The Impact of Capital Structure on Profitability of Companies Listed in Colombo Stock Exchange

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ABSTRACT

The issue of how companies select and change their strategic mix of securities has sparked considerable interest and discussion in corporate financial literature. The interest stems from the fact that the financing mix influences the cost and availability of capital, as well as the firm's investment decisions. The question of the importance of a firm's strategic financing decisions for its own valuation is at the forefront of such discussion, among other issues. The main purpose of this analysis was to investigate the impact of capital structure on the profitability of retailing companies listed on Colombo Stock Exchange. The study sample consists of 13 retailing companies listed on Colombo Stock Exchange from 2016 to 2020. Multiple regression models were used to determine the impact of capital structure on profitability. The independent variables (capital structure) are debt to equity ratios, debt to capital ratios, and equity to total assets ratios, while the dependent variables (profitability) are gross profit ratios, net profit ratios, return on assets ratios, return on equity ratios, and return on capital employed ratios. The results of study revealed that there is a positive relationship between debt to capital ratio and the profitability variables and each capital structure variable has a different significant level, indicating that capital structure has a significant effect on the profitability of Sri Lankan listed retailing companies.

Keywords: Capital structure, Profitability, Colombo Stock Exchange

INTRODUCTION

The issue of how companies select and change their strategic mix of securities has sparked considerable interest and discussion in corporate financial literature. The interest stems from the fact that the financing mix influences the cost and availability of capital, as well as the firm's investment decisions. The question of the importance of a firm's strategic financing decisions for its own valuation is at the forefront of such discussion, among other issues. It necessitates that managers find new ways to finance new investments. Financing decisions for companies include a broad variety of policy problems.

Capital structure planning entails considering the interests of shareholders and other groups to a large degree. A company's capital structure must be planned at the time of its promotion, and consequently, if funds are needed to finance investment, a capital structure decision must be made (Salawu, 2007). It is obvious that capital structure is an important management decision because it has a direct impact on the owner's equity return, risks, and market value of share. As a result, it is the responsibility of a company's management to devise an acceptable capital structure that is best suited to the company's operations.

Thus, financing policy, capital structure, and company ownership are all closely related in understanding how economic agents shape and adjust their asset-acquisition behavior across firms and capital markets, and thus affect the ratio of their income and returns to asset holdings, whether in the form of direct remuneration, capital gains, or dividend.

The evolution of capital structure theory today continues with a relaxation of some of the assumptions outlined in the original MM irrelevance theories. Some of these unreasonable assumptions include the absence of taxes

and transaction costs, as well as the assumption that all information relating to firm value or performance is freely available to all market participants.

Research Problem

Firms' performance in Sri Lanka's competitive market environment is dependent on their ability to efficiently assess the optimal and acceptable capital mix required to ensure that shareholders receive good returns. Firms must have reliable ways of assessing the sufficient amount of capital that is required to handle unforeseen losses resulting from their market, credit, and operating risk exposures in order to determine and mitigate risks. The firms' continued strong success against the backdrop of a sluggish economy has posed more questions than answers. Profits have increased for the majority of the last decade, despite poor economic growth.

Since the Modigliani-Miller propositions were made in 1958, the topic of capital structure has sparked considerable interest and debate. Propositions claiming that a firm's worth is independent of its capital structure have been tested and studied numerous times. However, the majority of the studies were conducted in other countries. The majority of companies listed on the Colombo Stock Exchange are in the non-financial sector. However, it is difficult to find any published work on the impact of capital structure on profitability of Sri Lankan listed companies, except banks, finance, and insurance, and previous researchers have not paid serious attention to the issues in this context.

As a result, the current thesis is primarily concerned with filling the aforementioned research gap.

Research Question

1. What are the variables influencing capital structure and profitability of companies listed on Colombo Stock Exchange?
2. To what extent does capital structure of companies listed on Colombo Stock Exchange affect its profitability?

Objectives Of The Study

- To identify the variables influencing capital structure and profitability of companies listed on Colombo Stock Exchange
- To analyze the impact of capital structure on profitability of companies listed on Colombo Stock Exchange

Significance Of The Study

This study will look at how capital structure influences the profitability of the selected company. Long-term financing options include share issues, debentures, and long-term loans from banks and other financial institutions. The majority of the results of the researchers did not analyze profitability; rather, they only examined optimal capital structure, which is difficult to make decisions about. As a result, this study is useful not only to the financial manager of an organisation, but also to future researchers who can get ideas for future research. The effective capital structure of public listed companies contributes to improved firm efficiency. To achieve financial success, the company must have an appropriate capital structure. Since the new industrial firm must operate in a highly dynamic and competitive environment.

