Capital Structure Policies in Pakistan: Survey Evidence

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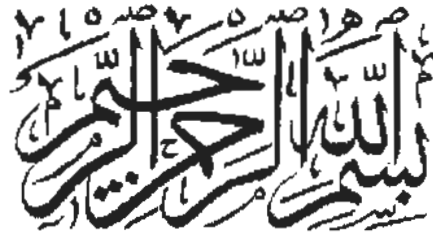## INTERNATIONAL ISLAMIC UNIVERSITY, ISLAMABAD

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A thesis submitted in partial fulfillment of the requirements for the Degree of Master of
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In the name of Allah, the most merciful and beneficent

DEDICATION

I dedicate this thesis to my parents, husband and my supervisor whose

support has enabled me

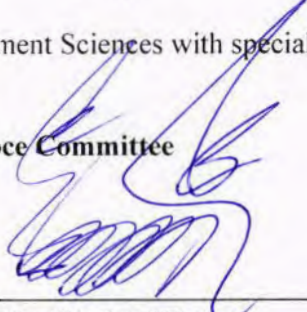to complete this research study successfully.

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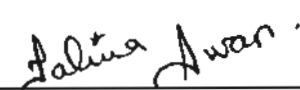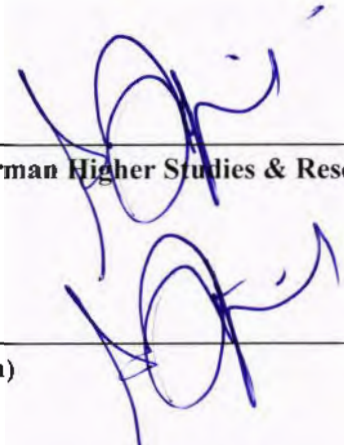
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ABSTRACT

This study aimed to apply the survey instrument of Brounen et al., (2006) on Pakistani public and private companies to assess their capital structure choices and application of the theories. Low levered firms prefer to use internal funds available to pursue their new projects on the other hand high levered firms use more debt financing to finance their projects. High levered firms are significantly different from low levered firms for the factors affecting the choice of debt. High levered firms are less significantly different from low levered firms for the factors affecting firm's debt policy. High levered firms are significantly different from low levered firms in the choice of short term and long term debt. Results of the study showed mixed evidences that Pakistani companies use pecking order theory and static trade off theory.

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DECLARATION

I hereby declare that this thesis, neither as a whole nor as a part thereof, has been copied out from any source. It is further declared that I have prepared this thesis entirely on the basis of my personal effort made under the sincere guidance of my supervisor and colleagues. No portion of work, presented in this thesis has been submitted in support of any application for any degree or qualification of this or any other university or institute of learning.

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APPRECIATION AND GRATITUDE

No words of gratitude will ever be sufficient for the Allah Almighty who made me capable of learning, blessed me with the knowledge & intellect and facilitated me with the finest of the mentors all through my academic years.

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And finally, to my parents, most wonderful parents of the world who grew me up to never frantically fall upon a yearning other than knowledge and my truly adorable sister and brothers, and my husband for high moral support.

Ms. Humaira Kousar

FORWARDING SHEET

The thesis entitled "Capital Structure Polices in Pakistan: Survey Evidence" submitted by

<u>Ms. Humaira Kousar</u> partial fulfillment of M.S degree in Management Sciences with

specialization in Finance, has completed under my guidance and supervision. I am

satisfied with the quality of student's research work and allow her to submit this thesis

for further process as per IIU rules & regulations.

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TABLE OF CONTENTS

LIST OF FIGURE

LIST OF TABLES

LIST OF ABBREVIATIONS

POT   Pecking Order Theory

ROA   Return on Investment

NPV   Net Present Value

CAPM   Capital Asset Pricing Model

EPS   Earnings Per Share

GDP   Gross Domestic Product

CFO   Chief Financial Officer

CHAPTER # 1

1.1 INTRODUCTION

Capital structure is the most important decision made by the management of a firm. Management has different choices i.e external financing (debt and equity) and internal financing (retained earnings and existing equity). Financing is the process of investing money in short term and long term assets. Company can arrange funds for investment from different sources. Sources of funds can be external or internal; external sources include debt and newly issued shares. In case of debt financing a firm have different options available, either firm can take cash loan from any financial institutions or firm can issue debt securities i.e bonds, debentures etc. Equity financing can be used by issuing new shares (common shares) and a firm can use its internally generated funds called retained earnings. Retained earnings are the portion of the profit which company has to retain for the future investments. Firm have the option to issue preferred shares for raising capital. Sometimes companies can issue hybrid securities which contain the characteristics of both securities. Capital structure is the combination of these financing sources. These financing sources can be categorized on the basis of time period i.e. short maturities and long maturities depending upon the maturity time period of investments. Debt financing generate value for the principles (shareholders) in the firms which facing extreme agency costs. Debt financing will decrease company's value where management's group control rights are separate from the investment providers. Firms with overinvestment problem have this advantage of debt financing. (Harvey, Lins, & Roper, 2004)

Capital structure researches have a very long history, which started with the work of Lintner (1956), Hirshleifer (1958)and Modigliani & Miller (1958). Modigliani &

2

Miller (1958) prove that under some assumptions in perfect financial market, company's value is irrelevant of its financing choices. Modigliani –Miller theorem assumed that investors in perfect capital markets have zero transaction cost, symmetric information, debt and equity choices become irrelevant and internally generated funds can be replaced by external funds. Later on these assumptions came under different capital structure theories. Three main capital structure theories came up subsequently are the pecking order theory, trade-off theory, and the agency cost theory. In trade-off theory a corporation set a debt to equity ratio and slowly moving in this direction (Myers, 1984). This theory also assumes that optimal capital structure can exists in some form and it can maximize the firm's value while at the same time minimizing outside claims to the cash flow stream. These outside claims comprise of agency cost, bankruptcy costs between bondholders, shareholders and taxes. Company's target debt ratio is the tradeoff between tax shield benefit and bankruptcy cost. Bankruptcy cost has not received much consideration; very limited research work has been done on the relevance of bankruptcy with the combination of the two sources equity and debt. With increase in the risk of bankruptcy will increase the cost of the following factors such as interest cost, lost credit, lost sales and inefficient operations(Indirect cost of bankruptcy) (Hill & Stone, 1980). Baxter (1967) describes the direct cost of bankruptcy that firm have to bear under the head of administrative expenses. (legal fee, referee's fee, trustee's fee) . Kwansa & Cho (1995) indirect cost of financial distress is significant so it's beneficial for the firm to target an optimal capital structure. That will make an appropriate balance between the tax saving and indirect cost of financial distress. Stiglitz (1969) stated the firm behavior is strongly affected by the possibility of the bankruptcy. In the result firm have to take decisions of merger and takeovers.

3

Dincergok & Yalciner (2011) investigated the factors that can have impact on the capital structure decisions in four emerging countries (Turkey, Brazil, Argentina, and Indonesia). Awan & Amin, (2014), Awan et al. (2011), Bas et al. (2009), Qureshi (2009), de Jong, Kabir, & Nguyen, (2008) , Shah, Hijazi, & Javed, (2004), Shah and Khan (2007), Hijazi and Tariq (2006), Baur (2004), Frydenberg (2004), Benito (2003) and a lot of other researchers investigated the determinant of capital structure. Titman & Wessels (1988) , Shyam-Sunder & C. Myers (1999), Rajan & Zingales, (1995), Benito (2003), Brounen, Jong, & Koedijk (2006), Ghosh & Cai (2011), Bessler, Drobetz, & Gruninger (2010), Antoniou et al. (2002), (Chen, 2004), González & González (2012) worked on pecking order theory in developed countries. Um (2001), Chen (2004), Ilyas (2008), Qureshi (2009) , Sheikh et al. (2012), Booth et al. (2001), Javed & Imad (2012) worked on POT in developing countries.

This research investigated the practical implications of the capital structure theories in Pakistani firms. This study applied the survey instrument of Brounen et al., (2006) on Pakistani public and private companies to assess their capital structure choices and application of the theories. Brounen et al., (2006) provided empirical analysis on capital structure theories in four countries (Netherland, United Kingdom, Germany and France) by taking a sample of 313 CFO's. They included both public and private firms of the four countries. They found presence of pecking order theory but that is not in result of information asymmetry. Private companies are different in many aspects from public listed companies. Agency problem is not significantly important. This study assessed their conclusions either they are valid in Pakistani scenario or not.

4

Ilyas (2008), Shah and Khan (2007), Rafiq et al. (2008), Qureshi (2009), Javed & Imad, (2012), and Qayyum (2013) studied the determining factors of capital structure in different Pakistani industries by using secondary data. Raqeeb & Zaidi (2012) examined the impact of credit rating on capital structure in nonfinancial firms. Earlier studies done in Pakistan were on the capital structure determinants in different industries by using secondary data. There is a need to analyze capital structure of the firms by using primary data so, that practically we can see how Pakistani firms apply theoretical concepts.

1.2 OBJECTIVES OF THE STUDY

    a. To evaluate application of theoretical concepts by the corporate professionals in Pakistan

    b. To explore the determinants of capital structure by using primary data

    c. To make comparison based on leverage and debt ratios of firms

1.3 SIGNIFICANCE OF THE STUDY

Capital structure decisions are very important and significant for any firm. This study will investigate the capital structure policies in Pakistan by using primary data. Previous studies investigated the capital structure polices and theories in Pakistan by using secondary data. This research adds a lot to the literature as this is the first primary data based study of the capital structure in Pakistan.

The study provided an insight into how financial managers make their capital structure decisions, whether they make conscious capital structure decisions following specific theory or these decisions are impulsive. The results of the study are useful for managers in devising capital structure policies in a better way. On the other hand, the

5

findings are helpful for shareholders as they get to know about the capital structure decisions being made by the firms.

1.4 PROBLEM STATEMENT

There is a need to analyze capital structure of the firms by using primary data so, that practically we can see how Pakistani firms apply theoretical concepts, how high levered firms are different from low levered firms? What is the difference between the firms having target debt ratio and the firms totally relying on equity financing? To fill the gap in the literature, this study investigates the application of capital structure theories and the factors affecting the capital structure choices based upon primary data.

CHAPTER # 2

2.1 LITERATURE REVIEW

Modigliani & Miller (1958) investigated the link in the market value and capital structure of the firm. According to their research, a firm using financial leverage and a firm without financial leverage they have the same market value. Capital structure is irrelevant to the worth of the corporations in without taxes economies. Under some assumptions, firm with financial leverage and a firm without financial leverage had equal firm's market value. Then they involved taxes in their model and found that if firm use hundred percent debt, profits and firm's market value will be maximum. Main assumptions of their model were

"Business risk can be fairly assessed by the standard deviation of operating income (EBIT) and that all present and future potential investors share similar expectations about corporate earnings and the chances of variation in those earnings. Another key assumption was they assumed the companies' stocks and bonds were traded in a perfect market. Yet another important assumption was that rate of interest on debt was a risk-free rate for firms as well as individuals. Their model with corporate taxes showed that debt brings benefits due to availability of tax shield due to interest being treated as a tax deductible expense."

