Capital Structure and Profitability of Nepalese Commercial Banks

A Thesis Proposal

Submitted

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Table of Contents

1. Background of the Study 1
2. Problem Statement and Research Questions 3
    2.1 Statement of the Problem 3
    2.2 Research Questions 4
3. Objectives of the Study 4
4. Rationale of the Study 4
5. Limitation of the study 5
6. Literature Review 5
    6.1 Theoretical Review 6
    6.2 Conceptual Review 8
    6.3 Empirical Review 8
    6.4 Research Gap 10
7. Research Methodology 10
    7.1 Research Design 11
    7.2 Population and Sample 11
    7.3 Nature and Sources of Data 11
    7.4 Data Collection Instrument and Procedures 12
    7.5 Data Analysis Tools and Techniques 12
    7.6 Conceptual Framework and Definition of Variable 12
8. Expected Results 15
9. Chapter Plan 15
REFERENCES 17

1. Background of the Study

In order to achieve firm's objective, management should take rational financing decisions regarding optimal capital structure (Goyal, 2013).The capital structure decision is one of the most important decisions made by financial managers.It is the combination of debt and equity capital. It is the aggregation of items appearing on the liability side of the balance sheet minus current liabilities (Khan & Jain, 1997). It is sum of net worth plus preferred stock plus long term debts. Every business firm aims to maximize the wealth of shareholders as measured by the firm's outstanding market price or shareholders' return. To achieve this intended objective, the management of a firm makes various decisions; one is setting an optimal level of capital (Ayalew and McMillan, 2021). Therefore, capital structure decision is considered as one of the effective tools of management to manage the cost of capital. Capital structure consist debt and equity capital which generates firm's assets. Business organizations can use either debt or equity capital to finance their assets. Moreover, enterprises may issue hybrid securities such as income bonds. These hybrid securities possess the features of both equity and debt securities (Nasimi, 2016)

Capital structure decision is crucial for any business firm to maximize the value of shareholders as it supposed to affect the firm's ability to deal with competitive environment. It is an important issue for the business managers today to choose the optimum combination of debt and equity to achieve value maximization by reducing the financing cost. Thus, theoretically capital stricture can play an important role in firm performance and financial stability of the economic system. Its influence on firm performance can be explained in various ways. Debt would improve profitability as the interests paid on debt are tax deductible and leverages the profits of the shareholders. Liabilities also could add operating pressure of managers so that they would take active interest in corporate operations and reduce in-service consumptions (Grossman, and Hart, 1983).

Furthermore, capital structure can affect market decisions by signaling (Ross, 1977), for debt financing would pass investors active signals and it indicates better quality of assets. So operating performance is passively relative to debt ratio. In addition, based on pecking order theory, profitability is negatively relative to book value financial

leverage ratio owing too high cost of equity financing (Myers and Majluf, 1984). Capital structure is the matter of great controversy and attention of finance academicians since the publication of seminal paper of Modigliani and Miller (1958). Since the MM's irrelevance theory of capital structure, a lot of literature has been explored in the field of capital structure. However, the dilemma and controversy is still going even after emergence of modern capital structure theories.

There is no doubt that the banking sector plays a significant role in the economicaldevelopment of any country. Therefore performance of commercial bank is crucial not only for the value maximization for their shareholders but also for the overall financial health make-up of a nation. Banks should choose and adjust their strategic financing mix in order to maximize the value and ensure that their operation are not either highly geared or too lowly geared in order to achieve optimal capital structure. Since Nepalese finance companies are not exception of achieving value maximization and risk reduction, this study focuses in identifying the relationship of capital structure with the profitability. In Nepal number of studies has been conducted to examine the determinants of capital structure of different corporations; however after the merger policy of Nepal Rastra Bank capital structure of Nepalese commercial bank have been changed so this research is specially directed toward commercial of bank after the merger policy. This study aimed at contribution the debate on capital structure and bank's profitability in terms of return on equity (ROE) and return on assets (ROA) (Bhatt & Jain, 2016).

Hence the aim of this study is to helpful to identify the potential problems in performance/ profitability and to examine the impact of financing decision /capital structure on profitability of commercial bank in Nepal with an emphasis on core business operations profitability. This will equip financial managers with applied knowledge of the potential problems in profitability and capital structure, as well as determining their optimal level of capital structure to achieve optimum level of firm's profitability and shareholders' wealth.

