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INFLUENCE OF CAPITAL STRUCTURE IN INDIAN CORPORATE FIRMS

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ABSTRACT

This research looks at how the capital structure of Indian enterprises was impacted by the Global Financial Crisis, specifically how its susceptibility altered and which variables had a stronger influence on the capital structure at that time. Initial data suggests that corporations in India use a wide range of capital structure methods, which likely reflects differences across sectors and business sizes. Capital structure decisions are strongly influenced by factors including profitability, tangibility of assets, business risk, tax concerns, growth potential, and firm-specific features. Financial structure choices in India are also found to be influenced by regulatory and institutional issues such government laws, industry rules, and access to financial markets. The qualitative section of the research sheds light on the factors that go into Indian companies' capital structure decisions. The results of this study have relevance for both academics and professionals in the business world. This research adds to the current academic literature on capital structure by focusing on the distinctive institutional and regulatory environments of the Indian business sector. The findings have important practical implications for financial managers, regulators, and investors, since they provide light on the tradeoffs inherent in various capital structure options and associated financial strategies.

KEYWORDS:- Capital Structure, Indian Corporate Firms, Global Financial Crisis, business risk, tax concerns

INTRODUCTION

Capital structure has come a long way since 1958, when Modigliani and Miller published their major study. All subsequent theories have made an effort to explain this perplexing topic by isolating the factors that play a role in determining the capital structure. Several elements have been found by researchers that may influence capital structure decisions made by organizations. Possible frauds, high transaction costs, conflicts of interest, information asymmetry, weak institutions, and so on are only some of the reasons why the system is flawed. The uniqueness of institutions lies in the fact that they serve a dual purpose: on the one hand,

their existence creates imperfection, and on the other, their presence is essential to correct imperfection if it is emerging out of asymmetry of information. While the existence of a capital market regulator may assist reduce the effects of information asymmetry in the market, one source of imperfection is the imposition of tax on people and enterprises by a government agency such a tax authority. Given that institutions can both create and remedy imperfections, and that corporations must comply with the requirements of various institutions like the tax authority, banking system, capital market, and regulatory authority, this suggests that institutional structure may explain the behavior of

corporations, especially its financial behavior. More specifically, "capital structure decision is not only the product of the firm's own characteristics, but also the result of tenets of corporate governance, legal framework, and institutional environment of the countries in which the firm operates".

The right capital structure can only be determined after careful consideration of a broad variety of elements, such as the company and its management, the economy, government regulation and social trends, the state of capital markets, and the dynamics of the sector.

To appreciate how firms in developing economies raise money for their operations, it is necessary to analyze the factors that influence their financing or capital structure choices. The setting of business financing choices raises several policy problems. The expansion of capital markets, the determination of interest rates and the values of securities, and the implementation of appropriate laws are only a few examples of the far-reaching influence they have on macroeconomic variables. Such decisions have narrower repercussions for the capital structure, corporate governance, and development of certain companies. The majority of what we know about capital structures comes from data collected in industrialized countries with whom we share many institutional traits. Countries have vastly different tax and bankruptcy laws, markets for corporate control, bank and securities market operations, and other economic infrastructures. Disparities in social and cultural norms, as well as economic advancement, are not universal.

TYPES OF CAPITAL STRUCTURE

There is no debt in the capital structure of a company that is not leveraged, but there is in the capital structure of a company that is leveraged. Consider the effect of leverage on capital structure using two different starting points (i.e., a leveraged and an unlevered base).

Non-Leveraged Based

When a company's capital structure has no leverage, the issuance of equity share capital may figure heavily. Funding might also be obtained through retained earnings. Retained profits provide an alternative to Equity Share Capital in the capital structure. Let's take a look at the pros and cons of such a capital structure to see what we can learn.

Leveraged Base

A corporation is considered levered when it has both debt and equity capital in its capital structure. Hybrid security is another name for preference shares. When used correctly, the application of leverage may result in a number of beneficial outcomes. The usage of leverage may be harmful to a company's finances in bad situations. This will be made clear in a minute.

CAPITAL STRUCTURE THEORIES

A company's capital structure choice revolves on the balance between debt and equity. The connection between a company's market value and its capital structure choice has been extensively explained by several capital structure theories. Capital structure theory is a cornerstone of contemporary finance theory and has provided useful insights into practical issues. As a result, knowing the theoretical underpinnings is crucial.

Net Income Approach

David Durand is widely credited as the creator of the Net Income Approach. The

core idea behind the net income method is that debt may help a company reduce its cost of capital. This strategy is founded on the idea that the incorporation of debt does not alter the investor's perception of risk. Debt interest (k_j) and equity capitalization (k_e) are so unaffected.

Net Operating Income Approach

David Durand also created the Net Operating Income Approach. The capital structure is irrelevant because the business cannot influence its total cost of capital by using leverage, according to the net operating income concept. This means that the cost of capital as a whole has not changed. This is because the advantage gained from the usage of debt is nullified as the average cost stays same due to equity investors increasing their capitalization rate of profits to offset the higher financial risk. However, the cost of debt may rise over a certain degree of leverage. For the cost of capital function to remain flat, the price of equity would need to decrease. As a result, there is no sweet spot or range of values for the capital structure.

