Impact of Capital Structure on Shareholder's Wealth

Tak, Alina

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CAPITAL STRUCTURE: IMPACT OF CAPITAL STRUCTURE ON SHAREHOLDER'S WEALTH

Content

1.0 INTRODUCTION

1.1 BACKGROUND STUDY:

The capital structure of a firm describes the way in which a firm raised capital needed to establish and expand its business activities. It is a mixture of various types of equity and debt capital a firm maintained resulting from the firms financing decisions. In one way or another, business activity must be financed. Without finance to support their fixed assets and working capital requirements, business could not exist. In all aspects of capital investment decision, the capital structure decision is the vital one since the profitability of an enterprise is directly affected by such decision. Therefore, proper care and attention need to be given while determining capital structure decision. Capital structure decisions are among the most significant finance decisions companies encounter. It has been long debated whether capital structures are influential on costs of capital and firm values. The theory of capital structure and its relationship with a firm‘s value and performance has been a puzzling issue in corporate finance and accounting literature since the Modigliani and Miller (1958) argue that under the perfect capital market assumption that, if there is no bankrupt cost and capital markets are frictionless, if without taxes, the firm‘s value is independent with the structure of the capital. Debt can reduce the tax to pay, so the best capital structure of enterprise should be one hundred percent of the debt. Since then, several theories have been developed to explain the capital of a firm including the Pecking order theory, Static Trade-off theory and agency cost theory. The firm‘s decision about its source of capital will affect its competitiveness among its peers. Therefore, firm should use the appropriate mix of debt and equity that will maximize its profitability.

The lack of consensus among the theories that try to explain the capital structure of a firm has led to many empirical studies in capital structure of the firm. These studies were trying to reach a conclusion about the impact of capital structure on shareholder's wealth. In connection to this, financing the firm's needs, the amount of debt to be undertaken is affected by several factors. Capital structure theory, specifically the trade-off model suggests that firms with high business risks should use less debt than lower risk firms. This because the higher the risk the higher probability that the firm will face financial distress. Furthermore, firms that have tangible asset should use more debt than firms that have more intangible assets since only tangible assets can be used as collateral. Besides, when financial distress occurs, intangible assets will most likely to lose value. It also stated that firms that are paying taxes at higher rates should take more debt since its bankruptcy risks is lesser than the lower taxpayer firms (Brigham et.al,1999). Pecking order theory that has been introduced by (Myers, 1977) is also relevant to deviation of capital structure. It states that firms have a preferred hierarchy for financing decisions. The highest preference is to use internal financing before resorting to any form of external fund. The Agency cost theory lastly states that an optimal capital structure is attainable by reducing the costs resulting from the conflicting between the managers and the owners. (Jensen and Meckling, 1976) argued that leverage level can be used to monitor the managers to pursue the overall firm's objectives and theirs. By doing so, cost is reduced leading to efficiency which shall eventually enhance firm performance (Buferna et.al, 2005).

How an organization is financed to both the managers of the firms and providers of funds. This is because if wrong mix debt and equity of finance is employed the performance and survival of the business enterprise may be seriously affected. This study wants to contribute

to the debate on the relationship between capital structure and firm performance to maximize shareholder's wealth from capital structure theory perspective. Financing decision facilitates the survival and growth of a business enterprise, which calls for the need to channel efforts of businesses towards realizing efficient financing decision, which will protect the shareholders interest. This implies effective planning and financial management through combination of an optimum capital structure by managers so as to maximize the shareholders wealth. A firm can finance investment decision by debts, equity or both. Financial managers are facing difficulties in precisely determining the optimal capital structure. Optimal capital structure means with a minimum weighted average cost of capital and maximize the value of the organization.

1.1.1 Overview of the industry:

Cement industry is one of the few industries that existed in Pakistan before the partition of the sub-continent. The major reason for the existence of this industry is the availability of the raw materials. Pakistan has inexhaustible reserves of limestone and clay, which can support the industry for another 50-60 years. The annual production of the cement at the time of the creation of Pakistan was only 300000 tons per year. By 1954 the production increased to 660000 tonnes per annum against a demand of 1000000 tonnes per annum. At this time PIDC took initiative and established two cement factories Zealpak (240,000 tonnes) and Maple Leaf (100,000 tonnes) having a capacity of 340000 tones, thereby increasing the production to 1000000 tonnes per annum. Since then besides expansion of the existing plants, new plants have also established. Besides producing OPC, the Pakistani cement industry also started producing SRC, Slag cement and white cement.

In 1921 the first cement plant was established at WAH. At the time of independence in 1947 there were four cement factories with an installed capacity of 470,000 tonnes per annum. These units were located at Karachi, Rohri, Dandot and WAH. In 1956 PIDC established two plants at Daudkel and Hyderabad and subsequently more plants were established in the private sector. The industry was nationalized in 1972 and the State Cement Corporation of Pakistan (SCCP) was established following the Economic Reforms Order, 1972. As a result of nationalization, a total of 10 cement units with an installed capacity of 2.8 million tonnes per annum were transferred to the SCCP. Effective price control was also vested with the SCCP and for a long time the industry operated under a regime of strict regulation and price control. While the cement industry was working under the state control, the SCCP established five new units with an installed capacity of 1.8 million tonnes per annum. For the next fifteen years no new cement plant was established under the private sector, which resulted in acute shortage of cement in late 70s and early 80s. This gap was filled by the import of cement. Severe shortage of cement and price deregulation prompted the private sector to establish more plants. Seven units were established in the private sector before commencement of the process of privatization in 1991.

1.2 THE PROBLEM STATEMENT:

The issue of capital structure has been a subject of major concern for researchers and scholars in recent years. Such concern has brought about a lot of arguments on the subject which led to numerous studies on it in the area of firms finance over the years. Capital

structure and its effect on firm performance and shareholder's wealth has became an issue that attract a large amount of researchers, such as (Kester W., 1986) Capital and Ownership structure, (Zeitun and Tian, 2007), (Onaolapo, A. and Kajola S.O , 2010), (Saeedi A., 2011),etc.

In spite the number of theories has explained the capital structure of firms. Despite the theoretical, appeal of capital structure, researchers in financial management have not found the optimal capital structure. For example, the lack of a consensus about what would qualify as optimal capital structure has necessitated the need for this research. A better understanding of the issues at hand requires a look at the concept of capital structure and its effect on shareholder's wealth.

