CHAPTER VII

SUMMARY, CONCLUSION AND RECOMMENDATIONS

7.1 Summary

The capital structure choices or financing policies have long been the issue of great interest in the corporate finance literature. This interest is due to the fact that the mix of a fund (leverage ratio) affects availability of capital, profit, cost and eventually firms' value. There is another possibility that perhaps, financing doesn't matter. Modigliani and Miller (1958) asserted that financing doesn't matter in perfect capital markets. For regulators and policymakers, the Modigliani and Miller propositions are the ideal end results. If that result could be achieved in practice, then investors' diverse demands for specialized securities would be satisfied at negligible cost. All firms would have equal access to capital, and the cost of capital would not depend on financing but only on business risk. Capital would flow directly to its most efficient use. Therefore public policy should accommodate financial innovation because it makes financing decisions unimportant. But for students or practitioners of corporate finance, the Modigliani and Miller (1958) propositions are benchmarks, not end results. The propositions say that financing does not affect value except for specifically identified costs or imperfections.

The logic of the Modigliani and Miller (1958) results is now widely accepted. The Modigliani and Miller perspective has been supported by other researchers such as Hamada (1969) and Stiglitz (1974). However, these conclusions are at variance with what one sees in the real world, where capital structure matters and banks would be extremely unwilling to finance a project entirely with debt capital. Thus, financing clearly can matter. The chief reasons why it matters include taxes, differences in information and agency costs.

There is no universal theory of the debt-equity choice and no reason to expect one. There are several useful conditional theories, related to capital structure and financing. For example, the tradeoff theory says that firms seek debt levels that balance the tax advantages of additional debt against the costs of possible financial distress. The tradeoff theory predicts moderate borrowing by tax-paying firms. The

pecking order theory says that the firm will borrow, rather than issuing equity, when internal cash flow is not sufficient to fund capital expenditures. Thus the amount of debt will reflect the firm's cumulative need for external funds. The free cash flow theory says that dangerously high debt levels will increase value, despite the threat of financial distress, when a firm's operating cash flow significantly exceeds its profitable investment opportunities. The free cash flow theory is designed for mature firms that are prone to overinvest. Theories of optimal capital structure differ in their relative emphases on, or interpretations of, these factors. The tradeoff theory emphasizes taxes, the pecking order theory emphasizes differences in information, and the free cash flow theory emphasizes agency costs (Myers 2001). Further, Myers (1984) pointed out that financial economists have not hesitated to give advice on capital structure, even though how firms actually choose their capital structures remains a puzzle as the theories developed did not seem to explain fully actual financing behaviour. This view is supported by Harris and Raviv (1991) who pointed out that numerous attempts to explain capital structure have proved to be inconclusive.

Most research on capital structure has focused on public, nonfinancial companies with access to developed (U.S. or European) capital markets. These companies have the broadest menu of financing choices and can adjust their capital structures at relatively low cost. However in developing countries like Nepal, debt ratios of established companies vary within apparently homogenous industries. There is also variation over time, even when taxation, information differences and agency problems are apparently constant.

Financing decision (i.e. capital mix decision) is one of the most important decisions of a firm. The financing decision involves decisions related to amount of financing, types of financing, financing mix and timing of financing. The financial manager of the firm should take right financing decision to maximize the stockholders' wealth. The maximization of stockholders' wealth is closely related to the maximization of firm value.

Capital structure or financing decisions are the important decisions that a firm has to take. This is because of the fact that capital structure can directly affect cost of capital

and profitability and eventually the capital structure coupled with a number of other factors determines the value of a firm. Capital structure decisions are central both to the theory and to the practice of corporate finance. A capital structure with reasonable proportions of debt and equity capital can maximize the shareholder's wealth to a limit possible and simultaneously can minimize the firm's cost of capital as a whole.

The relationship between capital structure and profitability has been the subject of remarkable milestone over the past decades throughout the irrelevance theory. However no clear cut empirical evidence is found that the capital structure affects the profitability of corporate non-financial firms in Nepal. This study discovered some fact on the relationship between capital structure and profitability in Nepalese reality.

The firms have to pay a fixed charge at every period irrespective to the firm's earnings. The cost of capital is concerned with what a firm has to pay for the capital- that is, the debt, preferred stock, retained earnings, and common stock- it uses to finance new investments. Firm's cost of capital is determined in the capital markets and is closely related to the degree of risk associated with new investments, existing assets, and the firm's capital structure. The greater the risk of a firm as perceived by investors, the greater the return investors require and the greater will be the cost of capital. Without the proper combination of capital structure components in financing of the firm, it is impossible to minimize the cost of capital. Determining the cost of capital is a major problem in Nepalese companies. This study has tested the empirical relationship between capital structures and the cost of capital in the context of underdeveloped economy such as Nepal by using the data of Nepalese listed companies.

The successful selection and use of capital is one of the key elements of the firms' financial strategy. Hence, proper care and attention need to be given while determining capital structure decision. Pandey (2004) reported that the capital structure decision of a firm influences its shareholders return and risk. Consequently, market value of its shares may be affected by the capital structure decision. The objective of a firm should therefore be directed towards the maximization of its value by examining its capital structure or financing policies from the point of view of its impact on the firm value. Maximizing firm value requires a perfect combination of

debt and equity. It implies that by changing the capital structure composition a firm can increase its value in the market. This study has examined the capital structure and its relationship with the value of the firm in the Nepalese setting. It seeks to provide evidence that may uncover the significant policy implication for finance managers, because they can utilize debt to form optimal capital structure to maximize the wealth of shareholders.