Brounen et al., (2006) investigated the corporate finance practices in firms from four countries (UK, Netherland, Germany, France). Capital structure determinants in each of the four countries and effect of public listing were also discussed in the study. They

found presence of pecking order theory but that is not in result of information asymmetry. Private companies are different in many aspects from public listed companies. Agency problem is not significantly important. These four countries moderately supported trade off theory. The findings are compared with the study of Bancel & Mittoo (2004) with 87 firms from 16 different countries. Study showed a Strong evidence in US for the target debt ratio and for the taxes. Tax actions are very significant for the firms under study. To determine the accurate amount of corporate debt, financial flexibility is significant. Findings showed that strong need for financing flexibility is not due to POT. Research findings proved that for capital structure choices, German and France firms are less apprehensive regarding valuing in capital markets. Publically listed companies more concerned about the timing of issuing new instruments. Leverage is vital for the public companies to become unappealing for the takeover target. Private firms do not consider these factors important in their option for capital structure. Lastly, as compare to private companies, registered companies are additional tending to indicate their projection to markets via increasing leverage level. Financial markets have some impact on the capital structure choices. Results are unexpected as compare to the findings of Bancel and Mittoo concluded that agency problem and signaling are the key features in capital structure choices.

Baskin (1989) analyzed the pecking order behavior empirically of 378 firms from the year 1960-1972. Research findings in this study and in the earlier studies showed that leverage change positively with past growth and negatively with the past profits. Findings also showed that companies who paid higher dividends previously, they take more loans.

According to Pecking order theory firms borrow because they need funds. If capital raised through issuing stocks is restricted due to asymmetric information, then leverage is the major source of funding. Findings showed that financial instruments whose value is driven by publically unknown future prospects are facing more problems due to asymmetric information.

Benito (2003) discussed the capital structure determination of the firms in UK and Spain, and how do they use trade off and POT in their decisions? Under trade off theory firms set their leverage levels at a point where marginal benefits of the leverage exactly offset the marginal cost of leverage. These things are not important in context of POT. Agents have more information than the outside investors; this is the main concern when raising capital. Companies strictly ranked their sources of financing: internal funds and external funds "debt and equity". Findings of the study supported the POT, debt ratios are anticipated to be considerably negatively related to the cash flow and profitability of the company and changes positively with its investment. POT states corporations rarely go for external financing if they earn high profits. Benito also analyzed various features of the two different financial systems (bank based and market based). On the basis of the findings Spanish financial system has been classified as bank based financial system and UK has been classified as market based financial system. Findings of the study show that bank can keep an eye on firms and surmount asymmetric information in a better way. Pecking order theory might have less role in the bank based financial system.

Qureshi (2009) analyzed the Pakistani manufacturing companies how they are using debt as their source of financing. Tong & Green (2005) model is used to analyze the pecking order theory in isolation by using time series data.

Ghosh & Cai (2011) analyzed capital structure of the firms either they are following an optimal capital structure or pecking order theory by using Compustat data-set from 1983-2003. Research result showed that companies will change their capital structure to the industry average if it is above the average. If it is below the average companies are unconcerned to the debt level. To make this concept easy they have developed a notion of the optimal capital structure range which a typically U.S firm will be unconcerned to its leverage level. Findings of the study showed that companies can use pecking order theory and optimal capital structure at the same time. When a company uses high leverage level in their financing, cost of using leverage will be very high to cut this cost company will use less debt. This is the reason for the company to adjust their leverage levels down.

Seifert & Gonenc (2010) investigated the pecking order theory in 23 emerging market countries with two main considerations of asymmetric information and agency cost. The study investigated that whether pecking order theory is pertinent in the emerging market countries or not. Findings of the study showed that pecking order hypothesis is not pertinent to all emerging market companies. Companies in these countries usually use more equity financing to finance their deficits than debt. Regression analysis showed that equity serves firms' deficit better than debt. Countries, which have

more asymmetric information issues and agency cost problems, they follow pecking order behaviors. Environmental considerations are also an important factor in companies' financial decisions.

Chen (2004) Chinese firms are significantly different from the firms in the advanced economies, they prefer short term financing as an alternative of long term financing. Companies prefer to use retained profit, then shareholder's equity and as a last resort debt financing.

(Bevan & Danbolt, 2000) Large amount of long maturity and short maturity debt is used by the companies with high growth prospects. Large companies mostly use long maturity loan and small corporations' use short maturity financing. Evidence showed that firms with high earnings use more amount of debt. Collateral requirements have increased by the bank; the reason can be, when large scale companies started using equity financing then banks moved their long term debts to small firms and to secure these loans they required high valued collaterals.

Dincergok & Yalciner (2011) investigated the factors that can have some impact on the capital structure decisions in four emerging countries (Turkey, Brazil, Argentina, and Indonesia) tangibility have positive effect on the long maturity debt and profitability have negative effect on the long maturity debt in all the countries under study. Interest rate and real GDP also have inverse relation with the financial leverage of the firm and stock market development and public sector debt have positive relation with the financial leverage.

12

Shah & Khan (2007) investigated the effect of seven variables on debt ratio of companies. Textile industry showed higher leverage with negative profitability. Negative profitability in textile is due the manipulation of figures to avoid taxes. Tangibility variable confirms the tradeoff theory but the others (earning volatility and depreciation) do not. Growth variable approve the agency theory hypothesis while profitability confirms the pecking order theory size variable do not confirm both the theories. Asymmetric information problem does not have considerable impact on the leverage. Growth variable approves the agency cost hypothesis. Earning volatility does not show any impact on leverage.

de Jong et al. (2008) investigated different country specific factors that can determine capital structure. Tangibility, size, risk, growth and profitability have considerable impact on the capital structure theories and consistent with the traditional capital structure theories.

Bauer (2004) studied the determinants of the capital structure in Czech Republic during 2000 to 2001. Leverage in terms of market value is higher as compared to in term of book value. Leverage ratio is moving in the same direction as the taxes and size but have negative impact on non-leverage tax shield, profitability, and tangibility. Market value of debt ratio has inverse relationship with growth opportunities. (Udomsirikul, Jumreornvong, & Jiraporn, 2011) analyzed the liquidity on capital structure decisions. Higher liquidity decreases the cost of equity, and then equity becomes more attractive than debt.

13

Strebulaev (2007) developed a model for the qualitative and quantitative prophecy of capital structure concepts in vibrant economy with sporadic adjustment. Important results of the study are

"(1) the properties of leverage in the cross section in true dynamics and in comparative statics at refinancing points differ dramatically, and (2) the model gives rise to data that are consistent with a number of empirical results and that, using methodologies commonly employed in the literature, may lead to rejection of the model."

Bancel & Mittoo (2004) surveyed the sixteen European countries on their capital structure choices and their determinants. Results of the survey showed that managers, while formulating the debt policies have to consider tax advantage of the debt, financial flexibility, and credit rating. For equity financing earning per share dilution is very important. Interest rates and price per share are main considerations while managers want to raise capital by using these two sources of financing. Findings of their study showed that legal environment is one of the significant features in the capital structure choices of the firms.

Frydenberg (2004) analyzed capital structure of Norwegian non listed firms. Maturity structure of debt is significantly affected by the factors like size, asset composition, return on investment and instability. Fixed assets shown economic significance while measured their elasticity with the debt. Firms use debt on priority basis when it is required to use external financing.

14

Capital structure decisions are different in public sector and private sector because of their governance structure. Public sector companies have more options of financing available as compare to the private sector. (Qureshi & Azid, 2006)

Graham & Harvey (2001) conducted a survey about cost of capital, capital budgeting and capital structure choices of the firms in US. There is a significant difference between the small and large firms about the capital budgeting practices. Small firms less likely to use NPV and CAPM. Their findings also showed that credit ratings and financial flexibility are the imperative factors in determining the debt policy. Equity issuance is affected by EPS dilution, stock price appreciation and equity undervaluation. Their study showed reasonable support that firms use target debt ratio and trade off theory. Their study showed a little support that signaling, bargaining with employees, transaction costs, free cash flow concerns, underinvestment, , and product market concerns have impact on capital structure choices.

Cheema et al. (2003) provided an overview of the ownership structure and state of the financial markets and summarized the corporate growth history of the country. They investigated the prominent features of the ownership structure of top 40 listed Pakistani companies. Country's majority of the companies are family controlled business groups, public companies, and affiliates of multinational companies (Cheema et al., 2003; Javid & Iqbal, 2008, Javid & Iqbal, 2010). Underdevelopment of the financial markets and concentration of ownership drives the firms to rely on retained earnings and informal sector borrowing (Javid & Iqbal, 2007).

15

Raqeeb & Zaidi (2012) examined the effect of credit rating on the capital structure decisions in Pakistani firms. Findings showed that credit ratings have greater impact on the capital structure of the corporations. Firms depend fewer on debt financing if they have higher credit ratings along with other factors (fixed to total asset ratio, ROA and size). Firms with good credit ratings have good market repute so they avoid more debts in capital structure to save them from any adverse situations.

Ooi (1999) analyzed the key factors which can affect the capital structure choices of the property companies in the UK. Findings showed that the property companies in UK heavily rely on external financing to support their investment activities. Financial risk is also vital consideration in capital structure decisions. Findings also showed that the corporate performance and tax burden do not have any significant influence on the debt equity choices of the companies. Corporate property managers also consider the prevailing market sentiments and borrowing cost when making capital structure decisions. Hatfield, Cheng, & Davidson, (1994) this study tested the DeAngelo & Masulis, (1980) theory that a firm would seek an "optimum debt level" and that a change in debt level can increase or decrease the firm value. But findings of the research do not support the arguments. Research results showed the relationship between debt level and firm value does not seem to be of concern to the market. Market does not consider industry average for leverage as discriminators for the firms' financial leverage.

Frank & Goyal (2003) investigated the leverage decisions of the U.S firms. Firm leverage will increase by the presence of firm size and collateral. Literature supports that

highly risky companies and companies having high market to book ratio have low debt financing. Findings of study showed that leverage and net operational loss carry forwards are inversely linked as projected by tradeoff theory. Findings also suggest that companies not paying dividend have higher debt as compare to companies paying dividends. Due to increase in leverage interest rate are high. They discussed the three forms of tradeoff theory; agency costs and stakeholder combined investment tax affects, taxes versus bankruptcy cost, are preferred.

Amidu (2007) investigated the determining factor of capital structure in Ghanaian banks. Banks in Ghana have relatively high short maturity debt financing and banks' leverage is inversely linked with operating investments. Operating investments and long maturity loans are positively related as found in this study. Short maturity loans of banks is positively related to bank size, growth and corporate tax and negatively linked to the profitability, risk and asset structure. On the other side bank's asset structure and profitability are positively linked to long maturity loans and bank's size, growth, risk and corporate tax are negatively linked to the long term debt. Finding of the study showed that except risk, in all the variable, short maturity loans and leverage seem to be positively related. Capital structure of the banks' is affected by banks' profitability, growth, size, corporate tax, and asset structure.