The study attempts to determine how firms choose their capital structure, while considering many significant factors that might affect it in order to achieve their primary objective: maximizing value and shareholder wealth, while overcoming the conflict of interest between its shareholders and managers. The researcher particular goal here is to investigate the capital structure determinants and its impacts on shareholder's wealth in cement industry in Pakistan. This study attempts to analyze the relationship between capital structure and shareholder's wealth and provides applicable guideline for anyone who wants to have insight of the theory capital structure perspective.

1.3 OBJECTIVE OF THE STUDY:

The objectives of the study are;

- To identify the relationship between capital structure and its impact on shareholder's wealth

- To find which theory of capital structure applies in cement industry of Pakistan for maximization of shareholder's wealth

The objective of this research study can be interpreted as whether there is any significant effect of capital structure on shareholder's wealth. This study will be helpful for the identification of which theory of capital structure could be applied in cement industry of Pakistan to determine how they can maximize their wealth.

1.4 SIGNIFICANCE OF THE STUDY:

The main objective of this study was the determinants capital structure and its impacts on shareholder's wealth of cement industry in Pakistan. In general, this study will cover many aspects of the topic but specifically it has been tried to determine the relationship between of capital structure determinants and shareholder's wealth. This study especially will help the managers to take the financing decision for their firms. The creditors can also take the benefit to minimize their risk, in funding a specific sector firms. This study will be beneficial to cement company's management and investors in making clear decisions on capital structure. In addition to the above, a lot of work is written because of the endless argument on capital structure theories. This study is another contribution to the existing work on the study of the impact of capital structure on maximizing company's value in cement industry.

1.5 JUSTIFICATION OF THE STUDY:

The reason for the researcher to base the study on cement industry of Pakistan, companies listed in Karachi stock exchange is, as it is still in the developing stage. The cement industry of Pakistan is considered as one of the thriving industrial sectors of the country. It has full

potential to contribute high amount of income and GDP to the reserves of the Government. As cement industry grows the whole economy also grows. And for a thriving cement industry it's important to create a capital structure which can offer balance between the ideal debt-to-equity capitals and minimizes the firm's cost of capital.

Furthermore, this research study will gather the point of view of the cement companies about creating a Capital structure portfolio. In addition, the intention of investors toward being a shareholder affect by relationship balance of debt and equity to minimize the cost of capital and maximize their wealth.

1.6 SCOPE OF THE STUDY:

This research is mainly focusing on the area of capitalization, which is a sub area of finance. This research study is taking place on cement companies listed in KSE, Pakistan and mainly the top sixteen companies of cement sector listed in Karachi stock exchange to analyze the relationship between capital structure and shareholder's wealth. This research will be useful for other companies of this sector as well as guiding them before becoming a shareholder of any company to analyze it Capital structure portfolio for a better investment prospect.

1.7 LIMITATIONS OF THE STUDY:

There are few limitations of the study;

- Financial statements are the only source of information of the selected companies of the sector.
- The result of the research can improve by using more variables or taking large number of sample size.

1.8 BASIC ASSUMPTIONS OF THE STUDY:

In this study, the researcher is going to analyze the relation between capital structure and shareholder's wealth. The basic assumption for the research study is whether the companies in cement sector capital structure directly affect shareholder's wealth or not.

2.0 REVIEW OF RELATED LITERATURE

2.1 INTRODUCTION:

Capital structure has been an important focus point in the literature since Modigliani and Miller started publishing their research about it in 1958. Capital structure is a remarkable topic because it has researched in both academic level and corporate level since the financing decisions of a firm are of vital importance for its operating and investing activities. Therefore, there are many theories, which discuss it in many different ways. It is referred how a firm mixes debt and equity in order to finance itself or in other words, it concerns about combination of funds, in the form of debt and equity. Therefore, there is still hot debate regarding that does an optimal capital structure exist and how capital structure affects shareholder's wealth and vice versa. The issue of capital structure is concerned with the optimal mix of debt and equity in the capital structure. This mix results in minimum weighted average cost of capital and this consequently maximizes the firm's financial performance in terms of shareholders'value. The optimasl capital structure in the real world can be explained by the trading-off between the gains from debt and different related costs such as bankruptcy, financial distress and agency costs (Scott 1976) and

(Copeland & Weston 1992).The leading theory of capital structure was started in 1958 by Modigliani and Miller. The demonstrate that in a perfect world (no taxes, perfect and credible disclosure of the information and no transaction and agency costs), the level of debt in a firm‘s capital structure would have no impact on the firm‘s value and performance, as well as shareholder value. After this initial work, capital structure mainly depends on theories which include corporate taxes, financial distress, agency costs, trade off and signaling. In their later work, (Modigliani and Miller 1963) focus initially on the advantages of debt finance through the effect of corporate taxes. Debt is useful through the trading-off between the benefits of tax reduction on interest payments and the costs of financial distress. In 1977 Miller continues to their work and states that the firm has an incentive to use debt and will continue to use it until their additional supply drives up interest rates to the point where tax advantages of interest deduction are completely offset by higher rates.

2.2 DIFFERENT THEORIES OF CAPITAL STRUCTURE

Capital structure theory, as known today, originates from the work of Modigliani and Miller, hereafter named M&M, who published their famous article in 1958. Many, if not all business and finance academics have heard and know about M&M‘s capital structure irrelevance proposition and several textbooks within corporate finance begin their explanations of capital structure and cost of capital with the work of M&M. In addition (M&M Myers, 2002) indicates that the capital structure theories and empirical evidences focus mainly on financing strategy as well as the selection of an optimal debt ratio for a certain type of firm that operates in a distinct institutional environment. According to (Myers, 2002), these theories are credible not because they do a perfect job highlighting

the differences in total debt ratios, but because the costs and benefits that drive the theories at work in financing strategies can be observed. While there is no universal theory of capital structure, there are however, some relevant conditional theories and these theories can be distinguished in their relative focus on the factors that could significantly impact the right mix of debt and equity. These factors comprise taxes, agency costs, and differences in information, institutional or regulatory constraints and a whole lot more (Myers, 2002). The same author stressed that each of these factors could be very significant for some firms and for other firms they could be highly unimportant. The leading theories are given below. Majority of these theories overlap and a blend of these theories help in explaining capital structure.

