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IMPACT OF CAPITAL STRUCTURE ON SHARE PRICES WITH SPECIAL REFERENCE TO THE PLANTATION SECTOR IN SRI LANKA

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ABSTRACT

Plantation sector has been recognized as an important strategic sector for socio-economic development of countries where this sector plays an important role in their economies. In the Sri Lankan context the plantation sector makes a significant contribution to Gross Domestic Product, foreign exchange earnings, employment and until recently to Government revenue. Hence, it plays a vital role in the economy. Consequently, the producers encounter several issues and challenges in the effort to enhance their profitability and reduce the threat of insolvency. Specifically, the Sri Lankan plantation sector is faced with the dilemma of maintaining an optimal capital structure which is directly influenced by the wealth of the firm. In this study an attempt has been made to explain and understand the relationship between the capital structure of the Regional Plantation Companies and the share price. This study is primarily based on secondary data that were extracted from the annual reports of 10 RPCs out of 20 which were listed in Colombo Stock Exchange (CSE) over the past seven year period from 2009 to 2015. These companies were selected by using random sampling method. Balanced Panel Data (BPD) of these 10 plantation companies were analyzed by using descriptive statistics and Ordinary Least Squire (OLS) regression model to establish the relationship between capital structure and the share price. Secondly, Pearson Correlation Analysis is used to describe the degree of association between capital structure and share price. The study found a negative relationship between the debt to equity ratio and the share price. Moreover, the study proved that there is a positive relationship between the interest coverage ratio and the share price. But it was revealed that the debt to total assets has no significant impact on the share price.

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INTRODUCTION

The present era is the era of intense competition and survival of the fittest is the slogan of the corporate world. In such a scenario decision-making has immerged as one of the difficult tasks as it declares the fate of every entity. Therefore, managers should take into consideration the cause and effect relationship while making any particular decision. Especially managers of the corporate sector should follow systems approach in their decision-making because a decision taken in isolation can bring an entity to the verge of a disaster. Of all the aspects of decisions, capital structure decision is the most important financial decision in corporate financing since the financial performance of an entity is directly affected by the demand for the shares of the company. Hence, proper care and attention need to be given while making the capital structure decisions. The term capital structure can be defined as the mix of a firm's permanent long-term financing represented by debt, preferred stock, and common stock (Horne, 2001). This is also called firm's capitalization. Masulis (1988) was exhaustively and inclusively described the capital structure as capital mix that encompasses a corporation's publicly issued securities, private placements, bank debt, trade debt, leasing contracts, tax liabilities, pension liabilities, deferred compensation to management and employees, performance guarantees, product warranties and other contingent liabilities. Capital Structure decision determines the proportion of debt and equity used to funding firm's activities. There could be hundreds of options but to decide which option is best in firm's interest in a particular scenario needs to have deep insight in the field of finance as use of more proportion of debt in capital structure

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can be effective as it is less costly than equity financing but it also has drawbacks because after a certain limit it affects company's finance leverage. Therefore, Business entities should maintain an optimum balance between debt and equity. The capital structure decisions involve the determination of debt equity ratio since the right mix of debt and equity enable firms to finance their activities more efficiently and enables firms to maximize firm's value which will also increase the shareholders wealth. Therefore, implementing an optimum capital structure is an excellent way for many companies to improve the wealth of the firm. In finance, capital structure refers to the way a corporation finances its assets through some combination of equity, debt or hybrid securities or how a firm finances its overall operations by using different sources of funds. A company's capital structure may include long-term debt, retained earnings and equity and preferred stocks. Equity capital represents the capital provided by the owners of the firm. Preferred stocks are equity in legal point of view. But, in practice preferred stocks have the characteristics of both equities and debts. Debt capital represents the capital provided by the long term debt capital providers of the firm. The capital structure of the firm is very important since it is related to the ability of the firm to meet the needs of its stakeholders. The Board of Directors or the Financial Manager of a company should always endeavor to develop a capital structure that would lie beneficial to the equity shareholders in particular and to the other groups such as employees, customers, creditors and society in general.

