The influence of capital structure on financial performance

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Abstract

The decisions that concern financial structure have an important impact on the company so that it is necessary to quantify their effects on the company's performance. The purpose of this paper is to determine whether there is a positive or a negative relation between debt and financial performance as previous research has not come to a general conclusion. In this paper we examine the factors that influence financial performance through panel data regression models using a sample of 16 pharmaceutical companies from 5 countries during 2001-2013. The results have shown that capital structure has an impact on company's performance, but the sign of that relation depends on the type of measure that is used to quantify the performance.

Introduction

There have been published numerous research papers about the importance and the effect of financial structure on financial performance. However, these researches have obtained different results depending on the types of measures used to quantify the performance or on the types of models used. In the first part of this paper we have summarized a few of the classic theories, as well as empirical results about this subject.

In the second part of the paper we have presented a case study on the correlation between financial performance and several factors that have been identified to have an impact on a company's performance. The sample used 16 pharmaceutical companies from 5 countries: Bulgaria, Poland, Romania, Hungary and Ukraine over the period 2001-2013. In order to see if the results depend on the type of performance measure we used both accounting and market measures: ROA, ROE, MBR, PER.

This study could be useful in making decisions about capital structure, but also to see what other factors influence the financial performance for emerging countries. We can see if the dividend policy or the investment policy has an effect on the firm's performance and then this can be used by the company's management in maximizing the profitability and the returns to the stockholders.

Literature review

After many years of research economists have come to the conclusion that in making decisions regarding the financial structure of a company there are several factors that have to

be taken into consideration. At first many believed that the financial structure did not matter at all. Modigliani & Miller (1958)[1] said that the market value of a firm does not depend on the capital structure. Later the authors revised this conclusion (Modigliani & Miller, (1963)) and they took into consideration the fiscal benefits that would be brought by the deductibility of the interest expenses. This meant that a firm that had more debt would have lower taxes to pay.

Jensen & Meckling (1976)[2] discuss the agency costs involved by the fact that the manager is not also the owner. If the number of shares owned by the manager decreases, he will try to gain benefits by other means and will be less interested in finding new opportunities that could bring profit to the firm. The stockholders will have to redirect a part of their resources for monitoring the management through audit, control systems, budget restrictions and for compensations offered to the managers in order to align their interests to those of the stockholders. A company cannot be financed only through debt because the managers could accept investment projects that have high expected returns, but that bring also a high risk for the company. If these projects fail the creditors have the highest loss.

Ross (1977)[3] has another view on the matter and contradicts the hypothesis from Modigliani and Miller's study according to which the market knows all the information about the company and that the financial structure is irrelevant. The author points out that the managers have internal information that is unknown to the market, meaning that the decisions regarding the activity and the capital structure of the company send a signal to the market, which may help the firm to differentiate itself from its competitors in the eyes of the investors. This means that the relation between the value of the company and leverage is positive, a higher leverage determining a higher value in the market's perception.

Miller & Modigliani (1961)[4] point out that the dividend policy does not have an impact on the market value of the firm. The authors explain the fluctuations of the stock price that appear when there is a change in dividends through the fact that investors see in these changes a shift in the managerial view of the future profits. Thus the dividend change becomes an occasion for the price to fluctuate but it is not the cause of it, the price being only a reflection of the future gains and growth opportunities.

Myers (1984)[5] introduces the pecking order theory that describes the way that a firm chooses its financing sources. Firms prefer to finance their projects internally, adapting their dividend distribution rate to the investment opportunities. The changes in profitability may determine lower internal resources so that the company will have to use external financing.

[1] Modigliani, F. & Miller, M. H., 1958. The cost of capital, corporation finance and the theory of investment. *The American Economic Review,* 48(3), pp. 261-297.
[2] Jensen, M. C. & Meckling, W. H., 1976. Theory of the firm: managerial behavior, agency costs and ownership structure. *Journal of Financial Economics,* 3(4), pp. 305-360.
[3] Ross, S. A., 1977. The determination of financial structure: The incentive-signalling approach. *The Bell Journal of Economics,* 8(1), pp. 23-40.
[4] Miller, M. H. & Modigliani, F., 1961. Dividend policy, growth and the valuation of shares. *The Journal of Business,* 34(4), pp. 411-433.
[5] Myers, S. C., 1984. The capital structure puzzle. *The Journal of Finance,* 39(3), pp. 575-592.