Eriotis, Vasiliou, & Neokosmidi (2007) investigated that leverage percentage of company is moving in the same direction as size which is measured by the sale figure. Liquidity of company is inversely linked to its debt ratio. Capital structure of the firm and

17

interest coverage ratio are inversely associated. Firms with high growth potential service low leverage in capital structure because it is inversely linked with growth. High growth means high variations in the earnings which lead to high risk. It is difficult to raise debt for high risky firm. Findings suggest that there is a capital structure differences among the firms which heavily use debt financing and those that use less debt financing. Homaifar, Zietz, & Benkato (1994) discussed that larger companies hold high level of debts as compare to smaller companies, because they have high debt capacity. Frank & Goyal (2003) also supported this study but from a different perspective that large firms increase debt to make their dividend payments. On the other hand small firms reduce debt for the payment of dividends. (Hovakimian, Hovakimian, & Tehranian, 2004) Firms with High market to book ratio have little target leverage ratio and good growth opportunities. Prospects of equity issue and of debt issue will decline with the market to book ratio. High share returns are linked to equity issue not with the debt issue. Hovakimian suggest that profitability has no impact on target debt ratio. (Barclay & Smith, 1995) suggested a strong relationship between loan maturity and company size. Large firm rely heavily on long maturity loans as compare to small firms which rely heavily on short maturity loans.

(Shyam-Sunder & C. Myers, 1999) tested old capital structure theories as substitute of POT on 157 companies from 1971 to 1989. They found that the POT , which envisages leverage determined by insufficient retained financing , has larger time series illustrative influence than a trade-off theory, which envisages that every company move step by step towards an optimum leverage ratio. They showed that the investigations used in this study have the power to accept substitute theories instead of POT. Chirinko &

18

Singha (2000) commented on a new model of POT introduced by Shyam-Sunder & C. Myers, (1999). Their results coupled with the power problem with static trade off model documented by Shyam-Sunder and Myers; pointed out that the realistic evidence can assess neither POT nor trade off theory. To discriminate among competing hypotheses and to explore the capital structure determinants there is a need of alternative tests.

Bessler et al., (2010) conducted a test of the POT on 6000 international companies during the time period of 1995 to 2005. Findings of the study showed that financing deficit and net equity issues are highly correlated. They have tested the main supposition of the POT that information asymmetry is a vital cause of the capital structure decisions. Firms with low information asymmetry issue large volumes of equity.

Shyam-Sunder and Myers (1994) reported more reliance in the POT as compare to trade off model. Frank & Goyal, (2003) extended the literature by testing the POT of on extensive cross-section of US publicly registered companies over the time period of 1971 to 1998. Findings showed that net equity issues find the shortage of capital more carefully as compare to issued loans which is opposing to POT. While large corporations show some facets of pecking order behavior, evidence is not strong to the presence of typical leverage features. For small and large firms, net debt issues are less significantly explained by the financing deficit.

(Panday, 2001) The paper examined the factors of capital structure determination of the Malaysian firms by using data from 1984 to 1999. Book value and market value

19

ratios are calculated by using short maturity, long maturity and total loans. The results of OLS regression showed that firm size has a significant positive association with all types of debt ratios and profitability has a negative relationship with the profitability. Earning volatility and short maturity leverage ratios are positively linked and negatively related to the long maturity debt ratios. Profitability has a persistent negative association with all types of debt ratios.

Qureshi (2009) investigated the leverage behavior in Pakistani manufacturing firm by using 34 years' data. The results indicated that leverage has two extensive and noteworthy relationships: first, negative association with current and past profitability; and second, positive association with past dividends which provides strong empirical support to POT in context of profitability and dividends. Furthermore his study also provided empirical confirmation to present a reasonable support to pecking order theory regarding growth whereas regarding size POT gets insignificant empirical support from Pakistan. (Mazhar & Nasr, 2010) investigated the determinants which effect capital structure decisions of companies registered in Islamabad stock exchange. Tangibility, tax provision, size, and profitability are positively or negatively linked to the financial leverage. Moreover, publically owned and privately owned firms use different modes of financing. Publically owned firms use higher level of debt financing as compare to private firms.

(Riaz & Afzal, 2011) investigated Pakistan's competitive performance in five manufacturing sectors; i.e. Engineering, cement, textile, chemical and sugar. The study showed that capital structure decisions can be different across the sectors as well as it can be different among the individual firm with in the same sector. Findings of the survey showed

20

that Return on Assets and Growth in Assets are negatively related to the debt ratios. Firms with high profit typically invest their extra profits as a substitute of using extra loans. Tangibility of assets and Size of the firm showed mixed results. All the firm specific factors have less significantly related to debt ratios.

Chakraborty (2010) analyzed that firm's own characteristics are not only affecting capital structure decisions, it can be affected by the surrounding environment. Factors which can affect from surrounding environment can be improvement or deterioration in the economic situation of a country, size of the banking sector or stock market existence.

CHAPTER # 3

3.1 THEORETICAL FRAME WORK

3.1.1 Pecking order theory (POT)

The POT of capital structure is utmost important theory. (Frank & Goyal, 2003). This theory was developed by Stewart C. Myers in 1984 which is also known as pecking order model of financial decisions (Fama and French, 2002). Initially Myers (1984) describes POT which states companies do not have an optimum capital structure. Companies have a preference in choosing retained profits to outside financing. If companies have the only choice of external financing it will follow a hierarchy for financing decisions and first they will issue the safest security. Debt securities are the first priority for the firms, then hybrid securities such as convertibles and at the end firms issue equity securities. Myers explains that lack of sharing accurate and timely information amongst investors and management the companies are hesitant to issue equity. Myers, (1984) pointed out that investors receive less information about firm's current and future return on assets that creates underpricing. According to this information asymmetry, Investors would have the assumption that firms will only use new equity financing when it's overvalued. This issue can be avoided by using the internal funds, such as retained earnings.

POT is based on two suppositions. First, managers are more informed than the perspective investors about the company's future predictions. Second, management will act for existing shareholder's wealth maximization. POT envisages that corporations use

retained earnings if sufficient otherwise use debt or equity financing if outer funds are necessary. (Sheikh & Wang, 2011)

The basic idea of the pecking order hypothesis is remarkably simple. Firms borrow money because they require funds. Once asymmetric information places limitations on equity financing, debt tends to become the primary incremental source of funding. Bankruptcy costs do restrict borrowing, but it appears that the supply of debt funds is more elastic than that of equity among our sample of large mature corporations. The evidence is consistent with asymmetric information producing substantially greater problems with those securities whose value is most dependent upon publically unknown future prospects (Baskin, 1989). Asymmetric information between existing shareholders and prospective shareholders, managers and shareholders provoke to signaling effect. Issuance of new equity and debt provides a signal to the market about the financial position of the company. Existing shareholders or management signal secret information to the capital markets in order to accurate the investors' perception (Frydenberg, 2004). Myers (1984) propose that if equity is underpriced in the market firm will be hesitant to issue new equity, Shareholders are inclined to respond pessimistically because they have a perception of equity issue only when equity is fairly priced or overvalued.

Myers and Majluf (1984), first firms use internally generated earnings (retained earnings) for financing their investments. If firms don't have sufficient earnings available internally then firm will go for external financing, first option which firm can use is the cash loan applied from the bank, second option can be the public debt (issuance of debt

securities) and as a last resort firms can avail the option of equity securities. Usually firms are hesitant to use equity option because of information asymmetry between management and new shareholders.

Myers (1977) implied that firms with objective of shareholder's wealth maximization will be hesitant to issue shares because transfer of wealth from shareholder to debt holders, while Myers and Majluf (1984) proposed that firms are hesitant to issue shares because of problem of adverse selection. Stultz (1990) propose that firms may be hesitant to issue stocks because of the associated costs.

Modigliani & Miller, (1958) presented the modern theory of capital structure. They provided evidence that debt and equity financing has no impact on firm value. Management of the firm should consider all combinations of debt and equity financing are good for the companies.

Pakistani manufacturing firms have low growth and returns and they paid dividends regularly for the said period. So, they have fewer profits to retain and prefer external source of financing which is easily available. Pecking order theory exists in its week form due to less developed capital markets. (Sheikh et al. 2012)

Ilyas (2008) studied the capital structure in Pakistani non-financial firms. Pakistani firms prefer to use internal or equity financing instead of debt financing due to the reason that bond market is not so developed here. Important source of external

25

financing for Pakistani firms are the commercial bank lending. Commercial banks usually provide secured and short term loans which are affordable for large firms only. Most of the Pakistani firms are medium sized so they prefer to use internal financing and equity financing. Another reason to use internal financing can be, these firms want to avoid legal obligations and scrutiny procedures related to financial leverage.

(Javed & Imad, 2012) investigated the different components of capital structure choices of 77 non-financial firms of Pakistan from 2008-2010. They analyzed capital structure determinants depending upon short maturity and long maturity debt categories. Findings showed that large scale firms have more access to long term debts as compare to small firms. Firms which have adequate long term assets; they can easily use low cost external funds by pledging their long term assets. The results are consistent with static trade off theory. High earning firms depend on internally generated earnings for their financing requirements which support pecking order theory.

(Marsh, 1982) analyzed that mostly companies choose debt and equity financing due to the market conditions and past security prices. Secondly he found that companies make their choices among financing options based upon their target debt ratios if they have. Third thing which he analyzed is that target debt ratio is influence by size of the company, risk of bankruptcy, and asset profile of the company.

3.1.2 Static Trade off theory

The static trade off model states that companies face trade off between costs and the advantages of debt financing, when other things are constant. Before the development of POT, static trade off theory was more popular and widely used. People feel comfortable to use static trade off because it's plausible and returns an interior optimum leverage ratio and it also rationalizes "moderate" borrowing (Myers, 1984). By considering the costs and advantages of an extra amount of debt, firms identify their optimal leverage. Possible bankruptcy costs and agency problems among stockholders and debtholders are the costs of the debt and at the leverage; the advantage of the last dollar of the debt just offsets the cost. The analogous prediction is made by trade off theory about dividends which says that firm value can be maximized by selecting the dividend payout ratio that is cost effective for the firm (Fama and French, 2002). The static trade off theory entails a static approach to financing decisions whereas the POT allow the firms to have an optimal debt to equity ratio for a specific point in time. Pecking order theory also attempt to explains behavior of prudent financial managers who attempts to maintain the financing flexibility and ensures the long-term survival of their firms by retaining their earnings as existing equity and create cash reserves, hence creating the financial slack that allows long term survival of the firm and financial flexibility while the tradeoff theory doesn't. It also elucidates stock market reactions to increase in leverage and decrease in leverage, which the trade-off model doesn't (Modigliani & Miller, 1963)

