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Impact on capital structure decision making: Indian medium-sized food industry analysis

Abstract: This paper seeks to investigate the relationship between equity and factors affecting them in Indian medium-sized food industry. The analysis has been done on medium-sized firms of food industry taken from prowess software. The data of 5 years has been taken from 2013-2017 so as to get a clear view of analysis over the period of time. Regression analysis is used in the estimation of functions related to equity with a measure of capital structure. The results reveal a significant positive relationship of tangible fixed assets and growth opportunities with equity, significant negative relationship of age, profitability, tax provision and total assets with equity. The research suggests that medium-sized food firms of food industry rely more on debt than equity.

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▰▰▰ INTRODUCTION

During the last 5 decades, the MSME's have succeeded in making a mark on the Indian economy by being the highly dynamic sector. It has also helped in the socio-economic development of the country by promoting entrepreneurship and employment opportunities (Annual Report 2017-18, 2018, p. 01). The MSME's are able to achieve the stability in the last 5 years by contributing the same percentage that is 33% which is one-third of manufacturing Gross Value of Output (GVO) in India (Annual Report 2017-18, 2018, p. 22).

There can be seen a wide gap between the protections of MSMEs on papers and practice which is being carried on by the government. The reason behind this can be various like government corruption and slow and inefficient legal system. These justify less trust in the financial markets in India (Allen, Chakrabarti, De, Qian & Qian, 2006).

The research to test firm characteristics' effect on choosing equity as finance has been done in developed nations as well as some emerging nations. There is a research done in India by Handoo & Sharma (2014) but it was done on large enterprises. As there have been no research related to SMEs which has also started opting for equity market. Till 2012 the small firms were not able to take advantage of equity firms as they were not allowed to enter the equity market. There is a need to understand the factors which affect SMEs decision of choosing equity in comparison to any other sources for finance.

In this paper, we are trying to test how the firm characteristics affect Small and Medium Enterprises (SMEs) decision of choosing equity to fulfill their financial needs. The SMEs data is extracted from Prowess, which is a database that contains financial and economic information of around 50268 numbers of companies in India. Here, we have taken the food industry for our research analysis as it is the 6th largest food and grocery market, with retail contributing 70% of the sales (Brand India, 2017). Moreover, as small and medium sized enterprises also behave in different manner so we have selected to study just about the medium sized firms.

OBJECTIVE

The main objective would be to test the effect of factors like tax rate, firm size, fixed assets, profitability, growth, and age of the firm helps in approaching the

equity financing. To test this we are analyzing the impact of all these variables on equity which will help in understanding if there is a need for more capital they would go for equity or any other source of financing. As the major source of financing is debt and equity that's why we have considered debt if these firms are not going for equity. It will help us in understanding the preference of owners of SMEs in opting for sources of financing for capital structure decision making.

The research methodology and the course of the research process

We have taken all the medium-sized firms which fall under the food industry over a five year period (2013-2017) from prowess software. To get the data from prowess we have taken the definition of medium-sized enterprises on the basis of assets. Firstly we ran a query to get all the companies which fall in the food industry and having assets of 5 crores to 10 crores. This query has resulted in 141 medium sized companies in total. As we wanted to analyze the companies which have been incorporated after 2000, finally 31 companies were selected from the software which had all the data needed for our research. The data has been taken for 5 years from 2013 to 2017 so as to get a clear understanding of the decision making related to equity. To test the relation between six independent variables and one dependent variable, we have chosen regression analysis as our statistical tool and E-views software to test the same.

Literature review

Capital structure decision is the toughest decision which a firm needs to make in its life. Myers observed two theories in detail which are: static trade-off theory where the firms will set a target debt-equity ratio and will work to achieve the same in that direction and pecking order theory where the firms prefer internal financing to external financing and debt to equity (Myers, 1984). The small firms have it more difficult than large firms in making capital structure decision as they can't take professional help for their day to day problems (Cassar & Holmes, 2003). Almost all the theories which are applied to large firms also apply to small firms, other than those theories basis of which is a conflict between manager and owner. This is because the owner and manager are the same in small firms.

