

## **CAPITAL STRUCTURE, PROFITABILITY & FIRM VALUE LINKAGES: EVIDENCE FROM INDIA**

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### **1. INTRODUCTION**

The capital structure uses the amalgamation of loans and investment capital to promote the organization's goal. The ideal capital structure for the company has been reached when the DER reduces its overall cost of capital. The various propositions of preferred shares, common stock, and debt instruments also express it. Capital Structure is an unsolved issue among academicians and researchers. Since the shareholder's prosperity is the main aim of financial management, the firm value will be maximized whenever the cost of capital is minimum. So, they are inversely related.

There has been a noticeable increase in interest in capital structure discussions since the 1950s, and the concept of determining the ideal balance of equity and debt to reduce capital costs and increase company value has emerged (Zeitun and Tian et al., 2007). It was formerly thought to have a slight impact on an organization's expansion, according to (Modigliani and Miller's et al., 1958, 1963) suggestions. They maintained that a firm's debt issuance had no bearing on its market value under specific circumstances, such as available investment, no insolvency, and no taxation. Instead, they made the implausible claim that a company would be better off with a Capital structure made solely of debt if there were favourable deductible borrowing overheads and corporate tax rates. They felt that if businesses could borrow more money at a suitable low interest rate, they could increase their value. Naturally, if all of their assumptions are valid, the theory will be acceptable. However, the idea of an optimal capital structure only becomes noticeable with the development of trade-off theory, which considers the possessions of monetary difficulties, agency problems, and corporation taxation given the existence of imperfect market circumstances and practices.

There are a few more commonly acknowledged hypotheses regarding the appropriate capital structure of an organisation in addition to the Modigliani and Miller hypothesis. One

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of these is the trade-off method, which holds that while deciding on the capital structure, it's crucial to maintain a correct balance between the potential tax benefits of issuing debt and the potential for increasing financial burden. Another viewpoint, known as the "pecking order theory," asserts that businesses would rather borrow money than issue more shares when they lack the internal resources to finance their investment projects (Myers, et al., 2001).

The free cash flow hypothesis, a third theory, contends that even extremely high levels of debt may raise a company's value if operating cash flows are far higher than the sum required to support its alluring investment ideas. Hence, academics have shown over time that the composition of the capital structure is crucial to the profitability and value of firms, despite the fact that (Modigliani and Miller's et al., 1958) claim has a strong theoretical base and is still widely accepted. Yet, figuring out the ideal debt to equity is a difficult undertaking that differs for every organisation.

The COVID-19 pandemic has resulted in problems with both health and the economy on a global scale (Guedhami et al., 2022). Due to the rush of stock market investors caused by this unexpected incident, the market value began to decline (Meliana et al., 2022). Investors were better able to understand how actual shocks and financial choices affect a company's value due to the industry's response to the COVID-19 pandemic, which highlighted the significance of financial security for firms (Ramelli and Wagner et al., 2020). Several research findings that show how the COVID-19 outbreak adversely affected firms' financial performance (Alsamhi et al., 2022). The COVID-19 pandemic caused a 16.89% decline in investment activity in 2020 compared to 2019. In this case, the company's management places a larger priority on the firm's financial stability, and organisations with excellent managerial capabilities usually restrict investment. Also, more capable managers reduced the amount of short- and long-term obligation required to maintain businesses. Also, in response to the crisis, these managers reduced their cash holdings. (Jebran and Chen et al., 2022). We revealed that industrialised nations particularly India need more research on this industry's capital structure. We examined into how the capital structure, along with its unique characteristics, affected the profitability and firm value in BSE-listed companies.

## **2. LITERATURE REVIEW**

Opoku-Asante (2022) states that corporate performance and capital structure are interdependent. S. Gul and H. R. Cho(2002) show that cost-effectiveness and leverage are negatively correlated. The ROA and ROE are the essential indicators to assess financial position, according to Kurfi (2021). In contrast, the debt ratio, the company's age, and

insider ownership were not statistically proven to have an impact on dividends, according to Bostanci et al. (2018). According to Robert Ouko Obonyo (2017), the DER has a major adverse cause on the financial firms. According to Chadha and Sharma (2015), the firm's financial leverage is substantially connected with its size, age, TA, growth, and Profitability.

