IMPACT OF CAPITAL STRUCTURE ON STOCK RETURN

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Abstract

This study delves into the complex variables that impact investor perceptions and market results by investigating the link between a firm's capital structure and its stock performance. The key to sound financial management is understanding a company's capital structure, which is the mix of stock and debt used to finance operations. Considerations include financial risk, cost of capital, financial leverage, market circumstances, investor perception, and regulatory framework. All these aspects interact with capital structure decisions and their impact on stock return. With financial risk being both a blessing and a curse, the effect of capital structure on stock returns is complex and multi-faceted. Using debt can increase earnings during good times, but it leaves you exposed during bad times. Decisions on the capital structure affect the cost of capital, which in turn affects the attractiveness of a firm to investors. By fine-tuning the arrangement of the capital structure, one may lower the cost of capital and, maybe, boost stock returns. Considering both the changes made to the capital structure and the company's financial performance is necessary for evaluating overall returns and, more importantly, for determining if stock returns are sensitive to changes in the structure. To put a number on this effect, we used stock returns as our dependent variable and debt-to-equity ratios, return on equity, and profits per share as our independent variables. The supplied variables were used to produce the findings using the regression model.

Keywords: Capital Structure, Stock Return, Financial Risk, Leverage

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Introduction:

The relationship between a company's capital structure and its stock returns is a critical aspect of financial management and investment analysis. Capital structure refers to the mix of debt and equity that a company uses to finance its operations and investments. It plays a significant role in determining the financial risk and cost of capital for a firm. Stock return, on the other hand, reflects the gains or losses that

investors experience from holding a particular stock over a specific period. Understanding the impact of capital structure on stock returns is essential for both investors and corporate decision-makers. The capital structure decisions made by a company can influence its overall financial health, profitability, and, consequently, the attractiveness of its stock to investors. This relationship is a complex interplay of various factors, including risk, cost of capital, and financial leverage. Furthermore, as we delve deeper into the intricate relationship between capital structure and stock returns, it is essential to recognize the diverse perspectives and methodologies employed by researchers and practitioners in analyzing this dynamic interplay. The multifaceted nature of this relationship necessitates a holistic approach that considers not only quantitative metrics but also qualitative aspects, market sentiment, and the evolving regulatory landscape. The impact of capital structure on stock returns is often subject to empirical scrutiny, with numerous studies attempting to decipher patterns and correlations. Research has explored how varying levels of debt-to-equity ratios influence stock price volatility, the cost of equity, and ultimately, shareholder returns. Additionally, studies have investigated the implications of capital structure decisions on a firm's ability to weather economic downturns and capitalize on periods of growth.

One of the focal points of this analysis is the notion of financial risk and how it intertwines with stock returns. While financial leverage can enhance returns, especially during periods of economic prosperity, it also exposes the firm to greater financial vulnerability in times of economic stress. Striking the right balance becomes paramount, and this delicate equilibrium is often contingent on industry dynamics, the firm's growth trajectory, and risk tolerance. Cost-of-capital considerations are integral to this discussion, as they directly influence the valuation of a firm and, consequently, its stock returns. By optimizing the capital structure to minimize the cost of capital, companies can potentially enhance their attractiveness to investors. The extent to which a firm relies on debt financing versus equity financing plays a pivotal role in this optimization process. Market conditions, characterized by economic cycles, interest rate fluctuations, and overall investor sentiment, contribute significantly to "the impact of capital structure on stock returns". Investors' perceptions of risk and reward are inherently linked to prevailing market conditions, influencing the demand for a company's stock. Understanding these market dynamics is crucial for anticipating how changes in capital structure may affect stock performance.

Financial Risk:

- The use of debt in a company's capital structure introduces financial risk. Debt obligations, such as interest payments and principal repayment, must be met.

- Higher financial risk may lead to higher stock returns during prosperous periods, as leverage can amplify returns. Conversely, during economic downturns, high financial risk can result in significant losses for shareholders.

Cost of Capital:

- The cost of capital, the rate of return investors demand to offset the risk of participating in a firm, is affected by decisions about the capital structure of the business.

- A well-optimized capital structure can minimize the overall cost of capital, making the company more attractive to investors and potentially enhancing stock returns.