Theoretical Discussion On Capital Structure Modigliani-Miller Theory

The Modigliani-Miller theorem serves as the foundation for modern capital structure theory. The basic theorem states that, under a certain market price mechanism, in the absence of taxation, bankruptcy costs, and asymmetric knowledge, and in an efficient market, the manner a company is financed has no influence on its value. It makes no difference whether the firm's capital is raised by the issuance of stock or by the sale of debt. It makes no difference what the company's dividend strategy is. As a result, the Modigliani-Miller theorem is also known as the capital structure irrelevance principle. The theorem was initially demonstrated under the assumption of no taxes. It is made up of two propositions that can also be applied to a tax situation.

Considering two companies that are similar except for their financial structures. The first (Firm U) is unlevered, meaning it is entirely funded by equity. The other (Firm L) is levered: it is funded in part by equity and partly by debt. According to the Modigliani- Miller theorem, the worth of the two companies is the same.

Trade off Theory

The trade-off theory of capital structure examines the different corporate finance options available to a company. When researching financial economics principles, the theory is very critical. According to the theory, businesses or firms are typically funded by a combination of equity and debt. The two ideas are the main focus of the theory. Financial distress cost and agency costs are two costs to consider.

The aim of the trade-off theory of capital structure is to understand how companies fund their investments, often with debt. The theory also investigates the benefits and drawbacks of either equity or bond funding. The trade-off principle allows for the existence of the cost of bankruptcy. According to Miller, the attractiveness of debt declines as the personal tax on interest income increases. When a company is unable to meet the obligations of its debt holders, it is said to be in financial distress. If the company continues to fail to make payments to its debt holders, it can become insolvent.

The direct cost of financial distress is the cost of a company's insolvency. Once an insolvency process is initiated, the firm's assets will be required to be sold at a distress price, which is typically much lower than the market value of the assets. Insolvency often entails a significant amount of administrative and legal costs. Even if the corporation is not insolvent, the financial distress may include a variety of indirect costs such as employee costs, consumer costs, supplier costs, investor costs, manager costs, and shareholder costs. Firms often face conflicts of interest among the firm's management, debt holders, and shareholders. These disagreements often result in agency problem.

Pecking Order Theory

There is an alternative theory that might justify why profitable companies borrow less. It is based on asymmetric information. Managers understand the firm's viability and prospects better than outside investors. As a result, investors will be unable to access the true value of a new issue of securities by the company. They may be particularly unwilling to buy newly issued common stock because they are concerned that the new shares would be overpriced.

Such concerns can explain why the announcement of a stock offering will cause the stock price to fall. If managers are more informed than outside investors. When their company's stock is overpriced, the manager would be tempted to time stock issues. To put it another way, when the managers are relatively pessimistic. Conversely, optimistic managers will see their company's shares as underpriced and decide not to give a 'pessimistic manager' signal, thus lowering the stock price.

These issues are avoided entirely if the corporation will finance from internal funds, i.e. earnings retained and reinvested. However, if external funding is needed, debt, rather than equity, is the path of least resistance. Issuing debt seems to have a minor impact on stock prices. There is less scope for debt to be devalued, so debt problem is a less concerning signal to investors.

Agency Costs Theory

There are three types of agency costs that can help understand why capital structure is important. Effect of asset substitution: As the D/E ratio rises, management has a greater incentive to pursue risky (even negative NPV) projects. This is due to the fact that if the project is successful, shareholders receive all of the benefits, while debt holders receive all of the disadvantages. If the projects are carried out, the firm's value will fall and wealth will be transferred from debt holders to shareholders.

Underinvestment: If debt is risky (as in a growth company), the project's profit would go to debt investors rather than shareholders. As a result, management has an opportunity to dismiss projects with a positive net present value, even though they have the potential to raise firm value.

Free cash flow: Once free cash flow is returned to investors, management has an incentive to destroy firm equity by empire building and perks, among other things. Financial discipline is imposed as debt is increased.