2. Problem Statement and Research Questions

2.1 Statement of the Problem

The choice of capital structure is one of the most important strategic financial decisions of firms. Capital structure is the mix of the long-term sources of funds used by a firm. It is made up of debt and equity securities and refers to permanent financing of a firm. It is composed of long term debt, preference share capital and shareholder's funds. The capital structure of a company is made up of debt and equity securities that comprise a firm's financing of its assets.

The capital structure decision becomes more vital for banks because the consequences of bank failure are more disastrous than the failure of other non-financial firm. Buser, at. el. (1981) argued that the capital structure decision of a bank is similar to that of non-financial firm. Although there are considerable inter industry differences in the capital structure of firms due to the unique nature of each industry's business. Most of the studies conducted abroad found a negative relationship between profitability and leverage. Titman and Wessels (1988) concluded that firm with high profit level would maintain relatively lower debt levels since they can obtain funds from plowing back profit. Furthermore Similarly, Kester (1986) found a significant negative relation between profitability and debt/asset ratios. Rajan and Zingale (1995) also confirmed a significant negative correlation between profitability and leverage in their study. However, some other researchers have concluded that the positive relationship between profitability and capital structure. Taub (1975), in a regression analysis of four profitability metrics against debt ratios found significantly positive association between debt and profitability. Abor (2005) also found a significantly positive relationship between total debt and profitability.

From ongoing research and literature it is clear that the relationship between capital structure and profitability is not conclusive and requires more empirical study especially in the context of Nepal where rare study has been done in this regard. Therefore the problem of this research is to study how the capital structure affects the commercial banks profitability in Nepal?

2.2 Research Questions

Following are the research questions for the study:

i. What is the capital structure status of commercial bank of Nepal?
ii. What is the profitability position of commercial bank of Nepal?
iii. What is the relationship of capital structure with profitability of commercial of Nepal?
iv. How does capital structure impact on profitability of commercial bank of Nepal?

3. Objectives of the Study

The general objective of this study is to examine the capital structure and profitability of commercial banks in Nepal. The specific objectives of this study are:

- To investigate the relationship between capital structure variables and profitability of commercial banks in Nepal.
- To examine the impact of financing decision or capital structure on profitability of core business operation of commercial banks in Nepal.

4. Rationale of the Study

There are few studies that have been done after the reform on capital structure and profitability of Nepalese commercial bank. This study is important which will provide insight information about capital structure influences on profitability of commercial banks in Nepal.The relationship between capital structure and profitability cannot be ignored because the long-term survivability of firm depends upon the improvement in the profitability of the firm. The interest paid on debt is tax deductible payments, so the addition of debt in the capital structure will improve the profitability of the firm. It is important to know the relationship between capital structure and the profitability of the firm in order to make sound decision on capital structure.So the study is expected to be equally beneficial for bankers, policymakers, regulators and researchers. Moreover, the study will be beneficial for the bankers to improve the performance and allocate the resources in a manner that would actually improve the profitability.

i. This study help to provide information regarding the composition of capital structure on the basis of term to maturity,
ii. This study have significant role to play in filling gap in understanding of the impact of capital structure decisions on profitability of selected Nepalese commercial bank,
iii. It is also hoped that this study may be able to explore the capital structure of selected commercial banks.
iv. This study will be useful for researchers, students and for those who wants to have further study in details,
v. Similarly, this study may be fruitful to financial institutions.

5. Limitation of the Study

This study is required for the partial fulfillment of MBS Degree. Hence, it is subject to some limitations, which affect the studies, and those limitations are given below;

i. There will be small size of sample so that the research might not generalized whole population of 27 commercial banks.
ii. The study is limited to only fourcommercial banks, namely Agriculture Development Bank, Himalayan bank ltd, Everest bank ltd, NIC Asia Bank may not represent the whole finance company of Nepal.
iii. This reliability of the secondary data highly depends on the accuracy of the annual report of the concerned finance companies.
iv. This study will be focused only secondary source of data collection.
v. In Nepal, there are limited numbers of literature about this type of study.