Advantages linked with the debt financing are the tax advantage. Green et al. (2002) examined that tax policy has vital effect on capital structure decisions of the companies. Interest expenses are tax deductible expenses makes debt less expensive than the other sources of financing. This tax advantage increased the use of debt by the firms. (Modigliani & Miller, 1963; Miller, 1977). When debt financing is increased due to this advantage, then the costs associated with debt financing (agency cost and bankruptcy cost) will also increase. At the point, where company have default probability greater than zero is called bankruptcy cost. (Sheikh & Wang, 2011)
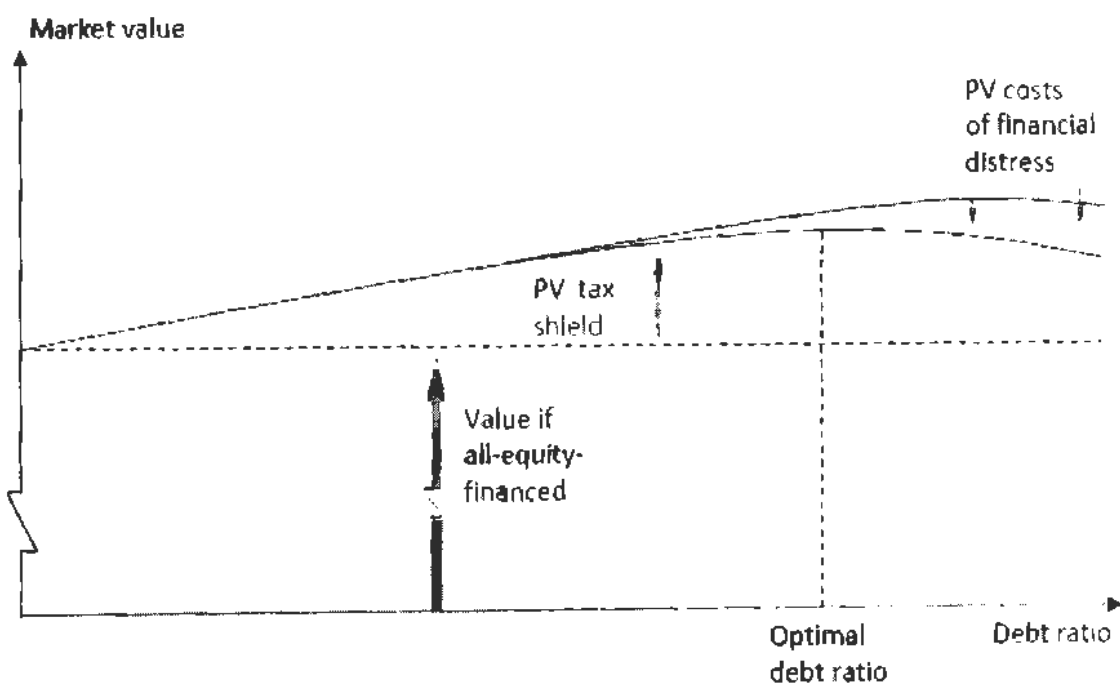

Figure 1: The static-tradeoff theory of capital structure (Source: Myers, 2001)

28

Based upon the literature bankruptcy cost can be direct and indirect. Direct cost can be of legal fees, other professional fee and the worth of time which management will spend in managing the bankruptcy. Indirect cost can be; sales loss, decrease in earnings and firm may not issue any securities to obtain credit.

Another cost which can incur due to the use of debt is agency cost. Jensen and Meckling (1976) introduced agency theory and discussed the relationship between agents and principle. In the real world managers do not always make decisions in favor of the principle, they have their own preferences. Management's primary objective is not maximizing shareholder's wealth; instead they want to work for their own well-being. This will create conflict of interest between management and shareholders, to resolve this issue company have to bear agency cost. Jensen and Meckling differentiate between (i) cost paid by the principles (shareholders) to evaluate the performance of the agents (management) and to monitor their actions and to provoke the agents to act in their best interest. (ii) Bonding expenses paid by the agents (management) to show that their decisions are in the best interest of the principle. (iii) Remaining loss which is faced by the conflict of interest between the two parties. Myers (2001) states shareholders and debt holders have disagreements only when firm has probability of default. If default risk is zero or minimum, debt holders have no concern with income and risk of the company. If company has a clear possibility of default and management is acting in the best interest of the principles, principles are getting benefits by using the money of lenders. Lenders can have the perception of this opportunistic behavior of management and they can write debt contracts accordingly.

29

González & González (2012) investigated the validity of POT and static trade off theory to describe the financing decisions varies with the size of the Spanish firms. Findings are consistent with trade off theory; companies set a target leverage percentage to which they adjust in each time period, using more debt due to tax advantage. Findings are also consistent with POT, firm's debt ratio is absolutely linked to available investment opportunities and the intangible asset's percentage and profitability is linked to the leverage ratio the other way round. Results also showed that prevalence of trade-off model and POT varies across firm size. The direct relation of debt ratio with the investment opportunities and intangible assets and inverse relation with profitability are significant in small firms than in medium sized and large firms. (Myers, 1984) defines financial distress cost consist of administrative and legal cost of bankruptcy and some other costs which can deteriorate firm value may also be included in it i.e. contracting cost, monitoring cost and moral hazard.

3.1.3 Agency Theory

Bufema et al. (2005) Agency theory states optimum capital structure may be determined by lowering conflict cost between management and the shareholders to minimum level. Jenson and Meckling (1976) stated that due to this difference of opinion among the parties (shareholders and bond holders) agency theory plays an important role in financing decisions of the company. If corporations are facing financial distress, management can be encouraged by the shareholders to use debt as source of financing. Debt holders will demand a higher rate of interest on their loans, which may lessen the agency conflict between the parties. If management is unable to make timely payments of interest and principle, debt holders can take legal actions that may create a fear of job

30

loss to the concerned manager. Due to this management will try to be more efficient in making interest payments, ultimately that will lead towards the shareholder's wealth maximization. Jensen and Meckling stated that financial policies can be used by the managers to get monetary and non-monetary benefits in a firm. Manager behavior is always influenced by the investment constraints. Theoretically, firms have to invest in the projects which will maximize the shareholder's wealth. Shareholder's wealth can be maximized by taking projects with positive Net Present Value. On the other hand, management is not taking investment decisions by using only the discounted cash flow technique (NPV). Management can use other arguments to make investment decisions that can create a conflict of interest between management and shareholders.

Frank & Goyal (2007) found in their study that agency cost can be one of the reasons for Pecking order, when conflict of interest is between the management/majority owners and outside investors. If Outside investors feel there is very less chances to get fair return on investment, they may be reluctant to supply equity funds. La Porta et al. (2002) found in their study that sometimes inside investors steal profits in a way that they can sell assets below the market prices to related companies, over paid themselves. consume excessive perks, or they can do adverse selection of the employees.

Harris & Raviv (1991) if the investors prefer the liquidation of the firms, managers assumed to continue the operations of the firm. Stulz (1990) if investors want cash payouts, managers assumed to invest all the available cash in some projects. In the previous two cases, conflict in operating decisions cannot be resolve by signing contracts

31

based on investment plans and cash flow. In Harris and Reviv's study, debt alleviates the issue by allowing the debtholders (investors) to liquidate the assets if cash flows are poor. In Jensen 1986 and Stulz (1990) free cash flows are lowered by debt payments. These benefits and costs can be traded off to get an optimal capital structure. In Harris and Reviv cost of debt in liquidation process is to issue prospectus about the firm. In Stultz model cost of debt is use of free cash flows in the payments of debt that can be used for investments.

3.1.4. Research Questions

- Are Low levered firms different from high levered firms?

- Are firms having target debt ratio different from the firms with zero debt level (depending 100 percent upon equity financing)?

3.1.5. Hypothesis

- H1: There is a significant difference between low levered firms and high levered firms.

- H2: There is a significant difference between firms with target debt ratio and with zero debt level (depending 100 percent upon equity financing).

CHAPTER # 4

4.1 RESEARCH METHOD AND DESIGN

This study investigated the capital structure practices in Pakistan. For this purpose, primary data have been collected from different companies. Survey instrument is adopted from the study of Brounen et al. (2006). Brounen et al. (2006) investigated the capital structure choices of European companies from four different countries (UK, Netherlands, Germany and France). Questionnaire includes the questions about the firm characteristics like size, industry, payment of dividend and publicly listed/ private listed. It also includes the characteristics particularly related to the capital structure: When company will issue the equity, what factors will lead to equity financing. What is the target debt ratio of the company, and how and when it will issue debt, convertible debt and foreign debt? Rest of the questions will analyze the Financial Manager's views about the capital structure choices on a 5 likert scale (1 strongly disagree and 5 strongly agree). Data have been collected from different financial and non-financial firms operating in federal and Punjab province. Respondents for the questionnaires were the CFOs or the Financial Managers in the companies. Questionnaire was sent to 200 companies, but 102 companies responded by contacting them later on.

Data analysis in done by using SPSS and Stata. SPSS is used for descriptive analysis for different items. Stata is used to apply t-test for differences of means high levered and low levered firms and firms with debt ratio and no debt ratio.

4.1.1 T-Test for Two Independent Samples

T-test can be used to determine if there are statistically significant differences between the means of two samples or groups (Zikmund, 2003). T-test can be used for independent or paired samples test that are normally distributed. (Pallant, 2008). The t-test for independent samples compare the sample results $(\bar{x}_1, \bar{x}_2)$ with the condition specified under the null hypothesis $(\mu_1 - \mu_2)$ dividing the difference by the standard error $s_{\bar{x}_1 - \bar{x}_2}$. The formula for t-test is

$$t = [(\bar{x}_1 - \bar{x}_2) - (\mu_1 - \mu_2)]/s_{\bar{x}_1 - \bar{x}_2}$$

t-test for differences of means for two independent samples applied on the high levered firms and low levered firms. The same is applied on the firms having target debt ratio and the firms totally relying on debt financing means with zero target debt ratio. For leverage, company's debt ratio less than 30% is defined as low levered companies and company's debt ratio more than 30% is defined as high levered company's. the companies having any target debt ratios considered as "firms with target debt ratio" and the companies which have zero debt to equity ratio considered as "firm using equity financing".

4.1.2 Reliability Test

Cronbach alpha is a measure of internal consistency. Internal consistency tells us to which extent all the items are measuring the same construct. It ranges from 0 to 1. (Tavakol, Dennick, 2011). All questions used in the study are in acceptable range of Cronbach alpha, which shows reliability in the questionnaire.

35

CHAPTER 5

5.1 RESEARCH FINDINGS AND INTERPRETATIONS

5.1.1 Descriptive Analysis

Table 1 (see in appendix) shows the details of respondents. From the total respondents of 101 companies, 48.3 % companies have sales volume between 1m and 50m. 40.4 % Companies have sales figure greater than 200m. Companies which have sales figure of more than 50m but less than 100m are 5.6 %. 4.5 % companies have sales figure greater than 100m but less than 15m and 1.1 % are from the range of 150m to 200m.