This study is mainly aimed at assessing financing policies of listed non-financial companies of Nepal. The specific objectives are: (1) to investigate the factors affecting capital structure decisions in Nepalese firms, (2) to assess the impact of capital structure on the firm's profitability, (3) to analyze the effect of leverage on the cost of capital, (4) to evaluate the effect of leverage on the firm value, (5) to analyze the views of executives on financing policies. This study covers a sample of 18 listed non-financial companies. The chosen sample include 12 major manufacturing companies, 4 hotels sector companies and 2 trading companies listed in the Nepal Stock Exchange Ltd. The sample companies are: Bottlers Nepal Limited, Nepal Lube Oil Limited, Bottles Nepal (Tarai) Limited, Unilever Limited, Gorakhkali Rubber Udyog Ltd., Himalayan Distillery Limited, Bishal Bazaar Co Ltd., Khadya Udyog Ltd., Nepal Bitumen & Barrel Udyog Ltd., Nepal Banaspati Ghieu Udyog Ltd., Salt Trading Corporation, Ltd. Fleur Himalayan Ltd., Shree Ram Sugar Mills Ltd., Shree Raghupati Jute Mills Ltd., Soaltee Hotel Ltd., Yak and Yeti Hotel Ltd., Oriental Hotels Ltd., Taragaun Regency Hotel Ltd.

This study is based on secondary as well as primary data. Secondary data are used in evaluating the determinants of capital structure as well as assessing the effect of capital structure on profitability, cost of capital and firm's value. The separate analysis is made for all samples, manufacturing sample and non manufacturing (trading, service and hotel) companies sample to draw information how capital structure decision is affected by industry classification. The data are collected from the sample companies (Financial Statements), Nepal Stock Exchange, Security Board of Nepal, Nepal Rastra Bank, Internal Revenue Department and Ministry of Finance. The period covered by the study is 1998 to 2012.

In order to assess the views of Nepalese executives, the survey instruments were used and for this purpose, a total of 275 structured questionnaires were prepared and distributed from February 2013 to May 2013 to practitioners of different companies. A total of 181 respondents provided their responses on different aspects of financing policies and practices in Nepal.

The methodology used in the study includes the descriptive, analytical, correlation and causal comparative research designs. Further, it includes the systematic collection and presentation of data to display the clear picture of a particular situation and to point out a complete and accurate description of the situation. The analysis involved descriptive, correlation, and regression models to measure relationship between different variables and to test the priori hypothesis. Both parametric and nonparametric tests were also used to examine financing policies, practices and behaviors.

Major Findings

Based on the analysis of data, the major findings of the study are summarized as follows:

1. Size of the firms, as measured by the natural logarithm of sales, is found one of the major determinants of capital structure. Since, it has negative and statistically significant coefficients for total leverage and short term leverage, whereas positive coefficient is found for long-term leverage. The results indicate that larger Nepalese firms use fewer amounts of short term debt and total debt whereas they use more long-term debt than smaller size. When it is compared with manufacturing and non-manufacturing samples, Size affects negatively to both total leverage and short term leverage in manufacturing samples whereas it affects negatively only to short-term leverage in non-manufacturing sample. As a whole, it indicates that larger firms in Nepal borrow less than smaller firms.

2. Liquidity is found one of the major determinants of capital structure. Since, liquidity negatively affects total leverage and short-term leverage whereas it affects positively for long-term leverage. It indicates that raising short-term debt capital by Nepalese companies is likely to be expensive and more risky; hence companies with

high liquidity tend to avoid raising external loan capital. The result is contradictory in the case of long-term leverage that even more liquid Nepalese firms prefer to raise of more long-term debt capital.

3. Tangibility is also found one of the major determinants of capital structure. Tangibility significantly positively affects the long-term leverage in all sample, and manufacturing sample. This may the case that the more tangible the assets of a firm are; the greater its ability to secure long term debt. The negative association between short-term leverage and tangibility is found for all samples as well as manufacturing and non-manufacturing samples. This result can be explained by the fact that those firms that maintain a large proportion of fixed assets in their total assets tend to use less short-term debt than those which do not.

4. Contradicting the priori hypothesis, the tax is significantly negatively related to leverage (capital structure) in all sample. Similar results have been documented in both manufacturing and non-manufacturing sample. However, tax is found as one of the major determinants of capital structure in Nepalese companies.

5. The negative and statistically significant coefficient of NDTS is found for total leverage and long-term leverage in all sample and non-manufacturing sample companies. As a whole, negative coefficient of NDTS indicates that firm with larger amount of annual depression charges relatively borrow less amount of debt capital. Thus, non-debt tax shield can be considered as one of major determinants of capital structure in Nepalese listed non- financial companies.

6. The coefficient of uniqueness is positively significantly related to total leverage and short-term leverage (as contrary to priory hypothesis) in all samples and manufacturing sample. As a whole the positive coefficient of SANS indicates that firm with relatively higher amount of annual selling and advertisement expenses prefer to use more debt capital. Thus, uniqueness (SANS) can also be considered as the determinants of capital structure in Nepalese firms.