Share price can be defined as the price of a number of saleable stocks of a company and derivatives or other financial assets. Demand and supply factors are the most basic factors that influence price of a share. Government policies, firm's and industry's performances and potentials have an impact on demand behavior of investors, both in the primary and secondary markets. The factors affecting share price can be divided into macro and micro economic outlook. Macro-economic factors are political factors, general economic conditions such as how the economy is performing and government regulations, international factors etc. The micro factors are the performance and management of the company itself (Christopher, Rufus and Ezekiel, 2009). The plantation sector of Sri Lanka has existed over a hundred years and initially owned and developed by the British, and the management of the plantations was also in the hands of the British companies (Kumara et.al, 2007). Later, with independence, the plantations were no longer under the British government and developed by Sri Lankan interests (Kumara et.al, 2007). The tree crop sector in Sri Lanka comprising of tea, rubber and coconut contributed 2% to the Gross Domestic Product in 2014. This was 23% of the GDP of the agricultural sector (Central Bank Annual Report, 2014). Tea is the most important plantation crop producing 318.4 million kilograms and exporting 317.2 million kilograms out of it which brings in Rs. 129,464 million (Ministry of Plantation Industry, 2014). The industry was introduced to the country in 1867 by James Taylor, a British planter who arrived in 1852.

Tea is by far the most important export crop in Sri Lanka, with the Export Development Board (EDB) estimating that the country produces 20% of global tea exports and is responsible for 5% of global production. Sri Lanka is the world's largest exporter of "orthodox" black tea, as opposed to the cut-tear-curl method favored in India, the third-largest global tea exporter by volume after Kenya and China and the fourth-largest overall producer of tea. This is largely owing to its high-quality Ceylon tea, cultivated in Sri Lanka since the 1860s, and praised globally for its flavor and color. According to the public agency for the industry, the Sri Lanka Tea Board (SLTB), private smallholder plantations supplied some 57% of total tea production in the country in the first half of 2015, or 99m kg out of the 172.5 kg total, followed by regional plantation companies, with 66.2m kg, or 38.3%. Approximately 6.5m kg of tea are sold weekly at the Colombo Tea Auction, the world's largest single-origin-tea auction. Tea exports reached a record $1.6bn in 2014, a 5% year-on-year (y-o-y) increase, with bulk comprising 49% of total exports. Tea exports were down 17% in 2015, earning $1.32bn, and by January 2016 earnings had fallen to a six-year low in dollar terms. Average auction prices have declined to what the SLTB describes as a "danger level", well below the cost of production, with production falling by 6m kg y-o-y in the second quarter as a result. Exacerbating the problem for tea factories and exporters, the government set the recommend minimum price for one kg of green leaf tea at LKR 80 ($0.58) in April 2015.

Tea is grown and produced at both plantations and smallholder farms, and is split into three different classifications: low-grown, cultivated at elevations below 2000 feet; mid-grown (2000-4000 feet); and premium high-grown teas, grown above 4000 feet and offering a distinct golden color and intense, powerful aroma. With the enactment of Land Reform Law No: 1 of 1972 and Land Reform (Amendment) law No: 39 of 1975, land area of 408,487 hectares (ha), majority of which were plantation areas were acquired by the Government and vested in the Land Reform Commission (LRC). Majority of these lands, especially plantation areas were handed over to Janatha Estate Development Board (JEDB) and Sri Lanka State Plantation Corporation (SLSPC) for the ease of management (Anon, 2008). With this nationalization process, the private land ownership is restricted to a maximum of 20 hectares per person and nationalized estates and factories under tea, rubber and coconut were handed over to JEDB and SLSPC (Anon, 2005). However, the Government later found that it was difficult to manage the plantations on their own, due to many issues such as labor problems, political interference, high expenditure on estates, inefficient management and falling margins. Therefore, the General Treasury of Sri Lanka faced difficulties to support plantation industry further the World Bank which provided funds to the treasury insisted that the plantation sector in Sri Lanka should be privatized (Abeykoon & Edirisinghe, 2007).

In 1992, 449 out of 502 estates were formed into 23 Regional Plantation Companies (RPCs) with a 99 year lease agreement, who, in turn, handed over their management to 23 private sector management companies, initially for five years. These companies faced financial losses and also made limited long-term investments due to the shortness of the prescribed period of tenure (Ranasinghe and Athauda 2009). Due to this, in 1995, the Government leased the estate properties and vested the Management of these estates in 21 RPCs for 53 years (Athukorala, 2009). At this moment, these companies had 51% of shares as major shareholders. Government as golden shareholder retained the rest 49% and later devoted 10% for employees, 20% for the public through Colombo Stock Exchange (CSE), and the rest was retained by the Government through the treasury (Anon, 2008). It is now 24 years since the privatization plantation sector took place in Sri Lanka. The

privatization of management increased the commercial validity of this vital sector by raising the productivity, increasing quality and reducing the cost (Caspersz *et al*, 1995).