Figure 2

Figure 3

publicly listed or Private

publicly listed or Private

Figure 4

dividend payments

dividend payments
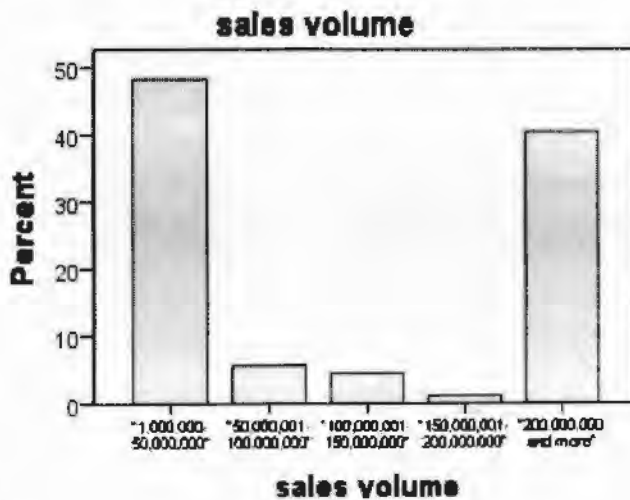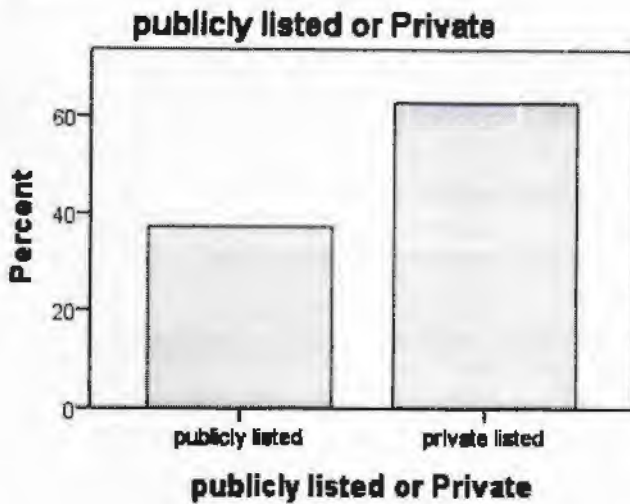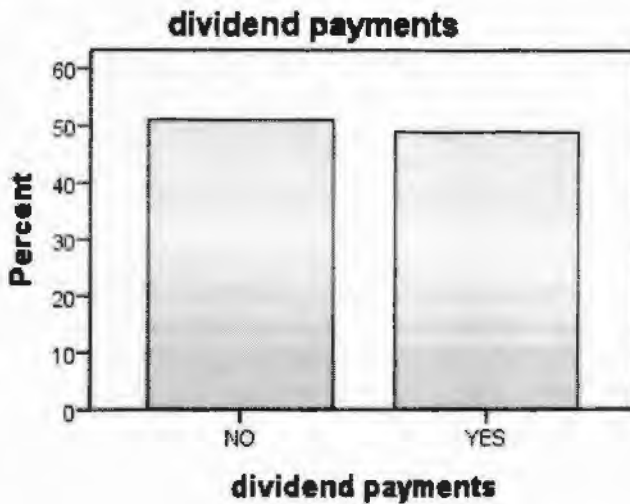
From the total 101 companies 37.2% were publically listed and 62.8 % were privately listed.39.4 % companies from the manufacturing sector, 33.3 % from others (financial sector) 15.4% from retail and wholesale sector ,4.0% from the transportation and energy, 4.0% from the communication and media, 3.0% from the Mining and Construction, 1.0% from technology sector. 49 % of the total companies are paying dividends and 51 % are not paying dividends.

Figure 5

industry
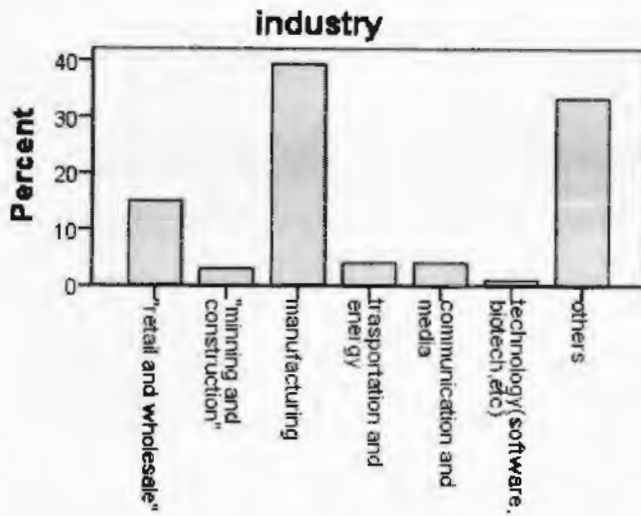
Figure 6
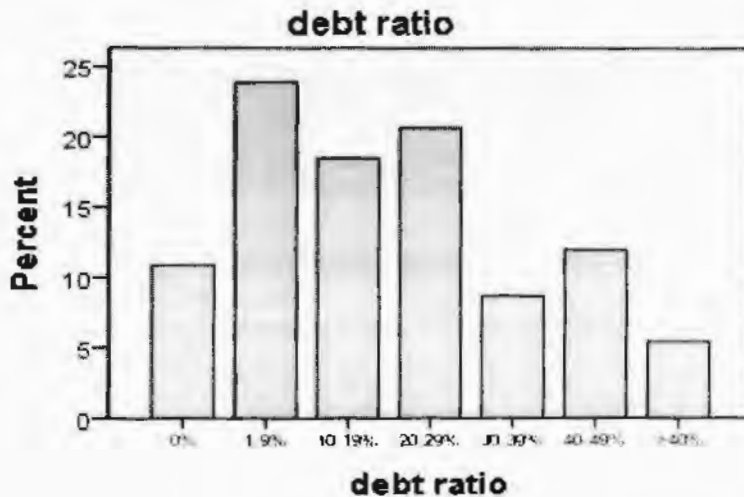
debt ratio

10.9% companies have 0 percent long term debt ratio means they are not using debt as their source of financing. These companies are relying 100 percent on equity financing. 23.9% companies have long term debt ratio of 1-9%. 18.5 % companies have long term debt ratio of 10-19 %. 20.7 percent companies rely on debt financing in the range of 20-29 %. 8.7 percent have long term debt ratio from 30 to 39 percent. 12 percent firms have debt ratio in the range of 40-49 percent and 5.4% companies have more than

39

49 percent debt ratio. Majority of the companies have long term debt ratio less than 30 percent. We consider less than 30 percent debt ratio to be low levered firms. These results are different from the study of Brounen et al. (2006). The four countries they have discussed have different long term debt ratios from our study.

Table 2 (see in appendix) shows that financial managers of companies consider the factors which are important for the amount of debt. The more significant element when issuing loan, "companies' limit their debt so their customers/suppliers are not worried about their firms is going out of business". 56.3 percent respondents consider this is most significant element with a mean of 3.45. 52.2 percent respondents consider that "financial flexibility" is the second significant factor with an average equals 3.54 while considering the amount of debt for a firm. "The volatility of earnings and the personal tax cost our investors face when they receive interest income" is on third number in ranking of importance with a mean of 3.11 and 3.20 respectively. 47.3 percent respondents consider "the potential cost of bankruptcy, near bankruptcy, or financial distress" is important with a mean of 3.23. "We restrict our borrowing so that profits from new/future projects can be captured fully by shareholders and do not have to be paid out as interest to debt holders" is important with 44.8% respondents and a mean of 3.19. Then 44 percent financial managers consider that "we try to have enough debt that we are not an attractive takeover target" can be a significant factor with a mean of 3.09. the other important factors can be credit rating of firms with an average equal 3.11, "the transaction cost and fees for issuing debt" with a mean of 3.33, "the tax advantage of interest deductibility" with a mean of 3.09 and "if we issue debt our competitors know

that we are very unlikely to reduce our sales" with a mean of 3.02 while considering the amount of debt.

Table 3 (see in appendix) shows that financial managers of the companies consider the other factors which can affect firm's debt policy. The most important factor financial managers consider is "we issue debt when our recent profits (internal funds) are not sufficient to fund our activities" with a mean score of 3.20. This finding showed that companies are following POT while making their capital structure choices. Secondly 42.9 percent "firms consider changes in the price of our common stock" is also an important factor with 3.21 means sore.

Table 4 (see in appendix) summarizes the results of "factors which can affect the firm's choices of long term and short term debt". In choice of "long term and short term debt" the most important factor which financial managers consider is "to issue long term debt to minimize the risk of having to refinance in bad times" with a mean rank of 3.51. Pakistani firms prefer to "issue long term debt due to the risk of refinancing of short term debt". Firm managers consider to "issue short term debt when short term rate are lower than the long term interest rates" is significant with the 3.39 means rank. 63.3 % firm managers consider it important "we expect our credit rating to improve. So borrow short term until it does" with 3.32 mean rank. "Borrowing short term reduces the chances that our firm will want to take on risky projects" is important with 3.25 mean score. 56.9 percent managers believe on "maturity matching of debt with the life of assets" with 3.17 mean ranks. 54.4 % "managers issue short term debt when they are waiting for long term market interest rates to decline" with 3.21 mean ranks.

41

Table 5 (see in appendix) shows the factors which can affect the decision about issuing common stock of the respondent firms. Over 83 % of the respondent "firms seriously considered issuing common equity". In issuing common equity the most important factor is, "if our stock price has recently risen, the price at which we can issue is high" with 3.39 mean scores. This result is different from the Bancel & Mittoo (2004) and Graham & Harvey (2001) they found "earning per share dilution" is the highly significant element while firms issue common equity. 45.5 % of firm mangers considered "maintaining target debt to equity ratio" is also significant with 3.32 mean score. This finding is in line with the "static trade off theory" and also supported by Bancel & Mittoo (2004). 42.1 percent managers think "stock is our least risky source of funds" (3.29 mean scores). Over 38 percent firm managers "consider whether our recent profits have been sufficient to fund our activities" is significant with 3.27 mean score. Over 36 % managers think undervalued or overvalued stock is important while considering issuing common equity (3.22 mean ranks). 3.18 mean score shows that "issuing stock gives investors a better impression of our firm's prospects than using debt". This outcome is in-line with signaling theory. Over 40 percent managers consider earning per dilution is important with 3.14 mean score. Over 72 % respondents think using a "similar amount of equity as is issued by other firms in our industry" can be important with 3.03 mean score. A few managers think "capital gain tax rates faced by our investors" are also important (3.18 mean) while considering issuing common equity.

Figure 7

hasyourfirmserioslyconsideredissuingcomon stock

hasyourfirmseriosiyconsid eredissuingcomonstock

Figure 8

hasyourfirmseriouslyconsideredissuingconv ertibledebt

hasyourfirmseriouslyconsid eredissuingconvertibled...

Figure 9

hasyourfirmseriouslyconsideredissuingdebti nforeigncountries

hasyourfirmseriouslyconsid eredissuingdebtinforeig...
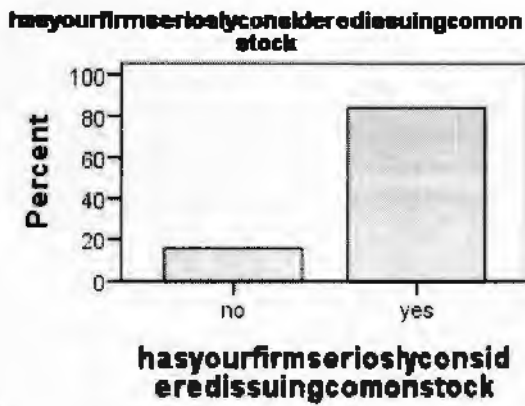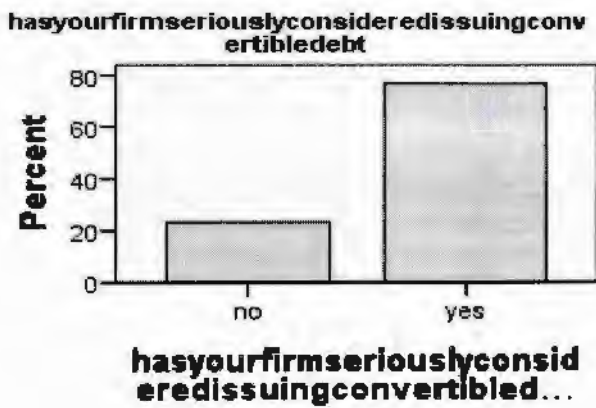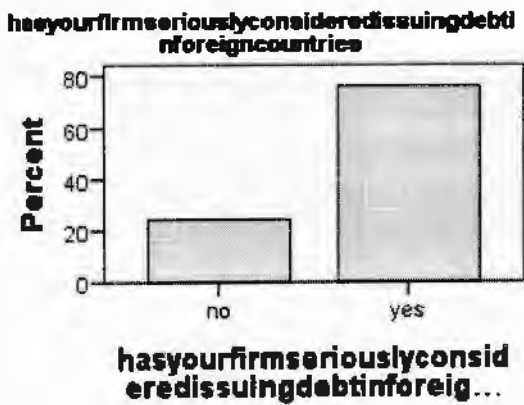
Table 6 (see in appendix) summarizes the results of issuing foreign debt by the companies and the factors which can affect firm's decision about foreign debt. Over 75 % firms seriously considering issuing debt in foreign countries. 52.1 % firms "consider favorable tax treatment relative to the home country name" is highly significant feature with 3.42 average value while considering issuing foreign debt. Over 35 percent managers agree with "keeping the sources of funds close to the uses of funds" with 3.05 mean score. "Foreign interest rates may be lower than domestic interest rates" is an important factor with 3.01 mean score. These findings are different from Bancel & Mittoo (2004) and Graham & Harvey (2001). According to their studies "providing a natural hedge is the most important variable that can affect the issuance of foreign debt".