2.2.1 The Modigliani-Miller Theory:

As previously mentioned, the irrelevance theory of capital structure, which has been introduced by (Merton Miller and Franco Modigliani, 1958) denoted by M&M throughout the researcher paper-was the first break through in relation to the subject of capital structure and its effects on financial performance. They first hypothesized that if markets are perfectly competitive, firm performance will not be related to capital structure, there by suggesting no significant relationship between a firm‘s capital structure and its performance. The value of the firm is similarly unaffected by its financial structure. Their assumptions of a perfectly competitive market exclude the impacts tax, inflation and transaction costs associated with raising money or going bankrupt. In addition they also assume that disclosure of all information is credible, thus there is no information asymmetry (Hamada, 1969 and Hatfield et.al, 1994). There were various criticisms, which encouraged M&M to issue an alteration to their first theory, which refers to as MM2. In

their revised proposition they incorporated tax benefits as determinants of capital structure. The vital characteristic of taxation is the acknowledgement of the interest as a tax deductible expenditure. According to M&M a company that respects its tax obligations, benefit from partially offsetting interest, namely the tax shield, in the form of paying lower taxes. Thus M&M indicate that companies can maximize their value by employing more debt due to tax shield benefits allied with the use of debt. Hence, firms benefit from taking on more leverage. M&M show that firm value and firm performance is an increasing function of leverage due to the tax deductibility of the interest payments at the corporate level (Modigliani & Miller, 1963). In reality, markets are inefficient, due to taxes, information asymmetry, transaction costs, bankruptcy costs, agency conflicts and any other imperfect elements. When taking these elements into consideration, the M&M theorem tends to lose the majority of its explaining power. Even though M&M theory was heavily criticized of some weaknesses and its irrelevant assumptions of the real world, this theory still provides the foundation for many other theories suggested by other researches.

2.2.2 Trade-Off Theory:

The tradeoff theory model originated from the debate over the M&M‘s theorem. When corporate tax was added to the original irrelevance proposition of M&M, a benefit for debt is observed that serves to shield earnings from taxes. This theory states that the optimal capital structure is the trade-off between the benefits of debt i.e., the interest tax shields and the costs of debt i.e., the financial distress and agency costs (Brigham and Houston, 2004).

2.2.3 Pecking Order theory:

Unlike the trade-off theory, the pecking order theory does not assume an optimal level of capital structure. As previously indicated (Myers and majluf, 1984) favor the pecking order theory, which incorporates the assumption of information asymmetries and transaction costs. This pecking order theory therefore suggests that firms should follow a financing hierarchy in order to minimize information asymmetry between the parties. It states that companies prioritize their source of financing, from internal financing to equity financing, according to the principle of the least resistance, preferring to raise equity as a financing means of last resort. So, the pecking order theory claims that internal funds are used first and only when all internal finances have been depleted, firms will optimum for debt. When it is not sensible to issue any more debt, they will eventually turn to equity as a last financing resource. Summarizing, theory predicts that more profitable firms that generate high cash flows are expected to use less debt capital than those who generate lower cash flows. The pecking order theory argues that businesses adhere to a hierarchy of financing sources and prefer internal financing when available. However, when external financing is required, firms prefer debt over equity. Equity entails the issuance of additional shares of a company, which generally brings a higher level of external ownership into the company. Therefore; the form of debt that a firm chooses can act as a signal for its need of external finance. Thus firms that are profitable and therefore generate high cash flows are expected to use less debt compared to those who do not generate high cash flows. This theory therefore suggests that firms prefer debt to equity (Muritala, 2012). All of the mentioned mechanisms suggest that the pecking order theory claims a negative relationship between capital structure and firm performance, since more profitable firms opt to use internal financing over debt.

2.2.4 Agency Cost Theory:

The next important theory mentioned in the literature is the agency cost theory. Jensen and Meckling developed this theory in their 1976 publications. This theory considered debt to be a necessary factor that creates conflict between equity holders and managers. Both scholars used this theory to argue that the probability distribution of cash flows provided by the firm is not independent of its ownership structure and that this fact may be used to explain optimal capital structure. Jensen and Meckling recommended that, given increasing agency costs with both the equity-holders and debt-holders, there would be an optimum combination of outside debt and equity to reduce total agency costs. Research made by (Fama, Miller, Jensen, 1976) observed how agency cost model. This is known as an agency cost model. It states that capital structure is determined by its agency cost. They found two types of problems create agency theory those are conflict between firm managers and shareholders as well as conflict between debt holders and shareholders.

2.2.5 Free cash flow theory:

Following the main agency theory as advanced by (Jensen and Meckling, 1976) and the existence of information of information asymmetry between managers and shareholders, (Jensen 1986) expanded the work to highlight an important problem, the free cash flow. "Free Cash flow is cash flow in excess of that required to fund all projects that have positive net present values when discounted at the relevant cost of capital" (Jensen1986). Substantial free cash flows in the hands of managers can be used in increasing dividends or repurchasing stocks and there by payout current cash. Otherwise, managers will invest in lower turn projects. Debt is used to control the manager's opportunistic behavior by

reducing the free cash flows. This will prevent over investment or investment in negative projects by committing the managements to pay fixed interest payments.

2.3 EMPERICAL STUDIES CAPITAL STRUCTURE DETEMINANTS:

In addition to above, empirically literature there is no comprehensive study between determinants of capital structure and financial performance according to the knowledge researcher. However, size- performance and risk –performance are well investigated in previous studies. Few studies have highlighted the relationship between firm's characteristics and its profitability of the firm. The following section summarizes all available studies in this concern.

2.3.1 Leverage:

The pecking theory of capital structure shows that if a firm is profitable, then it is more likely that financing would be from internal sources rather than external sources. In other words, firms tend to use internally generated funds first and then resort to external financing. This implies that profitable firms will have less amount of leverage (Myers and Majluf, 1984). By this, profitable firms that have access to retained profits can rely on them as opposed to depending on outside sources (debt). (Murindeet al., 2004) observes that retentions are a principal source of finance. (Titman and Wessel‘s, 1988) and Barton et al. (1989) agree that firms with high profit rates would maintain relatively lower debt ratios since they can generate such funds from internal sources. Empirical evidence from previous

studies seems to be consistent with the pecking order theory. Most studies found a negative relationship between profitability and capital structure (Friend and Lang, 1988); (Barton et al., 1989); (Van der Wijst and Thurik, 1993); (Chittenden et al., 1996; Jordan et al., 1998); (Shyam-Sunder and Myers, 1999); (Mishra and McConaughy, 1999);. (Cassar and Holmes, 2003), and (Hall et al., 2004) also suggest negative relationships between profitability and both long-term debt and short-term debt ratios. (Petersen and Rajan, 1994), however, found a significantly positive association between profitability and debt ratio. Therefore, propose based on the pecking order theory that a negative relationship exist between profitability and leverage.

