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ABSTRACT

Major financial decisions of a business organisation comprise determining the best alternative investment, selecting adequate funding scheme and defining an appropriate dividend policy. The ultimate goal is to maximize the value of the shares of company among the investment alternatives. This study examined the relationship between the financial structures of the companies in the UK. The research is aimed to investigate the relationship between capital structure and financial performance of small businesses in the UK. The research focused capital structure or the cost of the investment agreements and financing activities impact on the financial performance of SMEs in the UK.

The study design was cross-sectional in nature. The study population consisted of medium-sized companies operating in the United Kingdom. Data is collected from secondary sources. 62 organizations were selected for this purpose. The data of financial performance medium-sized enterprises with respect to their capital structure is obtained from the documents, published literature, paper and the libraries.

The results showed that the variables of interest on capital structure

- Current assets to total assets
- Long-term debt to total assets
- Total liabilities & assets
- Net income before taxes affect the return on assets
- Earnings per share and net profit margins has negative results while the value of the price of the winning poster current liabilities and the long-term debt to total assets have positive relationships.

The results also show that the rate of return on equity and total assets and total liabilities has slight impact on performance, but it has a positive correlation with the long-term debt to total assets. These results, in general, lead to the choice of capital structure are an important determinant of the end of the financial performance of the company.

Chapter One: Introduction

1.1 INTRODUCTION & BACKGROUND

Major financial decisions of a business organisation comprise determining the best alternative investment, selecting adequate funding scheme and defining an appropriate dividend policy. The ultimate goal is to maximize the value of the shares of the company among all the investment alternatives. This is including the installation of a new business, expanding the capacity of existing plant and modernisation of production facilities. The topic to be developed in this work is how to determine the profitability and risk of this alternative, so there is need to project a cash flow under certain assumptions and define the cost of money. Moreover, to carry out investment financial resources are required, so it is necessary to determine the financing options and measure their impact on profitability and investment risk. These funding sources have a cost, but should be offset by the investment fund. Funding will be convenient when percentage cost is equal to or less than the return or return on investment.

Financing alternatives are debt and equity. Debt comes from creditors, who demand a return on their money or capital. For the company is financed by debt, it constitutes a financial obligation; the equity is the contribution of investors who are the shareholders or partners of the company according to the type of society they constitute. They deployed an expectation of profit to allocate their funds to finance the business. They are aware that the financial compensation they will receive depends on the financial results of the company. If financed by shareholders, there is a risk capital paid by dividends. Debt is a commitment made by company, an obligation to pay, regardless of business results are satisfactory or not. By contrast, the contribution of capital from investors, the company offers an expectation of profit to the extent of net income, after paying the debt. This is satisfactory as investors are directly or indirectly involved in the management of the business. Resources used by the company to finance its investments come to constitute their capital, so that the cost of capital becomes the minimum percentage return demanded by creditors and investors; the proper determination of this cost will facilitate decision-making.

The last forty years has been the subject of widespread controversy to determine the combination of debt and equity to generate greater business value. The first theoretical approaches to capital

structure focused on the weighted average cost of capital (WACC) and the value of the company. They considered that there are some functional relationships between debt ratios. These scenarios were developed in perfect markets, but coming to contradictory conclusions. However thesis of Modigliani–Miller theorem (1958) served as a reference for further research that relaxed restrictions on their hypothesis. Modigliani–Miller theorem is allowing for some imperfection or real market situation.

Even today not all imperfections have been identified which a market may have. Not all known imperfections have been taken into account in assessing its impacts on corporate debt-value ratio. There is a consensus that the companies value and worth can vary by borrowing, tax effect and other market imperfections such as financial distress costs, and agency costs. Information asymmetry in many cases is determined by a structure of optimal capital that offsets costs with benefits (theory *trade off*). More recently, other studies focused their attention on the study of the real market: consumer-product characteristics and the level of industry competition. The reason is the influence of the capital structure results in disputes over control of companies. *Trade off* theory concluded that in these cases the companies set an optimal capital structure.

Financial performance is a measure of how a company can use their "*activities*" in the heart of the business to generate revenue. Erasmus (2008) pointed out that the measures of financial performance such as profitability and liquidity have a valuable tool for those involved. They are made available to assess the past and current financial position of the company. Brigham and Gapenski (1996) argued in theory that the model of Modigliani and Miller was valid, but in practice there are bankruptcy costs and that these costs are directly proportional to the level of indebtedness of the company. This finding implies a direct relationship between the capital structure and financial performance of a company.

Berger & Patti (2006) concluded that successful companies are more likely to achieve a capital structure for increased performance and returns, to act as a buffer against the risk of the portfolio. The most efficient firms are in a better position to replace net debt within the capital structure. It is a theory of the balance of the capital structure, where the differences in terms of efficiency allow companies to change their optimal capital structure, up or down. In addition, Singh and Hamid (1992) used in their research data from large enterprises in developing countries and found that companies use more debt financing to fund their growth in industrialized countries. Abor (2005a) also found a positive relationship between the total and the performance of

companies in Ghana and profit depends on more debt as main financing option. The reason is a perceived low financial risk.

Medium-sized enterprises seemed agree with previous results because they seem to have an over-reliance on debts, which are closed to a number of medium-sized companies in the power supply of the debts of the business, resulted. Examples of these companies include, but are not limited to: Avis Company Limited, Bank-green earth, Bugisu Co-operative Union, printing and Lweza Sapoba Sweppes London Clays Limited is (now in liquidation) last limited. The collapse of companies such as Avis Company Limited is due to a number of reasons, some of which were related to the composition of capital (Unite, 2008; Suto, 2003).

The role of capital structure to firm performance is explained for almost half a century ago by Modigliani and Miller (1958). Since then, the research has been extended in various formats to discuss more variables to capital structure to create a perfect model. The disagreement between the researchers observed both theoretically and empirically. Jensen (1986), for example, argues that the leaders may be tempted to engage in destructive value of investments in the presence of a free cash flow. Debt encourages them to participate in profitable projects in order to pay the interest. The avoidance of insolvency of the company financed through debt would require executives to be more effective (Suhaila, 2008; Ramakrishnan, 2002). Simerly and Li (2000) argument is quite logical, since the debt managers are able to use their capacity to cope with competitive pressure. They focused to reduce the discretion on the resources of the company. The debt could therefore impact on new and risky projects such as R & D, often crucial for the long-term survival of the company.

Factors bringing the different viewpoints in capital structure performance made researchers' examine the relationship between structure of capital and corporate performance. Lang et al. (1996) examined the moderating role of opportunity for business growth. According to the importance of this kind of opportunity, it is the demand that does not have the same impact on the business performance through information asymmetry. The same logic of asymmetric information and risk was examined by Simerly and Li (2000). They said that under the moderating role for the dynamics of the industry, the company will grow in a dynamic (moving) phase; debt does not have the same effect in the financial performance of the company. However, these studies have been limited to the examination of specific factors in the field of business (Lang et al, 1996) and surface (Simerly and Li, 2000) measurements. To our

knowledge, researchers have paid little attention to the facilitation of specific environment of the country in which the company operates. However, studies neglected that the capital structure of firms operating in various cultures with multiple behaviours. Rajan and Zingales (1995) analyzed the determinants of the capital structure of firms in the G7 countries (USA, Germany, Canada, Italy, France, Japan and the UK). These countries have similarities in the impact of the leverage; both in the Bank of the State (Japan, Germany, France and Italy) countries exchange (U.S., UK and Canada).

Demirgüç-Kunt and Maksimovic (1999) have shown that the activity of the stock market and the importance of the banking sector are two main causes of international differences in the capital structure. Booth et al. (2001) reported in their study the capital structure of the ten countries in the third world that are affected by the same variables as in the industrialized countries. There are still persistent differences between countries. They show that local factors are specific to the structure. In addition, many studies have shown that the perception of risk varies from one culture to another Shane, (1993). Therefore, if the debts of the risk of financing options are likely to have impact on the performance of the company, it should vary from culture to culture.

1.2 STATEMENT OF THE PROBLEM

The poor performance continues with the closure of small and medium-sized enterprises. This phenomenon has raised more questions than answers for researchers and practitioners. The performance of these companies is even worse, and some companies are forced into bankruptcy. A survey by the Global Entrepreneurship Monitor showed that at least 15 other companies are not effective with their capital structure performance and expected to be bankrupted. It was also observed that the debt financing, on average, increased from 2.7% to 10.4%. Non-performing commercial institutions activities are due to the bankruptcy of small and medium-sized enterprises. It is difficult to repay their loans due to insufficient financial resources. It is derived from the results of Berger (2006); the structure of the capital invested by these companies was a reason to influence the development of their financial capacity. It is a problem for which serious attention has not given. This issue explored an area of research and takes into account the contribution of the capital structure of the financial performance of SMEs.

1.3 PURPOSE OF THE STUDY

The study examined the relationship between the financial structures of the companies in the UK.