7. Effect of capital structure on profitability has also been investigated. The results indicate that the leverage variables like: short-term debt, long-term debt and total

debt are found to be significantly but negatively related to profitability (ROA). The result supports that profitable Nepalese firm use less amount of debt to finance their operation. This is also evidenced by negative coefficient of long-term leverage with ROCE. In general, capital structure has been found as the major influencing variable for firm's profitability in Nepalese firms.

8. Assets turnover is found positively related to profitability. It implies that Nepalese firms with high assets turnover should have higher profitability.

9. Size is found positively related to profitability it implies that the larger the firm size, there will be the better chances of efficient use of firm's assets, eventually profitability may be enhance.

10. Age is found positively related to profitability and it indicates that more reputed Nepalese firms should have higher profitability.

11. Tangibility is found to be negatively related to profitability. It indicates that Nepalese firms are not efficiently utilizing their tangible assets. This may the case that most of Nepalese firms are not operating at their full capacity.

12. Liquidity is found negatively related profitability in all samples. This result is different to that of manufacturing sample where liquidity was also found with positive and significant coefficient.

13. Effect of capital structure on cost of capital has also been investigated and the result supports that cost of capital is mainly affected by capital structure. Since there is significant positive association between leverage and cost of capital, it implies that as firm's debt level increases its cost of capital is also expected to increase. The capital structure (debt to total assets ratio (TL) significantly influence cost of capital because its coefficient is higher than that of other control variables. When sample is sub-divided into manufacturing and non-manufacturing sample groups, the capital structure does not stood as significant variable affecting cost of capital.

14. Assets turnover (ATO) is found positively and significantly related to cost of capital in all sample and manufacturing sample but it is found insignificant in non-manufacturing sample. In general it implies that Nepalese firms with high assets turnover should have higher cost of capital.

15. The liquidity variable is significantly negatively related to cost of capital implies that more liquid firm should have lower cost of capital. This may the cause that more liquid firms can use the low cost sources capital while raising needed capital.

16. Age has been found significantly positively related to cost of capital. It indicates that even more reputed Nepalese firms should have higher cost of capital. Further the result evidenced that in addition to capital structure, natural log of age (Lnage), is also considered as the influencing variable for cost of capital.

17. Eventually effect of capital structure on firm value has been investigated. The results indicate that market value of a firm is positively significantly influenced by its choice of capital structure. More specifically, there is a significant positive effect of total leverage, long-term & short-term leverage on the market value of the firm.

18. The major concern of this study was to analyze the impact of capital structure on value of the firm in the context of Nepalese non-financial firms. In addition to capital structure, profitability positively affects firm value whereas assets turnover, company size, and liquidity negatively affect firm value.

19. The analysis of the primary information indicates that majority of Nepalese sample firms there have formal financing policies but there is significant different between two groups of companies with respect to their financing policies practiced. The major financing policy setters are Board of Directors and President/ managing director percent. There is no difference between manufacturing and hotel & trading companies about financing policies setters.

20. Financing decisions in Nepalese firms are made using the information provided by own management and staff analysis as well as commercial bankers. Thus, more important influence on the setting of target leverage ratios is found from the firm's

own management group and staffs of analysts but information provided from commercial bankers are also considered.

21. The 'situational' and 'risk avoiding' are the two important methods used to describe the financing policies in Nepalese companies. The survey result indicates that majority of the Nepalese firms do regard the tax issues in designing their capital structure and financing decision. Further manufacturing and non-manufacturing (hotel & trading) companies in Nepal are not different about the tax issues related to financing decisions.

22. Nepalese non-financial companies do not have a policy of maintaining spare debt capacity and there is significant difference between manufacturing and hotel & trading companies with respect to the policy of maintaining spare debt capacity. There is significant difference between manufacturing and hotel & trading companies with respect to the policy of maintaining spare debt capacity. Further, Nepalese companies could not borrow more at the same interest rate but borrowing more at the same interest rate practices differs in accordance with the nature of firms.

23. There is some evidence that Nepalese firms make use the of off-balance sheet financing techniques. There is significant difference between manufacturing and hotel & trading companies with respect to the use of off-balance sheet financing techniques. Nepalese companies do follow industry norms for their financing decision. Among alternatives leverage measures, total liabilities divided by total assets (debt ratio) was considered as most important and long term debt divided by total assets was regarded next important leverage measures in Nepalese firms' financing decision procedures.

24. Nepalese enterprises pay more importance in 'projected cash flow or earnings from the assets to be financed' and 'financial flexibility' in governing financial decisions. Except 'projected cash flow or earnings from the assets to financed', for factors governing firms' financing decisions that there is significant difference between manufacturing and hotel & trading companies.

25. Attitudes varied considerably about the preferences for short-, medium- or long - term funding sources but a common theme was apparent. Nepalese firm prefer short (up to 1 year) followed by long (>5 years) maturity funding sources.

26. As regard to a source of long-term fund, Nepalese financial executives prefer 'long-term debt' as their most favorite followed by 'Internal equity' and 'external common equity' respectively, they do not strictly follow pecking order hypothesis. There is significant difference between manufacturing and non-manufacturing (hotel & trading) companies with respect to the preference (choice) for sources of long-term funds for financing new investments.

27. The survey explored the circumstances which might companies to make equity issue. One major circumstance for an equity issue is 'to fund a major expansion' and it is followed by 'to reduce leverage if market conditions right' and thereafter 'to make an acquisition'. There is significant difference between manufacturing and hotel & trading companies about circumstances making an equity issue.