2.3.2 Asset growth:

According to (Brush, Bromiley, &Hendricks, 2000) in the light of free cash flow hypothesis, they conducted in Maryland-USA found a strong positive relationship between sales growth and a firm‘s financial performance in terms of stockholders' returns and return on assets. Additionally, for the top 500 Australian companies. In addition of this (Hutchinson and Gul, 2006) they found that firms with high investment opportunities are associated with lower agency costs and better return on equity. According to (Amidu,2007), using return on equity and return on assets for Ghana, finds support for the fact that growing firms have a prospect of generating more returns for the owners.

2.3.3 Firm's size:

Many studies investigate the relationship between size and firm performance. According to the studies (Orser, Hogarth-Scott, & Riding 2000), using Canadian firms using changes in gross revenue to reflect performance. Theyfind a positive effect for a firm's size support

the arguments that size reflects greater diversification, economies of scale production, greater access to new technology and cheaper sources of funds. Besides, of those, (Shergill &Sarkaria 1999) using data of Indian firm also confirm a positive relationship between a firm's size and financial performance. However, according to the study, (Moen, 1999) for a Norwegian company finds that export performance is not subject to the firm's size (employment). He finds that small firms are just as successful as large firms and the main competitive advantages are their products and technology.

2.4 HISTORICAL PERSPECTIVES

(Gupta n.d) the firm's capital structure which increases the shareholder's wealth and decreases the firm's cost of capital is referred to capital structure of the firm. The statement explains as that basic goal of capital structure is to decrease the firms cost of capital and increase the shareholders wealth.

(Li & Cui 2003) implies that to increase the worth of equity for shareholders managers make decisions of financing their operations according to capital structure theories. The statement explains us that basic goal of the managers is to maximize the value of the firm by attaining higher profits those results in the maximization of shareholders wealth so we can say that capital structure substantially affect the shareholder's wealth.

(Abor, 2005) reviewed the impact of capital structure on profitability of the 22 companies listed in Ghana Stock Exchange during 1998 to 2002. Results showed that there is a significant positive relationship between capital structure (total debt to total assets ratio) and return on equity (ROE). Also he indicates that profitable companies have more

dependence to financing through liability and high percent (85%) of liabilities of these companies are short term liabilities.

(Sunder and Myers, 1999) examined the effect of four factors: assets tangibility, growth opportunities, company's tax status and profitability on the capital structure (debt ratio) of 157 American companies in the period of 1979 to 1981. Research results indicate a significantly positive relationship between assets tangibility with debt ratio and a significantly negative relationship between debt ratios with firm profitability. Moreover, there is no significant relationship between two variables, growth opportunities and the tax status with the debt ratio

(Rajan and Zingales, 1995) studied the determinant factors of capital structure of common company corporations in seven large countries around the world (America, Japan, Germany, France, Italy, Britain and Canada) during 1987 to 1991. In this study, they chose 4557 companies as samples of these seven countries. Research findings indicate that financial leverage has negative relationship with profitability and market value to book value ratio and positive relationship with the value of tangible fixed asset and firm size.

(Sogorb, 2005), Surveyed the impact of small and medium companies' features on their capital structure in Spain during 1994 to 1998. In this study, he used from data of 6482 nonfinancial companies in 8 industry order. Results show that tax reserves and profitability of these companies have negative relationship with capital structure while size, growth opportunities and assets structure in these companies have positive relationship with capital structure.

(Harris and Raviv, 1991), (Chevalier, 1995) and (Kovenock and Phillips, 1995) Surveyed the effect of various industries on capital structure decisions and conclusion was that the type of industry can affect the use of debts and firms performance.

(Daskalakis and Psillaki 2005) in their research reviewed the determinants of Capital Structure of the SMEs in the Greek and the French companies. This study was performed on the1252 Greek companies and 2006 French companies during a six-year period from 1997 to 2002. In this study, they used from assets structure (tangible assets to total assets ratio), size, growth opportunities and profitability of company as determinants of capital structure. Results for their research showed that assets structure and profitability have negative relationship with debt ratio (Capital Structure) in both +countries, but firm size and growth opportunities have positive relationship with Capital Structure.

The study conducted by (Eriotis, et al., 2002) investigated the association between debt to equity ratio and entity‘s profitability. They discovered that those entities that prefer to finance their investment activities using equity capital are more profitable than firms who finance by using borrowed funds.

The study conducted by (Huang and Song, 2006) examined the determinants of capital structure in Chinese listed companies in order to investigate whether firms in the largest developing and transition economy of the world entertain any unique characteristics in their capital structure choice. The paper employed a new database containing both market and accounting data of 1216 Chinese quoted companies from 1994 to 2003. Six measures of leverage are were used in the study such as book long term debt (LD) ratio, book total debt (TD) ratio, book total liabilities (TL) ratio, market long term debt (MLD) ratio,

market total debt (MTD) ratio and market total liabilities (MTL) ratio together with expressed capital structure determinants such as ROA, Size, tangibility, tax, growth, ownership structure and volatility. The data were analyzed using the Ordinary Least Square (OLS) regression method and the Tobit model. The empirical results showed that as in other countries, leverage in Chinese listed firms increase with firm size and fixed assets and decreases with profitability, non debt tax shields, and growth opportunity managers shareholdings. The study also revealed that state ownership or institutional ownership has no significant impact on capital structure of Chinese companies. However, Chinese firms tend to have much lower long-term debt as compared to those in developed economies

2.5 CURRENT PERSPECTIVE:

(Saleem, 2013) expressed that the best possible choice of debt and equity share that will increase the shareholder's wealth is referred to as capital structure of the firm. In above given statement the purpose of setting the capital structure is defined as the set of equity and debt combination that will maximize the shareholders wealth. If you are given the preferences to the shareholders of the firm by giving them the higher returns you are more focused on the shareholders wealth maximization that also results in increasing the overall firm's value in the market due to the goodwill created in the minds of their investors that are shareholders.

(San & Heng, 2011) revealed that decrease in WACC results in increasing the value of the firm that is defined as capital structure. There is no any specific formula or theory still designed to conclusively define the capital structure of the firm that increase the firm's

overall value after lots of researches that have conducted on the concept of capital structure. The process of minimizing the weighted-average cost of capital (WACC) that will maximize the firm's value is known as Capital structure selection. There have been unlimited researches done in regard of designing the theory that equally provides the Capital Structure of all the firms.

(Velnampy & Niresh 2012) revealed that profitability of the firm's is dependent upon the capital structure decisions of the firm having the different debt and equity combination that can well suited to increase the profitability of the firm. The result of the theory shows that important part of the firm's financial strategy is to prosperous choice and use of its capital. The relationship between firm's capital structure and the firm's profitability is very significant as the profitability of the firm can be directly affected by the capital structure decisions of the firms and decision about firms Capital structure is very important element in the firms overall strategy.

