

TABLE OF CONTENTS

TABLE OF CONTENTS.....	i
LIST OF FIGURES.....	iii
LIST OF TABLES.....	iv
LIST OF ABBREVIATIONS.....	v
1 INTRODUCTION.....	1
1.2 AIMS AND OBJECTIVES.....	4
1.3 RESEARCH RATIONALE.....	4
1.4 STRUCTURE OF THE STUDY.....	4
2 LITERATURE REVIEW.....	5
2.1 INTRODUCTION.....	5
2.1 CAPITAL STRUCTURE THEORIES.....	5
2.1.1 MODIGLIANI AND MILLER (IRRELVANCE THEORY).....	5
2.1.2 TRADE OFF THEORY.....	8
2.1.3 AGENCY COST THEORY.....	15
2.1. 4 PECKING ORDER THEORY.....	17
2.2 FIRM PERFORMANCE.....	20
2.2 LEVERAGE AND FIRM PERFORMANCE.....	20
3. METHODOLOGY.....	24
3.1 QUALITATIVE RESEARCH METHODOLOGY.....	24
3.2 DATA TYPE.....	24
3.1.1 DATA COLLECTION AND PROCESSING.....	25
3.1.2 SAMPLE.....	25
3.2 VARIABLES.....	26
3.2.1 INDEPENDENT VARIABLES.....	26
3.2.2 DEPENDENT VARIABLES.....	27
3.2.3 CONTROL VARIABLES.....	28
3.3 REASEARCH HYPOTHESIS.....	28
3.4 ESTIMATION METHODS AND MODELS.....	31
3.4.1 CORRELATION ANALYSIS.....	31
3.4.2 ORDINARY LEAST SQUARE (OLS).....	32

3.5 DIAGNOSTIC TEST	33
4 DATA FINDINGS AND ANALYSIS.....	34
4.1 DESCRIPTIVE SUMMARY.....	34
4.2 CORRELATION SUMMARY.....	38
4.3 MULTICOLLINEARITY TEST.....	40
4.4 REGRESSION ANALYSIS	40
4.5 INTERPRETATION	43
4.6 AUTOCORRELATION TEST.....	44
5 CONCLUSIONS AND RECOMMENDATIONS.....	47
5.1 CONCLUSIONS.....	47
5.2 LIMITATIONS	48
5.3 RECOMMENDATIONS	48

LIST OF FIGURES

FIGURE 1 TWO PIE MODEL OF CAPITAL STRUCTURE UNDER CORPORATE TAXES ..	6
FIGURE 2 TRADE-OFF THEORY	9
FIGURE 3 AGENCY THEORY	17
FIGURE 4 PECKING ORDER THEORY	19
FIGURE 5 DEBT LEVELS	36
FIGURE 6 PERFORMANCE MEASUREMENTS 200-2011	36
FIGURE 7 INDUSTRY SECTOR LEVERAGE	

LIST OF TABLES

Table 1 SUMMARY OF CAPITAL STRUCTURE THEORIES	19
Table 2 Descriptive statistics for whole sample.....	36
Table 3 Descriptive analysis for sample sector ...	
Table 4 Correlation Analysis	39
Table 5 ROA Model Summary	
Table 6 GPM model summary	
Table 7 ROE Model summary	
Table 8 Dependent variable ROA regression	
Table 9 Dependent Variable ROE regression	
Table 10 GPM Regression Model	
Table 11 Industry Sector Regression	

LIST OF ABBREVIATIONS

GPM	Gross profit Margin
LTD	Long term debt
MM	Modigliani and Miller
NPV	Net Present Value
OLS	Ordinary Least Square
ROA	Return on Assets
ROE	Return on Equity
STD	Short term debt
TTD	Total debt

1 INTRODUCTION

The Primary objective of a firm is to maximise shareholders profit. Managers accomplish this goal by making rational decisions concerning capital structure (Kimanthi 2015). Capital structure decisions is significant to the success of a firm because it involves different methods of financing that contributes to a firm's better performance. The term Capital structure can be defined as the combination of equity and debt through which a company finances its assets (Khanam 2014). Change in a capital structure is as a result of an increase or decrease in a firm's debt to equity ratio. When a firm includes debt as part of financing its projects, financial leverage comes into play. Financial leverage measures how a firm uses debt to expand its operations and increase profitability (Pandey, 2005). Subsequently firms employ debt mainly for the maximisation of the firm's value. However, when a firm increase its debt levels, such decision automatically reduces the firm's profitability. On the other hand, financial leverage could have potential effects on capital cost. This according to researchers could ultimately influence s an organisations profitability (Higgins, 1977; Miller, 1977). Gitman (2009) states that a firm maximises value when its cost of capital is minimised. The appropriate proportion of debt and equity that minimises cost of capital and also maximise value is referred to as the optimal capital structure (Goyal 2003). The thought provoking issue been faced by firms today, is how to combine debt and equity to achieve optimal capital structure. Unfortunately there seems to be no available theory which explains the appropriate mix of debt and equity to achieve optimal capital structure. The relationship between capital structure and firm performance has been a topic of concern to finance researcher since the seminal work of Modigliani and Miller.