The safer and first external resource chose by firms is debt, this is followed by hybrid instruments like convertible bonds and the last resource and the riskiest is issuing shares.

The sign of the relation between financial performance and capital structure has been discussed for many years, the results of the studies being different. Capon, et al. (1990)[6] have gathered the results of 320 empirical studies performed between 1921-1987. The main factors included in the studies and their results are presented below:

- Industry concentration – has a positive impact on firm performance
- Growth – growth in assets and sales have a positive effect on firm performance
- Size of firm – is not related to financial performance, but there have been studies that have shown a positive performance relationship when size has been measured as industry level sales
- Capital investment intensity – has a positive impact on performance at the industry level, but at the firm level it has a negative effect
- Advertising intensity – is positively related to performance at both industry and firm levels
- Research and development expenses – have a positive effect on financial performance at firm level.

There were not many studies about the relationship between financial performance and leverage in the sample but the authors pointed out that there was a positive correlation at the industry level and a negative correlation at the firm level.

The authors focused on the factors that may influence the results of the models. The study showed that model specification, estimation method, level of aggregation, return measure, time of study and research environment are elements that might determine obtaining different results.

McConnell & Servaes (1995)[7] employed an analysis on the relationship between firm value and leverage. The sample was split in high growth and low growth companies. The results have shown that leverage is negative related to performance for high growth companies, but it is positive related to performance for low growth firms. Another result is that ownership structure is also a determinant of financial performance. The authors obtained a positive correlation between Tobin's coefficient and the percentage of shares owned by institutional investors.

Krishnan & Moyer (1997)[8] considered that the home country of the company might have an impact on financial performance. The study was employed on a sample of 81 firms from 4 Asian countries: Hong Kong, Malaysia, Singapore and Korea. The results have shown

[6] Capon, N., Farley, J. U. & Hoenig, S., 1990. Determinants of financial performance: a meta-analysis. *Management Science,* 36(10), pp. 1143-1159.
[7] McConnell, J. J. & Servaes, H., 1995. Equity ownership and the two faces of debt. *Journal of Financial Economics,* Issue 39, pp. 131-157.
[8] Krishnan, S. V. & Moyer, C. R., 1997. Performance, capital structure and home country: an analysis of Asian corporations. *Global Finance Journal,* Issue 8, pp. 129-143.

that leverage is not related to financial performance for this sample of firms. The companies from Hong Kong had the highest returns and the firms from Korea had the highest debt ratios. The home country determined differences both in the capital structure and performance of the firms, mainly because of the different tax rates from every country, but also because of institutional factors and the different levels of government intervention in the economy.

Harvey, et al. (2004)[9] studied if debt financing could lead to higher value for companies that have high agency costs. The conflict of interests between stockholders and managers could lead to less growth opportunities for the firm and too many fixed assets from overinvestment. The results have shown that debt financing might help these companies to get higher returns as the firm will have to reach certain levels of disclosure and monitoring. Berger & Bonaccorsi di Patti (2006)[10] also pointed out that higher leverage will determine lower agency costs and a higher performance.

Another determinant of performance is ownership structure. Wagner, et al. (2015)[11] employed an extensive analysis of 380 articles on the relationship between family ownership and financial performance. In 61,3% of these studies the family ownership is positive related to performance. Depending on the type of measure used for performance, the results pointed out that in 73,7% of the cases ownership structure had a positive effect on ROA, in 60,9% of the cases the effect was positive on ROE and in 55.6% on MBR.