(Chowdhury & Chowdhury 2010) expressed that in order to increase the shareholder's wealth the suitable selection of capital structure of the firm between debt and equity combination plays the vital role. In order to define firm's value by implementing the process of future cash flows discounting technique, WACC is used. The purpose of selecting the right capital structure of the firms is to maximize the firm's value, profitability and shareholders wealth.

According, (Gropp and Heider, 2010) analyzed the factors determining the financial structure of U.S and European banks by collecting data for 14 years from 1991 to 2004 on 200 U.S and European banks. The main intention of this research was to identify the effect

of variables such as collateral, profitability, market-to-book ratio, size, risk and dividend on banks. The empirical estimation of fixed effects regression model indicates that risk, profitability and dividend have negative impact on leverage of the bank while collateral and size have direct a relation with debt ratio and the separate analysis of US and European banks also reports the same results. Furthermore, they suggested that regulatory capital requirements are of second order importance.

2.6 RESEARCH GAP FILLED BY THIS RESEARCH:

The research gap filled by the researcher is as many theories about capital structure has been issued but no theory has completing stated about in exact words about impact of capital structure on maximize shareholder's wealth. In cement sector, where large amount of capital spending is required, it's important to create an optimal capital structure portfolio. As in additions capital structure portfolio represents company's profile for further investment by the investors.

2.7 AREA FOR FUTHER RESEARCH:

This research study is only focusing on the nature of cement industry whether their capital structure portfolio's has impact upon their shareholder's wealth or not. However, investor's perspectives in automotive companies are not discussed in this research study. Therefore, the result of this study can improve by knowing the perspective of the investor's too. One other for the improvement of the study is to take some more independent or dependent variables (Sindhu, 2014).

3.0 RESEARCH METHODOLGY:

The basic purpose of this research study is to find relationship between the variables, which are firm specific factors such as, firm size, profitability (ROE), Leverage, Asset growth and share price. In this research, the researcher is observing the financial statement of different companies on cement companies in cement sector of Pakistan. In addition, these companies are already listed in Karachi stock exchange. It's a quantitative study and random sampling technique is used. The correlation analysis method is the use in this research to analyze the strength of the relationship between research variables.

3.1 Research design

3.1.1 Research Philosophy:

The philosophy of the research, which is use in this research, is positivism. The reason behind to select both the philosophy is it deals with the factual knowledge. In this research philosophy is positive, information is been gathered from observable experience then it has been analyzed by testing the hypothesis (Saunders, Lewis, & Thornhille, 2009).

3.1.2 Research Approach:

Quantitative-Deductive research approach is used in this research. There are numerous stages in this research approach. According to the (Saunders, Lewis, & Thornhille, 2009), they list down five stages of the deductive approach. First the construction of theory, second formulation of the hypothesis, third is the testing of the hypothesis, fourth is the evaluation of the theory and in last, the modification, of the theory in the light if result.

3.1.3 Research Strategy:

There are five major categories of the research strategy. One of the research strategies is documentation analysis, which is used in this research study. In this research strategy researcher can find the relationship between the variables without describing the cause of the relationship between independent and dependent variables (Saunders, Lewis, & Thornhille, 2009).

3.1.4 Research Choice:

There are three types of research choices, which are mono, multi and mixed method. The research choice of this research study, by which the research collects data, is mono method. In this research choice, the researcher is going to collect data by using only one method whether it is quantitative or qualitative (Saunders, Lewis, & Thornhille, 2009).

3.1.5 Research Time Horizon:

(Saunders, Lewis, & Thornhille, 2009) explains that there are two type of time horizon, which are longitudinal and cross sectional. The horizon of this research study is cross sectional. In this type of time horizon, the researcher will conduct a research in a shot span of time or he/she has a limited period to complete it.

3.1.6 Research Technique:

The research technique of this research study is scientific. This research technique is discussed in (Saunders, Lewis, & Thornhille, 2009), it is comprises on eight steps. Steps of this research technique are formulation the question of the research, generating

hypotheses, conceptual definition, operational definition, collection of data, analyzing, testing and conclusion.

3.1.7 Research Procedure:

The research procedures of this research study are as following;

- Background of the study
- Literature review of the study
- Formulation of hypothesis
- Gathering the data from financial statement
- Analyzing and interpretation of the data
- Conclusion and recommendation of the study

3.2 Research Structure:

3.2.1 Statement of the problem:

The problem statement of this research study is attempts to analyze the relationship between capital structure and shareholder's wealth.

3.2.2 Research Questions:

The research questions of this research study are as following;

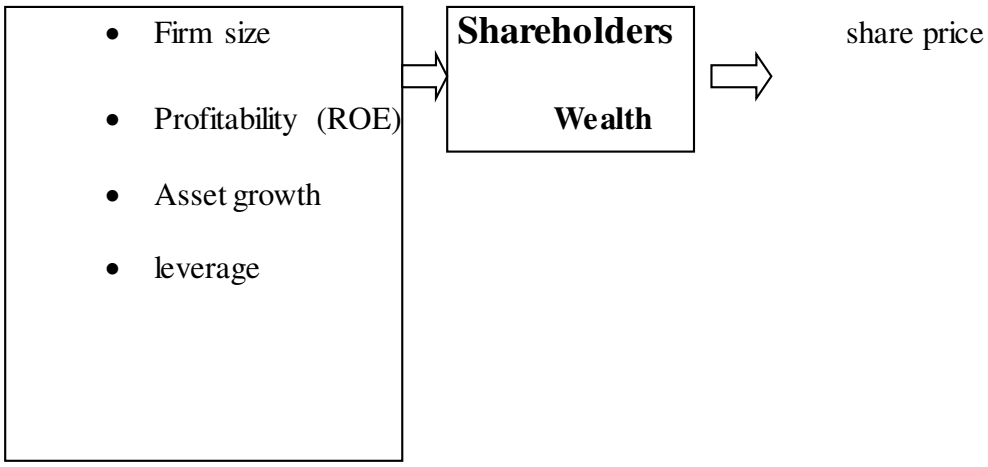
Q1: Does capital structure have significant effect on shareholder's wealth?