Financial Leverage:

- Stock returns may be magnified by financial leverage, which is taking of more debt in order to raise the possible return on equity.

- Factors such as the sector in which the firm operates, its development potential, and its risk tolerance determine the ideal amount of financial leverage.

Market Conditions:

- The effect of capital structure on stock returns is very sensitive to macroeconomic factors, interest rates, and the state of the market as a whole.

- In times of economic uncertainty, investors may be more sensitive to companies' financial risk.

Investor Perception:

- Investors' perceptions on a company's financial health, stability, and growth prospects are influenced by company's capital structure.

- Companies with a balanced and well-managed capital structure may be perceived as more reliable and attractive, potentially leading to higher stock returns.

Regulatory Environment:

- The regulatory environment, including tax laws and financial regulations, can affect the optimal capital structure of a company.

- Changes in regulations may impact the attractiveness of certain debt or equity instruments ultimately influencing stock returns.

Study Objectives

1. An examination of the connection between capital structure and stock return.

Study Importance

Since there is a correlation between capital structure and stock performance, this study is important. One study that looked at the connection between capital structure, size, growth rate, and stock return was Acheampong et al. (2014). This association has also been explored in other studies. However, many study the relationship between size, liquidity, capital structure, and stock return. Therefore, many groups, including managers, researchers, shareholders, and investors, stand to gain a great deal of knowledge from this study. Company managers may find this study useful in determining the ideal debt-to-equity ratio that maximises a company's potential for growth in value. More than that, the study results may help the company's management to attract fresh investors. The results of this study could also serve as a springboard for future investigations.

Literature Review

Uremadu and Efobi (2012) utilised 10 Indian companies that had been listed between the years 2002 and 2006 to investigate the extent to which changes in liquidity and capital structure had an impact on shareholder returns. The findings of the Ordinary Least Square and the log Linear Least Square indicate that there is a negative correlation between returns and long-term debt.

Ahmed, Fida and Zakaria (2013) analysed one hundred (100) companies listed on the Karachi stock market from 2006 to 2010 using structural models to determine what factors influence the capital structure's debt-to-equity balance and how it relates to returns. These businesses were hand-picked from the 2006–2010 Karachi stock exchange. Based on a set of Panel data, the Generalised Method of Moments (GMM) model shows that leverage and stock returns are causally related in both directions. Additionally, the model proves that leverage is more influential than stock return. It was shown that the relationship between leverage and stock returns is driven by growth,

profitability, and liquidity. All of this was carried out presuming that a correlation between leverage and stock returns actually exists.

Similarly, Olowoniyi and Ojenike (2013) looked at the same link using 85 publicly traded Nigerian companies during eleven years from 2000 to 2010. The panel co-integration analysis found that capital structure significantly affects stock returns over the long term. Other distinctive features of the company were also identified as important determinants of stock returns. Bergren (2014) and Bergqvist (2014) assessed the same from 2009 to 2013 using a sample of fifty (50) Swedish firms. Financial leverage, firm size, growth, and liquidity are all factors that positively affect stock returns, according to the research. According to what they found, stock investment returns were drastically impacted by profitability. Using fifteen(15) companies chosen at random from the Amman stock market between 2009 and 2012, Gharaibeh (2014) investigated the relationship between capital structure and firm liquidity. The study lasted for a full three years. Firms' stock returns were shown to be uncorrelated with their debt-to-equity ratios.

Ghi (2015) assessed the correlation between stock returns and loan utilization for 175 firms traded on the Vietnam Stock Exchange between 2010 and 2013. An extremely high debt-to-equity ratio has a negative effect on stock investment returns, according to the results of the ordinary least square regression model. Similarly, Nalurita (2015) used 38 publicly traded Indonesian firms active in the real estate, construction, and property industries between 2010 and 2014 to study the effect of capital structure on stock return. According to the results of the random effect regression, the analyzed businesses' stock returns were significantly and favorably affected by the debt-to-equity ratio and the company's performance, respectively.

Al Salamat and Mustafa (2016) conducted a study to determine whether or not there is a correlation between the capital structure of companies and the stock returns of those businesses that were listed in the industrial sector of the Amman Stock Exchange between the years 2007 and 2014. This conclusion was reached by the utilisation of an unbalanced panel regression analysis, which indicated that capital structure had a negative effect on stock returns. The profitability of the company, in addition to its liquidity, has been shown to have a favorable impact on the returns on stock.