An important and recent aspect that could improve the financial performance is CSR. Lu, et al. (2014)[12] gathered 84 articles published between 2002-2011 about the impact of CSR on financial performance. Most of the studies have shown a positive effect of CSR, but in 21 articles the relationship has been insignificant and in only 6 the effect was negative. The reverse causality was studied as well and in 15 of the studies the effect of financial performance on CSR was positive.

In a study on Romania Pantea, et al. (2014)[13] consider several determinants of financial performance like firm size, growth rate, fixed assets, number of employees, CSR index. The results pointed out that only firm size, fixed assets and the number of employees have an impact on financial performance, while growth rate and CSR index are insignificant. These results have been explained by the fact that the firms included in the sample have low sales growth rates and few of them have taken CSR measures.

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[9] Harvey, C. R., Lins, K. V. & Roper, A. H., 2004. The effect of capital structure when expected agency costs are extreme. *Journal of Financial Economics,* Issue 74, pp. 3-30.

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[12] Lu, W., Chau, K. W., Wang, H. & Pan, W., 2014. A decade's debate on the nexus between corporate social and corporate financial performance: a critical review of empirical studies 2002-2011. *Journal of Cleaner Production,* Issue 79, pp. 195-206.

[13] Pantea, M., Gligor, D. & Anis, C., 2014. Economic determinants of Romanian firms' financial performance. *Procedia-Social and Behavioral Sciences,* Issue 124, pp. 272-281.

All these studies show that there have been many changes in the opinions and hypothesis used in the articles. If at first it was thought that financial structure did not matter, later it became clear that it is a very important aspect that can help the company to send a signal to the market. The empirical studies revealed that the sign of the relationship between financial structure and performance is different depending on the period, sample of countries, macroeconomic context.

Case study

In order to test the relationship between financial structure and performance we employed a panel data regression using financial data for 16 pharmaceutical companies for years 2001-2013. The companies are from 5 countries: Romania, Bulgaria, Hungary, Ukraine and Poland. The data was collected from Thomson Reuters.

We performed several regressions using as dependent variables ROA, ROE, MBR and PER. The independent variables used in the models are: leverage, total debt to total assets, cost of debt, distribution rate of dividend, dividend yield, liquidity, fixed assets to total assets, logarithm of assets as a measure of the firm size, current assets turnover, receivables turnover.

Table 1: Regressions using ROA as dependent variable

Explanatory variables	Regression 1	Regression 2	Regression 3
LEV	-0.011399*	0.003054*	-0.013158*
LEV(-1)	0.000795		
LEV^2	0.000313*		0.000334*
GR_INDAT		-0.093901*	
RDOB	0.013899	0.300172*	0.297490*
DISTRIB_DIV	-0.026967	-0.035134***	-0.034908***
DIV_YIELD	0.201690***	0.172441	0.172820
POND_A_IMOB	-0.056404***	-0.103797*	-0.095834*
LNA	-0.004416	-0.008755**	-0.009846**
VIT_ROT_ACR	0.001366	0.012041***	0.006458
VIT_ROT_CRE	0.000486	0.000583	0.000697
R^2	26.73%	36.97%	34.84%

*-significant for 1%, **- significant for 5%, ***- significant for 10%

Results from the table above show that leverage has an impact on performance measured by ROA , but it has a negative sign in two of the regressions. This means that when the company has more debt the performance will decrease. Debt to total assets ratio also has a negative coefficient which may indicate that too much debt can lead to a lower profitability.

Cost of debt has a positive effect on performance, as the interest expense is tax deductible. If the company has more debt then it will have a fiscal advantage and more funds for investment. The variables that describe the dividend policy of the company are not statistically significant. This result could be determined by the fact that the companies

included in the sample were not very generous when it came to dividend allocation. The dividends paid had low values and were not frequent.

Fixed assets to total assets ratio was negative related to performance. Usually investing in fixed assets brings benefits to the company as the new technology helps reducing costs and improves the manufacturing process. For our sample the fixed assets ratio had both very low and high values. Overinvestment leads to higher costs as the assets are no longer used at full capacity and they generate maintenance costs.