3.2.3 Research Objective:

The research objectives of this research are as following;

To measure the impact of capital structure on shareholder's wealth

3.2.4 Conceptual Framework:



3.2.4.1 INDEPENDENT VARIABLES:

PROFITABILTY:

There are different views regarding the relationship between leverage and profitability according to capital structure theories. Trade of theory predicts that profitable firms would employ more debt because of the tax shield that comes from increased leverage (Myers, 1984)

FIRM SIZE:

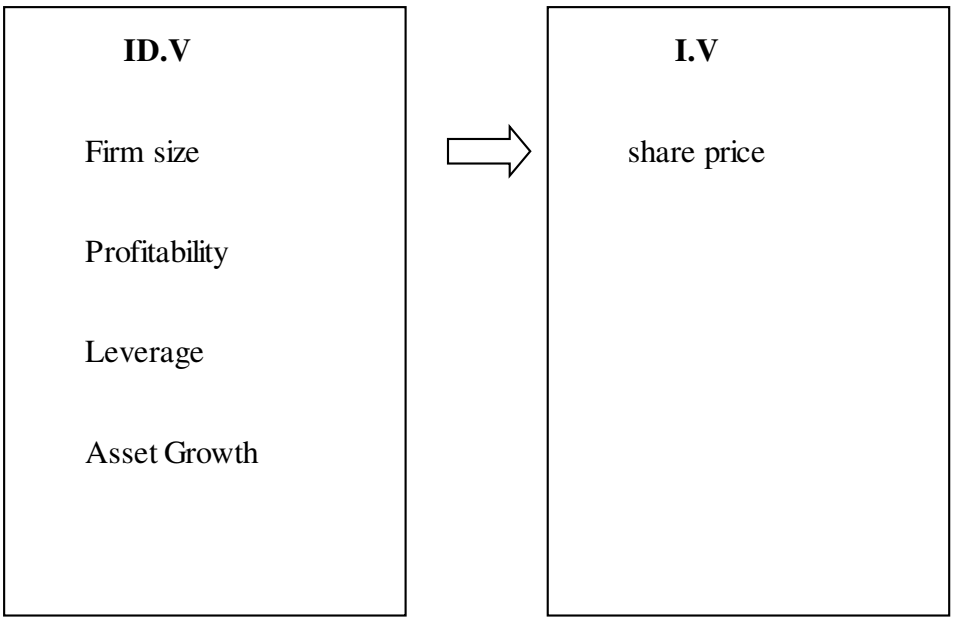
According to trade-of-theory, firm size could be an inverse proxy of the probability of bankruptcy. Larger firms are found to be more diversified and fail less often. They can lower costs, relative to firm's value in the case of bankruptcy. Larger are more likely to have higher debt capacity and are expected to borrow more to maximize the tax benefit from debt because of diversification (Titman and Wessel's, 1998).

LEVERAGE:

The pecking theory of capital structure shows that if a firm is profitable, then it is more likely that financing would be from internal sources rather than external sources. In other words, firms tend to use internally generated funds first and then resort to external financing. This implies that profitable firms will have less amount of leverage (Myers and Majluf, 1984). By this, profitable firms that have access to retained profits can rely on them as opposed to depending on outside sources (debt). (Murindeet al., 2004) observes that retentions are a principal source of finance. (Titman and Wessel's, 1988) and (Barton et al., 1989) agree that firms with high profit rates would maintain relatively lower debt ratios since they can generate such funds from internal sources.

3.2.4.2 DEPENDENT VARIABLE:

3.2.5 Research Variables:



3.2.6 Hypothesis:

H1: Leverage has a positive impact on shareholder's wealth on cement companies

H02: Firm's size has a positive impact on shareholder's wealth on cement companies.

H3: Asset Growth has positive impact on shareholder's wealth on cement companies

H4: The shareholder value creation is positively influenced by the profitability.

3.3 Research Tools and Techniques

3.3.1 Justification for selected tools and techniques:

In this research study, researcher use co-relational analysis to find the relationship between capital structure and shareholder's wealth. (Saunders, Lewis, & Thornhille, 2009) defines the co-relational analysis is a technique to assess the strength of the relation between the variables.

3.3.2 Population and target population:

Population and target population is defined by the (Cooper, 2014), the set of all the elements by which we want to make some conclusions is called population. On the other hand, target population is defined as the process of selecting some of the elements from the population in order to draw the conclusion about the entire population.

The population of this research study is on cement companies in Pakistan, which are listed in Karachi stock exchange.

3.3.3 Sample Size:

(Saunders, Lewis, & Thornhille, 2009) discuss in their study that sample size is the total number of observations used, which are used by the researcher, to draw conclusion about the given population.

The sample size of this research is sixteen cement companies in Pakistan. This sample size is selected according to the sample size table. It has been mentioned in the sample size table that if you have the population size of nineteen with a confidence level of 95% and margin of error is 5%, so at this level sample size is about of 16. For the purpose of data collection, the researcher is going to analyze the financial statement of the companies, from the year 2011 to 2015.

3.3.4Method of Sampling Selected and its Justification:

According to (Saunders, Lewis, & Thornhille, 2009), sampling method are two types, which are probability and non-probability. Random sampling technique is used in this research study, which is a part of probability sampling. In this sampling method, researcher can select those elements for the study, which are easily accessible.

4.0 DATA ANALYSIS AND INTERPRETATION:

For this research, audited financial statement of companies including balance sheets and cash flow statement analyzed for the purpose of data collection. In addition, the financial statements are available on the difference financial securities companies websites are examined (Darabi, M.Adeli & M.Torkamani, 2012).

4.1 DESCRIPTIVE STATISTICS:

In the descriptive statistics, analysis of the data is conducted by calculating the central indexes (mean, median and mode) and dispersion indexes (standard deviation, skewness, and kutosis) for all the industries. Subsequently, correlation is use to evaluate the strength of the relationship between the variables (Darabi, M.Adeli & M.Torkamani, 2012).

In this research study, numerical data of sixteen (16) cement companies for five year (from 2011 to 2015) extracts from financial statement, which is then examine by EViews in order to test the hypothesis.

Dependent Variable: LOGSP
Method: Panel Least Squares
Date: 06/24/16 Time: 10:36
Sample: 2011 2015
Periods included: 5
Cross-sections included: 16
Total panel (balanced) observations: 80

Variable	Coefficient	Std. Error	t-Statistic	Prob.