Literature Review

Menon (2015) investigated the Impact of Capital Structure on Stock Prices: Evidence from Oman of 113 companies listed on the Muscat Securities Market (MSM) for its three main sectors. The study tests the relationship between capital structure and share prices of the listed companies. The analysis is done by employing correlation analysis, One-way Anova and two-way analysis of variance. Further, Brown-Forsythe test and Welch test were also applied to check the robustness of the results to find an inverse relationship between amount of debt and share prices. Further, a positive relationship between amount of equity and share prices and debt equity ratio was also found. The results were statistically significant at 1% level of significance. The results indicate adding debt to overall capital inversely effects the share prices. The results are in tandem to Net Income Approach which portrays capital structure to influence firm value. Nirajini & Priya (2013) conducted an empirical study on the Impact of Capital Structure on Financial Performance of the Listed Trading Companies in Sri Lanka. In this study, an attempt has been made to analyze the Capital structure and financial performance during the 2006 to 2010 (05 years) financial year of listed trading companies in Sri Lanka. For the purpose of this study, the data was extracted from the annual reports of the sample companies. Correlation and multiple regression analysis are used for analysis. The results revealed that there is a positive relationship between capital structure and financial performance. And also capital structure significantly impacts on financial performance of the firm showed that debt asset ratio, debt equity ratio and long-term debt correlated with gross profit margin(GPM), net profit margin(NPM), Return on Capital Employed (ROCE), Return on Asset (ROA) & Return on Equity (ROE) at significant levels of 0.05 and 0.1.

Doan & Nguyen (2011) examined the relationship between firm's characteristics, capital structure and operational performances among a sample of 427 companies listed on the Vietnamese Stock Exchange during the period of 2007 to 2009. They have followed the examples of Titman & Wessels (1988) and Chang *et.al* (2009) and adopted a structural equation modeling (SEM) approach rather than the multiple regression analysis used by most of the previous studies. Specifically, they employed path analysis to analyze simultaneous relationship among the various variables. The results suggested that for listed enterprises in Vietnam, operational performances have had a negative effect on both of the measures of capital structure considered, namely, long term debt to total assets ratio (LDR) and the short term debt to total assets ratio (SDR), while the extent of state ownership has a positive effect on both. Further, they identified that the enterprise size has positive effect on LDR only, while enterprise age has a positive effect on SDR only. By contrast, business risk affects only LDR negatively. The ratio of LDR affects the two capital structure measures in opposite ways; the effect is positive on LDR and negative on SDR. They consider the evidence to be inconclusive on the question of direction of causality between operational performance and LDR. Sivaprasad & Muradoglu (2007) conducted an empirical study on the effect of firm's leverage on stock returns. They used explicit valuation model of Miller & Modigliani which was introduced in1958 and expanded the model further to test the relationship between stock returns and firm's leverage. A panel data of 2673 companies listed in Landon Stock Exchange for the period 1980 to 2004 was analyzed by them. They found that the leverage has a negative relationship with stock returns in overall sample. Further, they identified that stock returns have negative relation with leverage in the consumer goods, consumer services and industrial sectors. The coefficient for leverage is positive in the utilities risk class which is similar to the results obtained by Miller and Modigliani in 1958. As recommendation they have given that the firms may be able to increase their leverage with implications to the cost of capital. According to Sivaprasad & Muradoglu, a possible reason could be economic, where the availability of cheap debt has enabled firms to take advantage of cheap credit for expansion and profitable investments. This may have led to firms in the portfolios in experience high stock returns even after deductibility of the cost of capital. Further, they identified another possible explanation that this situation due to the asymmetry of information between firm and outside investors could affect firms' financing choices and capital structure decisions.