Review Of Empirical Evidence

The majority of empirical data on capital structure comes from studies of the determinants of corporate debt ratios, such as Titma and Wessels (1988), Rajan and Zingales (1995), and Graham (1996), as well as studies of issuing firms' debt vs. equity funding choices, such as Marsh (1982), Jalilvand and Harris (1984), Bayless and Chaplisky (1990), Mackie–Mason (1990), Jung, Kim, and Stulz (1990). (1996). These studies have successfully established firm characteristics such as size, R&D strength, asset market-to-book ratio, stock returns, asset tangibility, profitability, and marginal tax rate as significant determinants of corporate financing decisions. Profitability and market-to-book ratio effects have been found to be particularly significant.

Modigliani and Miller (1958 and 1963) show that in a frictionless environment, financial leverage is unrelated to firm value, but in a world with tax-deductible interest payments, firm value and capital structure are positively related. Other researchers also added shortcomings to the analysis, such as bankruptcy costs (Baxter, 1967; Stiglitz, 1972; Kraus and Litzenberger, 1973; and Kim, 1978), agency costs (Jensen and Mechling, 1976), and benefits from leverage-induced tax shields (De Angdo and Masulis, 1980), and maintained that an optional capital structure may exist. Empirical analysis by Bradley, Jarrell, and Kim (1984), Long and Malitz (1985), and Titman and Wessells (1988) generally supports bankruptcy costs or agency costs as partial determinants of leverage and optimum capital structure. Miller (1977) extended the study to include personal taxes, demonstrating that optimum debt usage exists at the macro – level but not at the firm level. Interest deductibility at the firm level is covered by interest deductibility at the investor level. In the study of Fama and French (2002), the conclusion has taken that the negative effects of profitability on leverage are consistent with the pecking order model, but they also find that there is an offsetting response of leverage to changes in earnings, meaning that the profitability effects are due in part to transitory changes in leverage rather than changes in the target.

Bancel and Mittoo (2002) surveyed managers of companies in seventeen European countries about their capital structure preference and its determinants. Their preliminary survey research yielded some intriguing results. Financial flexibility, credit rating, and tax advantages of debt are the most important factors affecting debt policy, while earnings per share dilution is the most important consideration in issuing equity. Evidence often shows that the degree of interest rate and share price volatility are important factors in deciding the timing of debt and equity issues. Hovakimian et. al (2003) successfully defined firm characteristics such as size, R&D strength, market-to-book ratio of assets, stock returns, asset tangibility, profitability, and the marginal tax rate as significant determinants of corporate financing choices. It has been stated that companies with high market-to-book ratios have low target debt ratios. High stock returns, on the other hand, increase the chances of equity issuance but have no impact on target leverage, which is consistent with market timing.

According to Drobetz and Fix (2003), the race between the trade-off theory and the pecking order theory is undecided; in reality, there is no disagreement on many issues. Firms with more investment opportunities use less leverage in their analysis, which supports both the trade-off model and a dynamic variant of the pecking order model. More efficient companies use less leverage, confirming the pecking order model but contradicting the trade-off model. Leverage is also closely related to the tangibility of assets and the uncertainty of a company's earnings. They also find that Swiss companies prefer to retain target leverage ratios.

METHODS AND METHODOLOGY SAMPLE SIZE

The study sample comprises of 13 retailing companies listed on Colombo Stock Exchange for a period of five years from 2016 to 2020. The secondary financial data is extracted from financial reports of the companies in order to compute all the measurements of dependent (profitability) and independent (capital structure) variables.

Data Analysis Procedure

Multiple regression models are used to find out the effects of capital structure on profitability in the context of Sri Lanka. Five regression models are formulated to check the effect of capital structure on profitability. The independent variable (capital structure) consists of debt to equity, debt to capital and equity to total assets ratios and dependent variables(profitability) are gross profit ratio, net profit ratio, return on assets ratio, return on equity ratio and return on capital employed ratio.