1.4 RESEARCH OBJECTIVES

This research is aimed to following objectives:

- To investigate the relationship between capital structure and financial performance of small businesses in the UK.
- To find out the relationship between capital structure, the cost of the investment agreements and loans and how they affect the financial performance of a company.
- To assess the effect of the capital structure, the cost of the investment agreements and loans to the financial performance of SMEs in the UK.

1.4 RESEARCH QUESTIONS

The researcher conducted the study with the following questions:

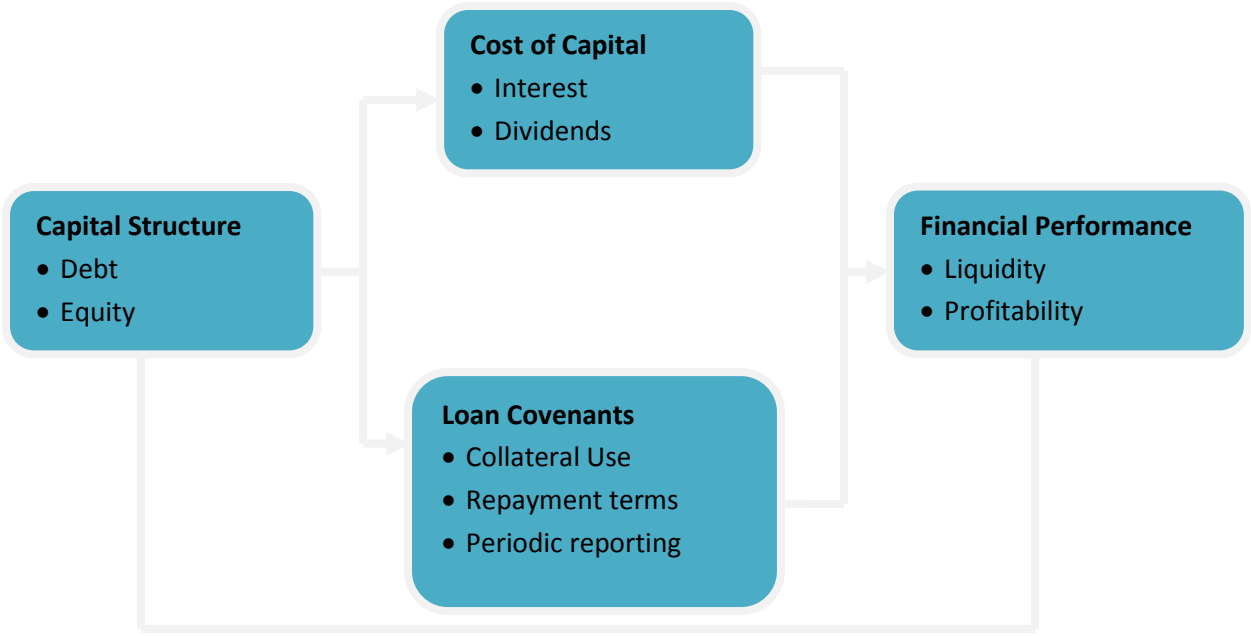
- Is there a relationship between capital structure and financial performance in medium-sized enterprises in the UK?
- Is there a relationship between capital structures, cost of capital and loan commitments of medium-sized enterprises in the UK?
- Whether capital structure or the cost of the investment agreements and financing activities has impact on the financial performance of SMEs in the UK?

1.5 SIGNIFICANCE

The researcher hopes that the findings of the study to be useful for the economy because it has focused more on the role of capital structure in determining financial results. The study will also inform researchers about the importance of capital structure of any business, and highlight areas for future research.

1.6 CONCEPTUAL FRAMEWORK

The conceptual framework is showing the relationship between the capital structure and financial performance.



Adopted from: Edward and Pointon 1984

The independent variable in this study was the capital structure and the dependent variable was the financial performance. The relationship between capital structure and financial performance was inversely correlated, as done by some researchers such as Fama and French, (2002) Booth et al (2001) and Wald (1999). Their studies provided empirical evidence that provided support to this negative relationship between debt and a company's performance.

The relationship between the independent variables and the dependent variable was expected to be negative. Inverse relationship between the capital structure and cost of capital and a positive relationship between capital structure and obligations of loan was pointed out by Dhankar et al. (1996) in his research on the cost of capital. This research was conducted for the optimal capital structure and the value of a company. A negative change was noted in the cost of capital structure and investment and vice versa, because the correlation cost of capital was increasing debt. The cost of debt is lower than the cost of the investment, because interest payments are tax free.

Chapter Two: Literature Review

In this chapter the literature for the study is evaluated. The literature focused the monitoring framework and work integrates the scientific theories. The basics of the study were to investigate the role of capital structure in determining to govern the financial results. The literature in question was obtained from newspaper articles, websites and textbooks. The process was began in the literature with a review of the definition of small and medium-sized enterprises in the UK, the independent variables theories of capital structure, the moderator variable, dependent variable and relationships.

2.1 FINANCIAL STRUCTURE

The financial decisions of the company are reflected in its financial statements, call profit and loss statement, statement of cash flow and balance sheet. Balance sheet reflects the financing scheme used to execute investments. Investment is an asset; and debt financing liabilities and form of equity contribution give rise to equity. 100% of the investment (asset) is fully financed by (liabilities plus equity.) The financing structure is identified with the debt / equity (D / C) ratio, i.e. the ratio between the amounts of debt (liabilities) and equity (net assets). Relationship is defined by the expectations of the company and the demands of creditors and investors.

As an example, if the debt to equity ratio is 3. It means that investors with a capital contribution of a monetary unit are equivalent of three sterling pounds of debt. 75% of the investment is financed by debt and 25% with input from investors. The creditors have invested more resources than investors pertaining that they have more confidence in the business or have chosen a hedging mechanism. This guarantees in its favour on the assets of the company or investors. Equilibrium to finance an investment could be 50% debt and 50% equity; but this relationship depends on the industry, the type of business, and the nature of investors and creditors.

For this reason, an investment that is carried out with funding of 33% debt and 67% equity, i.e. with a debt / equity ratio of 1 to 3 ratios does not necessarily indicate that the owners (investors) rely more in business creditors. It simply reflects the goodness of the business at a particular time and the negotiating capacity of investors and creditors. Cost of capital of the company depends on its funding structure i.e. debt / equity ratio; and the cost of different sources of finance used to run an investment. If the amounts of debt and equity capital were D and C, respectively,

Financial per unit time costs would represent by d/c, to determine the cost of capital (CC) we have the following:

- CC = [D / (D + C)] (d_0) + [C / (D + C) J (c_0) (please put the reference for this equation)

Viewed by another way, the cost of capital is the weighted average cost of capital of the company, where capital is the sum of financing through debt and input from investors. The unit of measure of the cost of capital is the interest rate, i.e. percent (%) by both period (annual, quarterly, monthly, etc) time can be expressed in real terms (net of inflation) or current rates (including inflation as part of its value).

2.2 THEORETICAL BACKGROUND

The issue of capital structure has been studied by several authors and from different perspectives. Due to the large amount of developed theories, it is conveniently organized into groups.

In 1958, *Merton H. Miller and Franco Modigliani* has developed several theories on capital structure. They suggested that the choice between debt financing and capital had no significant effect on the value of the company as long as they comply with certain assumptions. The assumptions are: a perfect capital market, the cost of debt is constant in time, spread 100% of profits and market expectations are homogeneous. However, the most important restriction was found in this theory is its limited application in small companies and family businesses (Chaganti et al., 1995). On the other hand, *equilibrium theories* propose that capital structure can be determined by means of exchanges between the tax advantages associated with financing through debt and disadvantages of over-indebtedness, bankruptcy costs and financial insolvency (Prasad et al., 2001). There are two branches of this theory: modern and traditional (static and dynamic models).

The first version of equilibrium theory assumes that the cost of debt financing is less than the capital. Companies increase their debt position for the cost of capital. However, this process was not sustainable because the excessively increasing the proportion of debt increase the possibility of incurring financial distress. One of the limitations of traditional theory is not considered in its entirety some market imperfections such as taxes, agency costs and costs associated with the bankruptcy (Ofek, 1993; Vasiliou, 2009).

On the other hand, modern versions of the theory of equilibrium models are incorporating the above limitations. They are arguing that there is an optimum balance where the cost of capital is

minimised and the value of the firm is maximized. *Static models* are aimed to provide information on how companies determine their capital structure. However, there are limitations because they focus on only one or two elements of the problem and ignore others (Tsyplakov and Titman, 2005). Another limitation is the focus on a single period. It ignores restructuring decisions in response to changes in the time value of assets (Fischer et al., (1989), cited in Sander, (1998). Meanwhile, *dynamic models* arise in response to finding a model that shows the evolution of changes in the capital structure over time (Titman, 2005). In general, these models make use of intuition used in real options theory. The theory suggests that it is optimal to defer any costly decision in an environment under uncertainty. Companies do not take funding decisions immediately even when they have a target capital structure approaches (Krishnan, 1997; King, 2008).

