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CAPITAL STRUCTURE AND COMPETITIVE BEHAVIOUR: THE EFFECT OF EQUITY FINANCING AND EARNING PRESSURE IN SRI LANKA

BY

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DECLARATION OF THE CANDIDATE:

"The work described in this thesis was carried out by me under the supervision of Dr. Y. K. Weerakoon Banda, Department of Finance, University of Sri Jayewardenepura, and a report on this has not been submitted in whole or in part to any university or any other institution for another Degree or Diploma"

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"I/We certify that the above statement made by the candidate is true and that this thesis is suitable for submission to the University for the purpose of evaluation".

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Dr. Y. K. WEERAKOON BANDA

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ABBREVIATIONS

NI Approach	-	Net Income Approach
NOI Approach	-	Net Operating Income Approach
MM Theory	-	Modigliani and Miller Theory
CSE	-	Colombo Stock Exchange
r_D	-	Cost of Debt
r_E	-	Cost of Equity
r_A	-	Cost of Capital

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ABSTRACT

This study examined the effect of capital structure on a firm's competitive behaviour, to substantiate that a firm's equity financing enhances its competent capacity and the pressure for higher earnings shrink the capacity to compete.

Based on secondary investigation method study concerned with variables such as, equity financing and earning that are associated with capital structure and competitive behaviour for the analysis. Fixed panel data model was employed for the multiple regression analysis.

The sample for the study was derived from the companies listed in the Colombo Stock Exchange. The sample consists of 77 companies representing 08 sub sectors categorized by Colombo Stock Exchange.

The findings of the study reveal that a firms' ability to compete is reduced by the pressure for higher earnings. Effect of equity financing is invisible in some sectors. Findings of two sectors reveal acquisition of higher amount of equity support to competition, but in another two sector, firm effect eradicate the advantage obtained through equity financing. Contrary to this, whereas the equity financing conducive to competitive advantage; in some sectors lack of competitive factors setback the desired performance of the sectors.

CHAPTER – 01

INTRODUCTION

1.1 BACKGROUND OF THE STUDY

An extensive body of research examined the effect of capital structure on firms' competitive behaviour have focused on debt. Chevalier, 1995a, 1995b; Phillips, 1995; Kovenock and Phillips, 1997; Maksimovic and Phillips, 1998; Zingales, 1998; Lang, Ofek, and Stulz, 1996; Mackay and Phillips, 2004 have examined the influence of capital structure on investment and output decisions. These studies document that the firms' investment decisions are negatively associated with debt and there is substantial inter- and intra-industry variations in leverage.

The role of equity financing has to be better understood in the competitive environment. There are limited number of studies that analyze capital structure and competitive behavior which are focused on equity. The motivation for the study arises from Yu Zhang, 2006.

Equity financing is preferred by managers when the managers believe that investors' views about project payoffs are likely to be aligned with them, thus maximizing the likelihood of agreement with investors. It is useful to compare the effects of equity on competitive behavior.

Management utilizes the funds raised through equity, does not tend to repay them to their owners as long as the business exists. Further, the managers do not have any statutory obligation to distribute earnings as dividends to the stockholders and they can reinvest the entire earnings back into the business.

Stockholders have no legal rights to compel the management to pay dividend. Once the organizations have obtained equity financing they have more reinvestment opportunities in the existing or diversified businesses. The effective and efficient reinvestment opportunities enable the organization to compete effectively in the business environment.

Scholars worried that the pressure from equity markets make firms more short-term oriented and less competitive (e.g Porter, 1992). However empirical studies show that typical practices associated with equity financing, such as institutional investor activism, does not obstruct firms' strategic behaviour and competitiveness (e.g David et al., 2001).

In Sri Lanka the interest rate has an increasing trend. Consequently this increases the cost of borrowings. The increase in borrowing cost has negative impacts on many sectors. This creates a climate where corporate is discouraged from initiating development projects, due to the high cost of borrowings. In this regard, all policy-makers and the business community need to proactively address an effective financing method to reverse the adverse trends.

On the other hand, earning forecasts are widely used by investors for stock valuation that affect the competitive position of the firm. The future earning of a company (the "consensus" earning forecast) creates a powerful force that influences a firm's competitive behaviour. If a firm fails to meet the expectations of future earnings, even by a small margin, it creates a big impact over the survival of the firm. Yu Zhang, Javier (2006) evidenced, the financial structure and the earning pressure have significant effect