Taani (2013) claims that total debt is insignificant in calculating roe in the Jordanian banking industry. Bank performance and Total debt, as indicated by ROCE and NPR is positively and significantly correlated. According to Chen (2004), SMS companies are more likely to conduct R&D activities when their debt is minimum. Profitability represents the amount of profit made from transactions (Tao et al. 2020). Good Profitability is a better sign for investors to empower their money since it suggests that company has promising future forecast (Yondrichs et al. 2021; Handayati et al. 2022).

**Table: 1 Capital Structure and Firm Value**

Authors	Outcome of the research
Sulistya Dewi Wahyuningsih(2023)	The results show that investment decisions are important financial decisions for businesses that can be controlled by proper fund administration and risk management.
JajaSuteja,Ardi Gunardi (2022)	Business value is positively and statistically significantly influenced by the capital structure and profitability. More profits will attract more investors to put their money into the business, driving up stock prices and affecting the company's value.
Sathyamoorthi (2019)	The performance of Malaysian and Botswanan firms and their capital structures, according to the study, are negatively correlated.
Ali and Iman (2011)	The Operating leverage, EPS, Share capital will also rise the firm value.
Anup Chowdhury (2010)	Financial leverage and Tobin's Q are positively correlated, whereas ROA and leverage are negatively correlated.

**Table:2 Capital Structure and Profitability**

Authors	Outcome of the research
Farhan(2020)	Either a low or high DER will lead to higher ROE estimates been recorded. Consequently, increased business profitability will result from an ideal DER structure.
Kyissima (2019)	Size, Investment Opportunities and Profitability have influence on DER, Asset Tang is insignificant to DER.
Das,Swain (2018)	It shows a poor association among the company's capital structure and monetary performance. The dividend payment per share from the preceding year, return on equity, market-to-book ratio, market capitalization, and liquidity on the Turkish stock exchange had favorable effects on dividend payout.
(Herciu, Ogreaan (2017)	The study also suggested that in order to achieve the desired degree of business efficiency, an optimal level of Capital Structure and effective resource utilisation and allocation should be used.
Nasimi (2016)	The short and long term obligations have a poor association and ROA, ROCE, and EPS are used to determine the firm performance.

## 2.1 RESEARCH GAP

The choices made regarding the capital structure of a corporation are among its most important aspects. Due to high debt or an unsuitable capital mix, many firms are in danger

of bankruptcy. It becomes crucial for Indian manufacturing businesses to have a perfect foundation in a developing economy like India. For Better financial decisions, the association among financial leverage and their performance is necessary. According to the available research, numerous studies on capital structure and firm value have been carried out in numerous nations and sectors. In most of previous researchers have included GPR and NPR were used to examine the profitability. The Present study have taken ROE, ROA, EPS, PER and PBR to estimate profitability. Thus, the current study's goal is to bridge up knowledge gap.

## **2.2 RESEARCH OBJECTIVE**

To examine the impact of Capital structure on Firm value and Profitability.

## **2.3 RESEARCH HYPOTHESIS**

H<sub>01</sub>: There is no significant impact of Capital Structure on Profitability.

H<sub>02</sub>: There is no significant effect of Capital Structure on Firm Value

## **3. RESEARCH METHODOLOGY**

### **3.1 SAMPLE**

The purpose of study, which focuses on Indian stock market, is to enhance capital structure, a key element of corporate financial management. This study examines how capital structure affects business value and profitability. The top 50 BSE-listed firms were chosen for this study based on their market capitalization for ten years from 2013 to 2022. The study's sample and the research period were chosen based on the data's availability. Panel data analysis benefits from firm heterogeneity, degree of freedom, reduced colinearity, higher variability, and improved effectiveness.

### **3.2 VARIABLE DESCRIPTION**

Independent Variable:

Debt Equity Ratio = Total Debt/ Total equity (Ahmed.F et al.,2018, Weygandt et al., 2012,IM Pandey,2019).