Titman S. & Wessel R. (1988) carried out a research on the determinants of the capital structure choice. This study extends empirical work on capital structure theories in three ways. First, it extended the range of theoretical determinants of capital structure by examining some recently developed theories that have not, as yet, been analyzed empirically. Second, since some of these theories have different empirical implications with regard to different types of debt instruments, they analyze separate measures of short term, long term and convertible debt rather than an aggregate measure of total debt. Third, a technique was used that explicitly recognizes and mitigates the measurement problems discussed earlier. This technique, which is an extension of the factor analytic approach to measuring unobserved or latent variables, is known as linear structural modeling. Their results suggest that firms with unique or specialized products have relatively low debt ratios. They also found that smaller firms tend to use significantly more short term debt than large firms. Their model explains virtually none of the variation in convertible debt ratios across firms and finds no evidence to support theoretical work that predicts that debt ratios are related to a firm's expected growth, non-debt tax shields, volatility, or the collateral value of its assets. They found some support for the proposition that profitable firms have relatively less debt relative to the market value of their equity.

MATERIALS AND METHODS

This study is solely based on secondary data. Therefore, the annual financial statements of the listed plantation companies, CSE fact book as well as book of listed companies were used to obtain secondary data. Further, the secondary data were obtained from various sources such as relevant articles, books and magazines, web sites etc. Secondary data was gathered from ten (10) plantation companies out of twenty (20), which were listed in the Colombo Stock Exchange (Gte) Ltd (CSE) during the period of seven years from 2009 to 2015 to investigate the effect of the capital structure on share prices. These companies were selected by using random sampling method. Further, this study is limited to the plantation sector of the CSE, which represents one of the leading sectors out of 20 sectors of the CSE.

Table 1. Descriptive Statistics of Variables for tea plantation companies

Variable	N	N*	Mean	SE Mean	Std Dev.	Q1	Median	Q3
TDE	70	0	1.8790	0.1880	1.3270	1.166	1.6620	2.620
DTA	70	0	0.5793	0.0416	0.2943	0.509	0.6197	0.7288
ICR	70	0	4.8400	1.2900	9.1300	0.430	2.3600	5.1100
SP	70	0	42.7100	5.2800	37.3300	20.510	32.250	53.250

Source: Annual Report Data, Minitab output, 2009-2015

Table 2. Pearson Bi-variate Correlation Coefficient

Variables	TDE	DTA	ICR	SP
TDE	1			
DTA	0.558	1		
ICR	-0.271	0.233	1	
SP	0.950*	-0.030*	0.438	1

Source: Annual Report Data, Minitab output, 2009-2015
**Significance at 5% level*

The study has been arranged into two analytical sections viz, first, descriptive way is used to describe the sample to make the study more informative, analytical and useful to readers. Secondly, Pearson Correlation Analysis is used to describe the degree of association among capital structure and share prices. Further, descriptive statistics were used to observe the relationship between capital structure and the share price from 2009 to 2015 along with the ratio analysis. The ratio analysis is a strong analytical technique that is used by internal as well as external stockholders of companies. This technique gives an idea about whether it is in a good financial position for long term expansion (Samuels et.al, 1995). To evaluate the impact of capital structure on share prices of corporate plantation sector in Sri Lanka three financial ratios namely Total debt to Equity (DTE), Debt to Total Assets (DTA) and Interest Coverage Ratio (ICR) were used. Next, the study analyzed the impact of capital structure on share price by using multiple regression analysis. To conduct regression analysis using OLS, following model was developed.

$$SP = \alpha + \beta 1\ DTE + \beta 2\ DTA + \beta 3\ ICR + €$$

α = Constant
SP = Share Price
DTE = Total Debt to Equity Ratio
DTA = Total Debt to Equity Ratio
ICR = Interest Coverage Ratio
€ = Error Term
β = Regression Coefficients

RESULTS AND DISCUSSION

Ratio analysis on ten selected tea plantation companies had been conducted for seven years from 2009 to 2015 separately. Ratio analysis suggested that there is a negative relationship between the total debt to equity ratio and the share price of the company. Further, it highlighted a positive relationship between the interest coverage ratio and the share price in the corporate plantation sector in Sri Lanka. But, this analysis showed that total debt to assets ratio has no significant impact on the share price of the company. In addition to this ratio analysis, a regression analysis and correlation analysis have been carried out to observe whether there is a strong relationship between capital structure and the share price. Table 1 presents the empirical results obtained from the models using Minitab. Before evaluating the relationship between capital structure and the share price, the research has filtered data using inter-quartile range to omit the errors that could occur in calculations. Therefore, data in table 1 is used in calculating limits and excludes of data. Accordingly, table 01 summarized variables used in the present study for 70 firm/year observations. The mean value of total debt to equity is 1.879 with a standard deviation (SD) of 1.327. The mean debt to total assets is 0.5793 with SD of 0.2943. On average, firms' interest coverage ratio is 4.84 times with a SD of 9.13.