Hypothesis testing

The main objective of the study is to investigate the impact of capital structure on the profitability of the selected companies listed on Colombo Stock Exchange. This study shall be guided by the following major hypothesis based on the tests of the null hypothesis and Here the correlation analysis and regression analysis are used to test the hypothesis.
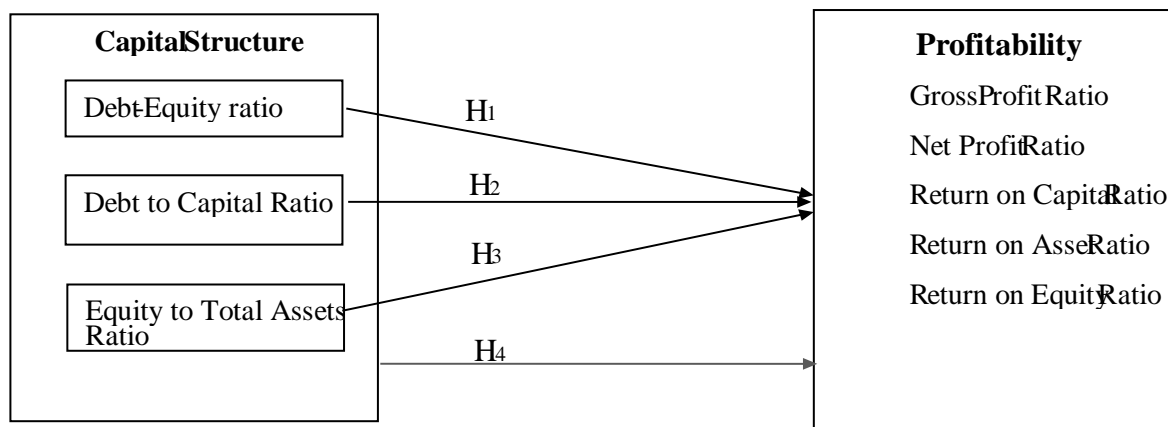
H_1: There is a negative relationship between debt- equity ratio and profitability

H_2: There is a positive relationship between debt to capital ratio and   profitability

H_3: There is a negative relationship between equity to total assets ratio and   profitability

H_4: Capital structure is significantly impact on profitability

CONCEPTUAL FRAMEWORK

Specification of Model

$GP_{it} = ß0_{it} + ß1DE_{it} + ß2DC_{it} + ß3EA_{it} + μ_{it}$ ………………… Equation-1

$NP_{it} = ß0_{it} + ß1DE_{it} + ß2DC_{it} + ß3EA_{it} + μ_{it}$ ………………… Equation-2

$RC_{it} = ß0_{it} + ß1DE_{it} + ß2DC_{it} + ß3EA_{it} + μ_{it}$ …………………Equation-3

$RA_{it} = ß0_{it} + ß1DE_{it} + ß2DC_{it} + ß3EA_{it} + μ_{it}$ ………………… Equation-4 $RE_{it} = ß0_{it} + ß1DE_{it} + ß2DC_{it} + ß3EA_{it} + μ_{it}$ ………………… Equation-5   Where:

DE- Debt – equity ratio

DC- Debt to capital ratio

EA- Equity to total assets ratio

GP- Gross profit ratio

NP- Net profit ratio

RC- Return on capital employed ratio

RA- Return on assets ratio RE- Return on equity ratio ß0- Intercept μ_{it} – error terms i-Number of firms t-Number of time periods

Operationalization of Variables

Type of variable	Variables	Measurement (Proxy)
Independent	Capital Structure	Debt to equity ratio = Long term debt/Equity capital
		Debt to capital ratio = Long term debt/Total capital
		Equity to total assets ratio = Equity capital/ Total assets
		Gross profit ratio = Gross profit/ Sales
		Net profit ratio = Profit before
Dependent	Profitability	interest and tax / Sales
		Return on capital employed = Profit before interest and tax/ Capital employed Capital employed = Total assets – Current Liabilities
		Return on assets ratio = Profit before interest and tax/ Total assets
		Return on equity ratio = Profit after tax / Equity capital

RESULTS AND DISCUSSION DESCRIPTIVE STATISTICS

	N	Maximum	Minimum	Mean	Std.deviation
GP	65	23.01468	-5.287149	14.27181	3.7778049
NP	65	8.3977968	-3.161258	14.27181	3.7778049
RC	65	11.8948	-1.228073	0.904906	0.9512654
RA	65	24.128509	1.994274	10.32905	3.2138839

RE	65	1.7017813	0.153347	0.904906	0.9512654
DE	65	367.94721	98.06439	202.9009	14.2443287
DC	65	104.35144	57.5498	67.96053	8.2438176
EA	65	27.683021	15.21041	19.15669	4.376835

Correlations Matrix

Variable	GP	NP	RC	RA	RE	DE	DC	EA
GP	1	.742	.409	.676 **	.333	- .468	.610**	.220
NP		1	.746	.688	.749	- .521	.523**	.417 **
RC			1	- .359	- .779 **	.349	.402	.299
RA				1	.572 **	- .655 **	.670	.705 **
RE					1	- .371 **	.328**	.672 **
DE						1	.115	.265
DC							1	.056
EA							1	1