Nurlaela, Mursito, Kustiyah, Istiqomah, and Hartono (2019) studied the impact of capital structure on stock returns. A total of 29 realty and property companies that were listed on the Indonesian stock exchange between 2012 and 2016 were studied to achieve this goal. Return on stock portfolios is unaffected by the debt-to-equity ratio, according to the results of the ordinary least square regression. A comparable approach

was used by Utami and Darmawan (2019) in their investigation of the impact of profitability, earnings per share, debt-to-equity ratios, and stock return. From 2012 to 2016, fifty-three non-financial companies listed on the Indonesian stock market were the primary targets of their inquiry. The regression result revealed that profitability and the debt-to-equity ratio both positively affected stock return, although this relationship was not statistically significant. Conversely, the company's return on stock was positively affected by earnings per share, and this effect was statistically significant.

Titman and Wessels (2020) concluded that there is a statistically significant difference between the amount of short-term debt utilised by larger corporations and that of smaller ones. They were unable to give evidence for the theory that states the presence of relationships between debt ratios and non-debt tax shields, expected growth volatility, or the collateral value of a firm's assets.

Ahmad et al (2013) analysed the factors that impact the capital structure and stock return of one hundred non-financial companies that were listed on the Karachi Stock Exchange (KSE) between the years 2006 and 2010. The period covered by this study is from 2006 to 2010. Based on the data, it can be concluded that leverage and stock return are interdependent on one another. On the other hand, liquidity, growth, and profitability have a significant influence on both leverage and stock return. The relationship between profitability and financial leverage is negative but it affects the stock return positively, there is a positive impact of growth on leverage and stock return, but there is a negative relationship between liquidity and both financial leverage and stock return, finally, the size of the firm has an insignificant relationship with financial leverage and stock return.

Acheampong et al (2014) examined the five manufacturing companies in Ghana that were active between 2006 and 2010 to see how the market size and financial leverage impacted their stock returns. The research result shows that financial leverage significantly lowers stock returns, whereas firm size significantly increases them. The liquidity of a stock is directly related to the size of its tradable shares. With a given degree of leverage, smaller firms outperform larger organisations in terms of returns. The impact of debt on stock prices for large companies is becoming less significant. This is because of the very indebted businesses and massive market capitalization. The effect on stock returns is small and limited.

Chiang and Zheng (2015) looked into the connection between liquidity and the anticipated stock return. This research focused on nations such as the United States of America, Canada, France, Germany, Italy, Japan, and the United Kingdom. The results are generated by the use of panel data regression, which in turn is applied to monthly

data covering a period of twenty years. There is a positive connection between liquidity and stock returns, according to the data. Tahmoorespour et al. (2015) studied the link between capital structure and stock return by selecting firms from eight different countries located in the Asia Pacific area. The period that they chose to analyse was from 1990 to 2012. The findings suggest that the influence of capital structure is dependent not only on the features of the market but also on the nature of the sector. This is because the market characteristics vary from sector to sector. The relationship between return and debt to common equity is inversely proportional in all three countries: Australia, China, and Korea. On the other hand, the ratio of long-term debt to common equity in the basic material companies in Australia and Korea has a positive influence.

Conclusion

A comprehensive examination of a wide range of market and financial conditions is required to fully comprehend the complex nature of the link between capital structure and stock performance. To make well-informed decisions that are by the objectives of the firm and the conditions of the market, investors and financial managers should take into consideration the risk-return trade-offs associated with various capital structures. This study will continue with additional parts that will look deeper into particular facets of this relationship. These sections will investigate empirical research, theoretical frameworks, and practical consequences for firms and investors. The out-of-date trade-off theory has been challenged by capital structure philosophers such as pecking order theory, market signal theory, and agency theory. This is because debt capital is presented as behavioral characteristics in the capital structure. This is because the function of the pecking order requires less power and knowledge, which is a way to improve directors' professional ambition. It has been stated by theorists that the capital structure of an organization has a negative impact on the efficiency of the organization; hence, managers take care when using loan capital to foot the bill for cost activities. Based on the findings, it was proposed that businesses should minimize their utilization of borrowed capital rather than increase the proportion of equity capital in their capital structure mix.

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