Table 7 (see in appendix) shows the findings of the factors which can affect firm's decisions about issuing convertible debts. Over 76 percent firms seriously considering issuing convertible debt. Over 59 percent managers issue convertible debt only to avoid short term equity dilution with 3.42 mean scores (most important factor). This finding is inconsistent with the findings of Bancel & Mittoo (2004). 50% respondent firms consider "other firms in or industry successfully use convertibles" as important variable with 3.41 mean score. With 3.38 mean score, "protecting bondholders against unfavorable actions by managers or stock holders" is also important factors while issuing convertible debts. Over 51% managers agree with "the ability to call or force conversion of convertible debt if/when we need" is important with 3.31 mean score. With 3.318

44

mean score, "to attract investors unsure about the riskiness of our company" is also a significant factor while issuing convertible debt.

5.1.3 T-test results

Table 9 (see in appendix) shows for factor (a) Null hypothesis is rejected at all conventional significance levels. So it is concluded that the low leverage companies' and high leverage companies' are significantly different. Financial flexibility is different in low leverage companies' and high leverage companies', means low leverage companies' prefer to use internal funds available to pursue new projects and use less debt financing. On the other hand, high levered firms use more debt financing for financing of the projects. For factor (b) null hypothesis is rejected at all conventional significance levels. So it is concluded that the low leverage companies' and high leverage companies' are significantly different. Credit rating is different in low leverage companies' and high leverage companies'. Credit rating is an important factor while companies choose their amount of debt financing. For factor (i) "Restrict borrowing so the profits can be captured fully by shareholders" null hypothesis is rejected at all conventional significant levels. So it is concluded that the low leverage companies' and high leverage companies' are significantly different. Low levered firms are more interested in restricting borrowings so that profits are fully captured by the shareholders. For factor (j) null hypothesis is rejected at all conventional significance levels. So it is concluded that the low leverage companies' and high leverage companies' are significantly different. According to the Brounen et al. (2006) a,c,d,g. are significantly different factors in UK firms with high financial leverage. b,f, are significantly important factors in Netherlands high levered firms. In Germany and France, low levered firms and high levered firms are not

45

significantly different in the factors which are important to choose amount of debt policy. According to Graham and Harvey (2001) b,d,f,g,I,j,l factors are significantly important for those firms with high financial leverage.

Table 10 (see in appendix) shows that there is no difference in the means of the low levered firms and high levered firms for all the factors which can affect firm's debt policy for Pakistani firms. "We issue debt when our recent profit (internal funds) are not sufficient to fund our activities" and "We delay retiring debt because of recapitalization costs and fees" are significant at 10 percent. According to Brounen et al. 2006, from all these factors two factors are significantly different in their means of low levered firms and high levered firms in UK; "firms issue debt when interest rate are particularly low" and "we issue debt when our recent profits are not sufficient to fund our activities". In Netherlands firms only two factors a,b,c,d,e,g are significantly important factors. In Germany and France most of the factors are insignificant.

Table 11(see in appendix) shows that for factor (f) H_0 is rejected at 1%,5% and 10% level. So it is concluded that means of the firm which have no debt ratio (means relying totally on equity financing) and the mean of the firms which have a debt ratio are significantly different. The debt level of other firms in the industry is affected by the firms' debt ratio. For factor (g) null hypothesis is rejected at all conventional significance levels. So it is concluded that means of the companies' which have no debt ratio and the mean of the companies' with a specific debt ratio are significantly different. The potential cost of bankruptcy, near bankruptcy and financial distress is different for

46

both type of firms with a debt ratio and without a debt ratio. If company is using more debt financing bankruptcy cost will be high as compare to the companies which are using less debt financing. Initially when firms are using debt financing, firms will get reduction in overall cost of capital due to cheaper source of financing. Later on when firm will gradually rise its leverage ratio, firm have to face a trade-off between potential advantages of using leverage and insolvency risk. For factor (j) null hypothesis is rejected at all conventional significance levels. So it is concluded that means of the firm which have no debt ratio and the average of the companies' which have a debt ratio are significantly different. For factor (m) null hypothesis is rejected at all conventional significance levels. So it is concluded that averages of companies which have no debt ratio and the mean of the firms which have set leverage ratio are significantly different. Firms with set debt ratio consider this factors more important. For factor (n) null hypothesis is rejected at all conventional significance levels. So it is concluded that means of the companies' which have no set leverage ratio and the mean of the companies' which have set leverage ratio are significantly different. This factor is important for the firms with set leverage ratio. According to Brounen et al. (2006) firms with target debt ratio have "a, b,c,d,e,f,g,h,j" factors are significant and important in UK firms, f,k,m are significant factors in Netherlands firms, b,c,f,j are significant in German firms, a,c,e are significant factors in France firm. Graham and Harvey (2001) found b,f and k are significant factors in companies' have set leverage ratio

Table 12 (see in appendix) shows for factor (a) H₀ is rejected at all conventional levels. So it is concluded that means of the companies' which have no debt ratio and

mean of the companies' which have set leverage ratio are significantly different. This factor is significantly important for those firms having a debt ratio. For factor (b) null hypothesis is rejected at all conventional significance levels. So it is concluded that means of the companies' which have no debt ratio and the companies' of the firms which have specific debt ratio are significantly different. This factor is significantly important for those firms having a debt ratio. For factor (f) null hypothesis is rejected at all conventional significance levels. So it is concluded that mean of companies' which have no set leverage ratio and the mean of companies' which have set leverage ratio are significantly different. This factor is significantly important for those firms having a specific debt ratio. For factor (h) null hypothesis is rejected at all conventional significance levels. So it is concluded that mean of firm which have no debt ratio and mean of firm which have set debt ratio are significantly different. This factor is significantly important for those firms having a debt ratio. According to Brounen et al. (2006) firms with target debt ratio have "a,b,c,d,f,g" factors are significant and important in UK firms, e,f are significant factors in Netherlands firms, b is significant in German firms and French firm. Graham and Harvey (2001) found all factors are insignificant in firms having target debt ratio.

Table 13 (see appendix) shows for factor (a) H_0 is rejected at all conventional levels. So it is concluded that mean of the firm which have low leverage and the mean of firm which have high leverage are significantly different. This factor is significantly important for those firms having high financial leverage. For factor (d) null hypothesis is rejected at 10% significance levels. So it is concluded that mean of firm which have low

48

leverage and the mean of firm which have high leverage are significantly different. This factor is significantly important for those firms having high financial leverage. For factor (e) null hypothesis is rejected at all conventional level all conventional significance levels. So it is concluded that mean of the firm which have low leverage and the mean of the firm which have high leverage are significantly different. This factor is significantly important for those firms having high financial leverage. According to Brounen et al. (2006) in UK high levered firms have a,b,d factors are significantly important. In Germany a,b,g factors of high levered firms are significantly important. Graham and Harvey (2001) found b,d,e,f factors of high levered firms are significantly important. In this study there are mixed results.

Chapter 6

6.1 CONCLUSION

The study has investigated the capital structure practices of Pakistani firms of different industries. Low levered firms prefer to use internal funds available to pursue their new projects on the other hand high levered firms use more debt financing to finance their projects. High levered firms are significantly different from low levered firms for the factors affecting the choice of debt. High levered firms are less significantly different from low levered firms for the factors affecting firm's debt policy. High levered firms are significantly different from low levered firms in the choice of short term and long term debt. Firms with a specific debt ratio are significantly different from firms without any debt ratio in some factors. But for majority of the factors firms with a specific debt ratio are not significantly different from firms totally relying on equity financing. Interest rates have significant impact on firms with a specific debt ratio and firms fully relying on equity financing. Findings showed that financial managers considered "target debt to equity ratio maintained by the firms" an important factor while issuing common stock that support static trade off theory. Agency cost is not considered an important factor by the financial managers. "Potential cost of bankruptcy, near bankruptcy, or financial distress" is significant for the firms using debt financing as compare to the firms totally relying on equity financing. Bankruptcy costs are the part of the static trade off theory. Financial flexibility is a significant for high levered firms that supports pecking order theory. Firms considered "we issue debt when our recent profits are not sufficient to fund our activities" an important factor which supports pecking order theory of capital structure. Results of the study showed mixed evidences that Pakistani companies use pecking order theory and static trade off theory.

51

6.2 PRACTICAL IMPLICATIONS

- The results of the study are useful for managers in devising capital structure policies in a better way.

- Findings will be helpful for shareholders as they will get to know about the capital structure decisions being made by the firms.