C	-12.23317	4.833607	-2.530856	0.0140
LOGFIRMSIZE	1.847290	0.461532	4.002519	0.0002
ROEP	1.403334	0.466909	3.005584	0.0038
LEVERAGEP	-1.274937	0.593875	-2.146812	0.0358

Effects Specification

Cross-section fixed (dummy variables)

R-squared	0.845092	Mean dependent var	3.378786
Adjusted R-squared	0.799381	S.D. dependent var	1.324218
S.E. of regression	0.593123	Akaike info criterion	1.997018
Sum squared resid	21.45950	Schwarz criterion	2.562749
Log likelihood	-60.88071	Hannan-Quinn criter.	2.223836
F-statistic	18.48790	Durbin-Watson stat	1.082037
Prob(F-statistic)	0.000000		

5.0 CONCLUSION AND RECOMMENDATIONS:

Natures of each of the companies are different in terms of financial position from one another. The research study which named "Capital structure: impact of capital structure on shareholder's wealth" discovered that how companies deal with the management of capital expenditures in the organizations and the factors by which it has a positive and negative impact. The main purpose of this study was to understand how shareholder's wealth is effect by the capital structure processes. Most of the time a company spends the surplus cash in the capital spending in order to reduce the borrowing. Alternatively payments of dividends made by the company to the shareholders in order to share the profit,(Darabi, M.Adeli & M.Torkamani, 2012).

This research study contains four hypotheses and in which two are acceptable and two are not acceptable, based on the result from all the hypotheses which favors the criteria, established in this study. After the testing of the hypotheses, it is proved that there is a correlation of Profitability and firm size with capital structure and liquidity and tangibility of assets as a negative relation with capital structure in the increment of shareholder's wealth. In other words, result confirms that the strength of the relation between the variables can be strong and weak too as not every variable has a positve impact of shareholder's wealth.

In the end, this research study sums up as the results of all four hypotheses are not acceptable only two are acceptable and two are not acceptable. The result supports two theories of capital structure one pecking order theory and other trade-off-theory. This study will provide important policy implications for financial managers in choosing appropriate capital structure for the maximize value of the firms. In addition to that the researchers can utilize the result of the study for further analysis and also incorporate other factor like agency cost, bankruptcy risk, and managerial actions, financial flexibility etc. to achieve a better view of the capital structure of different companies in Pakistan.

7.0 APPENDIX:

LIST OF COMPANIES:

ACPL	Attock Cement (Pakistan) Limited
BWCL	Bestway Cement Limited
CHCC	Cherat Cement Company Limited
DGKC	D.G. Khan Cement Company Limited
DNCC	Dandot Cement Company Limited
DCL	Dewan Cement Limited
FCCL	Fauji Cement Company Limited
FECTC	Fecto Cement Limited
GWLC	Gharibwal Cement Limited
KOHC	Kohat Cement Limited
LUCK	Lucky Cement Limited
PAKCEM	Pakcem Limited
PIOC	Pioneer Cement Limited
POWER	Power Cement Limited
SMCPL	Safe Mix Concrete Limited
THCCL	Thatta Cement Company Limited

TOTAL ASSETS:

	2011	2012	2013	2014	2015	Total Avg
ACPL	7,743.15	8,892.62	10,678.75	11,926.00	12,234.54	10,295
BWCL	33,378	33,694	39,856	34,795	62,240	40,793
CHCC	5365	4711	5065	6431	9,464	6,207
DGKC	49673.05	50,685.20	66356.719	73,282.07	74,391	62,878
DNCC	2,909.71	2759.798312	2690.829043	2867.790905	2,759	2,797
DCL	20,591.53	21,041.36	21,597.47	23,36.521	24,639	21,967
FCCL	32,210.83	30,703.47	30,305.05	29,381.33	30,528	30,626
FECTC	3,108.09	3,308.77	3,359.02	3856.638	4,253	3,577
GWLC	12,577.45	12,579.18	12,952.71	15,179.89	15,884	13,835
KOHC	9,124.40	9,212.88	10,794.50	14,151.46	17,061	12,069
LUCK	41,210	40,631	50,196	59,870	73,086	52,999
PAKCEM	19,217.17	199,527.87	20,196.86	19,243.57	18,376	55,312
PIOC	9847.4	10,110.50	11,602.20	11,877.10	12,114	11,110
POWER	5,169.41	5,183.08	5,619.14	5,785.82	5,988	5,549
SMCPL	322.253644	328.989914	346.20818	387.934327	458	369
THCCL	1,992.17	2,041.99	21,96.951	2,969.51	3,559	2,641

TOTAL LIABILITIES:

	2011	2012	2013	2014	2015	TOTAL AVG
ACPL	1944.74	2,279.76	2,849.92	3,479.95	3,299.40	2770.754
BWCL	9,629.47	8,083.86	6,755.39	12,250.58	36,827.63	14,709.39
CHCC	3,034	1,963	1,356	1,567	1,438	1,872
DGKC	19,455.77	17,785.67	15,569.92	11,765.53	12,095.37	15,334.45
DNCC	3,667.52	4,024.38	4,394.16	5,092.60	5,020.43	4,439.82
DCL	13,026.43	13,174.15	13,345.28	13,596.63	12,993.86	13,227.27
FCCL	21,196.81	17,253.36	14,368.69	13,593.15	13,109.31	15,904.26
FECTC	11,078.76	1,932.71	1,449.97	1,477.64	1,331.90	3,454.20
GWLC	9,592.31	9,918.12	9,057.29	8,869.78	8,401.88	9,167.87
KOHC	7,021.58	5,456.42	4,753.54	5,563.99	6,264.21	5,811.95
LUCK	13,437.03	7,369.50	9,160.73	5,977.45	13,827.10	9,954.36
PAKCEM	10,516.38	9,338.87	7,164.21	6,113.77	4,653.27	7,557.30
PIOC	5,322	5,192.50	5,432.90	5,074.70	3,781.30	4,961
POWER	4,197.43	4,057.67	4,123.77	4,357.27	4,126.04	4,172.44
SMCPL	118.40674	131.897746	133.890135	162.0701	160.180512	141.29
THCCL	10,125.54	1,083.75	1,090.23	1,820.26	1,905.62	3,205.08

NET INCOME:

	2011	2012	2013	2014	2015	Total avg
ACPL	684	1,437	2,138	2,014	2,206	1695.8
BWCL	179.230225	3,570.94	6,288.27	7,871.74	8,667.93	5315.619645
CHCC	69	437	1,228	1,316	1,288	867.6
DGKC	170.961	4,108.12	5,502.17	5,965.50	7,624.68	4674.2852
DNCC	-33.916	-506.774	-466.8	-52.026	-497.26	-311.3552
DCL	-362	383	450	437	710	323.6
FCCL	426	553	2,097	2,626	4,116	1963.6
FECTC	65.433	346.729	583.15	595.341	617.47	441.6246
GWLC	-984.542	-254.008	1,061.95	848.682	1,283.87	391.191
KOHC	63.716	1,660.51	2,632.63	3,154.83	3,322.27	2166.791
LUCK	3,970	6,782	9,714	11,344	12,377	8,837
PAKCEM	-118.421	1,488.21	108.802364	540.0675	593.1997	522.3717128
PIOC	120.7	601.5	1,535.10	1,768.90	2,496.10	1304.46
POWER	-926.67	1553.431	370.222	-73.909	433.833	271.3814
SMCPL	-4.966426	-6.754736	15.225877	13.546182	22.262785	7.8627364
THCCL	-74.495	-43.882	148.478	521.884	585.212	227.4394