Finally, theories of *information asymmetry* suggested that companies have a particular order of preference in their choice of financing (Myers, 1984). Companies are following a certain hierarchy in these options will maximize the value of the company. It contrasts with equilibrium theory proposed a target debt-equity ratio. According to Myers (1984), companies generally prefer internal financing through capital, and convertible debt to foreign capital. In particular, due to asymmetric information between the company and investors (creditors), the relative cost of funding will depend on the option chosen.

The logic of the above hierarchy is observed when using internal financing through retained earnings or new contributions from existing shareholders or owners. They have more information than new shareholders. Therefore, recent demands are higher returns on investment. This results in increasing capital through new investors. This is more expensive than internal financing. A similar argument can be used to explain the preference for internal financing over external debt. Thus, we have developed several models that propose various determinants (external and internal) of the capital structure. However, most of them have been studied based on data from public companies in developed countries. In contrast, only very few have considered the attributes of small and medium enterprises in developing countries to find the factors determining its financial structure. For example, the model developed by Titman and Wessels (1988) has been used to approximate the determinants of capital structure by means of a quantitative analysis of the internal variables. They identified determinants of the capital structure, particularity focusing the product, industry and company size. Although the study of

these authors was novel, it can also seem somewhat limited, since only public companies in the United States were studied.

There is recent empirical research, in addition to analyzing the determinants of the structure with internal attributes of companies (company size, growth and expected return, value of assets, industry, business risks, depreciation and control structure), to study the effect of external factors (tax regulations, capital market regulations, inflation, government budget deficit, business and industry cycle and stock market cycle). One example was the comparative study in the countries of the G-7 (considered, then, the seven most industrialized countries: Canada, United States, France, Britain, Italy and Japan) by Rajan & Zingales (1995). The aim was to know the importance of some factors such as size and profitability on the type of source of funding for the company. They concluded that there exists a significant similarity between the determinants of capital structure in all countries.

Similarly, Booth et al. (2001) conducted a comparative research in ten countries with emerging economies to show that the determinants of capital structure are not unique to the developed nations and can be applied in the same way. However, they also identified the characteristics of each country in significant differences; for example, the perception of the conditions of the macroeconomic environment influences the decisions of leverage, because depending on country risk, at both financial institutions and companies will have some care with the level of debt (Khan, 2008; Kale, 2007).

By applying the latest theories upon SMEs in the United States and Australia, Chaganti et al. (1995) found substantial differences between small and large business. Jones (1979) identified that the composition of the initial capital plays an important role in the success of small business. Too much debt at the beginning tends to generate cash flow problems. Similarly, Levin and Travis (1987) suggested that small businesses administrator preferences with respect to the choice between debt and equity play a more important role in large organisations. Meanwhile, Barton and Gordon (1987) argued that senior managers prefer to finance the activities of the small business using resources generated by it. There is empirical evidence that, in general, small business owners want to maintain control over strategic decisions (Shrivastava and Grant, 1985). Chaganti et al. (1995) found that the pursuit of business by having a stable job and desire to create a successful business are the most important decision in determining the source of capital. These results suggest that the personal characteristics of the entrepreneur play a key role in

capital structure decisions. Cassar and Holmes (2003) use this information by descriptive studies to build a large empirical research with scientific rigor. The results show that the structure of assets, profitability and growth are important determinants in the financing and capital structure of small and medium enterprises. Finally, we show that the analysis of the data indicates that traditional financial theories, typically developed for large public companies, can also be applied to SMEs.

2.3 CAPITAL STRUCTURE THEORY

According to Brigham (2004) and David (1979), the capital structure of the company looks at how to fund its activities. This may occur through a combination of debt or equity, or both. Theory of capital structure attributed to Modigliani and Miller believes that regardless of how the company finances its operations. The value of a company is independent to its capital structure based on the importance of capital structure (Gunay, 2002). The study is based on no brokerage costs, earnings before interest and taxes was not the assumption of debt and investors can use the same speed of the borrowing company. Although this argument does not reject an undertaking others may prefer a certain type of fund, the value of the impact business is not tied to financing methods, given a perfect market (Fischer, Heinkel and Zechner 1989).

2.4 TRADE-OFF THEORY OF CAPITAL STRUCTURE AND TAXES

Myers (2001) in his study of the capital structure showed a modest theory of arbitration to demonstrate the relationship between debts. The purpose of the theory of capital structure is to explain the balance used to finance investment whether it can match the business strategy, and sometimes debt. Theory of arbitration is expected that the company will be based entirely on the capital of the bank debt low. In other words, the market share of the company's debt and debt of any combination of low dominant depends on its priority structure (Gonenc, 2003). This result contradicts the idea that small / young people avoid debt, because they cannot access these markets, or face high costs to do so (Hackbarth, Hennessy, and Leland, 2007). In the theory of compensation, there is a debt "hierarchy" and the best bank debt in the bond market, because of the lower costs of failure implied (Hackbarth et al, 2007).

Myers (2001) indicated that the marginal value of the company will borrow to the point where the tax shields from additional debt of the financial crisis to increase the present value of the

potential costs of delay. According to Modigliani and Miller (1958), the attractiveness and interest income reduce debt. When a company is in financial difficulties, the company is unable to deal with the debt holders. If the company fails to pay the creditor, the company may go bankrupt. The theory can be explained by financial distress and agency costs (Pandey, 2005). Pandey (2005) stated that direct costs and moral explanations include, the cost of failure may reflect low financial difficulties of its employees. Customers, ultimately, stop buying products and investors may refuse non-profitable investment and costs management opportunities to avoid any risk (Gleason, 2000).

Murinde, et al (2002) observed a significant effect of fiscal policy on the decisions of the capital structure of the company. In this sense, the tax on corporate income tax allows companies to deduct the interest on the debt in the calculation of taxable profits. This indicates that the debts and tax incentives for businesses are paid through debt interest payments, equity and dividends relating to tax deductions. This means that more or less impact on the debt, the company can reduce or increase the value of the company depends on the nature of a person. He concluded that the correlation between compensation theory cannot explain the high profitability and low debt ratios between. Rajan et al (1995) confirmed the negative correlation between profitability and financial leverage of the United States, Japan and Canada, although no significant correlation was found in France, Germany, Italy and the UK.

2.5 DETERMINANTS OF CAPITAL STRUCTURE

Empirical studies have identified several functions at the company, which will affect the capital structure of the company include:

2.5.1 Asset structure

The structure of the company has an important role in determining the capital structure. Company having fixed assets should generate greater liquidation value according to Titman & Wessels (1988); Harris & Raviv (1991). Bradley et al (1984) believes in the importance of investment in fixed assets as it can direct the company to low leverage higher interest rates to borrow if the debt is secured by assets. It is believed that the debt can be easier if durable goods are used as collateral (Wedig, Sloan, Hassan, and Morrisey, 1988). This will involve having a liquidation value; it is also relatively easy to finance business activities cheaper. Hovakimian et

al (2004 b), suggested a positive correlation between the percentage of total assets, capital structure and financial ratios. They stated a leverage corporate debt and negative amortisation between the two.

2.5.2 Firm Size

Big business is considered to be more diversified, which reduces the income changes, so as to withstand high debt advantage (Castanias 1983). If a company is small, it may have relatively expensive solution. Therefore, the major lending companies are more likely to recover funds from small business lender. This simply means that large firms have more debt. The relationship between size and social structure of empirical evidence support the existence of a positive correlation. Because Buckley and Smith (1996), Al Sakran (2001) and Hovakimian et al (2004) showed that the doctrine of small firms tend to resort to equity financing, while the big companies are likely to resort to debt. Casal et al (2003), Esperanza, et al (2003) and Hall et al (2004) found that the ratio of enterprise scale and long-term debt is a positive correlation. There was negative correlation between the size and the ratio of short-term debt.

2.5.3 Firm Age

As always in business, a consolidation of its operations increases their ability to take on more debt. Therefore, it is a positive correlation exists between the ages of the debt. The company's reputation is the standard model of the age structure of the capital measure. A company in the sector is consolidating its operations may aim to increase its ability to meet the needs of the former positive debt. Hall et al (2004) agrees with aspects of the capital structure as described above, and found that age is positively related to long-term debt and short-term debt is negatively correlated. Lanza et al (2003), however, found that long-term and short-term debt is both negatively correlated with age. Green (2002) also found that the likelihood of a recovery in the age of debt capital for the initial equation. There is no effect on the form of additional capital.

2.5.4 Firm Growth

The growth is likely to require more internal funds to promote the company in debt (Hall et al, 2004). According to Marsh (1982), the high-growth companies will seize the relatively high debt ratio. For possession of small business more focused, it is expected that high-growth firms need

more external funding, and must show a greater influence (Heshmati, 2002). Aryeetey (1994) found that the growth of media companies seem to be more likely to use external finance, but it is not clear if the debt funding induce growth, or both. While companies through various stages of growth, is also expected to change the source of funds. You might be able to pass from inside to outside sources, as stated by Etey Arye (1994). Myers (1977) believes that there are opportunities for growth of the company and its capital structure with a relatively low debt ratio.