6. Literature Review

Review of literature is the study of past research studies and relevant materials. It is an advancement of existing knowledge and in-depth study of subject matter. It starts with a search of a suitable topic and continues throughout the volumes of similar or related subjects. In a literature review, the researcher takes hints from past dissertation but he/she should take heed of replication. Literature review means reviewing research studies and other pertinent preposition in the related area of the study so that all the past studies their conclusions and deficiencies and further research takes place.

6.1 Theoretical Review

In literature, there are a number of theories that attempt to explain firm profitability in relation to capital structure.There is significant positive impact of capital structure on firm's profitability (Singh and Bagga, 2019).Moreover, higher profitability measures of ROA and net interest margin tend to be associated with relatively higher total and short-term debt ratios, loan to deposit ratios, and credit risks (Ayalew and McMillan, 2021). The theoretical explanation of the link between the mixture of debt and equity and firm value dates back to 1958 following the work of Modigliani and Miller (Ebaid, 2009). They came up with the Modigliani and Miller (MM) proposition I, which led to the theory of capital structure irrelevance. Later in 1963, Modigliani and Miller modified proposition I, and came up with MM proposition II. Weaknesses of the theories of Modigliani and Miller led to the development of many theories in an attempt to explain the relationship between capital structure and firm value.Such theories include static trade theory, the pecking order theory and the agency cost theory.

The Modigliani and Miller Model Theory

The capital structure irrelevance theory of Modigliani and Miller (1958), forms the basis for the development of theoretical frameworks of captain structure and firm value (Lawal et al, 2014). This proposition states that under the assumptions of perfect and frictionless capital market, given no bankrupt cost and no taxes, capital decision of a firm is irrelevant. That is a firm with debt has the same value as the unlevered firm. When there are no taxes and capital markets function well, it makes no difference whether the firm borrows or individual shareholders borrow. Therefore, according to Lawal et al (2014), a firm's value does not depend on its capital structure. Myers (1984) adds that according to the capital structure irrelevance theory, financial leverage of a firm does not affect its value. The proposition also holds under the assumptions of no transaction costs and homogenous expectations.

MM proposition II Modigliani and Miller in 1963 came up with MM proposition II by incorporating tax in their 1958 proposition. The modification recognizes the impact of tax shield on firm value. This is on the understanding that interest payment on debt is

tax deductible (Myers and Majluf, 1984). Thus, the best capital structure of a firm should be one with hundred percent of debt instruments (Lawal et al, 2014).

Static Trade Off-Theory

The simplifying assumptions of Modigliani and Miller led to the development of alternative theories of capital structure and firm value. Among these theories is the static trade-off theory. The theory starts by relaxing the assumption of no bankruptcy costs made by Modigliani and Miller (Myers and Majluf, 1984). It makes the proposition that debt financing is accompanied with financial distress and the probability of financial distress increase rapidly with additional borrowing. The cost of financial distress little by little offsets the interest tax shied in MM proposition II. Therefore, a capital structure optimum is reached when the present value of costs of distress starts to offset the present value of tax savings due to additional debt. Managers will try to increase debt levels to the point where the value of additional interest tax shields is exactly offset by the additional costs of financial distress. The static trade theory suggests the existence of an optimal debt-equity ratio (Ghazouani, 2013). PV of bankruptcy cost is the present value of bankruptcy costs while PV of tax shield is the present value of the tax shield or saving. It shows that as debt increases, the value of the firm also increases up to a certain point where additional debt decreases firm value. This is optimal amount of debt that maximizes firm value.

The Pecking Order Theory

This theory is an alternative to the static trade off theory. It is based on asymmetric information and proposes that firms prefer internal finance to external finance. This is so because funds from internal sources such as returned earnings are raised without sending any adverse signals that may lower the share price. In addition, if external finance is required, firms issue debt first, then hybrid securities and issue equity only as a last resort. An issue of debt is less likely to be interpreted by investors as a bad omen than the issue of equity. Therefore, firms issue debt rather than equity if internal finance is insufficient. Unlike the static trade off theory, the pecking order theory proposes that there is no well-defined target debt-equity mix because of the existence of internal and external equity with internal financing a priority in the pecking order (Myers and Majluf, 1984).