The study next analyzed the Pearson Correlation among the observed variables to identify the relationship between capital structure and the share price. According to Table 02, there is a weak negative relationship between total debt to equity ratio and share price (0.950). It is obvious that as debt increases companies become more risky and which results in decrease in share price. Further, this analysis showed that there is a weak negative relationship between debt to total assets and the share price i.e. -0.030. Therefore, when debt to total assets ratio increases share price will decrease but not in a significant amount. The third independent variable is interest coverage ratio. This ratio indicates the ability of the company to meet its interest costs. When considering the relationship between interest coverage ratio and the share price, it revealed that there is a positive significant relationship of 0.438. Accordingly, when interest coverage ratio increases share price will also increase. It is obvious that higher interest coverage ratio reduces the risk of the company because the company is in a financially healthy position to meet its debt obligations which result in higher share price. In order to test the hypothesis, a Regression Analysis has been conducted to determine whether there is a significant relationship between capital structure and share price. Table 03 provides the results for the model tested in the present study:

S = 20.9923
R-Sq = 21.6%
R-Sq (Adj) = 12.9%

As per the results of the above regression analysis, the regression equation can be developed as follows.

$$SP = 33.24 + 4.03\ ICR$$

This regression analysis was done at 0.05 significance level. Therefore, if the P value of any independent variable is less than 0.05, it has a greater influence in changing share price. According to table 3, p value is below 0.05 for constant value and for interest coverage ratio. Therefore, this result suggests that changes in interest coverage ratio have significant impact on the changes in share price.

Table 3. Regression Results

Dependent variable: Share Price (SP)				
Parameter	Coefficient	SE Coefficient	T value	P Value
Constant	33.24	14.10	2.36	0.026
TDE	3.107	6.868	0.45	0.655
DTA	-21.85	24.31	-0.90	0.377
ICR	4.030	1.576	2.56	0.016

Source: Annual Report Data, Minitab output, 2009-2015

So it can be revealed that only the interest coverage ratio has the significant level lower than 0.05 levels. Therefore, it can be concluded that it is the only variable that can be affected highly to the share price.

Conclusion and Recommendations

This study attempted to assess the impact of capital structure on share price using a seven year (2009-2015) data set on 10 plantation companies listed in CSE. In order to find out the impact of capital structure on share price the research applied total debt to equity ratio, total debt to total assets and interest coverage ratio. Further, correlation analysis and regression analysis were done to identify the relationship between capital structure and the market price. Considering the statistical results, it can be concluded that there is a negative relationship between the total debt to total equity ratio and the share price and positive relationship between the interest coverage ratio and the share price. But the analysis suggested that there is no significant impact from the debt to total assets ratio to determine the share price. This finding is consistent with Jie Cai & Zhe Zhang (2005), Muradoglu & Sivaprasad (2008). Therefore, the research suggests that the investors who prefer to invest their surplus funds in the plantation sector need to select companies which have lower debt to equity ratio and higher interest coverage ratio. However, the investors don't necessarily give much more concentration to the debt to total assets because as it has no significant impact to determine the share price. As per the correlation analysis total debt to equity ratio has weak negative relationship with the share price and total debt to assets has less negative relationship with the share price as well. Interest coverage ratio shows positive significant relationship with the share price.

This research results imply that the investors in the plantation sector to invest their funds in companies which has lower debt to equity ratio otherwise more debt in company capital structure implicates solvency risk of the company. Further, it is beneficial to the investors to invest in companies which have higher interest coverage ratio because such companies are generating enough earnings to discharge its debt obligations. However, the investors do not pay much concentration to the debt to total asset ratio since it has no significant impact on determining the share price. Somehow, there are lot of other variables which affect to the share price other than the factors considered for this study. This study has highly focused on micro factors which affect to the share price. But, macro factors such as demand and supply, political instability, inflation etc are also have some impacts on the share price. As a recommendation it is suggested that all the plantation companies to have a greater focus on the relationship between capital structure and the share price which will ultimately lead to develop their market share and lower the threat of insolvency. Further, optimum capital structure has been explored, adopted and recommended for Sri Lankan plantation sector which maximizes their benefits and leads to an appropriate balance between growth of the business, optimizing shareholders' wealth and minimizing the risk of insolvency simultaneously.

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