Correlation Analysis

To test hypothesis H_1, H_2, H_3, correlation analysis between capital structure variables (debt equity ratios, debt to capital ratios, and equity to total assets ratios) and profitability variables (GP, NP, RC, RA, RE) of retailing sector are used. The correlation table above shows the relationship between debt equity ratios, debt to capital ratios, and equity to total assets ratios and proxy variables of profitability

The correlation between debt equity ratio and GP, NP, RC, RA, and RE is positive since the R value of debt equity ratio and gross profit ratio is 0.468, R value of debt equity ratio and net profit ratio is 0.521, R value of

debt equity ratio and return on capital employed ratio is 0.349, R value of debt equity ratio and return on assets ratio is 0.284, and R value of debt equity ratio and return on equity ratio is 0.236

Debt to capital ratio has a positive correlation with GP, NP, RC, RA, and RE because R value of debt to capital ratio and gross profit ratio is 0.610, debt to capital ratio and net profit ratio is 0.523, debt to capital ratio and return on capital employed ratio is o.402, debt to capital ratio and return on assets ratio is 0.670, and debt to capital ratio and return on equity ratio is 0.328

The correlation between equity to total assets ratios and GP, NP, RC, RA, and RE is positive since R value of equity to total assets ratios and gross profit ratio is 0.220, net profit ratio and equity to total assets ratios is 0.417, return on capital employed ratio and equity to total assets ratios is 0.299, return on assets ratio and equity to total assets ratios is 0.705, and return on equity ratio and equity to total assets ratios is 0.672.

According to the above findings, hypothesis H2 can only be accepted because there is a positive relationship between the debt to capital ratio and the profitability variables.

Regression analysis

In this section, the researcher used regression analysis to test hypothesis H4 and determine the effect of capital structure on profitability.

H₄: capital structure is significantly impact on the profitability of the retailing companies in Sri Lanka.

Regression analysis between debt equity ratio and profitability variables

Dependent variable	R2	Significance level
GP	.133	0.005
NP	.510	0.002
RC	.482	0.003
RA	.560	0.002
RE	.152	0.005

Based on the above table, R^2 is 0.133 for a regression analysis between debt equity ratio and gross profit ratio. That means that 13.3 percent of the variance in Gross profit ratio is determined by variation in debt equity ratio, while the remaining 86.7 percent is undetermined at a significant level of 0.005. This means that other variables could account for 86.7 percent of the variation in gross profit ratio.

Based on the above table, R^2 is 0.510 for a regression analysis between debt equity ratio and net profit ratio. That means that 51 percent of the difference in net profit ratio is determined by changes in debt equity ratio, while the remaining 49 percent is undetermined at a significant level of 0.002. This means that other variables could account for 49 percent of the variation in net profit ratio. Based on the above table, the R^2 for the regression between debt equity ratio and return on capital employed ratio is 0.482. That is, 48.2 percent of the variation in return on capital employed ratio is determined by the variation in the debt equity ratio, while the remaining 51.8 percent is undetermined at a significant level of 0.003. This means that other variables could account for 51.8 percent of the variance in return on capital employed ratio.

R^2 is 0.560 in the regression analysis between debt equity ratio and return on assets ratio based on the above table. That is, 56 percent of the variation in return on assets ratio is determined by the variation in the debt equity ratio, while the remaining 44 percent is undetermined at a significant level of 0.002. This means that other variables could account for 44 percent of the variation in return on assets ratio.

R^2 is 0.152 in the regression analysis between debt equity ratio and return on equity ratio based on the above table. That is, 15.2 percent of the variation in return on equity ratio is determined by the variation in the debt equity ratio, while the remaining 84.8 percent is undetermined at a significant level of 0.005. This suggests that other variables could account for 84.8 percent of the variation in return on equity ratio.

Regression analysis between debt to capital ratios and profitability variables

Dependent variable	R2	Significance level
GP	.715	0.001
NP	.321	0.002
RC	.134	0.005
RA	.208	0.003
RE	.250	0.005

R^2 is 0.715 in regression analysis between debt-to-capital-ratios and gross profit ratio, according to the table above. That means that 71.5 percent of the variation in gross profit ratio is caused by changes in debt to capital ratios, while the remaining 28.5 percent is undetermined at a significant level of 0.001. This suggests that other variables could account for 28.5 percent of the variation in gross profit ratio.