2.5.5 Firm Risk

The level of risk is an important factor in a company's capital structure Kale et al., (1991). The ability to operate a business risks is produced by more volatile sources of income of the company, the company defaults, and access to bankruptcy costs and agency are high. According to Johnson (1997), firms in volatile earnings growth is likely to encounter. The cash flow is too low to pay the debt. A number of studies suggest an inverse relationship between risk and borrowing i.e. Bradley et al (1984). Titman et al (1988), Friend et al (1988); McKee & Mason (1990); Kale et al (1991) studies showed a positive relationship. Lanza et al (2003) also found that the risk of the company has long-term debt and the positive correlation between short-term.

2.6 COMPONENTS OF CAPITAL STRUCTURE

2.6.1 Equity Financing

If a company does not use debt financing, it is Equity financed Company (Brigham 2004). Business risk is defined as the product of the risks inherent in the operation of the business debt. If a company does not use debt, it shares income. The return on investment is determined by the specified network among the holders of the rate of return on capital.

- *ROE = Net income to common stock holders / Common equity*

This simply means the risk free trade is measured by the standard deviation of equity. The question now is whether the company's return on capital employed ROCE measure is not significant. Debt to income ratio would have a leverage effect.

2.6.2 Debt Financing

When a company decides to use debt financing, facing financial risks, the company is known as leverage. Financial risk as Brigham and Houston (2007) defined: the additional risk placed on

the common stockholders by the results of the debt financing decision. The possibility of liquidity risk, the company's profits will not be funding methods as expected. They also went on to say, when there is a risk of debt financing, it benefits expire before the obligation to shareholders to share in the form of retained earnings. Company must fulfil the obligations that are generally fixed capital.

2.7 COST OF CAPITAL

Through a series of circumstances affect the cost of capital, the choice of capital structure influence (Sanford, 2001), and costs. Sanford (2001) pointed out those investors who provided the debt financing funds are riskier position. The owners are recurring residual of the net cash flows of the company. An entrepreneur is rewarded by dividends and increases the value if companies like sets often reflected in the price appreciation (Unite, 2008; Tian, 2007).

The cost of capital, then, in general summarizes the various sources of funding for the organisation. Michael (1992) has discussed several associated costs. Michael (1992) noted that in the case of equity financing, shareholders generally do not make money through loans raised its capital contribution. They do not know there is usually a required rate of return, real estate, thus forming the basis of the cost of capital of society. Therefore, it is imperative to note that the heavily indebted company depends more on the total capital borrowings increased the risk of debt and shareholders.

Another important aspect of Sanford (2001) presented in his work, the weighted average cost of debt capital risk and equity financing, both of which require a higher return for the assumption can be reduced to a point that leverage increases from zero, because the cost of debt is less than the cost of capital. As a result, the degree of leverage of the company is able to choose a weighted average cost of capital.

2.8 INTEREST (COST OF DEBT)

Pandey (2006) pointed out that the company may increase the debt in various forms, including access to both a particular type of debt (bonds) to financial institutions or bonds of public interest. Therefore, the pre-tax cost of debt is the rate of return by the creditor requirements. Michael (1992) pointed out that in two of the most popular external financing in the form of debt (most businesses seem to be more expensive). Many companies tend to be used in preference to

other forms of debt financing. Michael (1992) and Myers (2002) took advantage in the capital structure, the use of debt financing and the impact of company taxation. Myers et al (2006), warned heavy reliance on debt indicating financial problems and bankruptcy costs (which may be directly or indirectly) the risk.

2.9 DIVIDENDS (COST OF EQUITY)

When investors provide capital to a company they have right to acquire the Company's dividend in the future, as it becomes part of the company owners (Michael, 1992). Pandey (2006) pointed out that firms need to raise capital through retained earnings. Opportunity cost of retained earnings is the rate of return for shareholders to receive dividends. External finance is the minimum rate of return to shareholders through the purchase of new shares in order to avoid a decrease in funding for their current price and market shares.

2.10 RELATIONSHIP BETWEEN CAPITAL STRUCTURE AND FINANCIAL PERFORMANCE

Hutchinson (1995) in his study suggested that financial leverage has a positive impact on the profitability of shares, provided that the power of the assets of the business income exceeds the average cost of interest on corporate debt. Taub (1975) also found a significant positive correlation between measures of asset-liability ratio and profitability. Nerlove (1968), Beck (1973) and Petersen and Rajan (1994) have also identified the debt was positively correlated with profitability, but for the industry. In his study of the leveraged buyout (LBO), the percentage of the total financing, profitability and total debt Roden and Llewellyn (1995) established between the ends of a significant positive correlation.

However, some studies show a negative impact of debt on the profitability of the company. Fama and French (1998), for example, believe that the excessive use of (some words missing here) agency problems between shareholders and creditors of the debt has caused, and may lead to a negative correlation between leverage and profitability. Majumdar ET Chhibber (1999) in their study in India found that the use of a negative impact on performance. Gleason et al (2000) argue the impact of a negative impact on the profitability of the company. Polish study, Harms (1998) also found a negative correlation between debt and income. In another study, Harms (2003) studied between capital structure and corporate performance in Poland and Hungary, in

industrialized countries, relatively large sample of corporate relations. method of analysis of panel data to study the relationship between the different sources of debt, i.e. bank loans and the performance of the commercial credit and corporate debt and the overall performance of the relationship between the measure of profitability, good. Their results show a significant and negative in many countries. He discovered that the debt, bank loans, the type of commercial credit is not important, important is the overall debt.

Mesquita and Lara (2003) in their study found that the relationship between the return on investment and the debt is expressed as a negative correlation between the long-term financing. However, they found a positive correlation between equity financing and short-term investments. SLA (2007) and the negative margin will be significantly related to the performance of Ghana and its impact on society of corporate debt and medium-sized enterprises in the short-term debt of the scientific literature found in South African politics. This suggests that increasing the amount of short-term debt will lead to profitability.

2.11 CAPITAL STRUCTURE AND PERFORMANCE

The method of neoclassical economics defined business objectives as to maximize shareholder wealth funds. The financial performance of the financial community this can be achieved by the implementation of investment projects to ensure the best decisions to achieve the risk-benefit ratio. Some people think that the yield is given by (debt and equity, or leverage ratio) capital structure can be obtained by determining the optimal capital structure of the company which is the most convenient low, taking into account the conditions of the financial markets improve. Response elements were carried out by two theories: financial theory and stakeholder theory. Taking into account the objective of maximizing shareholder wealth through the benefits of the stakeholders of society share the first 50 years of the last century, approximate representation, there is an optimal structure. Therefore, there is an optimal level of debt and the first running of the growing relationship between the ratio and then decreased.

Modigliani and Miller (1958) showed that the capital value of the capital structure of the company's neutrality, debt financing has the advantage of low cost shareholders to arbitration because it increases the financial risk immediately confiscated. Impact of the introduction of the tax on corporate profits, Modigliani and Miller (1963) shows unlimited growth and performance of the debt ratio. Return on investment is to increase the compensation of the tax debt. However,

this analysis was conducted by Miller (1977) mitigation, taking into account the tax as a whole, i.e., income and debt. It can more offset the impact of the tax deduction the interests of shareholders in the interest of profits taxable income of the company. In this case, the debt is very limited or no impact on performance.

The relationship between capital structure and properties still seem to consider market imperfections. Players are faced with a difficult environment, information asymmetry, adverse selection and moral hazard resulting opportunism of the actor. The optimal debt levels are resulting from compensation (weigh), the advantages and disadvantages of debt. This level may also be necessary to deal with the compensation of the related debt (Scott, 1976). Due to restructuring of the tax incentives and financial difficulties (financial distress), it is the most important contribution by providing the agency theory.

In agency theory, business owners need to manage their role as representatives of the shareholders of the company according to their interests. However, under the influence of opportunism, they can participate in to maximize their utility (Jensen and Meckling, 1976). It caused the actions of agency costs between shareholders and managers. According to Jensen (1986), there is the possibility of increasing the cash flow proxy conflict. Free cash flow is to provide funds to finance the project. The temptation is great not to reallocate capital to shareholders. The company provides the most cited examples of mergers and acquisitions. Jensen (1986) argues that the debt opportunistic behaviour by managers an important mechanism for the control. The discretionary cash flow to reduce debt ceiling that is likely to reduce unprofitable investments, such acquisitions are too often leaders. Debt must be paid at maturity, irrespective of the profitability, forcing managers to generate cash to meet those obligations to pay interest. Discipline of debt is a leader in resource efficiency; it is possible to create the project value for shareholders. It has been conducted in many studies, indicating that the debt will affect the direction that threatens job, your reputation and well-being (Grossman and Hart, 1982). Debt can also improve business productivity and growth, confirming its strength.