Indian Food Industry

Food Industry is indispensable for the overall development of an economy as it provides a vital linkage and synergy between the agriculture and industry. It helps to diversify and commercialize farming; enhance the income of farmers; create markets for export of agro foods as well as generate greater employment opportunities. Through the presence of such an industry, a wider range of food products could be sold and distributed to distantlocations.

The Indian food industry has unfolded itself as high-profit and high-growth sector. It is one of the largest industries in India, and is ranked 5th in terms of production, consumption, export and expected growth. The food industry, which is valued at US$ 39.71 billion, is expected to grow at a Compounded Annual Growth Rate (CAGR) of 11 percent to US$65.4 billion by 2018. It contributes 14% to manufacturing Gross Domestic Product (GDP), 13% to India's export and 6% to total industrial investment. Food and grocery account for around 31 percent of India's consumption basket. Government is also encouraging investments in this industry by approving proposals of joint ventures, foreign collaborations, industry licenses, and 100% export oriented units. The Indian food retail market is expected to reach Rs 61 lakh crore (US$ 894.98 billion) by 2020 (Brand India, 2017). Indian Government has come up with different schemes so as to seize an opportunity presented by this industry. The schemes given by Government are mega food parks, infrastructure for agro-processing clusters, operation greens, etc (Ministry of Food Processing Industries, 2019).

Capital Structure

Capital Structure of SMEs has been conventional till the time capital market came into play from 2012. Earlier they have to rely on banks and own funds for their requirement (Kulkarni & Chirputkar, 2014). As observed by Kulkarni (2014), the listing is going to be beneficial for them in raising funds, enabling expansion, growth and to shape the future of SMEs. In any country, there are two strong pillars for getting finance: banking and capital market.

Debt

The size of the company collaborates in decision making of going for debt as information asymmetry plays an important role in determining the concentration of debt in a company (Ghosh, 2007). The inclusion of debt in capital structure helps in strengthens the value of any firm (Scott Jr, 1977). The SMEs still were not able to adequately raise funds from banks for growth and expansion (Kulkarni & Chirputkar, 2014). Moreover, it was also needed to increase the competition in financing for SMEs so that banks would not be able to create their monopoly.

Equity

In India, SMEs were so far deprived of the benefits of direct access to public funding through capital markets till 2012. With the increase in the need for finance and the problems, they faced in getting finance from banks now the capital market is also coming into the limelight (Maiti, 2018; Sarkar, 2016). The main problem faced by SMEs in getting finance from banks is that it has become demanding. It commenced succeeding the bank's deleveraging period, tightening lending criteria by banks as well as the introduction of more stringent capital requirements associated with Basel III (Sarkar, 2016; Chakraborty, 2010). The equity finance doesn't only help SMEs but also helps in improving capital allocation, efficient risk distribution and at the macro level for better economic performance has been experienced in other developed countries (Banerjee, 2006). The equity in India is mainly been branched to the founder's family only (Allen et al., 2006).

Stock Market and Macro-Economic Variables

The stock market does get affected by a number of factors. This discussion has been important for a long period of time. As discussed in the theory of efficient market that various kinds of information help in turning a market efficient at different levels i.e. weak, semi-strong and strong. The stock market which is strongly efficient would also reflect the changes in the macro environment (Pandey, 2003; Charkravarty, 2005). The macroeconomic factors which can affect the prices of the stock market are money supply, exchange rate, rate of in-

flation and index of industrial production in India. There is no Granger causality between the gold price and exchange rate with stock market prices, the unidirectional relationship between money supply, rate of inflation and industrial production with stock prices. The money supply gets affected because of the changes in the stock market and not the other way around. Similarly, the rate of inflation and industrial production changes affects the stock market but not the other way around (Charkravarty, 2005). There is a negative relationship between the inflation rate and the prices of the stock (Chatrath, Ramchander & Song, 1997).