Firm size is statistically significant in two of the three regressions and it has a negative coefficient, revealing that a big company does not mean high performance. This result may be caused by bad management and agency costs. Receivables turnover and current assets turnover are not statistically significant in any of the three regressions.

Table 2: Regressions using ROE as dependent variable

Explanatory variables	Regression 1	Regression 2	Regression 3
LEV	0.177413*	-0.077777*	-0.039557*
LEV(-1)		0.000933	0.001322
LEV^2		0.005433*	0.004657*
GR_INDAT	-0.917009*	0.296947**	
RDOB	0.325825	-0.044707	0.061158
DISTRIB_DIV	-0.075004	-0.045220	-0.060371***
DIV_YIELD	0.475693	0.269155	0.279863
LICHID	-0.019355***	0.001602	-0.012132**
POND_A_IMOB	-0.264299**	-0.127336***	-0.162090**
LNA	-0.046917*		
VIT_ROT_ACR	0.078891*	0.007692	
VIT_ROT_CRE	-0.001784	0.000664	
R^2	98.75%	99.67%	99.64%

*-significant for 1%, **- significant for 5%, ***- significant for 10%

Leverage has a negative impact on ROE in regressions 2 and 3, showing that the more debt a company has the lower it will be its performance. Debt to total assets ratio is significant but it has different signs in the two regressions that included this variable. Square leverage is significant, so there is a non-linear relationship between leverage and ROE. This relationship can be used in finding the optimal capital structure. Cost of debt is not significant in these 3 regressions, showing that financial performance measured by ROE is not influenced by these expenses.

The regressions employed for ROE as dependent variable did not point out that there would be an effect of dividend policy on performance. Both dividend distribution rate and dividend yield have insignificant coefficients.

Fixed assets ratio has a negative impact on performance in all 3 regressions. This result shows that too many fixed assets generate high maintenance costs, but also opportunity cost. Companies have other options when it comes to technology and do not have to buy it in order to use it. Sometimes it is preferable and less expensive to use the equipments having a leasing contract or a partnership with other companies.

Liquidity is significant in regressions 1 and 3, but the effect on performance is negative. Excessive current assets may cause a great loss for the firm. Stocks lead to storage costs and in case they are perishable, the company will lose the funds invested in it. Receivables can become losses if they are partially collected, but they affect the company's stability if they are collected completely, but long after their due date.

Firm size was included only in the first regression and it has a negative impact on performance. A big company will not have a higher performance without a proper management. Current assets turnover is significant only in the first regression. The positive coefficient shows that the faster the current assets turn into income for the company the higher the performance it will have. Receivables turnover is not significant in all the regressions.

Table 3: Regressions using MBR as dependent variable

Explanatory variables	Regression 1	Regression 2	Regression 3
LEV	-49.59043*	2.322711*	3.182373**
LEV(-1)		0.019640	-1.518888*
LEV^2		-0.414200**	-0.827607**
GR_INDAT	180.3223*		
RDOB	37.42597	5.774143	21.12633**
DISTRIB_DIV	2.883426	-0.326839	-0.071739
DIV_YIELD	-20.14089	-0.363372	-7.956236***
LICHID	3.531036*	-0.046886	0.009048
POND_A_IMOB	11.36089	1.779019**	-4.087221**
LNA	-2.391549	-2.309318*	
VIT_ROT_ACR	0.553152	-0.043428	0.650411***
VIT_ROT_CRE	0.322337	-0.016907	
R^2	92.77%	98.42%	89.86%

*-significant for 1%, **- significant for 5%, ***- significant for 10%

Leverage is significant in all 3 regressions that used MBR as dependent variable. In the last two regressions this variable has a positive coefficient, indicating that for the market it is a good sign that a company has the capacity to acquire more debt. Investors trust the company more because being able to use debt as a financing source means that the firm is stable and has a low risk. MBR has also a non-linear relationship with leverage. Cost of debt is significant only in the third regression. The positive coefficient points out that the deductibility of interest expenses helps the company to increase the performance.