Modigliani and Miller (MM) (1958) also referred to as MM Proposition I, is believed to be the preliminary point of most research carried out on capital structure. MM (I) argued that capital structure is irrelevant in determining a firm's value (Irrelevance theory). They based their theory on perfect market conditions which assumed a free tax economy, no transaction cost, no bankruptcy cost and no free access to information. However, after several criticisms, MM amended its initial theory and then considered corporate taxes which suggested that firms can only maximise value when more debt capital is utilized (Modigliani and Miller 1963).

After the MM the seminal works of in 1958 and 1963, there has been subsequent theoretical and empirical studies on the impact a firm's choice of capital structure has on its financial performance. Nevertheless, there has been several theories developed to explain the relationship between a firm's performance and its capital structure they are; Trade-off theory, Pecking order theory and Agency theory. The first two are referred to as the most dominant theories of capital structure (Ebaïd 2009).

The Trade-off theory stipulates that firm value is maximised when there is an optimal level of capital structure. According to Tang and Jang (2007), the optimal level of capital structure is established when the benefit of debt offsets the cost of debt. The benefits of debt is tax savings (DeAngelo and Masulis 1980) and the cost of debt include bankruptcy cost (Kraus and Litzenberger 1973) and agency cost (Jensen and Meckling 1976). However, the trade-off theory suggests that debt is important in the financing of a firm that a firm can replace debt with equity and equity with debt until value is maximised. Hence debt is considered to be less expensive when compared to equity (Park and Jang 2013). But, an excessive utilization of debt may result in high bankruptcy risk. The overall implication of the trade-off theory is that firms set target leverage and they adjust their leverage towards the target.

On the contrary, the pecking order theory suggested by Myers and Majluf (1984), states there is no optimal capital structure, firms follow a particular order of financing when selecting sources of funding. The theory further explains that managers first select internal financing (retained earnings) to fund projects first, but when there is need for additional funds they issue debt and later equity. The pecking order theory is centred on information asymmetry, where managers have access to more information than others, the cost associated with information increases. Hence, managers would rather issue shares when they are over-valued. However, the theory suggest that because of information asymmetry that exist between firms and potential investors, managers would rather choose internally generated funds over debt, and debt over equity (Myers and Majluf 1984). Furthermore, it is also suggest that firms with greater earnings should use less debt to finance their investment opportunities.

According to the Agency theory of Jensen and Meckling (1976) conflict of interest exist between managers and shareholders. That is, interest of managers and

investors vary. However, both further explained that managers would rather achieve their own personal goals than to maximise returns to favour stockholders. According to the agency theory there are two categories of agency conflicts: conflict between managers and shareholders; and conflict between shareholders and debtholders. The agency theory goes ahead to explain that this conflict might result in several problems such as over investment problem and under investment problem. Jensen (1976) further argued that increasing debt would act as a disciplinary tool to managers as it restrains managers from investing in projects with negative NPVs, which on the long run makes firms more profitable. Berger and Udell (2006) proposed that high debt ratio or low equity (asset) ratio minimises the agency cost of outside equity. According to them this will help boost up the value of firms by motivating/compelling managers to act in its shareholders interest.

Debt financing raises the pressure on manager's performance, because it reduces the availability free cash flow at their disposal (Jensen, 1986). In addition, firms with higher influence should be most motivated to improve their performance. Although, a debt level would imply higher agency costs because of the separate interests of debtors and that of shareholders. This moral hazard also drives home the fact that leverage (debt) could also be associated with performance (Jensen and Meckling, 1976; Myers, 1977). The leverage and firm performance relationship has been a puzzling issue in finance literature since the early seminal work of MM. Although, the evidence on this correlation have been contradictory. While some studies found a positive correlation between leverage and financial performance (Hadlock and James, 2002; Berger and Udell, 2006). They argued that the effect leverage has on financial performance is positive only if firms profit surpasses its debt cost (Hutchinson, 1995). Which is possible only if the firm commits itself to a certain level of debt (Hadlock and James, 2002). Berger and Udell (2006) examined the link between leverage and financial performance in the banking sector and found that high debt is correlated to high profit. While some researchers argue that leverage and financial performance are negatively related.

1.2 AIMS AND OBJECTIVES

The aim of this study is to empirically examine the relationship between debt level and financial performance of UK firms listed on the London Stock Exchange over the period of 2000-2011

In order to achieve this aim, the objectives include

- Examine the impact of capital structure on financial performance
- Investigate the relationship between leverage and firm financial performance.
- Evaluate the financial performance of UK firms using profitability performance measurements (ROE, GPM and ROA).
- Test for relationship between the different levels of debt on firm performance.

1.3 RESEARCH RATIONALE

There are several studies on the relationship between leverage and financial performance both in developed and developing countries. Although there have been some centred on UK firms. This study aims to provide an in-depth look into the relationship between leverage and firm financial performance and also the impact capital structure choice has on firm value. This study will help managers make efficient and effective decisions pertaining to firm's value.

1.4 STRUCTURE OF THE STUDY

The remaining parts of the thesis is divided into four parts (Chapter 2-5). Chapter 2 reviews the theories of capital structure, examine the relationship between leverage and firm financial performance and empirical results on the relationship between performance and leverage. Chapter 3 explains the methodology of this study. Chapter 4 presents, analyse and compare previous the empirical results of this study. Finally chapter 5 concludes the research findings of this study and discuss its limitations and future research directions.

FOR COMPLETE PACKAGE OF THIS PROJECT:
CONTACT US BY EMAIL: contact@cleanscriptgroup.com Or
fill and submit our enquiry form.