Chapter 7

7.1 References

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APPENDIX

Table 1

Sales Volume	1,000,000-50,000,000	48.3%
	50,000,001-100,000,000	5.6%
	100,000,001-150,000,000	4.5%
	150,000,001-200,000,000	1.1%
	>200,000,000	40.4%
Industry	Retail and Wholesale	15.2%
	Minning and Construction	3.0%
	Manufacturing	39.4%
	Transportation and Energy	4.0%
	Communication and Media	4.0%
	Technology(software, biotech,etc)	1.0%
	Others	33.3%
Public or Private	Publicly listed	37.2%
	Private listed	62.8%
Dividend payments	NO	51.0%
	YES	49.0%
Debt ratio	0%	10.9%
	1-9%	23.9%
	10-19%	18.5%
	20-29%	20.7%
	30-39%	8.7%
	40-49%	12.0%
	>40%	5.4%

Table 2

What factors affect how you can choose the appropriate amount of debt for your firm?	Importance	Mean
Financial flexibility (we restrict debt so we have enough internal funds available to pursue new projects when they come along)	52.2%	3.54
Our credit rating (as assigned by rating agencies)	40.3%	3.04
The volatility of our earnings and cash flows	49%	3.11
The tax advantage of interest deductibility	37.5%	3.09
The transaction costs and fees for issuing debt	39.2%	3.33
The debt level of other firms in our industry	23.2%	2.86
The potential cost of bankruptcy, near bankruptcy, or financial distress	47.3%	3.23
We limit our debt so our customers/suppliers are not worried about our firm going out of business	56.3%	3.45
We restrict our borrowing so that profits from new/future projects can be captured fully by shareholders and do not have to be paid out as interest to debt holders	44.8%	3.19
We try to have enough debt that we are not an attractive takeover target	44%	3.09
The personal tax cost our investors face when they receive interest income	49%	3.20
If we issue debt our competitors know that we are very unlikely to reduce our output/sales	34.1%	3.02
To ensure that upper management works hard and efficiently, we issue sufficient debt to make sure that a large portion of our cash flow is committed to interest payments	35.1%	2.93
A high debt ratio helps us bargain for concession from our employees	13.9%	2.39

Table 3

What other factors affect your firm's debt policy?	Importance	Mean
We issue debt when interest rates are particularly low	23.2%	2.41
We use debt when our equity is undervalued by the market	40%	2.85
We issue debt when our recent profit (internal funds) are not sufficient to fund our activities	48.9%	3.20
Changes in the price of our common stock	42.9%	3.21
We delay issuing debt because of transaction costs and fees	42.5%	2.99
We delay retiring debt because of recapitalization costs and fees	34.1%	2.94

63

	Importance	Mean
Using debt gives investors a better impression of our firm's prospects than issuing stock	35.2%	2.93
We issue debt when we have accumulated substantial profits	39.1%	2.95

Table 4

What factors affect your firm's choice between short term and long term debt?	Importance	Mean
Matching maturity of our debt with the life of our assets	56.9%	3.17
We issue long-term debt to minimize the risk of having to refinance in "bad times"	65.7%	3.51
We issue short-term when short-term interest rates are low compared to long-term rates	65.1%	3.39
We issue short-term when we are waiting for long-term market interest rates to decline	54.4%	3.21
We borrow short-term so that returns from new projects can be captured more fully by shareholders. rather than committing to pay long-term profits as interest to debt holders	48.5%	3.22
We expect our credit rating to improve. So we borrow short-term until it does	63.3%	3.32
Borrowing short-term reduces the chance that our firm will want to take on risky projects	59.4%	3.25

Table 5

Has your firm seriously considered issuing common stock? If "yes", what factors affect your firm's decisions about issuing common stock?	Importance	Mean
Earning per share dilution	40.5%	3.14
The amount by which our stock is undervalued or overvalued by the market	36.4%	3.22
If our stock price has recently risen, the price at which we can issue is "high"	50%	3.39
Providing shares to employee bonus/stock option plan	34.1%	2.97
Maintaining target debt to equity ratio	45.5%	3.32
Diluting the holdings of certain shareholders	32.5%	2.86
Stock is a our "least risky" source of fund	42.1%	3.29
Whether our recent profits have been sufficient to fund our activities	38.5%	3.27
Using a similar amount of equity as is issued by other firms in our industry	72.3%	3.03
Issuing stock gives investors a better impression of our firm's prospects than using debt	45.5%	3.18
Inability to obtain funds using debt, convertibles, or other sources	38.5%	3.04
Common stock is our cheapest source of funds	39.5%	2.97
The capital gain tax rates face by our investors (relative to tax rates on dividends)	2.8%	3.18

Table 6

Has your firm seriously considered issuing debt in foreign countries? If "yes", what factors affect your firm's decisions about issuing foreign debt?	Importance	Mean
Providing a "natural hedge" (e.g.: if the foreign currency devalues, we are not obligated to pay interest in own currency)	27.1%	2.96
Keeping the "source of funds" close to the "use of funds"	35.1%	3.05
Favorable tax treatment relative to the home country name (e.g.: different corporate tax rates)	52.1%	3.42
Foreign interest rates may be lower than domestic interest rates	30.1%	3.01
Foreign regulations require us to issue debt abroad	27.4%	2.93

Table 7

Has your firm seriously considered issuing convertible debt? If "yes', what factors affect your firm's decisions about issuing convertible debts?	Importance	Mean
Convertibles are an inexpensive way to issue "delay" common stock	41%	2.80
Our stock is currently undervalued	44.9%	2.94
Ability to "call" or force conversion of convertible debt if/when we need to	51.9%	3.31
Avoiding short-term equity dilution	59.6%	3.42
To attract investors unsure about the riskiness of our company	45.6%	3.18
Convertibles are less expensive than straight debt	38.9%	2.91
Other firms in our industry successfully use convertibles	50%	3.41
Protecting bondholder against unfavorable action by managers or stockholders	53.8%	3.38

Table 8

Variables	No. of items	Cronbach's Alpha
What factors affect how you choose the appropriate amount of debt for your firm?	14	0.660
What other factors affect your firm's debt policy?'	8	0.683
Has your firm seriously considered issuing common stock? If "yes", what factors affect your firm's decisions about issuing common stock?	13	0.697
Has your firm seriously considered issuing debt in foreign countries? If "yes", what factors affect your firm's decisions about issuing foreign debt?	5	0.770
Has your firm seriously considered issuing convertible debt? If "yes", what factors affect your firm's decisions about issuing convertible debt?	8	0.729
What factors affect your firm's choice between short- and long-term debt	7	0.678

Table 9

What factors affect how you can choose the appropriate amount of debt for your firm?

S.no.	Variables	Ho	Mean (Leverage)		t-stat	P value
			Low	High		
a)	Financial flexibility (we restrict debt so we have enough internal funds available to pursue new projects when they come along)	$\mu_1-\mu_2=0$	2.6	4.40	16.17***	0.0000
b)	Our credit rating (as assigned by rating agencies)	$\mu_1-\mu_2=0$	2.69	3.43	2.98***	0.0037
c)	The volatility of our earnings and cash flows	$\mu_1-\mu_2=0$	2.89	3.33	1.86*	0.0655
d)	The tax advantage of interest deductibility	$\mu_1-\mu_2=0$	3.21	2.98	1.04	0.3012
e)	The transaction costs and fees for issuing debt	$\mu_1-\mu_2=0$	2.95	3.65	3.88***	0.0002
f)	The debt level of other firms in our industry	$\mu_1-\mu_2=0$	2.83	2.90	0.38	0.7046
g)	The potential cost of bankruptcy, near bankruptcy, or financial distress	$\mu_1-\mu_2=0$	3.30	3.16	0.65	0.5150
h)	We limit our debt so our customers/suppliers are not worried about our firm going out of business	$\mu_1-\mu_2=0$	3.36	3.53	0.93	0.3539
i)	We restrict our borrowing so that profits from new/future projects can be captured fully by shareholders and do not have to be paid out as interest to debt holders	$\mu_1-\mu_2=0$	2.57	3.78	5.60***	0.0000
j)	We try to have enough debt that we are not an attractive takeover target	$\mu_1-\mu_2=0$	2.60	3.51	4.06***	0.0001

k)	The personal tax cost our investors face when they receive interest income	$\mu_1-\mu_2=0$	3.34	3.06	1.36	0.1774
l)	If we issue debt our competitors know that we are very unlikely to reduce our output/sales	$\mu_1-\mu_2=0$	3.00	3.04	0.19	0.8465
m)	To ensure that upper management works hard and efficiently, we issue sufficient debt to make sure that a large portion of our cash flow is committed to interest payments	$\mu_1-\mu_2=0$	2.96	2.89	0.24	0.8142
n)	A high debt ratio help us bargain for concession from our employees	$\mu_1-\mu_2=0$	2.53	2.26	1.32	0.1903

(***) represents level of significance at 1%, 5% and 10%. (**) represents level of significance at 5% and 10%. (*) represents level of significance at 10% and null hypothesis is rejected at these level.

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67

Table 10
What other factors affect your firm's debt policy?

| S.No. | Variables | Ho | Mean (leverage) | | t-stat | P value |
			Low	High		
a)	We issue debt when interest rates are particularly low	$\mu_1-\mu_2=0$	2.55	2.27	1.17	0.2433
b)	We use debt when our equity is undervalued by the market	$\mu_1-\mu_2=0$	2.75	2.96	0.89	0.3744
c)	We issue debt when our recent profit (internal funds) are not sufficient to fund our activities	$\mu_1-\mu_2=0$	3.41	3.00	1.73*	0.0864
d)	Changes in the price of our common stock	$\mu_1-\mu_2=0$	3.19	3.23	0.22	0.8248
e)	We delay issuing debt because of transaction costs and fees	$\mu_1-\mu_2=0$	3.06	2.91	0.62	0.5363
f)	We delay retiring debt because of recapitalization costs and fees	$\mu_1-\mu_2=0$	3.14	2.75	1.82*	0.0732
g)	Using debt gives investors a better impression of our firm's prospects than issuing stock	$\mu_1-\mu_2=0$	2.82	3.07	1.15	0.2519
h)	We issue debt when we have accumulated substantial profits	$\mu_1-\mu_2=0$	3.06	2.82	1.00	0.3191

(***) represents level of significance at 1%, 5% and 10%. (**) represents level of significance at 5% and

10%. (*) represents level of significance at 10% and null hypothesis is rejected at these level.

Table 11

What factors affect how you can choose the appropriate amount of debt for your firm?

S.no.	Variables	H_0	Mean (Debt ratio)		t-stat	P value
			No	Yes		
a)	Financial flexibility (we restrict debt so we have enough internal funds available to pursue new projects when they come along)	$\mu_1-\mu_2=0$	3.69	3.51	0.46	0.6496
b)	Our credit rating (as assigned by rating agencies)	$\mu_1-\mu_2=0$	3.12	3.03	0.23	0.8169
C	The volatility of our earnings and cash flows	$\mu_1-\mu_2=0$	2.82	3.18	0.99	0.3329
d)	The tax advantage of interest deductibility	$\mu_1-\mu_2=0$	3.35	3.04	0.87	0.3935
e)	The transaction costs and fees for issuing debt	$\mu_1-\mu_2=0$	3.63	3.26	1.19	0.2483
f)	The debt level of other firms in our industry	$\mu_1-\mu_2=0$	2.25	2.99	2.91***	0.0084
g)	The potential cost of bankruptcy, near bankruptcy, or financial distress	$\mu_1-\mu_2=0$	3.75	3.12	2.71**	0.0110
h)	We limit our debt so our customers/suppliers are not worried about our firm going out of business	$\mu_1-\mu_2=0$	3.63	3.41	0.87	0.3912
i)	We restrict our borrowing so that profits from new/future projects can be captured fully by shareholders and do not have to be paid out as interest to debt holders	$\mu_1-\mu_2=0$	3.13	3.20	0.26	0.7992

j)	We try to have enough debt that we are not an attractive take over target	$\mu_1-\mu_2=0$	2.63	3.19	2.14**	0.0407
k)	The personal tax cost our investors face when they receive interest income	$\mu_1-\mu_2=0$	3.06	3.23	0.54	0.5965
l)	If we issue debt our competitors know that we are very unlikely to reduce our output/sales	$\mu_1-\mu_2=0$	3.00	3.03	0.09	0.9254
m)	To ensure that upper management works hard and efficiently, we issue sufficient debt to make sure that a large portion of our cash flow is committed to interest payments	$\mu_1-\mu_2=0$	2.06	3.10	3.06***	0.0058
n)	A high debt ratio help us bargain for concession from our employees	$\mu_1-\mu_2=0$	1.81	2.51	2.46	0.0225

(***) represents level of significance at 1%, 5% and 10%. (**) represents level of significance at 5% and 10%. (*) represents level of significance at 10% and null hypothesis is rejected at these level.