If the debt encourages the leaders, the interests of shareholders are purely management. They achieve the highest degree of economic performance. It also led to a lack of victims of exercise that can be connected to the holders of the costs of response to significant adverse selection. Therefore, the important companies leverage the leadership can do projects with the highest risk, mainly due to the success of their projects announced and limit losses in the event of a failure

replacement. Similarly, a high level of indebtedness of the company, its value depends on future investment opportunities; the project may reject positive net present value if all bond yields. Myers and Majluf (1984), assuming that the hierarchy of the financial sector (financial system), focused the determinant of a matrix related to the relationship no doubt. The financial participation of the Company driven by adverse selection costs

2.12 CONCLUSIONS

The development of the theory of capital structure allowed us to assess the problem of corporate finance from different points of view. Initially with theoretical scenarios proposed in perfect markets, giving rise to two opposing schools of thought, known as the model of Modigliani and Miller. They can be concluded as:

- The traditional view holds the view that there is a financing mix between debt and equity that minimizes the weighted average cost of capital. It can increase the value of the company with judicious use of financial leverage.
- The thesis of Modigliani and Miller believes that there is no optimal financial structure. It is justified by a supposed independence between firm value and the weighted average cost of capital relative to the leverage.

Later the theory of compensation (trade *off*) came between the benefits and costs of borrowing as a middle ground between the two opposing theses classic. Given market imperfections, it admits the existence of optimal equity structure originated from other parameters. It does not correspond only to the effect of borrowing, but frictional taxes and other market factors.

Recently, this theory has been enriched by a large number of analytical contributions have tried to reconcile and integrate actual behaviours not considering coming in classic financial schemes, such as the costs of financial distress thought, conflicts of interest between investors and shareholders and directors of the company. It has the possibility of using debt as a mechanism to signal to the capital market, or for strategic reasons on factor and product markets, including the labour market, or in some cases to influence the control of the organisation.

This raises a challenge to the primary objective of financial management to maximize shareholder wealth by maximizing the market value of the company when they highlight problems of incentives, property rights, signalling, and uncertainty of asymmetric information, strategies actual production and consumption and control of enterprise. Restrictions have come

to be treated from different viewpoints of the economics of transaction costs, the economics of property rights, agency theory, interaction models debt market product, and control Theory Company. More recently by the contractual theory of the firm it is intended to solve these problems through the design of new securities.

On the other hand, the *pecking order theory* is opposed to all analytical work aimed at identifying the determinants of optimal capital structure, arguing that firms follow a hierarchical sequence preferences for the various funding sources that will be selected as the most desirable are depleted. The level of preferences begins with the use of internal funds (self-financing). Second is decided by the bank debt, issuing bonds as a last resort and leaving the issue of shares. This business does not have a target debt ratio, and the ratio at a given time is simply the result of their particular history of restrictions. Latest versions have emphasized the limitations caused by asymmetric information, and financial distress costs on capital structure.

The contributions of each of the theories that explain a particular capital structure; together they create a body of knowledge disposable anything, and although none has been generally accepted. It is clear that the models posed new theories resemble increasingly the reality they represent, though its operation is strongly reduced.

Chapter Three: Research Methodology

This chapter describes the methods used to carry out the study. It is including the source of the study design, population and sample selection, data collection and research tools, to varying degrees, processing and analysis of data.

3.1 RESEARCH DESIGN

In the planning phase of a study, before thinking of a specific design, it is useful to frame research question one (or more) of these approaches. This limited the number of designs suitable for our purposes. On a smaller list of possible designs will be easier to review and study them. Secondly it is easy to choose the one which is less validity problems but that also is compatible with our available resources (subject, time, ethical considerations, etc). Some of these approaches are not mutually exclusive and other common designs can compete in the same study.

The study design was cross-sectional in nature. It is aimed to capture business owners and managers or opinions. A cross-sectional study design was chosen because it gave enables researchers to conclude that the population at a given time in a large population of the capital structure and financial snapshot. In addition, quantitative and qualitative data was used for analysis.

3.2 STUDY POPULATION

The study population consisted of medium-sized companies operating in the United Kingdom. According to statistics, the London Business Register (2007) there is a total of about 2462 companies registered in London Stock Exchange.

3.3 SAMPLE SIZE, SELECTION AND RESPONSE RATE.

The dimensions of the samples were determined using Krejcie, (1970). He has developed model to estimate the size of the sample table and the formula to determine the confidence level based on the size of the sample is required in a given population. 62 companies were selected for this purpose from different categories. Demography of these companies is presented in the list below:

Table 01: Sector wise Division

1	Banks	10
2	Cement	6
3	Chemical	4
4	Petroleum	13
5	Automobile and Machinery	6
6	Pharmaceutical	2
7	Power and Energy	3
8	Manufacturing	12
9	Services	5
10	Textiles	1

3.4 DATA COLLECTION

Data is collected from secondary sources. Secondary data are readily available, relatively inexpensive and can be obtained quickly. The data of financial performance medium-sized enterprises in the lieu of capital structure is obtained from the documents, published literature, paper and the libraries (www.morningstar.com).

The study data sets come from the London Stock Exchange. The sample consisted of all companies in the London Stock Exchange 100 Index. Listed companies are selected based on data availability. Selected for the study period was 2006-2009. We have a number of test results limit 62 companies. The sample was composed of 10 departments. Table 1 provides details.

3.5 MEASUREMENT OF STUDY VARIABLES

Capital structure*:* The capital structure is composed of asset-liability ratio, which is calculated by adding the total liabilities of the company's funds to all shareholders (Pandey, 2005). Total liabilities of the company are limited to liability to third parties, regardless of the duration of the loan.

- The ratio of debt to total capital = Total Liabilities / Shareholders

By the above formula, the debt ratio calculated so that the selected group of proportional representation in the course of business respondents.

Cost of capital: capital gains on the total cost of the investment, which is also known as the weighted average cost of capital (WACC; Pandey, 2005), as a whole, or the average. The

weighted average cost of capital is a measure of net taxes (Pandey, 2005). The formula used to calculate;

- $k_o=k_d$ (1-T) wd+$k_e w_e$
- $k_o=k_d$ (1-T) D / D+E + k_e E / D+E

Financial performance was measured in two different aspects namely in terms of liquidity and profitability ratios (Pandey, 2005). Liquidity ratios measured the ability of the firm to meet current obligations (liabilities) and profitability measured the operating efficiency of the company. Pandey, (2005) highlights the most common measures of liquidity as:

- Profit Margin = Profit / Sales
- ROI = EBIT (1-T) / Total Assets
- ROE = Profit after tax / Equity (Net Worth)

3.6 MODEL

After going through the literature review, financial performance of firm's indicators has been identified, that are EBIT, ROE, ROA, EPS, P/E and Net Profit Margin. All these indicators are being termed as dependent variables, while Capital Structure has been taken as the Independent variable for our model The Relationship among leverage and performance was investigated by the following regression model.

- Performance $_{I, T} = \beta_o + \beta 1 CLTA_{I, T} + \beta_2 LogTA_{I, T} + e_{I, T}$
- Performance $_{I, T} = \beta_o + \beta 1 LTLTA_{I, T} + \beta_2 LogTA_{I, T} + e_{I, T}$
- Performance $_{I, T} = \beta_o + \beta 1 TLTA_{I, T} + \beta_2 LogTA_{I, T} + e_{I, T}$

Where:

- $CLTA_{I, T}$ = Current Liabilities to Total Asset for firm I in year t.
- $LTLTA_{I, T}$ = Long Term Liabilities to Total Assets for firm, I in year t.
- $TLTA_{I, T}$ = Total Liabilities to Total Assets for firm, I in year t.
- $LogTA_{I, T}$ = Logarithm of Total Assets for firm, I in year t.
- $e_{I, T}$ = The error term

The expected signs of betas for the variables of study are as follows:

- EBIT is assumed to be Negative
- ROA is assumed to be Negative

- ROE is assumed to be Negative
- EPS is assumed to be Negative
- P/E Ratio is assumed to be Negative
- Net Profit Margin is assumed to be Negative

The literature suggests a number of measures of financial performance of the company, including accounting measures such as ROA, ROE, GM, ROE, and ROA, EPS, operating margin and net margin. This study examines six variables common between EBIT, ROE, ROA, PE, EPS and net profit margin. In the context of previous literature, leverage is measured after three indices:

- Current liabilities to total assets
- Total assets Liabilities
- Total liabilities to total assets

3.7 DATA PROCESSING AND ANALYSIS

The data have been collected, sorted, tested, sorted, coded and analyzed using a computerized analysis software SPSS data call. Charts, pie charts and bar charts are used for the analysis and presentation of descriptive results of the study.

Chapter Four: Results & Discussion

Chapter four discussed the calculation and results obtained from data. Further a thorough discussion is made to reflect and see whether the objectives are accomplished and to what extent.