Agency Cost Theory

This theory states that an optimal capital structure will be determined by minimizing the costs arising from conflicts between managers, employees, creditors and shareholders (Iqbal, 2012). Developed by Jensen and Meckling (1976), the agency cost theory argues that agency costs results from the divergence of interest between shareholders and managers who do not have full ownership of the firm. Jensen and Meckling (1976) argue that the choice of capital structure may help mitigate agency costs. For instance, increase in debt reduces agency costs through the threat of liquidation (Grossman & Hart, 1986). Therefore, by reducing agency costs, debt increases firm performance. However, too much leverage generates significant agency costs such as financial distress, which has a negative impact on performance (Berger & Patti, 2006). The arguments set by this theory, suggests the existence of an optimal combination of debt and equity like the static trade off theory.

6.2Conceptual Review

This is the process of evaluating the variables of the current study with the previous studies. The variables (Dependent and independent) might be different from one to another with the changes of time. In this study the dependent variable is finance company profitability i.e. return on assets and return on equity because it may be changed by internal and external forces. Similarly, independent variable of the study is Capital structure i.e. total debt ratio, debt equity ratio, time interest earn ratio and so on (Nasimi, 2016).

6.3 Empirical Review

Several studies have been done to examine the effects of capital structure on profitability of finance companies in Nepal. Some of these studies including a work by Modigliani and Miller (1958) who in their research concluded that the value of the firm is self-determining of capital structure and that the value of an unlevered firm is equal to that of a levered firm. The research was based on the assumption of absence of taxes. This assumption was considered unrealistic and in their subsequent research Modigliani and Miller (1963) took tax into consideration and concluded that because of tax shield on debt as a factor, the value of a levered firm was more than the value

of an unlevered firm and that this value was equal to the value of the tax shield. Modigliani and Miller (1977) later modified their earlier research of 1963 and incorporated the effect of personal taxes. Personal taxes were classified into two categories, tax on income from holdings shares and tax on income from debt securities. In this research (1977), Modigliani and Miller identified certain special cases where gain from leverage became zero, giving the original (1958) result. Thus their results signify the existence of an optimal capital structure at the macro level but not at the micro level.

Deesomsak et al. (2004) examining the effect of capital structure's effect on firm performance, reported a negative relationship between capital structure and firms performance measured by gross profit margin in the Malaysian firms. The study indicated that in Singapore, Taiwan and Australian the relation of leverage with firm's performance is negative but statistically insignificant. Moreover, the effect of firm size on leverage is significant and positive for all the countries except Singapore, because in Singapore firms have government support and are less exposed to financial distress costs.

Nimalathasan&Brabete (2010) examined methodically the relationship between capital structure and financial performance of firms listed on Columbia Stock Exchange, Sri Lanka. The study guides the entrepreneurs and policy planners to formulate better policy decisions regarding the mix of debt and equity capital to control over capital structure planning.

Abor (2005) investigate the relationship between capital structure and profitability of listed firms on Ghana Stock Exchange. He reveals a positive relationship between short term debt to total assets and return on equity due to low interest rates. Further, he suggests that in Ghanaian firm's short term financing shows 85 percent of total debt and is considered a main element of financing for them. Moreover, a negative relationship find between long term financing and equity returns, and a positive relation exists between total debt and profitability. He also suggests that debt is considered as a major source of financing for high profitable firms.

6.4 Research Gap

Although, there are abundant studies on capital structure and profitability worldwide, the focus of those studies was concentrated mainly on how the capital structure should be, or how much the company should earn the profit but none of the theses have put effort to find out the relationship between capital structure and profitability. For instance of these studies are Amidu, (2007), Determinants of capital structure of banks of Ghana: an empirical approach, Baral, (2004), Determinants of capital structure: a case study of listed companies of Nepal, Buser, at al, (1981), Federal deposit insurance, regulatory policy and optimal bank capital, Deesomsak, at al, (2004), The determinants of capital structure: evidence from the Asia Pacific region etc. However, this study will mainly address the impact of capital structure on profitability, along with the capital structure of the bank, and the profitability position.

During review of literature, there was found most of the research is done considering capital structure and profitability for manufacturing company rather than banking sectors. Very few studies are done by considering Earning per share as dependent variable but study use earnings per share as dependent variable and conduct the analysis both profitability and capital structure of banking sectors as well. Not only that, previous studies are fail to coverage the impact of capital structure on profitability of commercial banks after the merger policy of Nepal Rastra Bank in Nepal.