The macroeconomic factors like the exchange rate have a positive effect and oil prices have aninverse effect on the stock market in India (Gay, 2016). The relationship among the exchange rate would differ according to the type of company whether it is a domestic or multinational company. The companies which deal in resources like gold, oil, gas, etc will have an inverse relationship with the exchange rate and companies which deals in industrial goods like building material; chemicals, etc will have a direct relationship with the exchange rate (Abdalla & Murinde, 1997). The gold prices and stock prices have the feedback causality between them that means, they both granger-causes each other. Another interesting fact is that the gold prices of India get affected by many international factors (Mishra, Das & Mishra, 2010). According to the random walk hypothesis of the stock market, the consecutive prices changes of individual securities are independent over time and price changes occur without any significant trends or patterns (Pandey, 2003). There is a significant positive correlation between abnormal return and environmental score (Gupta & Goldar, 2004).

Stock Market and Micro Economic Variables

Market efficiency as a term in the stock market is related to the effect that information has on the prices of the stock prices. As discussed above, there are three types of market efficiency that is, weak, semi-strong and strong. The weak market efficiency means the prices of the stock can be predicted just using the past prevailing prices. The semi-strong market efficiency means that it also reflects any publicly available information to the public with past trends. The strong market efficiency means that prices get affected by information whether it is made public or remained private (Poshakwale, 1996). The institutional struc-

tures of the Indian corporates or businesses are unique in comparison to other businesses in the world (Chakraborty, 2010). There is very strong evidence which shows that the Indian stock market is not able to predict itself for the future (Chatrath, Ramchander & Song, 1997; Poshakwale, 1996). The weekend effect can also be seen in BSE as it has many high prices on Friday than any other days of the week (Poshakwale, 1996).

The capital structure decision making of firms are affected by tax rates prevailing in the country (DeAngelo & Masulis, 1980). The center of the study was tax in Modigliani and Miller study. Firms which have high marginal tax rate would be using more leverage so as to shield themselves from high taxes (Huang, 2006). If a firm chooses to go for more debt then it will have two effects: on one side it will enhance the tax savings till the time it survives and on another side, it reduces the probability of firms' survival. These two contradicting effects show how it can have both the good and bad effect on the value of the firm (Brennan & Schwartz, 1978).

Leverage of the firms decreases with firms' marginal tax rate (Huang, 2006). The firms can enjoy tax savings by taking advantage of the incremental effect of a single debt issue (Brennan & Schwartz, 1978). Tax Rate has a negative effect on the leverage of Indian firms (Handoo & Sharma, 2014). The tax and leverage are negatively related in manufacturing sector Public Sector Undertakings (PSUs) in India (Mishra, 2011).

H1: Tax rate prevailing in a country has no effect on the firms' choice of equity financing.

The large firms would be having more bargaining power among the stakeholders of the company as compared to the small firms. Therefore large firms would be having a negative effect on the cost of debt and equity (Huang, 2006). Moreover, Huang (2006) observed that small firms would also lack in providing information to stakeholders that result in an increase in the cost of debt as well as equity.

The firm size has a positive effect on the leverage of Chinese firms (Huang, 2006). The firm size has a negative effect on the leverage of Indian firms (Handoo & Sharma, 2014). Firm size has a positive relationship with long-term leverage of a firm (Cassar & Holmes, 2003).

H2: Firm size has no effect on the firms' choice of equity financing.

According to agency cost theory, if a firm has high fixed assets then they would be able to provide it as collateral for the debt. This reduces the risk for firms to apply for debt (Cassar & Holmes, 2003).

The fixed assets owned by firms have a positive effect on the leverage of the Chinese firms (Huang, 2006). The asset tangibility has a positive effect on Indian firms' leverage decision making (Handoo & Sharma, 2014). The fixed assets have a direct effect on the leverage of a firm (Cassar & Holmes, 2003).

H3: Tangible fixed assets have no effect on the firms' choice of equity financing.

The firms' growth opportunities have different viewpoints. At one end some researchers think that high growing firms' manager and shareholders' objectives will contradict each other as shareholders will still be interested in getting more returns. On the other end, some researchers think that if high growth firms will be having more debt then they won't be able to grow further as their maximum income will be used in paying interest expenses (Huang, 2006).