4.1 DETERMINANTS OF CAPITAL STRUCTURE

4.1.1 Dependent Variables

As proposed in the model of Roman division. *Et al* (2000), the concept of capital structure will be represented by four elements: debt, family loans, capital and retained earnings, considering-as Poutziouris *et al.* (1998) - owners of small businesses are adverse to sources of capital beyond the aforementioned. Debt and family loans refer to any future obligations to third parties contained in liabilities, while equity and retained earnings framed the items included in the net worth of a company. For purposes of this research, it is recognized as equity contributions made by companies, while retained earnings relate to capital generated by the company (Suhaila, 2008).

4.1.2 Independent Variables

To define the independent variables and their inclusion in the model start from the theoretical justification described by Romano *et al.* (2000), supplemented with the following variables that were modified for this investigation.

• *Company size*: Modigliani and Miller (1958) argue that firm size does not significantly affect the capital structure of it. There are several studies showing a link between the size and financial structure (Berger and Udell, 1998; Hutchinson, 1995). For example, Chittenden *et al.* (1996) found that the theory of asymmetric information is particularly relevant to small businesses because the costs associated with external financing are greater for small business than for large companies. Meanwhile, Sonnenfeld and Spence (1989) argue that family businesses have a low debt-equity ratio to avoid damaging the family's reputation, personal guarantees and the loss of its assets in case of financial insolvency (Saad, 2010).

• *Formal administrative* and strategic planning: This entry came from the combination of three concepts used by Romano *et al.* (2000): business plan, business objectives and growth plans. The inclusion of this variable in the model is justified by research of Chaganti *et al.,* (1995). He

argued that the strategy of the company can be a useful variable to explain the behaviour of the capital structure. It is also common for SME owners use a business plan, as a supporting document to seek external funding sources such as bank loans (Berger and Udell, 1998). In line with this proposal, Harvey and Evans (1995) found that banks emphasize the importance of a complete business plan, positively related to loans obtained.

For the purposes of this paper, it is considered that formal administrative and strategic planning consists of five elements: mission and vision, strategic plan, organisational chart, job description manuals and training. It is assumed that a strategic plan is the development of a vision and mission, setting goals and formulating a strategy that, together, determines the direction of the company (Thompson and Strickland, 1999). Also, according to Smyrnios *et al.* (1998), the description of the organisational chart, job manuals and training managers play an important role in both business objectives and management system of a family business.

• *Parental Control*: This refers to the willingness of the shareholders to share control of the company externally. It seeks to analyze, first, the willingness to accept external intervention in the family business; secondly, to assess future plans on the control of the company (Smyrnios *et al.*, 1998). Berger and Udell (1998) argued the facts relating to the control and risk aversion influence the choice of sources of capital. Hutchinson (1995) suggested that entrepreneurs have a high preference for maintaining the independence of business use social capital (while not involve the participation of external) or accumulated earnings and funding sources. Storey (1994) suggested that small business owners tend to use debt because they are opposed to sharing control of the business.

• *Age*: Van der Wijst (1989) found that older entrepreneurs use less debt and are more reluctant to accept the participation of young people outside. Zimmerer and Scarborough (2002) argue that years of professional experience often defined if the principal has the power to view, manage and integrate the operations into a successful synergy. Bertrand and Schoar (2002) showed that the background and preparation of senior managers can predict financial decisions.

• *Age of the company*: According to Dollinger (1995), the sources of capital depend, to some extent, the stage in which the company is located, i.e., birth, growth and maturity. The companies tend to consolidate capital financed by the difficulties of access to bank loans, while established companies are able to leverage their assets with debt. Therefore, it is not uncommon for entrepreneurs funded, primarily, through personal savings, friends and relatives (Hutchinson,

1995, Delgado *et al.*, 2006). However, it is important to note that there is research that indicates that the rate of business growth is also a key factor in the choice of financing. Berger and Udell (1998) found that small companies with high growth rates, which operate in highly risky sectors, used to finance capital; while growing at low rate debt.

It is concluded that while the company matures, it begins to rely on other methods of financing; first short-term bank loans and long-term after, until it was ready to rise outside funds and even become public.

4.2 DESCRIPTIVE STATISTICS

The descriptive statistics is the branch of Statistics, which includes many techniques used to describe a set relatively large data. The descriptive analysis describes the conditions, locations and events as they are. In contrast to the experimental analysis, in which researchers placed controls on conditions and different treatments or interventions administered to experimental and control groups. In statistics, the descriptive analysis takes the form of descriptive statistics. The purpose of this is to summarize or describe a collection of quantitative data. Researchers use these statistics to describe or characterize the population or sample under study.

Table 02: Descriptive Statistics

	ROE	ROA	PE Ratio	Net Profit	EPS	DE
mean	0.2502	0.078	21.0978	0.1175	27.6268	2.7398
median	0.2018	0.0733	6.2941	0.067	11.92	1.4841
minimum	16.196	0.6915	4916.667	26.4982	419.81	35.7662
maximum	2.322	2.4759	850.68	9.9961	157.18	136.644
Standard Deviation	0.9547	0.2015	276.1854	1.6344	53.0745	9.1904
Jerquer beta	766474	119624	1235234	1479171	4735	354117
probability	0	0	0	0	0	0

Table 02 represents the descriptive statistic analysis of the variables used in study. First row of the table shows the mean of the variables including Return on Equity, Return on Asset, P/E Ratio, Net profit margin, Earning per Share and D/E Ratio. The respective mean values are 0.2502, 0.078, 21.0978, 0.1175, 27.6268 and 2.7398. The mean value of 2.7398 of D/E Ratio

shows that average firms' uses 73 percent debt in their capital structure. It is also analyzed that average Return on Equity of LSE 100 Index firms' is £27.62 during the period of 2006-09. Average net profit margin of firms' is 11.75 percent of their sales during the period analyzed. Average Price Earnings ratio of firms in 2006-09 is 21.09 indicating the value of firms'. Average return on asset is 7.8 percent and average return on equity is found to be 25.02 percent. The second row of the table explains the median of the given variables, median is defined as the middle value of data when it is arranged in ascending or descending order. Third and fourth row gives details of firms' ratios in terms of maximum and minimum values respectively.

The fifth row explains the variability of variables from their mean value and the sixth row shows the result of JarqueBera test explaining whether the sample data follows the normal distribution or not. In our analysis all the variables are normally distributed.

4.3 REGRESSION

Regression analysis is a statistical tool used by economists traditionally. However, the usefulness of this technique transcends disciplines and key to the sociologist-researcher to help predict within a certain range of probability of occurrence or any social situation, determine the influence of multiple variables on the other. The utility of regression analysis in sociology is wide, being applicable to the study of markets, of deviant behaviour, political science, demography, epidemiology and poverty, among others (most of the examples have been done on these issues).

Table 03 represents the result of exponential generalized least square regression used to test the relationship among independent variables CLTA, LTLTA and TLTA and dependent variable EBIT. The result indicates a negative and highly significant relationship between the variables. Log (TA) has been used as a control variable to increase the effect of independent variable on dependent variable and substantial positive relationships are detected. The Result shows that for all the three models in EBIT, H_o is rejected at significance level of 5%. Adjusted R^2 is found to be 94.36%, 96% and 94% respectively which are high. The Values of DW test shows that there is no problem of autocorrelation.

Table 03: Regression Analysis of EBIT & ROE

Regression	EBIT			ROE		
	Model 1	**Model 2**	**Model 3**	**Model 1**	**Model 2**	**Model 3**

C	1669.28	6665.68	3603.32	478.8269	208.49	440.29
	(336.76)***	(237.54)***	(1249.31)***	(272.72)***	-233.61	(270.09)*
CLTA	3254.934			29.44		
	(528.36)***			-20.02		
LTLTA		1007.35			62.14	
		(290.00)**			(19.78)***	
TLTA			1650.93			1.91
			(338.36)***			-13.18
Log (TA)	450.14	667.58	536.92	35.07	19.09	32.00
	(25.88)***	(11.28)***	(66.71)***	(15.96)**	-13.8	(15.73)*
Adjusted R-square	0.943	0.96	0.94	0.46	0.72	0.46
Durbin Watson	2.35	2.25	2.34	2.5	2.43	2.44

Table 03 also represents the result of exponential generalized least square regression used to verify the association among independent variables CLTA, LTLTA and TLTA and dependent variables ROE. The result indicates a positive but immaterial relationship for CLTA and ROE where as positive and a weighty relationship is detected among LTLTA and ROE. Relationship among TLTA and ROE is found to be negative but insignificant.

Log (TA) has been used as a control variable to increase the effect of EBIT and a negative and significant relationship is detected in model 1 and model 3 respectively for ROE and negative but petty for model 3. The result shows that we failed to reject H_o at significance level of 5% in model 1 and model 3. We cannot reject H_0 in model 2 at significance level of 5% and Ho is rejected for control variable at significance level of 5% in model 1 and model 3. They are failed to reject for model 2. Adjusted R^2 is found to be 46%, 72% and 46% respectively. The Value of DW test shows that there is no problem of autocorrelation. The result provides evidence that all the three variables of capital structure i.e. CLTA, LTLA and TLTA influence the performance

measure EBIT. The result proves that high level of financial leverage leads to lower EBIT. The result supports the intention that because of agency conflicts, companies are overleveraged and affecting their performance unconstructively. The result also supports the argument of Zeitun & Tian (2007) but contradicts with Brick & Ravid (1985). The result is similar to the argument of pecking order theory that profitable firms should finance their investment opportunity with retained earnings. Therefore, a negative relationship could be developed between debt level and performance measure.