Thus, research gap weakness are found in past studies, this research have been conducted to find out the impact of capital structure on profitability of commercial banks in Nepal by collecting the data from Reports of NRB (Nepal Rastra Bank) Reports of Nepal Banker's Association, Annual report of banks etc.

7. Research Methodology

This study will follow descriptive research design. Population for the research will be 27 finance companies listed in Nepal. Purposive sampling techniques will be use and sources of data will be secondary sources. Correlational matrix and regression mode will be used for the study.

7.1 Research Design

This study will follow descriptive and explanatory research design for capital structure and profitability of commercial banks in Nepal. A research design is the overall path or method by which the research study is guided. It serves as a framework for the study directing the collection and analysis of the data, in which the research method is to be utilized and sampling plan to be followed. Research designed is the way through which we find the required answer of the research questions and ultimately meet the research objectives.

7.2 Population and Sample

Purposive sampling technique will be taken to select the samples among population. At present, 27 commercial banks are operating in the country. However, the analysis of all these commercial banks in terms of capital structure and its impact on profitability will be onerous to conduct. There are few commercial banks to issue debenture and bond.So taking this numbers as the population of the study, only four commercial banks; namely Agricultural Development Bank Ltd., Himalayan Bank Ltd., Everest Bank Ltd. and NIC Asia Bank Ltd. been taken as the sample of the study.

There are 27 commercial banks in Nepal, among them I will select fourcommercial banks because each bank issue debenture and bond. In which the sample will representfollowing commercial banks in Nepal.

i. Agricultural Development Bank Ltd
ii. Himalayan Bank Ltd
iii. Everest Bank Ltd
iv. NIC Asia Bank Ltd

7.3 Nature and Sources of Data

The data used in this study are fully secondary in nature. Published annual reports of concerned finance company are taken as basic source of data. The relating to financial performancesaredirectly obtained from the concerned banks. Similarly, related books,

magazines, journals, articles, reports bulletins, and Nepal Rastra Bank, related website from internet etc. as well as supplementary data.

7.4 Data Collection Instrument and Procedures

The study uses the secondary data of 10 years obtained Bank Supervision from Reports published by Nepal Rastra Bank (NRB), Reports of Nepal Banker's Association, Annual report of banks and financial institutions etc from 2011 to 2020.

7.5 Data Analysis Tools and Techniques

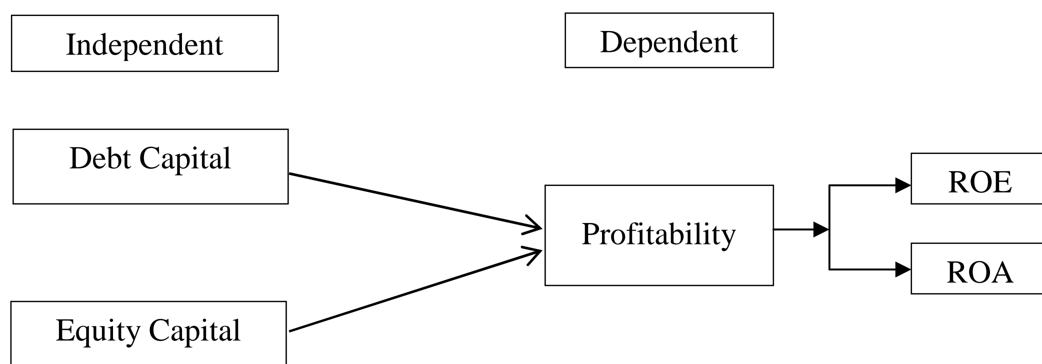
Table will be used to manage data. To test the correlational matrix and regression mode analysis will be used. Microsoft Word, Excel and SPSS (Statistical Package for the Social Sciences) will be used to process and extract the result from the available information.

7.6 Conceptual Framework and Definition of Variable

Conceptual Framework

Conceptual framework is an analytical tool used to make conceptual differences or organize ideas. It is within the framework of this theory that the entire study proceeds. It explains the relationship among the dependent and independent variables explaining how one variable makes an impact on the other.

Below is a figurative representation of the variables to be explored by this research study:-



Source: Researcher’s construct using the idea of Nasimi, (2016).