28. The foremost circumstance to make a debt issue is 'to fund a major expansion' and the next major circumstance is 'to add to liquidity'. There is difference between manufacturing and hotel & trading companies about the circumstances making a debt issue.

29.Nepalese non financial companies' decisions regarding the choice between short-term and long term debt is highly affected by 'we except our rating to improve so we borrow short- term until it does' as well as 'matching the maturity of debt with the life of assets'. Manufacturing and hotel & trading companies are different regarding factors of choice between short-term and long term debt the circumstances making a debt issue.

30. As regard to the factors affecting firm's choice to the appropriate amount of debt, the most important factor is 'volatility of our earnings and cash flow' and the next important factor stood 'financial flexibility, and followed by 'tax advantage of interest deductibility'. Manufacturing and hotel & trading companies are different in respect to the factors affecting firm's choice to the appropriate amount of debt.

31. Nepalese sample companies are not much more interested in issuing convertible debt. The survey further evidenced that among the factors affecting to issue convertible debt, 'less expensive than straight debt' is an important features affecting convertible debt policy and the next important factor is the 'ability to call or force conversion if/when necessary'.

32. As regard to the factors affecting the firm's choice to issue common stock; the most important factor is 'maintaining target debt-to-equity ratio'. The factors on next order of importance are: 'inability to obtain funds using other sources', 'if our stock price has recently risen, the price at which we can issue is high', and 'whether our recent profit has been sufficient to fund our activity' respectively. Manufacturing and hotel & trading companies are different in respect to the ranking on factors affecting the firm's choice to issue common stock.

33. The survey has provided the evidence that in average more than 20 percent of the common stock is owned by the largest three stock owners in Nepalese companies. There is no significant difference between manufacturing and hotel & trading companies about the ownership percentage of largest three stock owners. The majority of responding companies' common stock is owned by less than 500 to 1000 people (i.e. shareholders).

34. Only small number of the Nepalese companies has been found to have issued right share. It indicates that right share issue is less practiced in Nepalese non-financial companies. As regard to the situation firms prefer to issue right share, it is found that majority of Nepalese companies prefer to issues right shares 'to reduce transaction costs/cost of issue' and 'for new project expansion and to decrease debt'. Further manufacturing and hotel & trading companies are different with respect to the opinion for the situation firms prefer to issue right shares.

35. As regard to the 'how much a company should borrow in relation to its equity capital, the survey result indicates that the optimal level of debt/equity ratio is more than 1:1 but less than or equal to 2:1. Majority (in aggregate) of Nepalese financial executives are in favor of choosing 2:1 or less of company borrowing in relation to

equity. The result shows that manufacturing companies and non-manufacturing companies are different regarding the choice of the appropriate level of company borrowing in relation to equity capital.

36. Important owner related factors influencing capital structure are goals, knowledge, and need for control. Manufacturing companies and non-manufacturing (hotel & trading) companies are significantly different as regard to owner related factors influencing capital structure except need for control. Whereas important firm characteristics factors influencing capital structure are liquidity, tax, size and others. Likewise, availability of the funds, conditions in the market, and state of the economy are considered the important other external factors influencing capital structure in Nepal.

37. Nepalese financial executives have asserted that proper level of capital structure improves investors' earnings. Whereas, manufacturing and non-manufacturing (hotel & trading) companies are different on the statement that capital structure improves investors' earnings. They also contended that higher ratio of long-term debt to equity causes firms to reduce their profitability. The results indicates that capital structure seem to improve investors, earnings.

38. The survey has explored the key factors influencing firm's profitability. The result shows that growth, assets turnover, debt, and size are considered as the important factors influencing the firm's profitability. Manufacturing and non-manufacturing (hotel & trading) companies are different with respect to ranking of factors influencing firm's profitability.

39. Nepalese corporate executives believe that proper debt level will result in lower overall cost of capital. Different opinion has been reported with respect to the use of proper debt level will result in lower overall cost of capital from manufacturing and non-manufacturing (hotel & trading) companies' executives.

40. The duration for the estimating of the company's cost of capital is also an important part of the corporate financing policies. Survey result reveals that Nepalese companies have first priority for estimating cost of capital on an every investment

basis and they also estimate it 'infrequently'. There is no significant difference between manufacturing and non-manufacturing (hotel & trading) companies with respect to the frequency in estimating cost of capital.

41. The methods to estimate before tax cost of debt have also been identified through questionnaire survey. 'Current average' is mostly preferred and it follows 'marginal cost' to estimate before tax cost of debt in Nepalese companies. Further there is a significant different between manufacturing and manufacturing (hotel & Trading) companies with respect to the choice of methods to estimate before tax cost of debt.

42. The dividend growth model is found most popular method of estimating the cost of equity capital in Nepalese firms. CAPM has also been found in practice in Nepalese financial market. The Speaman correlation coefficient of 0.90 indicates that manufacturing and non-manufacturing (hotel and trading) companies are very much similar as regard to the ranking.

43. The survey has uncovered the fact about weighting factors. The result indicates that 'current market weights' occupy the top of the choice, followed by 'current book weights' in computing weighted average cost of capital in Nepalese sample companies. Manufacturing and non-manufacturing (hotel & trading) companies are not different on the choice of weighting factors.

44. Nepalese financial executives usually make further adjustment on estimated cost capital to reflect the risk of individual investment opportunities. The chi-square value provides the evidence that there is difference between the manufacturing and hotel companies with respect to the adjustment on estimated cost of capital.