The growth opportunities are positively related to short-term leverage (Cassar & Holmes, 2003). The firms' growth opportunities have a negative effect on the Chinese firm's leverage (Huang, 2006). The firms' growth will have a positive effect on the Indian firm's leverage (Handoo & Sharma, 2014). The growth and leverage are positively related in manufacturing sector Public Sector Undertakings (PSUs) in India (Mishra, 2011). The growth opportunities and leverage are positively related (Cassar & Holmes, 2003).

H4: Growth opportunities have no effect on the firms' choice of equity financing.

Age of the firms has no significant effect on capital structure decision making of Indian firms (Handoo & Sharma, 2014).

H5: Age of the firm has no effect on the firms' choice of equity financing.

According to Huang (2006), profitability is said to have different effects on the capital structure of a firm according to various theories. The tax-based models proposed that firms would go for more leverage as they would like to protect themselves from high taxes. Contrarily, pecking order theory advocates that highly profitable firms would first use their retained earnings and if that is not enough then only they will go for debt. The firms which would be making more profit would like to invest its excess profit in their own growth so that reduces the debt and equity needs (Cassar & Holmes, 2003).

As suggested by different empirical analysis profitability has disparity on its effects on firms' leverage. The firms' profitability has a negative effect on the Chinese firm's leverage (Huang, 2006). There is a negative effect on Indian firms' leverage due to increase in profitability (Handoo & Sharma, 2014). The

profitability and leverage are negatively related in manufacturing sector Public Sector Undertakings (PSUs) in India (Mishra, 2011).

H6: Profitability has no effect on the firms' choice of equity financing.

Table 1 defines the independent variables which we have taken for our research. These all definitions have been selected after going through all the past researches and selecting the ones best for our research. It has been selected on the basis of the definition of MSME which is constructed on the proportion of assets owned by them.

Table 1. Independent Variables and their definition

Independent Variables	Definition
Tax Rate Prevailing	Tax Provision/Earnings Before Interest and Tax (EBIT)
Firm Size	Natural Logarithm of Assets
Tangible Fixed Assets	Fixed Assets/Total Assets
Growth Opportunities	Percentage Change in Assets
Age of the Firm	Number of years since the incorporation of the firms
Profitability	EBIT/Total Assets

S o u r c e : own study.

Result

Regression analysis is used to investigate the relationship between independent variables (change in total assets, age, EBIT/ total assets, fixed assets/ total assets, tax provision/ EAT and percentage change in total assets) and dependent variable (equity). The regression analysis equation is provided in table 2. It shows that all the coefficients are significant at a level of 90 percent.

Table 2. Result of E-views

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Dependent Variable: EQUITY
Method: Least Squares
Date: 05/18/19   Time: 16:22
Sample: 1 155
Included observations: 150
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Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	130.4251	15.11623	8.628145	0.0000
__CHANGE_IN_TOTAL_ASSE	1.211882	0.149294	8.117405	0.0000
AGE	-0.048540	0.017106	-2.837669	0.0052
EBIT	-5.654003	1.543159	-3.663914	0.0003
FIXED_ASSETS	2.344437	0.737673	3.178152	0.0018
TAX_PROVISION	-0.072196	0.070478	-1.024375	0.3074
TOTAL_ASSETS	-8.219005	0.730823	-11.24622	0.0000

R-squared	0.604693	Mean dependent var		2.495267
Adjusted R-squared	0.588107	S.D. dependent var		4.095654
S.E. of regression	2.628545	Akaike info criterion		4.816281
Sum squared resid	988.0225	Schwarz criterion		4.956777
Log likelihood	-354.2210	Hannan-Quinn criter.		4.873360
F-statistic	36.45742	Durbin-Watson stat		0.770103
Prob(F-statistic)	0.000000			

S o u r c e : E-views Software.

It can be seen from the analysis that all these independent variables are able to predict 58.81% of the dependent variable i.e. equity. The overall significance of regression analysis is optimal at a significance level of 99%. This means that we are still not able to capture all the relevant factors which can have an impact on financing decision making of medium sized enterprises.