Definition of Variable

Independent variables

Sekraran (2012) explained the independent variable as the one which influences the dependent variables in either positive or negative way.Capital structure can be a mixture of a firm's long-term debt, common equity and preferred equity. A company's proportion of short-term and long-term debt is considered when analyzing capital structure. When analysts refer to capital structure, they are most likely referring to a firm's debt-to-equity (D/E) ratio, which provides insight into how risky a company is. Usually, a company that is heavily financed by debt has a more aggressive capital structure and therefore poses greater risk to investors.

i. Interest Coverage Ratio

The interest coverage ratio (ICR) is measure of company's ability to meet its interest payments. It is a financial ratio that measures company's ability to make interest payments on its debt in a timely manner.

Interest Coverage = EBIT / Interest Expense (Nimalathasan&Brabete, 2010).

ii. Debt to Equity Ratio

Debt/Equity Ratio is used to measure a company's financial leverage, calculated by dividing a company's total liabilities by its shareholders' equity. The D/E ratio indicates how much debt a company is using to finance its assets relative to the amount of value represented in shareholders' equity.

Debt to Equity = Total Liabilities / Total Shareholder's Equity (Muhammad, Shah, & Islam, 2014).

iii. Total debt Ratio

Total debt ratio is used to measure a company's financial leverage, calculated by dividing a company's total liabilities by its total assets. The total debt ratio indicates how much debt a company is using to finance its assets.

Debt to Equity = Total Liabilities / Total Assets (Muhammad, Shah, & Islam, 2014).

Dependent variables

The value of dependent variable is derived from the value of other variables. Sekraran (2012) dependent variable is the one on which the researcher have primary interest.Profitability ratio is a dependent variable for the current study. The independent variables can increase or decrease to the dependent variable. To find out the impact of independent variable on the dependent variable, this study used the regression and the correlation methods.

Profitability ratios are a class of financial metrics that are used to assess a business's ability to generate earnings relative to its associated expenses. For most of these ratios, having a higher value relative to a competitor's ratio or relative to the same ratio from a previous period indicates that the company is doing well. It includes return on equity, return on assets for the current study.

i. Return on Assets

Return on Assets or Investment is the raise in the cash flows produced by the operating cycle as a result of asset or investment outlays. It is the return for aking immediate spending.

Return on Assets = Net Income / Total Assets (Muhammad, Shah & Islam, 2014).

ii. Return on Equity

Return on Equity is the measure of the amount of net income returned as a percentage of shareholders equity. Return on equity measures a firm's profitability by revealing how much profit a company generates with the money shareholders have invested.

Return on Equity = Net Income / Shareholder’s Equity (Muhammad, Shah &Islam, 2014).

8. Expected Results

The expected results of the study depend on its objectives which are as below.

i. This study will analyze the capital structure status and profitability position of commercial banks of Nepal.
ii. This study will examine the relationship of capital structure with profitability of commercial banks in Nepal.
iii. This study will investigate the impact of capital structure on profitability of Nepalese commercial banks i.e. positive or negative.

9. Chapter Plan

A chapter plan is an outline that helps us to organize material in a way that is easy to comprehend. It can be a very useful tool in helping to find the main points of the chapter. The report will be divided into five chapters excluding preliminary sections, references & appendix. The preliminary section will include title page, approval page, acknowledgement, table of contents, list of tables and figures, acronyms and abstract.

Chapter I: Introduction

Chapter one gives detail about the study area and the concept note about the research problem under study. It will include background of the study, statement of the problem, objective of the study, rationale of the study, limitation of the study and chapter plan of thestudy.

Chapter II: LiteratureReview

This chapter is about review of related literature. Review of literature gives the investigator a thorough and profound knowledge of the research topic. It provides guidelines to use statistical methods for analysis of collected data.

Chapter III: Research Methodology

This chapter is about research methodology. It includes introduction, research design, study site description and rationale behind selection of study area, study population

and sampling, nature and sources of data and methods of data organization, processing andanalysis.

Chapter IV: Results and Discussion

Data analysis includes tabulation, coding and classification of the data gathered in accordance with the research design, to perform quantitative analysis. The details about the analysis and interpretation of the findingsin accordance objectives are described here.

Chapter V: Summary and Conclusion

This is the last chapter of the study. It will presents thebrief background of the study, objectives, literature review and methodologies with summery of findings, conclusion and implementation.Conclusion includes theorization based on findings and, finally, the recommendations based on those findings are stated.

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