45. Majority of the respondents have underlined the positive answer on the use cost of capital for purposes other than project analysis. So it can be asserted that Nepalese financial executives prefer to use cost of capital for purposes other than project analysis. Further manufacturing and non-manufacturing (hotel & trading) companies are found different for the use of cost of capital for purposes other than project analysis.

46. Survey result has explored the significant relationship between a firm's market value and its choice of capital structure. Manufacturing and non-manufacturing (hotel & trading) companies are not different with respect to the agreement that a firm's market value is directly related to its choice of capital structure.

47. Though there exist a significant relationship between a firm's market value and its choice of capital structure in Nepalese companies, but the use of an excessive amount of debt has been reported to eventually results in the market price of their firms stock being adversely affected. Manufacturing and non-manufacturing (hotel & trading) companies are not different on the statement that excessive amount of debt will eventually result in market price be adversely affected.

48. Survey result indicates that the utilization of debt capital in the capital structure of a firm does make it have higher market value than a firm without debt capital in its capital structure. Manufacturing and non-manufacturing (hotel & trading) companies are not different about the agreement that the utilization of debt capital in the capital structure of a firm does make it have higher market value than a firm without debt capital in its capital structure.

49. Most appropriate proxy (measure) for firm value is earnings per share; it is followed by market value of debt plus equity. The price/earnings ratio and Tobin-Q are in third and fourth choice respectively as appropriate proxy (measure) for firm value. The positive Spearman correlation coefficient ($r_s = 0.77$) indicates that the choice of measure of firm value is very much similar between manufacturing and hotel & trading companies.

50. Survey provides the evidence that debt-equity mix is a major determinant of market value in Nepal. This implies that firms can only maximize their market values by an appropriate capital mix of debt and equity capital. Manufacturing and non-manufacturing (hotel &trading) companies are not different about the favor of statement that debt-equity mix is as determinants for market value in Nepal.

51. Maximizing a firm's market value has been found as the major focus when deciding its choice of capital structure in Nepal. But survey evidenced that

manufacturing and hotel & trading companies are different about the statement that maximizing a firm's market value should be the major focus when deciding its choice of capital structure. In aggregate it can be concluded that maximizing a firm's market value should be the major focus when deciding its choice of capital structure.

7.2 Conclusion

Based on the results of regression models developed in secondary data analysis and primary information analysis, the study has attempted to generate the following conclusions: The firm specific determinants of capital structure using three models are broadly similar. The financing decisions of Nepalese companies can be explained by the determinants suggested by much of the empirical literature. One of the major determinants of capital structure is size. Size coefficient evidenced that larger Nepalese firms use fewer amounts of short term debt and total debt whereas they use more long-term debt. In aggregate it could be concluded that larger firms in Nepal borrow less than smaller firms.

Since, liquidity negatively affects total leverage and short-term leverage whereas it affects positively for long-term leverage. Thus, it can be concluded that companies with high liquidity position tend to avoid raising short-term as well as total leverage, whereas even more liquid Nepalese firms prefer to raise more long-term debt capital. Tangibility significantly positively affects the long-term leverage but negative association is found between short-term leverage and tangibility. Thus, it is concluded that those Nepalese firms that maintain a large proportion of fixed assets in their total assets tend to use less short-term debt whereas they use more long-term debt.

Since tax rate and leverage is negatively related, it can be concluded that increase in tax rate can cause to lower use of debt capital in Nepalese firms. Negative coefficient of NDTS indicates that firm with larger amount of annual depression charges relatively borrow less amount of debt capital. The positive coefficient of SANS (uniqueness) indicates that firm with relatively higher amount of annual selling and advertisement expenses prefer to use more debt capital. The main conclusions of the study are that size, liquidity, tangibility, tax rate, non-debt tax shields and uniqueness are the major determinants of capital structure in Nepalese listed non-financial companies.

The effect of capital structure on firm's profitability has also been empirically tested in Nepalese reality. Leverage variables like short-term debt, long-term debt and total debt are found to be significantly but negatively related to profitability (ROA). The result has revealed that profitable Nepalese firms use less debt to finance their operation. Further the significant negative coefficients of long-term leverage with ROCE implies that higher proportion of long-term debt in the capital structure decreases profitability (ROCE) of Nepalese sample companies. Unlike debt, assets turnover (TURN), size (SIZE) and liquidity (LQUI) have positive and significant coefficients with profitability (ROA) in manufacturing firms. While tangibility (TANG), and assets growth (GROW), firm's age (Age) have negative and significant coefficients with ROA. The results provide the evidence that capital structure (SDA, LDA and DA), efficiency (TURN), reputation (AGE), tangibility (TANG), liquidity (LIQUI) and firm size (SIZE) are considered as the factors that affect firm's profitability. This study therefore concludes that investors who concern for profitability (ROA and ROCE) should be dependent to level of debt used by the firms since the level of debt does affect the firms' profitability (ROA & ROE).

In addition to capital structure; TURN, AGE, TANG, LIQUI and SIZE are also found as influencing variables for firm's profitability. Unlike debt, assets turnover (TURN), size (SIZE) and liquidity (LQUI) have positive and significant coefficients with profitability (ROA), while tangibility (TANG), and assets growth (GROW), firm's age (Age) have negative and significant coefficients with ROA in manufacturing firms. In non-manufacturing (hotel & trading) samples, LDA and DA were found negative and significant with profitability (ROA). It implies that higher debt in capital structure cause to reduce profitability (ROA) in hotel and trading companies in Nepal.