The results reveal a moderate positive relationship between fixed assets and percentage change in total assets with equity. This shows that growth opportunities and tangible fixed assets directly affect the decision of medium-sized firm in the food industry to go public for their financial needs. The positive relation of growth opportunities may be due to the reason that as they have growth opportunities they would also be able to convince their investors easily. This is in line with the already existing literature done by Huang (2006). This result is refuting all other literature done by Cassar and Holmes (2003), Handoo and Sharma (2014) and Mishra (2011). The positive relation with tan-

gible fixed assets refute all the past researchers such as Huang (2006), Handoo and Sharma (2014) and Cassar and Holmes (2003).

This would be interesting to further explore the reason behind this.

Moreover, the result shows that firm size and profitability have a strong negative impact on decision making of equity from the market. This means that the larger the size and profitability less would be the chances of increase in finance taken from equity. This supports the findings of Huang (2006) and Cassar and Holmes (2003) that larger the size of the firm less would be its dependency on equity and refuting the findings of Handoo and Sharma (2014). This shows that larger sized firms would be more interested in getting finance from debt. The negative impact of profitability is refuting the analysis done by Huang (2006), Handoo and Sharma (2014) and Mishra (2011). This shows that if the profitability of any firm would increase they would be more interested in going fordebt.

Finally, a negative weak impact can be seen on equity from tax provision and age of the firm. This describes that greater the tax provision and age of the firm, less likely the firm would be interested in going for equity. This has also in line with the past researchers Brennan and Schwartz (1978), Handoo and Sharma (2014) and Mishra (2011). As all the researches are showing the very weak impact of tax provision and age on debt and equity. This means that capital structure decision making doesn't get affected that much by tax provision and age.

The table 3 displays whether or not the hypothesis has been accepted or rejected after doing the regression analysis.

Table 3. Acceptance or Rejection of Hypothesis

Hypothesis	Accept or Reject
H1	Reject (Negative weak Impact)
H2	Reject (Negative Strong Impact)
H3	Reject (Positive Moderate Impact)
H4	Reject (Positive Moderate Impact)
H5	Reject (Negative Weak Impact)
H6	Reject (Negative Strong Impact)

S o u r c e : own study.

◼◼◼ Conclusion

The financing decision plays a pivotal role in the development of any business organization. This decision is crucial because of the effect it can have on various organizational decisions and maximize profitability which is the main objective of any business. This present study evaluated the relationship between varied independent variables present in any organization with the dependent variable equity. The results revealed a significantly positive relationship between tangible fixed assets and growth opportunities. Additionally, it reported a significantly negative relationship of tax provision, firm size, age of the firm andprofitability. It shows that if the Indian medium sized food firm has tangible fixed assets at its disposal or are more inclined to get more growth opportunities then they would opt for equity in place of debt. On the similar grounds, if these firms have more tax provision, large firm size, experienced and have more profit at their disposal then they would likely to opt for debt in place of equity.

This research can become base for the further research in the area of financing choice of SMEs in India. The findings which we have got are very interesting. The findings of Indian medium food sized industries are almost dissimilar with the research done in the past. This shows that there is still a lot remaining to understand in detail in SME sector of India. This can be done by comparing different industries in this sector to get a clear view of the picture.

Future Research, Limitation, and Implication

Our study done on food industry SMEs has some limitations. In particular, one potential criticism is that the analysis is only done on one industry of SME, which cannot be said to be having a duplicating effect on other industries too. This opens the road for further researchers to conduct analysis on different industries and then compare the results of the same to understand the overall effect on SMEs on capital structure decision. They can further even compare it with the large companies to differentiate between SMEs and large sized companies. Another limitation which has a significant effect was that it just contains the medium-sized companies only as it was getting difficult to obtain financial data of micro and small companies. This can also be researched further by targeting one city at a time to make data collection easy. Moreover, the

factors researched by us is able to predict only 58.81% so that also need to explored further to get more factors.

This particular study will be helpful in making a significant addition to already established SMEs literature. This will also give a way to new researchers to study on this particular topic in detail so as to come up with a framework in the future. This study can also help the government in coming up with supportive policies for SMEs in a developing economy.

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