The variables that describe the dividend policy are not statistically significant. This is a surprising result as dividend distribution is a way to send a positive signal to the market that increases the share price. The companies in our sample do not focus on dividend distribution so the investors are not particularly interested in this aspect.

Liquidity is significant only in the first regression and the coefficient is positive, indicating that the market values the companies that can easily pay their short term liabilities. Fixed assets ratio is significant in regressions 2 and 3, but the sign is different in both so we cannot say for sure if the effect on MBR is positive or negative.

Firm size is significant only in the second regression and it has a negative impact on performance measured by MBR. Many investors are interested in new and smaller companies, as they have a higher expected growth rate. Large pharmaceutical companies have low expected growth rates and they have to invest a lot of funds for research and development. Current assets turnover and receivables turnover do not have a significant impact on MBR.

Table 4: Regressions using PER as dependent variable

Explanatory variables	Regression 1	Regression 2	Regression 3
LEV	7.302320***	27.65299***	28.22817**
LEV(-1)		-6.494353	-5.063890
LEV^2		-4.183390	-4.346409
RDOB	73.335514	265.2353**	276.6723**
DISTRIB_DIV	1.692337	2.630833	0.806293
DIV_YIELD	-7.976559	-37.42968	
LICHID	-1.162596	0.817277	0.950230
POND_A_IMOB	-59.39748*	-72.25745*	-65.95694*
LNA	-9.575962*	-8.201204*	-8.320102*
VIT_ROT_ACR	-2.403546	-1.591968	
VIT_ROT_CRE	0.412882	.0355151	
R^2	86.34%	88.16%	87.95%

*-significant for 1%, **- significant for 5%, ***- significant for 10%

For financial performance measured by PER leverage has a positive impact, result that supports the statement that firms with debt opportunities are highly valued by the market. Square leverage is not significant, so the relationship between leverage and PER is linear. Cost of debt has a very important effect on performance as the coefficient is positive and has a high value. The benefits of the interest expenses deductibility are pointed out by this result, as well as the fact that debt in normal limits sends a positive signal to the investors.

Dividend distribution rate and dividend yield are not significant in these regressions as well. This result indicates that for our sample the investors are not very interested in dividends and that they have other expectations. Liquidity does not have an impact on PER, so we can say that this variable is related only to financial performance measured by accounting indicators.

Fixed assets ratio has a negative impact on PER an opposite result to the one pointed out in the regressions that used MBR as dependent variable. PER depends on the profit of the firm as well, so if these assets generate losses then PER will have a lower value.

Firm size is negative related to PER, a result that is consistent with the regressions that used the other three measures of performance. Investors value more a smaller company that manages its assets in a more efficient manner than a large company that has great losses ass the assets are not used at their full capacity.

Conclusions and future research

Capital structure is an important aspect for a company's management with great impact on financial performance, although at first it was thought that it did not matter. A company's performance is influenced by many factors and in this paper we tried to identify a part of them. In order to do that we performed an analysis using data panel regressions on 16 pharmaceutical companies for the years between 2001-2013. As dependent variables we used ROA, ROE MBR and PER.

The results have shown that for the financial performance quantified using accounting measures leverage has a negative impact, but for market measures it has a positive impact. This indicates that the ability to acquire debt is seen by the market as a sign of stability and low risk. The relationship between leverage and performance measured by ROA, ROE and MBR is non-linear which means that an optimal capital structure can be found in order to maximize the profitability of a company.

Dividend policy does not affect financial performance for the sample of companies that we used. These companies did not maintain a stable dividend distribution process so the investors were not influenced by this aspect in valuing the company. Investment policy had also a negative effect on performance as the companies did not have a proper asset management. Overinvesting in fixed assets and large stocks caused losses for the company leading to a lower financial performance.

For a future research we would like to extend our sample to multiple industries and to split the period in before and after the financial crisis, to see if this caused changes in the sign of the relationship between performance and its determinants. Due to the lack of data we could not include in our study corporate governance variables. It would be interesting to see how CSR or managers compensation affect firm performance.

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