Effect of capital structure on cost of capital has also been investigated in Nepalese perspective. The significant positive association has been found between leverage and cost of capital. Since the coefficient is higher than that of other control variables, it implies that as firm's debt level increases its cost of capital is also expected to increase. With respect to the other control variables, assets turnover is found positively related to cost of capital but the liquidity variable is negatively related to cost of capital. The results imply that firms with high assets turnover also have higher cost of capital whereas more liquid firm should have lower cost of capital. Further

positive coefficient of age indicates that even if reputed Nepalese firms should incur higher cost of capital.

The effect of capital structure on firm value has been examined empirically for a sample of listed non-financial companies in Nepal. The results reveal that market value of a firm is positively influenced by its choice of capital structure (financial leverage). More specifically, there is a significant positive effect of total leverage, long-term & short-term leverage on the market value of a firm. Capital structure has been found to be the major determinant of firm's value.

The study has also discovered from the analysis that, in Nepal, a firm's market value is positively significantly influenced by its choice of capital structure. With respect to the other control variables, profitability is positively related to firm value; whereas assets turnover, size and liquidity are negatively related to firm value. In general, it can be concluded that capital structure with controlling effect of profitability, assets turnover, size and liquidity seem to affect firm value of Nepalese listed firms.

The survey of the practice of corporate financing policies is both reassuring and puzzling. Based on primary evidence the study also concludes that majority of Nepalese sample pursue formal financing policies. Their major financing policy setters are board of directors and president/ managing director. Their financing decisions are made using the information provided by own management and staff analysis as well as commercial bankers. The 'situational' and 'risk avoiding' are the two important methods used to describe the financing policies in Nepalese companies. Nepalese firms do regard the tax issues in designing their capital structure and financing decision. Nepalese firms do not have spare debt capacity and they could not borrow more at the same interest rate. Nepalese firms make use the of off-balance sheet financing techniques. Nepalese firms do use industry norm for financing decision. Financial ratios that mostly used by Nepalese corporations to measure leverage are: (1) total liabilities divided by total assets, (2) long-term debt divided by total assets, (3) long-term debt divided by net worth etc. Among alternatives leverage measures, total liabilities divided by total assets (debt ratio) was considered most important in these firms' financing decision procedures. Nepalese enterprises pay

more importance in ‘projected cash flow or earnings from the assets to be financed’ and ‘financial flexibility’ in governing financial decisions.

As regards to the preference for a particular maturity structure in borrowings, respondents had shown their first ranking on short (up to 1 year) and the second rank on long (>5 years) maturity funding sources. With respect to the long-term source of funds in order of preference for financing new investments, ‘long-term debt’ was the first choice and ‘Internal equity’ and ‘external common equity’ were ranked second and third respectively. Nepalese firms, to some extent, follow the pecking order hypothesis. Further main circumstances making an equity issue are: 'to fund a major expansion', and 'to reduce leverage if market conditions right'. Circumstances that would make a debt issue are: to fund a major expansion and it is followed by to add to liquidity.

Important factors affecting firm's choice between short-term and long-term debts are 'we expect our rating to improve, so we borrow short-term until it does', matching the maturity of debt with the life of assets, 'borrowing short-term reduces the chance that our firm will want to take on risky projects'. The main factors affecting firm’s choice to the appropriate amount of debt are: ‘volatility of our earnings and cash flow’, ‘financial flexibility, and 'tax advantage of interest deductibility’. Likewise important factors affecting the firm’s choice to issue common stock are: ‘maintaining target debt-to-equity ratio’, ‘inability to obtain funds using other sources’, ‘if our stock price has recently risen, the price at which we can issue is high’. Nepalese non-financial companies are narrowly held as regard to the ownership structure.

It has been evident that the participating executives subscribe to the concept of an optimal capital structure. Further, they believe the prudent use of debt can lower the firm's overall cost of capital and that debt use can affect firm value.

Right share issue is less practiced in Nepalese non-financial companies. Main situations to issue right shares are: ‘to reduce transaction costs/cost of issue’ and ‘for new project expansion and to decrease debt’. Nepalese financial executives are in favor of choosing borrowing in relation to equity capital is less than or equal to 2:1. Owners related factors influencing capital Structure are: goals, knowledge and need

for control. Based on opinion survey important firms' characteristics factors influencing capital structure are: liquidity, tax, size and other. Other external factors influencing capital structure are: the availability of the funds, conditions in the market and state of the economy.

Nepalese practitioners are in agreement that capital structure seems to improve investors, earnings. As majority of the respondents showed their agreement (strongly agreed and agreed), it can be concluded that higher ratio of long-term debt to equity causes firms to reduce their profitability. Important factors influencing firm's profitability based on opinion survey are growth, assets turnover, debt, and size.

Nepalese financial executives have asserted that debt in firm's capitalization can lower overall cost of capital. The mostly followed duration for the estimating of the company's cost of capital is every investment basis as well as annually practice. Current average and marginal cost methods are mostly used in Nepalese companies as methods to estimate before tax cost of debt. Dividend growth model is the most popular method of estimating the cost of equity capital. The current market weight is mostly practiced by Nepalese firm for calculating weighted average cost of capital. Nepalese financial executives usually make further adjustment on estimated cost capital to reflect the risk of individual investment opportunities. Nepalese financial executives prefer to use cost of capital for purposes other than project analysis.