Table 12
What other factors affect your firm's debt policy?

S.no.	Variables	H₀	Mean (Debt Ratio)		t-stat	P value
			No	Yes		
a)	We issue debt when interest rates are particularly low	$\mu_1-\mu_2=0$	1.81	2.53	2.35**	0.0281
b)	We use debt when our equity is undervalued by the market	$\mu_1-\mu_2=0$	1.625	3.10	5.25***	0.0000
c)	We issue debt when our recent profit (internal funds) are not sufficient to fund our activities	$\mu_1-\mu_2=0$	3.19	3.21	0.04	0.9683
d)	Changes in the price of our common stock	$\mu_1-\mu_2=0$	3.07	3.24	0.54	0.5979
e)	We delay issuing debt because of transaction costs and fees	$\mu_1-\mu_2=0$	2.63	3.06	1.34	0.1946
f)	We delay retiring debt because of recapitalization costs and fees	$\mu_1-\mu_2=0$	2.19	3.11	3.64	0.0014***
g)	Using debt gives investors a better impression of our firm's prospects than issuing stock	$\mu_1-\mu_2=0$	2.60	3.00	1.05	0.3074
h)	We issue debt when we have accumulated substantial profits	$\mu_1-\mu_2=0$	2.20	3.09	2.55	0.0199**

(***) represents level of significance at 1%, 5% and 10%. (**) represents level of significance at 5% and 10%. (*) represents level of significance at 10% and null hypothesis is rejected at these level.

Table 13

What other factors affect your firm's choice between short term and long term debt?

S.no.	Variables	H₀	Mean (Leverage)		t-stat	P value
			Low	High		
a)	Matching maturity of our debt with the life of our assets	$\mu_1-\mu_2=0$	3.48	2.52	2.57**	0.0135
b)	We issue long-term debt to minimize the risk of having to refinance in "bad times"	$\mu_1-\mu_2=0$	3.41	3.71	1.04	0.3028
c)	We issue short-term when short-term interest rates are low compared to long-term rates	$\mu_1-\mu_2=0$	3.29	3.62	0.99	0.3269
d)	We issue short-term when we are waiting for long-term market interest rates to decline	$\mu_1-\mu_2=0$	3.43	2.71	1.94*	0.0625
e)	We borrow short-term so that returns from new projects can be captured more fully by shareholders. rather than committing to pay long-term profits as interest to debt holders	$\mu_1-\mu_2=0$	3.38	2.86	2.16**	0.0358
f)	We expect our credit rating to improve. So we borrow short-term until it does	$\mu_1-\mu_2=0$	3.53	2.86	2.35**	0.0250
g)	Borrowing short-term reduces the chance that our firm will want to take on risky projects	$\mu_1-\mu_2=0$	3.20	3.37	0.50	0.6213

(***) represents level of significance at 1%, 5% and 10%. (**) represents level of significance at 5% and 10%. (*) represents level of significance at 10% and null hypothesis is rejected at these level.

Table 14

What factors affect your firm's choice between short and long term debt?

S.no.	Variables	H_0	Mean (Debt ratio)		t-stat	P value
			No	Yes		
a)	Matching maturity of our debt with the life of our assets	$\mu_1-\mu_2=0$	3.13	3.18	0.12	0.9083
b)	We issue long-term debt to minimize the risk of having to refinance in "bad times"	$\mu_1-\mu_2=0$	3.13	3.63	1.19	0.2502
c)	We issue short-term when short-term interest rates are low compared to long-term rates	$\mu_1-\mu_2=0$	2.93	3.53	1.48	0.1560
d)	We issue short-term when we are waiting for long-term market interest rates to decline	$\mu_1-\mu_2=0$	3.07	3.25	0.55	0.5848
e)	We borrow short-term so that returns from new projects can be captured more fully by shareholders. rather than committing to pay long-term profits as interest to debt holders	$\mu_1-\mu_2=0$	3.6	3.11	1.46	0.1602
f)	We expect our credit rating to improve. So we borrow short-term until it does	$\mu_1-\mu_2=0$	3.33	3.32	0.04	0.9692
g)	Borrowing short-term reduces the chance that our firm will want to take on risky projects	$\mu_1-\mu_2=0$	3.47	3.18	0.91	0.3701

(***) represents level of significance at 1%, 5% and 10%. (**) represents level of significance at 5% and 10%. (*) represents level of significance at 10% and null hypothesis is rejected at these level

Capital Structure Policies in Pakistan: Survey Evidence

1	2	3	4	5
Strongly Disagree	Disagree	Neutral	Agree	Strongly Agree

Please Bold the letter you want to choose in the options.

1) Industry
   a) Retail and wholesale
   b) Mining, construction
   c) Manufacturing (Name of industry...............................)
   d) Transportation, energy
   e) Communication, media
   f) Tech (software, biotech, etc.)
   g) Others

2) Publicly listed or Private listed_____

3) Your company is paying regular Dividends?

   YES / NO

4) Long term debt ratio

   0 %   1-9%   10-19%   20-29%   30-39%   40-49%   >49%

5) Annual sales volume in Rupees _____

6) **What factors affect how you choose the appropriate amount of debt (Bank loans, bonds, debentures etc.) for your firm?**

   a) Financial flexibility (we restrict debt so we have enough internal funds available to pursue new projects when they come along)

                                                 1   2   3   4   5

   b) Our credit rating (as assigned by rating agencies)   1   2   3   4   5

   c) The fluctuations in our earnings and cash flows   1   2   3   4   5

   d) The tax advantage due to the interest expense   1   2   3   4   5
   (More interest payments will reduce taxable income)

   e) The transactions costs and fees for issuing debt   1   2   3   4   5

   f) The debt levels of other firms in our industry   1   2   3   4   5

   g) The potential costs of bankruptcy, near-bankruptcy, or financial distress

                                                   1   2   3   4   5

h) We limit debt so our customers/suppliers are not worried about our firm going out of business

    1   2   3   4   5

i) We restrict our borrowing so that profits from new/future projects can be captured fully by shareholders (inform of dividends) and do not have to be paid out as interest to debt holders

    1   2   3   4   5

j) We try to have enough debt that we are not an attractive takeover target (no other company can take over our company)

    1   2   3   4   5

k) The personal tax cost our investors face when they receive interest income

    1   2   3   4   5

l) If we issue debt our competitors know that we are very unlikely to reduce our output/sales (by using loans we can increase our output)

    1   2   3   4   5

m) To ensure that upper management works hard and efficiently, we issue sufficient debt to make sure that a large portion of our cash flow is committed to interest payments

    1   2   3   4   5

n) A high debt ratio helps us bargain for concessions from our employees

    1   2   3   4   5

7) **What other factors affect your firm's debt policy?**

a) We issue debt when interest rates are particularly low

    1   2   3   4   5

b) We use debt when our equity is undervalued by the market

    1   2   3   4   5

c) We issue debt when our recent profits (internal funds) are not sufficient to fund our activities

    1   2   3   4   5

d) Changes in the price of our common stock

    1   2   3   4   5

e) We delay issuing debt because of transactions costs and fees

    1   2   3   4   5

f) We delay retiring debt because of recapitalization costs and fees

    1   2   3   4   5

g) Using debt gives investors a better impression of our firm's prospects than issuing stock

    1   2   3   4   5

h) We issue debt when we have accumulated substantial profits

    1   2   3   4   5

8) Has your firm seriously considered issuing common stock? If "yes", what factors affect your firm's decisions about issuing common stock?

a) Earnings per share dilution   1   2   3   4   5

b) The amount by which our stock is undervalued or overvalued by the market
     1   2   3   4   5

c) If our stock price has recently risen, the price at which we can issue is "high"
     1   2   3   4   5

d) Providing shares to employee bonus/stock option plans
     1   2   3   4   5

e) Maintaining target debt-to-equity ratio
     1   2   3   4   5

f) Diluting the holdings of certain shareholders
     1   2   3   4   5

g) Stock is our "least risky" source of funds
     1   2   3   4   5

h) Whether our recent profits have been sufficient to fund our activities
     1   2   3   4   5

i) Using a similar amount of equity as is used by other firms in our industry
     1   2   3   4   5

j) Issuing stock gives investors a better impression of our firm's prospects than using debt
     1   2   3   4   5

k) Inability to obtain funds using debt, convertibles, or other sources
     1   2   3   4   5

l) Common stock is our cheapest source of funds
     1   2   3   4   5

m) The capital gains tax rates faced by our investors (relative to tax rates on dividends)
     1   2   3   4   5

9) Has your firm seriously considered issuing debt in foreign countries? If "yes", what factors affect your firm's decisions about issuing foreign debt?

a) Providing a "natural hedge" (e.g.: if the foreign currency devalues, we are not obligated to pay interest in own currency)
     1   2   3   4   5

b) Keeping the "source of funds" close to the "use of funds"
     1   2   3   4   5

c) Favorable tax treatment relative to the home country name (e.g.: different corporate tax rates)

| | 1 | 2 | 3 | 4 | 5 |

d) Foreign interest rates may be lower than domestic interest rates

| | 1 | 2 | 3 | 4 | 5 |

e) Foreign regulations require us to issue debt abroad

| | 1 | 2 | 3 | 4 | 5 |

10) Has your firm seriously considered issuing convertible debt? If "yes", what factors affect your firm's decisions about issuing convertible debt?

a) Convertibles are an inexpensive way to issue "delayed" common stock

| | 1 | 2 | 3 | 4 | 5 |

b) Our stock is currently undervalued

| | 1 | 2 | 3 | 4 | 5 |

c) Ability to "call" or force conversion of convertible debt if/when we need to

| | 1 | 2 | 3 | 4 | 5 |

d) Avoiding short-term equity dilution

| | 1 | 2 | 3 | 4 | 5 |

e) To attract investors unsure about the riskiness of our company

| | 1 | 2 | 3 | 4 | 5 |

f) Convertibles are less expensive than straight debt

| | 1 | 2 | 3 | 4 | 5 |

g) Other firms in our industry successfully use convertibles

| | 1 | 2 | 3 | 4 | 5 |

h) Protecting bondholders against unfavorable actions by managers or stockholders

| | 1 | 2 | 3 | 4 | 5 |

11) What factors affect your firm's choice between short- and long-term debt

a) Matching the maturity of our debt with the life of our assets

| | 1 | 2 | 3 | 4 | 5 |

b) We issue long-term debt to minimize the risk of having to refinance in "bad times"

| | 1 | 2 | 3 | 4 | 5 |

c) We issue short-term when short-term interest rates are low compared to long-term rates

| | 1 | 2 | 3 | 4 | 5 |

d) We issue short-term when we are waiting for long-term market interest rates to decline

| | 1 | 2 | 3 | 4 | 5 |

e) We borrow short-term so that returns from new projects can be captured more fully by shareholders. rather than committing to pay long-term profits as interest to debt holders

        1   2   3   4   5

f) We expect our credit rating to improve. So we borrow short-term until it does

        1   2   3   4   5

g) Borrowing short-term reduces the chance that our firm will want to take on risky projects

        1   2   3   4   5