Earlier studies advocate that firm's size may have an effect on its performance. Larger firms enjoy number of capabilities such as economies of scale which may influence financial performance (Ramaswamy, 2001; Frank & Goyal, 2003; Jermias, 2008). Therefore a size variable has been introduced. Size is calculated by taking log of total assets and incorporated in the model to control the effects of firm size on dependent variable. The result shows that greater value of total assets enhances the firm performance and is also evident from earlier researches (Rocca, 2010; Ramakrishnan, 2002).

The result also indicates that CLTA and TLTA have an insignificant and LTLA has a positively significant influence on the ROE. The result concludes that increase or decrease in the values of variables of capital structure that includes CLTA and TLTA doesn't influence ROE whereas increase in LTLA results in higher ROE. The result is also consistent with the argument of Zeitun & Tian (2007). They also reported an insignificant relationship. General theory reports that change in capital structure affect performance indicator ROE. The contradiction may be due to inefficient market environment and incomplete information.

Table 04 represents the result of exponential generalized least square regression used to test the relationship among independent variables CLTA, LTLTA and TLTA and dependent variable ROA. The result indicates a negative and highly significant relationship between the variables. Log (TA) has been used as a control variable to increase the effect of independent variable (IV) on dependent variable (DV) and highly significant positive relationships are detected. The Result shows that for all the three models in ROA, Ho is rejected at significance level of 5%. Adjusted R2 is found to be 98%, 97% and 97% respectively which are high. The Values of DW test shows that there is no problem of autocorrelation.

Table 04: Regression Analysis of ROA and EPS

Regression	ROA	EPS

	Model 1	Model 2	Model 3	Model 1	Model 2	Model 3
C	18.5	120.03	134.55	151.63	124.39	152.97
	(1.02)***	(2.26)***	(4.29)***	(2.41)***	(2.85)***	(7.19)***
CLTA	10.07			22.67		
	(1.84)***			(3.04)***		
LTLTA		6.65			21.85	
		(2.64)***			(2.85)***	
TLTA			12.24			18.60
			(1.94)***			(1.76)***
Log (TA)	5.85	6.14	6.62	7.16	5.96	7.18
	(0.05)***	(0.11)***	(0.29)***	(0.08)***	(0.27)***	(0.44)***
Adjusted R-square	0.98	0.97	0.97	0.92	0.95	0.92
Durbin Watson	2.17	2.24	2.22	2.15	2.25	2.28

Table 04 also represents the result of exponential generalized least square regression used to test the relationship among independent variables CLTA, LTLTA and TLTA and dependent variable EPS. The result indicates a negative and highly significant relationship between the variables. Log (TA) has been used as a control variable to increase the effect of independent and dependent variables and highly significant positive relationships are detected. The Result shows that for all the three models in EPS, H_o is rejected at significance level of 5%. Adjusted R^2 is found to be 92%, 95% and 92% respectively which are high. The Values of DW test shows that there is no problem of autocorrelation the result provides evidence that all the three variables of capital structure i.e. CLTA, LTLA and TLTA influence the performance measure ROA.

The result proves that high level of financial leverage leads to lower ROA. The result supports the intention that because of agency conflicts companies' overleveraged and in result affecting their performance unconstructively. The result is also consistent with the argument of (Tiam & Zeitun (2007); Gleason, Mathur & Mathur (2000), (Tzelepis & Skuras, 2004) and (Krishnan & Moyer, 1997). The result is aligned with the argument of pecking order theory that profitable firms should finance their investment opportunities with retained earnings. Therefore, a negative relationship could be developed among debt level and performance indicator.

The result provides evidence that all the three variables of capital structure i.e. CLTA, LTLA and TLTA influence the performance measure EPS. The result proves that high level of financial leverage leads to lower EPS. The result is in line with the argument of pecking order theory that profitable firms should finance their investment opportunities with retained earnings. Therefore, a negative relationship could be developed between debt level and performance measure. Most of time firm increases there EPS from not giving dividends. The theoretical concept supports the result because high level of debt increases the cost of debt and thus reducing profits and ultimately results in lower EPS (Ofek, 1993; Krishnan, 1997).

Table 05 represents the result of exponential generalized least square regression used to test the relationship among independent variables CLTA, LTLTA and TLTA and dependent variable PE ratio. The result indicates a negative and highly significant relationship between CLTA and LTLTA with dependent variable but insignificant relationship with TLTA. Log (TA) has been used as a control variable to increase the effect of IV on DV and significant negative relationships are detected in model 1 and model 2 and negative but insignificant for model 3. The Result shows that for model 1 and model 2 in PE ratio, Ho is rejected where as in model 3 Ho is failed to be rejected at significance level of 5%. Adjusted R2 is found to be 84%, 83% and 72% respectively. The Values of DW test shows that there is no problem of auto correlation.

Table 05: Regression Analysis of PE Ratio & Profit Margin

Regression	PE Ratio			Profit Margin		
	Model 1	**Model 2**	**Model 3**	**Model 1**	**Model 2**	**Model 3**
C	67.193	37.14	43.53	52.78	6.54	46.54
	(19.21)***	(12.71)***	(20.21)***	(6.69)***	(1.70)***	(3.47)***
CLTA	18.86			23.63		
	(2.90)***			(2.42)***		
LTLTA		12.49			10.02	
		(1.168)***			(2.03)***	
TLTA			1.422			17.568
			-1.49			(1.1666)***

Log (TA)	2.770	1.610	1.821	1.827	1.12	1.45
	(1.039)***	(0.749)***	-1.121	(0.356)***	(0.11)***	(0.190)***
Adjusted R-square	0.84	0.83	0.72	0.97	0.98	0.96
Durbin Watson	2.7	2.96	2.72	2.06	2.02	2.23

Table 05 also shows the independent variable to test CLTA, and LTLTA TLTA and net profit margin due to the relationship between the results of the least-squares regression of the index variable generalized. The results showed that the negative and highly significant correlation between the variables. Value of log (TA) was used as a control variable to increase the impact of the independent variables on the dependent variable, detected highly significant positive correlation. The results showed that the three types of margins, H_0 were rejected at the 5% level of significance. Adjusted R^2 is found that 97%, 98% and 96%, which is high. Value of the DW test indicates that there is no problem autocorrelation. CLTA results provide evidence of the PE and LTLTA a significant negative impact on the effects of TLTA positive and four were significant in a PE can be ignored. The results support the thesis (Zeitoun and Tian, 2007). One of the reasons could be more insignificant price movements does not represent the true value of the business in addition to account for the majority of investors still believe that the remains of the performance counter.

The capital structures of these three variables (CLTA, ITLA and TLTA) affect the results of tests that measure the performance show that the net profit margin. The results showed high levels of debt resulting from the net profit margin. The results also confirm the argument (Pratheepkent, 2011). As a result, the company has generated profits and gains to finance their investment opportunities theory of the hierarchy is the same. Thus, a negative correlation was possible in evolution of debt and performance measurement. The net profit margin was affected by leverage, because the increase in the interest burden of the debt will increase resulting in lower profits.

4.4 CONCLUSION

This study examined the effects of the financial results of the company's capital structure. During the period 2006-2009 annual data is obtained from the London Stock Exchange. Depending on

the sample and measure the financial performance of the use of (earnings before interest and taxes, return on equity, return on assets, the price of the winning reports, earnings per share and net profit margins). The results describe the lack of tools and generalized estimating square exponential statistics. The results showed that the variables of interest of the capital structure of current assets to total assets, the long-term debt to total assets, total liabilities and total assets and net income before taxes *affect* the return on assets, earnings per share and net profit margins. The value of the price of the winning poster current liabilities and total assets of positive relationships were found with the long-term debt to total assets. It is negligible ratio negatively correlated with aggregate total assets liabilities. These results, in general, lead to the choice of capital structure are an important determinant of the end of the financial performance of the company (Khan, 2008; Rocca, 2010).

Chapter Five: Conclusion & Recommendations

5.1 CONCLUSION

Research shows that medium-sized firms use debt and equity structure. This is mainly due to the fact that small and medium-sized enterprises consider debt financing, pay less. The tax shield acts as a cheap source of tax. Preference means that the interest on the debt and the cost of equity is the main form of these entities.

Many small and medium-sized enterprises use the capital structure of debt. It implies that the interest rate paid significantly reducing the overall profitability of the company. It was also established that the use of debt capital is about average size which forced to comply with the loan to avoid default. The results show that many companies use the capital structure of the debt is due to the fact that the payment of loan interest rates high turnover rate limited areas. This affects financial performance. It can be concluded that the measures of capital structure used in a slight impact on the financial performance of medium-sized enterprises. The results stated that smaller and medium-sized enterprises, to a certain extent, depend on the use of a combination of capital structure.