There is a significant relationship between a firm's market value and its choice of capital structure. An excessive amount of debt would eventually results in the market price of their firms stock being adversely affected. Utilization of debt capital in the capital structure of a firm does make it have higher market value than a firm without debt capital in its capital structure. 'Earnings per share' is the best measure for firm value. The 'market value of debt plus equity', 'price/earnings ratio' and 'Tobin-Q' are also the usual measures for firm value in Nepalese companies. Firms can only maximize their market values by an appropriate capital mix of debt and equity capital. When deciding a firm's choice of capital structure, maximizing its market value should be its major focus since majority of the respondents (strongly agreed and agreed) affirmed the statement.

The variables considered as influencing in determining capital structure of developed capital market realities are also considered as influencing variables in Nepalese context too. The financial executives believe that the prudent use of leverage can lower the firm's average financing costs. Further the evidence indicated that formulation of an appropriate corporate debt policy appears to be central part of the firm's financial management process in Nepalese firms. Financial executives stood decisive in stating that capital structure is relevant.

Overall, the study finds that firms in the non-financial sector of Nepal have adopted capital structure to some extent on the pecking order hypothesis. Due to underdeveloped debt market and inefficient equity market, sample firms are largely financed by short term debt. Banks are the major source of finance in this country and due to information asymmetry problems, weak regulatory structure and volatility in earnings; loan is protected with strict covenants which can force the firms to borrow less amount of long-term debt.

The finding of this study suggests that maximizing the wealth of shareholders requires a perfect combination of debt and equity. Changing the capital structure composition, a firm can increase its value in the market. Nonetheless, this could be a significant policy implication for finance managers, because they can utilize debt to form optimal capital structure to maximize the wealth of shareholders. Based on the findings of this study, it can be conclusively stated that capital structure decisions have various implications and one of them is its effect on the value of the firm which formed the basis of this study.

7.3 Recommendations

Based on the evidence derived from secondary data analysis and the examination of the primary information, some recommendations are forwarded. The major recommendations are:

1. As size is negatively related to total leverage and short term leverage, it shows that small firms are employing higher level of debt. Thus it is suggested that even larger firms should make judicious use of leverage to maximize market price of common stock.

2. Liquidity is negatively related to total leverage and short-term leverage whereas it is positively related to long-term leverage. This result indicates that more liquid firms borrow fewer amounts of total debt and short-term debt but these firms borrow more long-term debt. It is recommended that even more liquid firms should use more debt to take advantages of cheapest sources of funds.

3. Tangibility positively affects the long-term leverage whereas negative association is found between short-term leverage and tangibility. It indicates that firms having more tangible assets borrow more long-term debt but firms having fewer tangible assets borrow more short-term debt. It is recommended that firms having more tangible assets should also borrow short- term debt as short-term debt is cheapest sources of funds.

4. Tax is negatively related to leverage. It indicates that firms having more tax burden borrow less amount of debt. It seems that Nepalese firms are unable to take advantage of tax benefit from the use of debt. It is recommended that Nepalese firm should use optimal debt capital in their capital structure and take the benefit of debt and reduce the tax liability.

5. The NDTS is negatively related to leverage. It indicates that firm with larger amount of annual depression charges relatively borrow less amount of debt capital. It seems that Nepalese firms are unable to take advantage of tax benefit from the use of debt. It is recommended that Nepalese firms having larger amount of annual depression charges should use more debt capital in their capital structure and take the tax benefit of debt.

6. Uniqueness is positively significantly related to leverage. It indicates that firm with relatively higher amount of annual selling and advertisement expenses prefer to use more debt capital. It is suggested that even firm with relatively lower amount of annual selling and advertisement expenses should borrow reasonable amount of debt as debt is cheapest sources of fund.

7. Since there is a significant positive association between leverage and cost of capital, it implies that as firm's debt level increases its cost of capital is also expected to increase. Thus it is recommended that Nepalese firms should borrow reasonable (optimal) amount of debt to lower cost of capital.

8. Assets turnover is found positively related to cost of capital and it implies that Nepalese firms with high assets turnover should have higher cost of capital. It is suggested that Nepalese firms even with high assets turnover try to raise low cost bearing source of capital (optimal use of debt capital).

9. The liquidity is negatively related to cost of capital implies that more liquid firm should have lower cost of capital. It is recommended that Nepalese firms even with lower liquidity position try to raise low cost bearing source of capital for funding their investment needs.

10. Age is found positively related to cost of capital and it indicates that more reputed Nepalese firms should have higher cost of capital. It seems that Nepalese aged firms are not aware of optimal capital structure. Thus it is recommended that even more reputed firms should maintain optimal capital structure thereby cost of capital can be minimized.

11. Leverage is negatively related to profitability. It indicates that profitable Nepalese firms use less amount of debt in their capital structure. It further implies that excessive use of leverage may lower the profitability. Thus it is recommended that Nepalese firms should judicial use of debt in their capital structure to enhance profitability.

12. Assets turnover is positively related to profitability and it implies that Nepalese firms with high assets turnover should have higher profitability. It is suggested that Nepalese firms even with low assets turnover try to enhance their efficiency to increase profitability.

