

“AN EMPIRICAL STUDY ON CAPITAL STRUCTURE AND ITS IMPACT ON BANK'S PERFORMANCE : WITH SPECIAL REFERENCE TO SBI”

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1.0 INTRODUCTION

Given the objective of maximization of shareholders' wealth, the need for an optimum capital structure cannot be over emphasised. In operational terms, every firm should try to design such capital structure. But the determination of an optimum capital structure is formidable task. It should be clearly understood that identifying the precise percentage of debt that will maximise price of shares is almost impossible, however to determine the proportion of debt to use in the financial plan in conformity with the objective of maximizing the share price. The key factors governing the capital structure decision are profitability & liquidity.

The growth in the Indian Banking Industry has been more qualitative than quantitative and it is expected to remain the same in the coming years. Based on the projections made in the India Vision 2020" prepared by the Planning Commission and the Draft 10th Plan, the report forecasts that the pace of expansion in the balance-sheets of banks is likely to decelerate". The total assets of all scheduled commercial banks by end-March 2010 is estimated at 40,90,000 crores. That will comprise about 65 per cent of GDP at current market prices as compared to 67 per cent in 2002-03. Bank assets are expected to grow at an annual composite rate of 13.4 per cent during the rest of the decade as against the growth rate of 16.7 per cent that existed between 1994-95 and 2002-03. It is expected that there will be large additions to the capital base and reserves on the liability side.

The Indian Banking Industry can be categorized into non-scheduled banks and scheduled banks. Scheduled banks constitute of commercial banks and co-operative banks. There are about 67,000 branches of Scheduled banks spread across India. As far as the present scenario is concerned the

Banking Industry in India is going through a transitional phase.

The Public Sector Banks (PSBs), which are the base of the Banking sector in India account for more than 78 per cent of the total banking industry assets. Unfortunately they are burdened with excessive Non Performing assets (NPAs), massive manpower and lack of modern technology. On the other hand the Private Sector Banks are making tremendous progress. They are leaders in Internet banking, mobile banking, phone banking, ATMs. As far as foreign banks are concerned they are likely to succeed in the Indian Banking Industry.

The State Bank of India, the country's oldest Bank and a premier in terms of balance sheet size, number of branches, market capitalization and profits is today going through a momentous phase of Change and Transformation - the two hundred year old Public sector behemoth is today stirring out of its Public Sector legacy and moving with an agility to give the Private and Foreign Banks a run for their money.

The bank is entering into many new businesses with strategic tie ups - Pension Funds, General Insurance, Custodial Services, Private Equity, Mobile Banking, Point of Sale Merchant Acquisition, Advisory Services, structured products etc - each one of these initiatives having a huge potential for growth.

2. OVERVIEW OF LITERATURE

The real debate on the capital structure was started after the publication of the celebrated paper of Modigliani and Miller (MM) in 1958. With the assumptions of perfect market and no tax world MM proposed that the selection of debt-equity was independent of the value of the firm. Modigliani and Miller provide path and guidelines for the researchers to analyze the financing patterns and later several hypotheses have been put forward or considerable work has been done by researchers to analyze the determinants of capital structure. In 1963, Modigliani and Miller wrapped up the corporate tax assumption and intended that the value of the firm or cost of capital varied with the variation in the utilization of debt capital due to tax benefits (Baral 1996).

Since Modigliani and Miller's (1958) irrelevance proposition, firm's capital structure decisions have been intensely investigated. The irrelevance proposition states that under

strict assumptions, among which are the absence of corporate taxes, the structure of capital is irrelevant to the determination of a company's value. The assumption on taxes proved to be crucial for the irrelevance proposition. In fact, a few years later, Modigliani and Miller (1963) concluded that the introduction of corporate taxes and the possibility of deducting interest on debt from taxable profits would induce firms to be completely financed by debt. However, as this is not usually observed, several authors, including Modigliani and Miller themselves in Modigliani and Miller (1963), argued that bankruptcy costs, and other costs associated with debt, could explain why firms were not totally financed by debt. This discussion on the benefits and costs of debt is central to the trade-off theory of capital structure. According to this theory, there are forces leading firms to less leverage, for instance bankruptcy costs, and forces leading to more leverage, among them the above mentioned tax benefits of debt and the agency costs of free cash flow. The combination of these forces results in the existence of a target leverage at which the value of firms is maximized. The main predictions of this theory on leverage ratios are related with the profitability of firms. Profitability should have a positive impact on leverage, as it contributes to a decrease in bankruptcy costs. In addition, more profitable firms benefit more from the tax benefits of debt (DeAngelo and Masulis, 1980).

As these firms have freer cash-flow, the existence of debt payments also helps to reduce agency costs of equity, by aligning the interests of managers and shareholders (Jensen and Meckling, 1976, and Jensen, 1986). Besides profitability, there are other characteristics of firms that help to explain target leverages. According to theory, bankruptcy costs are expected to be lower for firms with more tangible assets, as these could be used as collateral. In addition, the existence of depreciation expenses helps to explain less leverage, as these expenses result in tax benefits.

Studies showed contradictory results about the relationship between increased use of debt in capital structure and firms performance. Some studies (Taub, 1975; Roden and Lewellen, 1995; Champion, 1999; Ghosh *et al.*, 2000; Hadlock and James, 2002, Berger and Bonaccorsi di Patti, 2006) showed positive relationship and some (Kester, 1986; Friend and Lang, 1988, Fame and French, 1998, Gleason *et al.*, 2000; Miserly and Li, 2000, Booth *et al.*, 2001 Ibrahim, 2009) showed negative or weak/no relationship.