**Dependent Variables:**

1. Return on Equity = Net Income / Total Equity (Ketuldip Singh Chhikara et al.,2022; Chadha and Sharma et al.,2015, Bansal and Singh et al., 2016, Rastogi and Saxena et al., 2016.
2. Return on Asset = Net Income/Total Asset (Bauwhede et al., 2009)
3. Earnings Per Share = Profit after tax/No.of.Shares (I.M.Pandey 2019, Sofiyan et al., 2022)

4. Price Earning Ratio = Market value of share/Earnings Per Share (I.M.Pandey 2019, Dr. Pankaj Kumar et al., 2017)
5. Price to Book Ratio = Market value of share/Book value of share. (I.M.Pandey 2019, Julia Safitri et al., 2021)
6. Tobin's Q = Market value of assets/Replacement cost of assets. (Chadha and Sharma et al., 2016, IM Pandey 2019)

**3.3 PANEL DATA REGRESSION MODEL**

The model framed for Panel Data Regression is given below:

$$Y_{it} = \alpha + \beta X_{it} + \epsilon_{it}$$

Hence, Y is the Dependent Variable, the indices i and t shows individuals and time,  $\alpha$  and  $\beta$  are coefficients, X means Independent Variable and  $\epsilon_{it}$  is the error term

**Table 3: Panel Data Regression Models**

S.No	Model
1	$ROE_{it} = \alpha + \beta DER_{it} + \epsilon_{it}$
2	$ROA_{it} = \alpha + \beta DER_{it} + \epsilon_{it}$
3	$EPS_{it} = \alpha + \beta DER_{it} + \epsilon_{it}$
4	$PBR_{it} = \alpha + \beta DER_{it} + \epsilon_{it}$
5	$PBR_{it} = \alpha + \beta DER_{it} + \epsilon_{it}$
6	$TQ_{it} = \alpha + \beta DER_{it} + \epsilon_{it}$

Panel data analysis is more efficient since the predictor variables and degrees of freedom are less correlated. Panel data analysis minimises the interaction between the variables to provide more trustworthy parameters (Hsiao et al., 1999). Hence, the analysis uses data that include both a cross sectional series and a time series. In the study, panel data with both fixed effect and random effect are used. Applying the Hausman test enabled for the selection of the superior model (Dharmendra, Singh et al., 2016).

**4. ANALYSIS & INTERPRETATION**

**Table:4 Descriptive Statistics**

Variables	Mean	Std Dev	Variance	Skewness	Kurtosis
DER	1.364	1.645	2.707	1.304	1.455
ROE	1.487	2.732	7.469	7.279	69.387
ROA	3.259	4.827	23.308	1.448	0.601
EPS	5.311	203.41	4.138	5.579	30.539
PER	1.585	10.038	100.77	9.672	92.588
PBR	8.079	14.689	215.78	1.881	2.010
Tobin's Q	3.948	1.186	1.408	3.230	10.135

Source: Computed Data

According to Table 4, the average DER is 1.364, and the standard deviation of 1.645. It reveals that the business is making better use of its assets, increasing shareholder equity, and using less of the economy for borrowing. The mean value of ROE,ROA, EPS,PER and PBR is less than the Standard deviation, So they are closely associated. It suggests that the business is effective in generating income. The EPS has a mean of 5.311 with a std dev of 203.41. It shows that the reliability in earnings. The PBR has a mean of 8.079 and variance 215.78, which means that the concern has good returns throughout the study period.

**Table:5 Correlation Analysis**

	DER	ROE	ROA	EPS	PER	PBR	TQ
DER	1	0.032	-0.030	-0.145**	-0.013	-0.377**	0.153**
ROE	0.032	1	0.103*	-0.018	-0.032	-0.070	-0.012
ROA	-0.030	0.103*	1	0.005	-0.078	-0.025	-0.201**
EPS	-0.145**	-0.018	0.005	1	-0.001	-0.027	-0.017
PER	-0.013	-0.032	-0.078	-0.001	1	-0.066	-0.043
PBR	-0.377**	-0.070	-0.025	-0.027	-0.066	1	-0.080
TQ	0.153**	-0.012	-0.201**	-0.017	-0.043	-0.080	1

\* 0.05 significant level, \*\* 0.01 significant level

Source: Computed Data

The table 5 shows that, DER is negatively correlated with EPS (-0.145) and PBR (-0.377) at significant 1% level. It shows that a rise in debt may decrease the ROE and ROA. The DER is positively among TQ (0.153) at 1% level of significance. It reveals that a rise in debt value may increase the firm value. Hence,  $H_{01}$  null hypothesis is rejected and alternative hypothesis, There is an impact of capital structure on profitability is accepted.  $H_{02}$  null hypothesis is disproved, and the alternative view, the Capital structure has an impact on Firm Value, is accepted. ROE, ROA and PER are not closely associated with DER during the study period.