Modigliani-Miller Approach

The Modigliani-Miller hypothesis and the NOI approach are the same thing. However, the Net operating income strategy serves just as a concept and has no bearing on actual business performance. The capital structure's insignificance is not backed up by any practical reasoning on the Net operating income method. The M.M. hypothesis agrees with the NOI method in that the cost of capital remains constant regardless of the debt-equity ratio. It explains why the total cost of capital and the value of the company may be kept constant. That is to say, the M.M. method

insists that adjusting the level of leverage has no effect on the weighted average cost of capital.

There are three basic tenets that form the backbone of the M.M. theory. This includes:

Proposition I

A company's market value is calculated by taking its predicted operating income and dividing it by the risk-adjusted discount rate. It doesn't matter how much leverage you have.

Proposition II

Equity returns are calculated by adding the appropriate capitalization rate to an anticipated premium. The spread between the capitalization rate and the yield on debt represents this premium.

Proposition III

No matter how an investment is funded, the capitalization rate will always serve as the firm's investment decision-making threshold.

These hypotheses are grounded on a basic market process known as arbitrage. Buying a security at a cheaper price in one market and selling it at a higher one in another is an example of arbitrage. According to M.M., the total values of two businesses that are otherwise similar save for the financing pattern will converge via the arbitrage process, hence the market value of these enterprises will not change. If two assets belong to the same risk class and have the same projected returns, but are selling for different prices, rational investors would use arbitrage to eliminate the discrepancy.

It's challenging to refute the M.M. thesis theoretically. However, they have been harshly attacked by various specialists who have questioned the theory's foundational

assumptions. Individuals, via the application of leverage, may affect corporate leverage; this is the primary idea behind M.M. This argument fails to hold water in a real world setting since it is very unlikely that individual investors will switch from using corporate leverage to using personal leverage.

M.M. also assumes that corporations are exempt from paying income tax. Worldwide, no country has failed to tax business profits. Furthermore, interest paid on debt may be deducted from income according to tax law provisions. If this is the case, the corporation will be incentivized to use leverage since debt will be a much cheaper source of funding. M.M. acknowledged in a follow-up essay published in 1963 that the firm's total cost of capital may be reduced if additional debt was introduced into the capital structure due to the tax aspect. Despite these caveats, M.M. theses are helpful in grasping the ideas behind the capital structure.

Traditional Approach

The conventional method lies somewhere in the middle of the Net Income and Net Operating methods. It incorporates aspects of each of those strategies. Ezra Solomon is a leading proponent of the conventional view. A corporation may improve its total value and minimize its overall cost of capital by using "debt to equity propositions" wisely, according to the conventional understanding of leverage and valuation. Since interest payments on debt are lower than dividends paid on common stock, this makes sense. By increasing debt and decreasing equity, one may switch to a less expensive funding

mechanism. As a result, the firm's market value drops and the cost of capital decreases. According to Solomon's take on the classic perspective, there are three separate points at which studying the effect of leverage on the cost of capital and the value of a corporation is possible.

Optimal Capital Structure Theory

According to the Optimal Capital Structure hypothesis, a company's capital structure is determined by a balance between debt and equity. Managers of corporations strike a balance between the tax benefits of higher debt and the risk and expense of financial difficulty when making financing decisions. According to this hypothesis, either excessive or inadequate debt levels are detrimental to a company's viability. Low ROIC results from either having too little debt (which leads to underinvestment) or too much (which leads to overinvestment) Too little debt in the capital structure leads to agency expenses. Michael Jensen⁸ argues that poorly levered enterprises incur substantial agency costs. Thus, according to the theory of optimum capital structure, the value of a levered business rises because of the tax exemption on borrowings but falls because of the bankruptcy risk associated with carrying excessive levels of debt. The best capital structure is one that maximizes the company's value via the use of debt and equity.

Signaling Theory

According to the signalling hypothesis, corporate managers know more than outside investors do about their companies, and as a result, managers' financing choices send a "signal" to investors about how they value the company.⁹ If management believes their

company is undervalued, they may choose to issue debt in order to attract new external financing and send a message to investors about their optimism over the company's future cash flows. Managers may choose to issue shares at the present higher price if they feel the market has now overvalued their company. Therefore, according to the idea of price signals, undervalued companies are more likely to issue debt than stock.

Pecking Order Theory

Myers proposed pecking order theory, a subset of signaling theory. He claims that while making financial choices, business leaders do not factor in the appropriate capital structure. Managers often use a common sense approach, focusing instead on securing the "cheapest value" when allocating capital. According to this idea, equity is only employed as a last option if other forms of funding, such as debt, have already been exhausted. Issuing equity has a larger information cost than other options in the Pecking Order, hence it should be used as a last resort. Therefore, according to Myers, corporations with sizable free cash flows need to maintain a relatively modest leverage ratio.