SHAREHOLDER'S EQUITY:

	2011	2012	2013	2014	2015	Total avg
ACPL	5,798.41	6,612.89	7,848.82	8,446.05	8,935.13	7,528.26
BWCL	14,611.27	18,471.22	23,955.02	22,544.16	25,412.18	20,998.77
CHCC	2,331	2,748	3,709	4,864	8,026	4,336
DGKC	30,217.29	32,899.53	47,956.80	61,516.54	62,296.07	46,977.24
DNCC	757.807586	2,355.90	2,768.59	3,257.74	2,780.32	2,384.07
DCL	3,590	4,030	3,708.86	4,731.43	6,808	4,574
FCCL	11,014.02	13,905.11	12,936.36	15,788.19	17,418.98	14,212.53
FECTC	1,029.34	1,376.06	1,909.05	2,379.00	2,921.23	1,922.93
GWLC	699.32	445.701	1,609.50	2,582.56	4,045.87	1,876.59
KOHC	2,102.82	3,756.46	6,041.05	10,797	8,587	6,256.86
LUCK	27,773	33,262	41,035	49,792	59,259	42,224
PAKCEM	8,700.79	10,189.00	13,032.65	13,129.81	14,364.43	11,883.34
PIOC	2,466.60	3,136.50	4,442.70	5,134.80	6,720.30	4,380.18
POWER	971.979	1,125.41	1,495.37	1,428.54	1,862.17	1,376.69
SMCPL	203.846904	197,092,168	212.318045	225.864227	298.127012	39,418,621.63
THCCL	702.968	958.24	1,106.72	1,349.96	1,673.50	1,158.28

CURRENT ASSETS:

	2011	2012	2013	2014	2015	Total avg
ACPL	2,347.48	3,349.14	4,623.95	5,719.76	61,313.64	15,470.79
BWCL	5103.634	5167.017	7963.337	8231.087	9308.628	7154.7406
CHCC	1718	1289	1,534	2,905	2,267	1,943
DGKC	18295.03	18265.583	25789.999	31033.326	31,426.34	24,962.06
DNCC	733.866	663.718	663.555	834.255	789.722	737.0232
DCL	1,226	1,493	2,103	2,611	3,237	2,134
FCCL	4792.126	4159.818	5039.09	5188.357	6413.596	5118.5974
FECTC	905.583	1147.351	1287.59	1865.802	2280.121	1497.2894
GWLC	951.541	977.091	1209.835	1968.973	2070.404	1435.5688
KOHC	1953.618	2318.382	4126.166	6989.75	8433.637	4764.3106
LUCK	9,444	9,555	13,007	19,672	27,018	15,739
PAKCEM	2525.674	2930.523	3390.715	3218.189	3598.401	3T132.7004
PIOC	1,184.20	1,941.00	3,701.80	4,262.00	4674.2	3,152.64
POWER	794.316	894.607	1285.111	1363.51	1545.2	1176.5488
SMCPL	128.38	142.696	154.04	185.45	204.919	163.097
THCCL	1055.648	770.483	824.613	1113.366	823.233	917.4686

CURRENT LIABILITIES:

	2011	2012	2013	2014	2015	Total avg
ACPL	1,378.38	1,334.51	1,652.48	2,223.87	2,225.73	1,762.99
BWCL	9629.474	8083.854	6755.39	7446.036	10163.789	8415.7086
CHCC	1800	1,040	782	881	827	1066
DGKC	12657.194	11205.943	9307.593	5940.563	6583.476	9138.9538
DNCC	2279.54	2692.55	3334.638	3721.588	4057.239	3217.111
DCL	6,373	6,460	5,572	5,700	5,341	5,889
FCCL	7384.74	5494.173	4409.43	4482.506	4730.377	5300.2452
FECTC	1502.939	1652.248	1206.989	972.51	815.068	1229.9508
GWLC	4946.487	4004.811	3104.6	3941.691	4283.74	4056.2658
KOHC	2810.539	2899.296	2294.227	3695.537	4122.87	3164.4938
LUCK	10,697	3,624	3,846	4,556	7,431	6,031
PAKCEM	3560.745	4332.812	3427.2	4382.922	3354.685	3811.6728
PIOC	1,846.40	1,589.70	1,713.30	1,531.20	1,642.90	1,664.70
POWER	1443.074	2241.036	2132	2199.329	1806.814	1964.4506
SMCPL	95.259	130.71	133.89	165.604	139.017	132.896
THCCL	1146.939	890.715	87.892	984.409	517.843	725.5596

FIXED ASSETS:

ACPL	5,321.98	5,471.66	5,998.66	6,125.80	5,999.67	5,783.55
BWCL	16433.331	15,803.68	23470.214	24224.367	24658.98	20918.114
CHCC	3388	3,245	3427.37	3361.632	6830.753	4050.6214
DGKC	25995.385	27185.726	28740.974	29832.625	29958.97	28342.736
DNCC	2155.3538	2085.626	2016.895	2022.8584	1958.25	2047.79664
DCL	19311.801	19491.501	19448	20654	21292	20039.4604
FCCL	26,658.08	25,897.95	24734.325	23881.426	23880.553	25,010.47
FECTC	2163.305	2137.494	2051.702	1965.116	1961.145	2055.7524
GWLC	11616.953	11547.891	11527.658	13102.85	13722.67	12303.6044
KOHC	7140.84	6789.84	6610.34	7109.21	8164.178	7162.8816
LUCK	31,705	31,017	31,008	31,937	35,019	32,137
PAKCEM	15792.18	15313.38	14824.04	14515.59	14237.69	14936.576
PIOC	8,614.00	8,131.20	7,860.70	7,575.70	7,330.70	7,902.46
POWER	4268.503	4268.835	4314.4	4402.67	4423.374	4335.5564
SMCPL	189.64	189.32	183.49	211.92	228.801	200.6342
THCCL	804.663	840.341	943.879	1415.559	2149.869	1230.8622