**Table:6 Unit Root Test**

Variables	T-Stat	Prob
DER	-23.06*	0.00
ROE	-12.09*	0.00
ROA	-57.17*	0.00
EPS	-616.76*	0.00
PER	-3.35*	0.00
PBR	-236.81*	0.00
TQ	-110.591*	0.00

Source: Computed Data

\*Significant at 1% level

The Table 6 demonstrates "Levin-Lin-Chu Unit Root Test" the importance of taking panel data stationarity and integration order into consideration in order to reduce multicollinearity issues (Lta and Demirgune et al., 2020). Following (Khan et al., (2021) we apply to test whether our data series are stationary at a level. A standard strategy was tested by (Levin et al. in 2002). Table 3 reports the outcomes of these examinations. The select variables are stationary. All the variables Adj t-statistics are at 1% level of significance. This shows that at level I, all variables are stationary (0).

**Table:7 Capital Structure with ROE, ROA, EPS, PER, PBR and Tobin's Q**

Dependent Variable	Independent Variable	Beta Value	P Value			Model
ROE	C	1.696	(0.004)	R.Sq	0.000	Pooled OLS Model
	DER	-0.081	(0.7681)	Adj R Sq	-0.001	
	Wald (Chi-Sq)	57.71		F-Statistic	0.087	
	Prob	0.000		P value	0.768	
ROA	C	77.490	(0.000)	R.Sq	0.020	Random Effect Model
	DER	-17.86	(0.001)	Adj R Sq	0.018	
	BP Test Prob	C-11.067 (0.000)		F-Statistic	10.407	
		T-8.870 (0.002)		P value	0.001	
		H Test		Chi Sq	1.513	
	Wald (Chi-Sq)	37.73 0.00		P Value	0.218	
EPS	C	1.459	(0.000)	R.Sq	0.000	Pooled OLS Model
	DER	0.020	(0.761)	Adj R Sq	-0.000	
	Wald (Chi-Sq)	23.15		F-Statistic	0.092	
	Prob	0.00		P value	0.761	
PER	C	62.989	(0.000)	R.Sq	0.000	Pooled OLS Model
	DER	-0.000	(0.502)	Adj R Sq	-0.000	
	Wald (Chi-Sq)	15.70		F-Statistic	0.451	
	Prob	0.67		P value	0.502	
PBR	C	12.20	(0.00)	R.Sq	0.141	Random Effect Model
	DER	-3.023	(0.00)	Adj R Sq	0.142	
	BP Test Prob	C-295.92 (0.000)		F-Statistic	82.21	
		T-2.218 (0.136)		P value	0.000	
		H Test		Chi Sq	1.115	
	Wald (Chi-Sq)	(253.07) (0.000)		P Value	0.290	
TQ	C	2.66	(0.045)	R.Sq	0.027	Random Effect Model
	DER	9.46	(0.000)	Adj R Sq	0.025	
	BP Test Prob	C-584.63 (0.000)		F-Statistic	13.895	
		T-2.096 (0.1477)		P value	0.000	
		H Test		Chi Sq	0.203	
	Wald (Chi-Sq)	53.72 0.00		P Value	0.651	

Source: Computed Data

Sample: 2013-2022

ROA = 77.490-17.86DER

PBR = 12.20-3.023DER

TQ = 2.66+9.46 DER

The table 7 indicate that the ROA have a negative impact on DER. The Breusch - Pagan test shows that the cross section and Time series both are significant. The Hausman test is applied which reveals that the Chi sq value 1.513 with P value of 0.218. So, the Random Effect Model is applied. The R- Sq value of 0.020 and the F statistic value of 10.407. Hence, "H01 null hypothesis is rejected and alternative hypothesis, There is an impact of capital structure on profitability is accepted". The PBR have a negative impact on DER. The cross section and time series were insignificant from the Breusch- Pagan Test. The Hausman test which reveals that the chi-sq value 1.115 with p value (0.290) which is insignificant, the Random Effect Model is accepted. The R- Sq value of 0.141 and the F statistic value of 82.21. Hence, "H01 null hypothesis is rejected and alternative hypothesis, There is an impact of capital structure on profitability is accepted". The ROE, EPS and PER is not associated with DER at 1% or 5% level of significance, So Pooled OLS Model has been applied.