TECHNIQUES OF ANALYSING CAPITAL STRUCTURE

Capital structure ratios are used to evaluate a company's sustainability over the long term. The following ratios are often used to evaluate a company's capital structure.

Financial Ratios

Financial statement analysis and interpretation may be done with the use of ratio analysis. Ratio analysis is the technique of calculating and analyzing ratios to aid in decision making.

Time Series Analysis / Trend Analysis

When data is collected and analyzed over time, the results are presented in the form of a time series. The statistics in this set have been gathered, recorded, and tracked throughout time. This data set consists of a succession of points in time, often recorded at regular intervals. The use of line charts to display these data is widespread. When taking temporal measurements, these series are useful in fields including statistics, signal processing, pattern identification, econometrics, mathematical finance, meteorology, seismology, control engineering, astronomy, and communications engineering. Methods for extracting useful statistics and other properties from time series data are included in this examination. This series use a model to forecast future values from existing data.

Common size Statement

This statement is often referred to as a "component percentage" or "100% statement" since each component is expressed as a percentage of the whole. Total assets, total liabilities, and total sales are shown in this statement as a percentage of 100. Changes in individual items could not be compared to overall changes, which was a weakness of the comparative statement.

Inter- Firm Analysis / Cross Section Analysis

An example of an observational study, cross-section analysis looks at a sample, or cross-section, of a population at a certain time and place. Cross-sectional regression is used in economics to determine whether or not one or more independent variables have a significant influence on a dependent variable, and how large of an effect that

has. Descriptive in nature (neither longitudinal nor experimental), cross-sectional studies provide snapshots of data.

Coefficient of Variation

Dispersion may be measured objectively using the standard deviation. Coefficient of variation is the relative measurement that corresponds to this. Karl Pearson's relative dispersion index is the gold standard for such analyses. It is used in situations where comparing the dispersion of many series is of interest. The series with a larger coefficient of variation is considered to be less consistent, uniform, stable, or homogeneous than the one with a smaller coefficient of variation. Conversely, a less-variable series is described as being more uniform, steady, or homogeneous because of its lower coefficient of variation.

It should be noted that although the standard deviation and the arithmetic mean may be used in combination with any average to compute relative dispersion, statisticians almost generally employ the former. When the mathematical mean and the standard deviation are used to express the relative dispersion Coefficient of variation, sometimes written as a percentage, measures the spread of a set of numbers.

Correlation Analysis

Correlation analysis is a statistical method for gauging the closeness of a link between two or more variables. The term "correlation analysis" describes the method used to evaluate the degree of association between the variables. Thus, correlation serves as a useful statistical tool for examining the mutual fluctuations of two or more independent variables. By comparing one series of data with another

series to which it may be functionally connected, a business executive may use correlation analysis to make estimates about expenses, sales, pricing, and other factors. Economic behavior can be better understood with the help of correlation analysis, which also helps pinpoint the most crucial variables upon which all others depend, may shed light on the propagation of disturbances, and points the economist in the direction of potential avenues for redress. It is well known that the correlation coefficient is both a popular and overused statistical tool. Misuse occurs when people fail to recognize that a correlation coefficient only reflects the linear strength of a link and does not prove causation. We may use correlation analysis to learn how closely related two or more variables are. It does not provide us with any information on the causes and effects at play. However, just because two variables are highly correlated does not suggest that there is a causal link between them.

Regression Analysis

Almost every scientific field makes use of regression analysis, a subfield of statistics. The core of economic theory and economic life may be reduced to the measurement or estimation of the connection between economic variables. The average degree to which two or more variables are related, expressed in the same units as the original data, is what is known as regression. Regression analysis, as described by Morris Hamburg, is the process of estimating one variable given the values of one or more other variables, as well as the assessment of the errors associated with this estimation process. Values of the dependent variable are

estimated based on the values of the independent variable, thanks to this analysis. It is also useful to get a measure of the estimate error introduced by employing the regression line. The correlation coefficient may be calculated with its aid as well. One variable is considered dependent while the other is considered independent in regression analysis.

CONCLUSION

Capital structure impacts of the Global Financial Crisis have been studied extensively in emerging nations. In India, hardly many research have been conducted on this topic. However, there have been scant systematic efforts to evaluate how firm-specific and dividend policy variables affect India's private sector. Therefore, this study has attempted to ascertain the effects of the Global Financial Crisis on the Indian corporate sector by taking these crucial factors into account. Because there is little consistency in the combination of variables used to describe the determinants of capital structure by different scholars, the capital structure analysis has been crucial. Despite decades of research, there was surprisingly little consensus on even the most basic empirical facts. It is also helpful to outline the key variables that should be considered while evaluating the capital structure. The capital structure of any country is affected by a variety of factors. This is owing to the fact that many countries' political, legal, and economic situations are unique. Therefore, the emerging economies have been influenced by different trends than the developed economies. This study examines how the Global Financial Crisis affected the factors that determine the capital structure of

Indian companies, including how the capital structure's vulnerability changed and which factors had a greater impact on the capital structure during the crisis.

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