R^2 is 0.32 in regression analysis between debt-to-capital ratios and net profit ratio based on the table above. That means that 32.1 percent of the variation in net profit ratio is influenced by changes in debt-to-capital ratios, while the remaining 67.9 percent is undetermined at a significant level of 0.002. This suggests that other variables could account for 67.9 percent of the variation in net profit ratio.

R^2 is 0.134 in the regression analysis of debt to capital ratios and return capital employed ratio based on the above table. That is, 13.4 percent of the variation in return capital employed ratio is determined by variation in debt to capital ratios, while the remaining 86.6 percent is undetermined at a significant level of 0.005. This implies that other variables may account for 86.6 percent of the variance in return capital employed ratio.

R^2 is 0.208 in the regression analysis between debt-to-capital-ratio and return on assets ratio according to the table above. That is, 20.8 percent of the variation in return on assets ratio is determined by changes in debt-to-capital ratios, while the remaining 79.2 percent is undetermined at a significant level of 0.003. This means that other factors may account for 79.2% of the variation in return on assets ratio.

R^2 is 0.250 between debt to capital ratios and return on equity ratio in regression analysis according to the table above. That means that the variation in debt to capital ratios accounts for 25% of the variation in return on equity ratio the remaining 75% is undetermined, with a significant level of 0.005. This suggests that other factors could account for 75% of the variation in return on equity ratio.

Regression analysis between equity to total assets ratio and profitability variables.

Dependent variable	R2	Significance level
GP	.304	0.004
NP	.085	0.001
RC	.094	0.001
RA	.550	0.000
RE	.498	0.002

Based on the above table, R^2 is 0.304 for a regression analysis of equity to total assets ratio and gross profit ratio. That is, 30.4 percent of the variation in gross profit ratio is determined by the variation in the equity-to-total-assets ratio, while the remaining 69.6 percent is undetermined at a significant level of 0.004. This means that other variables may account for 69.6 percent of the variation in gross profit ratio.

R^2 is 0.085 in regression analysis between equity-to-total-assets ratio and net profit ratio according to the above table. That is, 8.5 percent of the variation in net profit ratio is determined by the variation in the equity to total assets ratio, while the remaining 91.5 percent is undetermined at a significant level of 0.001. This means that other variables could account for 91.5 percent of the variation in net profit ratio.

In regression analysis between equity-to-total-asset ratio and return on capital employed ratio, R^2 is 0.094 according to the above table. That is, 9.4 percent of the variation in return on capital employed ratio is determined by the variation in the equity to total assets ratio, while the remaining 80.6 percent is undetermined at a significant level of 0.001. This suggests that other variables could account for 80.6 percent of the variation in return on capital employed ratio.

R^2 is 0.550 in regression analysis of equity-to-total-assets ratio and return on assets ratio based on the above table. That is, 55 percent of the variation in return on assets ratio is decided by the variation in the long-term debt ratio, while the remaining 45 percent is undetermined with a significant level of 0.000. This means that other factors may account for 45 percent of the variation in return on assets ratio.

In regression analysis between equity-to-total-assets ratio and return on equity ratio, R^2 is 0.498 according to the above table, that is, 49.8 percent of the variation in return on equity ratio is determined by the variation in the equity-to-total-assets ratio, while the remaining 50.2 percent is undetermined at a significant level of 0.002. This means that other variables may account for 50.2 percent of the variation in return on equity ratio.

As a consequence of the above findings, the researcher accepts hypothesis H4 that capital structure variables have a substantial effect on company profitability.

To test the hypothesis, GP, NP, RC, RA, and RE are used as dependent variables, while debt equity ratio, debt to capital ratio, and equity-to-total-assets ratio are used as independent variables.

CONCLUSION

The main purpose of this analysis was to investigate the impact of capital structure on the profitability of retailing companies listed on the Colombo Stock Exchange. The study sample consists of 13 retailing companies listed on the Colombo Stock Exchange from 2016 to 2020. Multiple regression models were used to determine the impact of capital structure on profitability. The independent variables (capital structure) are debt to equity ratios, debt to capital ratios, and equity to total assets ratios, while the dependent variables (profitability) are gross profit ratios, net profit ratios, return on assets ratios, return on equity ratios, and return on capital employed ratios. Correlation analysis revealed a positive relationship between debt to capital ratio and the profitability variables. So, hypothesis H_2 is agreed, and regression analysis revealed that each capital structure variable has a different significant level, indicating that capital structure has a significant effect on the profitability of Sri Lankan listed retailing companies.

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