3. RESEARCH METHODOLOGY

3.1 RESEARCH DESIGN

“A research design is the arrangement of conditions for collection and analysis of data in a manner that aims to combine relevance to the research purpose with economy in procedure.” For this research purpose, the research design is analytical and descriptive design.

3.2 UNIT OF ANALYSIS

Unit of analysis means the study of variables associated with the research problem. There are several variables under the study but the main variables have to be studied. For this research, a unit of analysis is SBI.

3.3 SAMPLING DESIGN

When some of the elements are selected with the intention of finding out something about the population from which they are taken, that group of elements are referred to as sample and the way in which sample is selected is referred to as 'sample design. The sampling design for this research “convenience based non - probability sampling.” The non - probability sampling means wherein items for the sample are deliberately selected by the researcher leading to personal bias.

3.4 DATA COLLECTION METHOD

For this research purpose, the data have been collected through annual reports of the SBI. The present study is done for the last five Accounting Years i.e. 2007-08 to 2011-12. The secondary data will be very helpful in evolving an appropriate methodology for the study and in formulating a conceptual framework for the study. For these purposes, various secondary sources like customer satisfaction index, annual reports of banks, books and periodicals, research articles, seminar reports, working papers, study reports of

government agencies, news papers, study reports of expert committees, plan documents, web sites etc.

3.5 OBJECTIVE

The purpose of this paper is to demonstrate the impact of defining the main variables of capital structure and performance on experimental results. Therefore, the following hypotheses are extracted :

1. There is a significant relation between total debt to owners fund & return on long term fund of SBI.
2. There is a significant relation between total debt to owners fund & return on net worth of SBI.
3. There is a significant relation between total debt to owners fund & return on assets of SBI.
4. There is significant relation between total debt to owners fund & total income to capital employed of SBI.
5. There is a significant relation between total debt to owners fund & EPS of SBI.

3.6 DATA ANALYSIS & INTERPRETATION

After gathering necessary data, they were analyzed by Excel and the variables were calculated. Then the variables entered in SPSS software and then correlation between dependent and independent variables were measured by using Pearson correlation coefficient. The four profitability ratios of five years & one capital ratio for those five years were analysed for finding correlation. Correlation is denoted by r . if $r = 1$ then its correlation is positive & perfectly correlated. If $r = -1$ then its correlation is negative. If $r = 0$ then it's known as there isn't any correlation. The following data were collected for research purpose.

Year	R	2007 -08	2008 -09	2009 -10	2010 -11	2011 -12
Total debt to owners fund ratio		10.96	12.81	12.19	14.37	12.43
Return on long term fund	0.57	86.83	100.35	95.02	96.73	96.84
Return on net worth	0.20	13.73	15.75	13.89	12.71	13.94
Return on assets	0.00	1251.05	1023.40	1038.76	912.73	776.48
Total income to capital employed	0.23	8.96	8.99	8.62	8.48	9.40
Earning per share	0.065	106.56	143.67	144.37	116.07	174.15

The table shows the performance ratios of Return on long term fund, Return on net worth, Return on assets, total income to capital employed & earning per share & capital structure variable ratio of total debt to owner's fund. The correlation between long term debt to owners fund & Return on net worth, Return on long term fund, Return on assets, total income to capital employed & earning per share were defined by taking five years ratios of SBI.

3.7 FINDINGS & CONCLUSION

Tests on coefficient of correlation demonstrated that there is a meaningful link between one variables of capital structure and four variables of performance except the link between return on assets that is not meaningful. As per the above table the ratios of profitability i.e. return on long term fund, Return on net worth, Return on assets, total income to capital employed & earning per share is found.

1. The table shows that there is a positive correlation between total debt to owners fund & return on long term fund as the value of r is positive. But that's not perfectly positive as its value is less than one i.e. 0.57. So the null hypothesis is rejected & alternative hypothesis is accepted as there is significant relation between these two variables of SBI.
2. There is a negative correlation between total debt to owners fund & return on net worth as the value of r is negative. But that's not perfectly negative as its value is more than minus one i.e. -0.20. So the null hypothesis is rejected & alternative hypothesis is accepted as there is significant relation between these two variables.
3. There isn't any correlation between total debt to owners fund & return on assets as the value of r is zero. So the null hypothesis is accepted & alternative hypothesis is rejected as there isn't any significant relation between these two variables.
4. There is a negative correlation between total debt to owners fund & total income to capital employed as the value of r is negative. But that's not perfectly negative as its value is more than minus one i.e. -0.23. So the null hypothesis is rejected & alternative hypothesis is accepted as there is

significant relation between these two variables.

5. There is a negative correlation between total debt to owners fund & Earning per share as the value of r is negative. But that's not perfectly negative as its value is more than minus one i.e. -0.065. So the null hypothesis is rejected & alternative hypothesis is accepted as there is significant relation between these two variables.

CONCLUSION

Financing decisions are one of the most critical areas for finance managers. It has direct impact on capital structure and financial performance of the companies. It has always been an area for interest for researchers to understand the relationship between capital structure and financial performance of the company. The research defined that the capital structure decision affects the profitability of any companies. The capital structure of SBI is having some negative & positive effects on different profitability ratios over the period. When there is change in capital structure it will also make changes in performance of bank.

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