Although the results of this study show that companies, on average, prefer debt. They have the advantage of debt financing, but still has a relationship with their overall financial performance. Many of the companies mentioned are largely a result of lending rates debt financing problems of interest (cost of capital). Except for the injection of additional capital into these transactions, to reduce the impact of the erosion of the capital, many of these operations will be forced to close their results cannot meet their financial obligations.

The Modern Theories of *Capital Structure, Static Equilibrium Theory of Capital Structure and Financial Hierarchy*, are taken as reference framework for large companies to develop capital markets. Hence, the explanatory power of the Theories of Capital Structure are faced with certain restrictions when trying to explain the behaviour of the financing of SMEs, given that the theoretical assumptions underlying them may be only partially verified in the capital structure adopted by this group of companies. Unlike large companies, the problems of information asymmetry are exacerbated in SMEs, given the opacity of information and lack of career and financial history. This, coupled with the motivation to maintain ownership and control by

business entrepreneurs, offers a scenario whose characteristics determine investment decisions and financing of SMEs, and therefore the capital structure of this group of companies.

Given the characteristics of SMEs and the findings of the empirical studies conducted to date, the Financial Hierarchy Theory seems to provide a better explanation of the behaviour of the sources of financing used by SMEs. As predicted by the Theory of Financial Hierarchy, self-generated funds is the primary source of funding for this group of companies; however, a change is observed in the order of the hierarchy given by the above theory, since funding shortfall to SMEs show a tendency to resort to attracting external debt rather than equity, contradicting the established hierarchy by this theory.

Moreover, it is expected that SMEs penetrate through different stages to become big business. This calls into question the explanatory power of Modern Theories of Financial Structure, as problems arising from information asymmetries will be corrected in so far as they reach a new stage. Based on the above, the model proposed by Berger and Udell (1998) financial growth cycle seems to better explain the capital structure adopted by SMEs in each of the stages of development, depending on their size and age. The business growth is accompanied by greater transparency of information and the formation of a financial track record and, conditions permitting you access to new sources of funding. This approach accounts for the constant development of SMEs and their effects on the capital structure due to the availability of funds differently depending on the phase in which it is. Some of the sources of own markets private equity incorporated by Berger and Udell (1998) in their model, such as venture capital funding and business angels, are quite developed in the United States and Europe. These investors could be donors necessary for the survival of SMEs in United Kingdom.

The results show that the benefits of increasing the leverage of the company have a negative impact on financial performance. The findings suggest that administrators cannot use the capital structure of excessive debt, should try to finance their projects, retained earnings, and the leverage used as a last option. Managers should achieve the optimal level of the structure of capital to maximize the performance of the company, and try to keep as much as possible. Major limitations of this study, first, that only an emerging market, which is not necessarily representative of the emerging markets in general, although many of these markets has its main features, some of which have their own unique characteristics and standard, so that the results can not cover all emerging markets.

The second major problem is the amount of data in this study. More uniform results can be calculated using a series of longer time. Third, the impact of capital structure on the performance of various sectors, but also can be studied and compared. The capital structure remains controversial and mysterious, especially in emerging markets in developing countries. Further research should explore the determinants of risk and commercial growth, such as the size and capital structure, in combination with the results with those of developed countries. Most of the performance variables can be captured more accurately calculated. The data must be used for a period of time to study the estimates more reliable results. The research should study the behaviour of investors, to see if they are interested in investing capital or debt financing of the company.

5.2 RELATIONSHIP BETWEEN CAPITAL STRUCTURE AND FINANCIAL PERFORMANCE

The research objective of this study is whether the relationship between capital structure and financial performance. The results of this study show that between the capital structure and financial performance was significantly negatively correlated, as shown in Table 05. Negative correlation means that the change in mid-sized companies of the capital structure of London will result in a reduction financial performance. Negative correlation means that SMEs in London against the use of more than the fear of losing control of fairness, use more debt in the capital structure would be appropriate.

These results are consistent with Rajan and Zingales (1995) and Wald (1999) found that there is significant adverse outcomes related to the relationship between the relations of the United States, the UK and Japan, profitability and debt / equity is consistent. In addition, similar to the results of Fama and French (2002); Booth et al (2001), and Wald (1999), this research provides a negative correlation between the level of debt and performance of empirical evidence to support or of profitability. In addition, Fama and French (1998), for example, believe that the excessive use of debt, the result of agency problems between shareholders and creditors, which could lead to a negative correlation between debt and profitability.

In addition, Majumdar and Chhibber (1999) in his study in India found that the use of a negative impact on performance, while Krishnan and Moyer (1997), linking the capital and the return to their country of origin. Gleason et al (2000) also found that the impact of a negative impact on

the profitability of the company. SLA (2007) and the negative margin will be significantly related to the performance of Ghana and its impact on society of corporate debt and medium-sized enterprises in the short-term debt of the scientific literature found in South African politics. This suggests that increasing the amount of short-term debt will lead to profitability.

5.3 RELATIONSHIP BETWEEN CAPITAL STRUCTURE, COST OF CAPITAL AND LOAN COVENANTS

The second objective of this study was to examine the capital structure of the relationship between the cost of medium-sized enterprises in the investment agreements and lending rate in the UK. The results of this study shows that, for the capital structure, which means that changes in the capital structure, will result in the cost of capital and increase the results have covenants. This credit was positively correlated cost of capital commitments and loan. In other words, the relationship between assets and liabilities, interest rates and higher safety requirements were higher than the highest acquisitions of commercial mortgages. This means, therefore, SMEs over the debt burden is likely to suffer as much money will be required to repay the loan. This also proves the company to pay a higher rate of interest. It was also pointed out that the interest rates applied by monetary financial business is high enough, then you might be able to help explain why some businesses are closed due to lack of funding problems of maintenance certificate said. It 'also important to note that the above results are contradictory results Dhankar et al. (1996) in their capital, cost optimisation of the capital structure and the value of a case study in India Business pointed out that changes in the capital structure and cost

Capital formation or negative correlation, due to the rise and fall of the constant cost of debt is less than the cost of the investment cost of the levels of capital and debt, because interest payments are tax exempt. In other words, because the cost of capital is measured using historical data, the weighted average cost of capital is likely to decrease with the increase of the debt. This means that the changes are not changes in the social structure is represented by the ratio between the costs of capital. Conflicts can also be made based on the difference in the environment of this study to explain the measures have been used in the measurement of variables and potential respondents of the class that participated in the survey.

In the capital structure and the loan agreement with the positive results of result rows Dichev and Skinner (2002 b), Beneish et al, (1993), who found that breaches of contracts with financial

covenants involve changes of considerable interest and the reduced availability of credit rates. Chava et al (2008) and Nini and others in their study (2008) in violation of the contract and a significant reduction in capital spending to become the inclusion of new provisions, restrictions on the results associated costs.

5.4 EFFECT OF CAPITAL STRUCTURE, COST OF CAPITAL AND LOAN COVENANTS ON FINANCIAL PERFORMANCE

The third objective is to study the effect of the capital structure of medium-sized enterprises in the financial costs and benefits of loan capital in London. To predict the impact of capital structure were the results of the regression analysis, the cost of capital and financial performance of the loan agreement, the capital structure, the cost of investment and loan agreements should performance Financial 11.5%. 88.5% of the variation is not part of the study of other factors to explain. Therefore, it is depending on the performance of the financial position of the capital structure. Therefore, the use of high debt policy does not lead to significantly lower yields. Increasing the capital structure of corporate debt in proportion to illustrate the results did not significantly affect the overall financial performance of SMEs.

5.5 RECOMMENDATIONS

Recommendations are forwarded as:

- London SMEs should avoid excessive reliance on debt financing SMEs or pursuing higher than the industry average debt policy should seriously consider increasing the equity portion of its capital structure, in order to avoid undue negative impact on the performance of debt. This can be done through a private placement, which raises funds for loans of financial institutions, but not necessarily in one direction.
- The banks or financial institutions should consult regularly and try to figure out the best way for SMEs, fostering lasting relationships, ultimately leading to customer loyalty.
- In terms of interest rates, the financial institution proposal should be based on an examination of SMEs to reduce crime, and in the public interest to further reduce the base rate and medium-sized enterprises to improve their financial performance.

- Financial institutions should consider extending the repayment period, especially those who are considered low-risk customers. Taking into account, you might be able to help financial institutions to improve the chances of recovery of debts can be lost.

5.6 AREAS FOR FURTHER RESEARCH

The capital structure does not account for a large part of the results showed that the financial results of medium size. Further research should examine the factors that affect the financial performance of SMEs, the capital structure. This research focuses on the financial performance of the structure of the environment and the capital of the company, if the geographic scope of the five departments in London, England. Researchers should consider seeking district similar to broaden the scope of this study in the level of London. Financial results and debt policy of small and medium enterprises in London is another area of potential research.

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