure to respond to changes in market conditions and changing business needs.

Increased Stakeholder Value

The ultimate aim of capital structure optimization is to increase shareholder value. Companies that optimize their capital structure by aligning their financing decisions with their business goals and market dynamics will maximize shareholder returns over the long-term.

CONCLUSION

The right balance between debt financing and equity financing is key to finding the best capital structure for a company. Companies should consider their industry dynamics and growth objectives, as well as their risk tolerance and cost of capital.

Risk and return trade-off and Capital structure decisions must balance risk and return. Debt financing can offer tax benefits and lower capital costs, but it can also increase financial risk and leverage, while equity financing can provide flexibility and reduce financial risk, but it can dilute ownership and raise capital costs.

Financial flexibility a well-functioning capital structure provides companies with financial flexibility, allowing them to adjust to changing market conditions and pursue growth opportunities, while also managing risk effectively. This flexibility allows companies to weather economic downturns and take advantage of strategic opportunities.

Investor perception and Stakeholder value and Stable and optimal capital structures increase investor confidence, support stock performance, and create long term value for shareholders..

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