The TQ have an optimistic influence on DER. Breusch - Pagan Test shows that cross section and time series are insignificant. By the Hausman test it clear that the chi-sq value 0.203 with p value (0.651) which is insignificant, the Random Effect Model is applied. The R- Sq value of 0.027 and the F statistic value of 13.895. Therefore, "H02 null hypothesis is disproved, and the alternative view, the Capital structure has an impact on Firm Value, is accepted". The wald test exhibits that there is an association among the ROA, ROE, EPS, PBR, PBR, TQ with DER.

## **5. FINDINGS AND SUGGESTION**

The capital structure significantly influences the monetary success of BSE-listed companies. The study found that ROA is negatively affected by DER (Debt Equity Ratio). Owing to the overall amount of debt, the debt-to-equity ratio and profitability are inversely related, with a rise in debt position being associated with a decline in profitability. According to (Modigliani and Miller's et al., 1963) updated theory, enterprises can obtain better financing arrangements and maximise shareholder returns by using the tax-shielding and leveraging effects of debt. Both (Vatavu et al., 2015) and (Houshang Habibniya et al., 2022) reported similar findings Businesses commonly choose to issue additional shares or use debt when seeking funding from outside sources, which increases their cost of capital (Tan et al., 2020).



The Tobin's Q has an optimistic effect on DER. This implies that companies can boost shareholder value by having higher debt-to-capital ratios. It implies that debt is frequently more affordable than equity. As a result, as debt levels increase, stockholders' returns also increase, increasing the company's value. High profitability makes the unfavorable effects of poor investment choices on firm value more pronounced because it is possible that these activities will boost the company's return. A good capital structure, as well as efficient resource utilisation and allocation, should be employed, according to the study, in order to attain the necessary level of business efficiency (Nasimi et al., 2016).

The PBR have negative impact on DER. It shows that Companies that heavily rely on assets to produce profit have a greater advantage when using debt than companies that typically depend on equity or shareholder funds (Dr. N Suresh et al.,2020).The maximization of shareholder value is one of the main objectives of company management, thus it makes sense to study the connection between debt levels and shareholder wealth as the final and most significant factor in the investigation of debt levels and business success. However, if adjustment costs are involved, it can be more cost-effective for enterprises to reduce their debt drastically. When debt can be paid off, the interests of managers and shareholders can coincide. It could take longer if a company has to pay more debt to attain the necessary level, primarily if it produces greater free cash flow. Additionally, it can take longer if the company wants to maintain its debt capacity.

## **6. CONCLUSION**

A crucial aspect of the financially healthy company's survival is that the company must have enough liquidity while it is consistently profitable and must focus on boosting its fortune and producing more wealth. For a business to be successful, the administration of finances must be done effectively. In this study, the profitability ratios, is used to evaluate the performance of the chosen enterprises. It has a significant role in the company's effective strategic exercise. It is important to make ongoing attempts to boost performance because this will increase efficiency and boost investor satisfaction. The study found that a company's capital structure significantly increases its company value, larger the profit the more capital will be invested by investors, driving up stock prices and affecting the company's value.

## **7. LIMITATIONS & SUGGESTIONS FOR FUTURE RESEARCHERS.**

The study sample focuses on the BSE-listed companies in India from 2013-2022. The future researchers and academicians can include NSE-listed companies with all non-financial listed sectors. The determinants and effects of capital structure can be done with different countries.

## **8. CONFLICT OF INTEREST STATEMENT**

The authors declare that they have no known competing financial interest or personal relationship that could have appeared to influence the work reported in this paper. There was no external fund received for the study. There is no conflict of interest.

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