13. Since size is positively related to profitability, the smaller the firm size, there will be the chances of less efficient use of firm's assets, eventually profitability may be

deteriorated. Thus, smaller size Nepalese companies should increase efficiency and try to enhance size to increase profitability.

14. Age is found positively related to profitability and it indicates that more reputed Nepalese firms should have higher profitability. Since young firms are not able to generate sufficient profit, it is recommended that even young (less-reputed) firms should try to diversify their business and increase efficiency to enhance profitability.

15. Tangibility is negatively related to profitability. It indicates that Nepalese firms are not efficiently utilizing their tangible assets. This may the case that most of Nepalese firms are not operating at their full capacity, thus Nepalese firms should enhance capacity and best utilize their tangible assets to increase profitability.

16. Liquidity is negatively related to profitability. It indicates that excessive liquidity lower the profitability since idle cash earns nothings. Thus it is recommended that Nepalese firms should maintain optimal level of liquidity that helps smooth operations and maximize profitability.

17. Market value of a firm is positively influenced by its choice of capital structure. It indicates that by changing the capital structure composition a firm can increase its value in the market. It is suggested that maximizing the wealth of shareholders requires a perfect combination of debt and equity.

18. Market value of a firm is positively related to profitability. It indicates that profitable Nepalese firms have the higher market value. Thus it is suggested that maximizing the market value of a firm requires an effort to increase profitability by controlling the costs.

19. Since market value of a firm is negatively related to assets turnover, it indicates that firms not only generate high assets turnover but should control cost that may positively contribute for high market value.

20. As size is negatively related to market value of a firm, it indicates that larger size Nepalese firms have lower market value. It is suggested that even larger size Nepalese should enhance market value by controlling cost and increase profitability.

21. The survey results pointed out that 'situational' and 'risk avoiding' are the popular methods for describing financing policies in Nepalese companies. It seems that chosen financing policies are not supportive to generate reasonable profit by the Nepalese companies because without 'risk accepting' profit may not be enhanced. Thus, 'risk accepting' which is less emphasized by companies, should be followed as the appropriate methods for describing financing policies in Nepalese companies.

22. Since tax issues have a major influence on financing decisions in Nepalese firms. As interest expense is tax deductible expense, Nepalese firms are suggested to use optimal level of debt that provides positive tax benefit to their firms.

23. Nepalese firms do not follow a policy of maintaining spare debt capacity. It indicates that they are not aware of the importance of financial planning and optimal capital structure decisions. Thus Nepalese financial executives are recommended to exercise the sound financial planning and set the optimal target debt ratio and maintain a spare debt capacity.

24. Nepalese firms mainly raised short (up to 1 year) and long (>5 years) maturity funding sources but they are not aware of the importance of the 'policy of matching assets and liabilities' which looks appropriate in respect of cost as well as refunding perspective. Thus they are suggested to follow 'policy of matching assets and liabilities' while raising debt capital.

25. Survey indicates that right share issue is less practiced in Nepalese companies. It seems that they are not aware of the importance of right share issue. Thus Nepalese firms are suggested to issue the right shares as source of equity financing.

26. Since respondents have provided affirmative answer with regard to the statement that use of an excessive amount of debt would eventually result in the market price of their firms stock in an adverse way, what becomes clear is that the use of excessive

debt is likely to reduce the share price in the market. Thus, Nepalese firms are suggested to use optimal level of debt that can maximize the market price of companies' common stock.

27. It can be seen from the analysis that by changing the capital structure composition a firm can increase its value in the market. Thus it is suggested that maximizing the wealth of shareholders requires a perfect combination of debt and equity.

28. Financing decision (i.e. capital mix decision) is one of the most important decisions of a firm because the financing decision involves decisions related to amount of financing, types of financing, financing mix and timing of financing. It is suggested that the financial manager of the firm should take right financing decision to maximize the stockholders' wealth, since the maximization of stockholders' wealth is closely related to the maximization of firm value.

29. It is recommended that firms are strongly advised to always compare the marginal benefit of using debt to the marginal costs of debt before concluding on using it in financing their operations. This is because as shown by this study, debt capital impacts positively/negatively on firm's value just like equity capital.

30. Financial leverage (debt) can significantly decreases the burden of taxes on the firm but a careful analysis is very important and mandatory to evaluate the precise level of debt financing to maximize the profitability of the business. Thus it is recommended to Nepalese practitioners for a careful analysis before issuing excessive debt capital.

Scope for future research

1. This study investigates the relationship between financing policies and its impact on firm value of Nepalese firms.

2. This study is based on the data of only one (Nepalese) market of developing economy so it cannot represent all the markets of developing economies. However, markets of developing economies have some shared features and few characteristics are unique like, regulation of the markets etc. Thus, further studies can be conducted

covering the data of other developing countries in the developing economy to obtain better result.

3. Further study can be conducted by adding industry characteristics variables and macro level variable as independent variables. Likewise more profitability proxy variables may be helpful to clarify the results of these types of studies.

4. This study includes only fifteen years data. To find consistent results, long time series data is required. Thus further studies can be conducted using data of long time series for more reliability of results.

5. This study is mainly concentrated on the financing policies of manufacturing and non-manufacturing (i.e. hotel and trading) sector of Nepal. However, it is equally important to focus on other sectors like: service, finance etc. It is suggested that the study on these sectors can also be carried out by highlighting their positions as well as practices and behaviors.

6. Future research can be conducted by comparing the financing policy and firm value of small and large firms; public and private firms actively traded and non-actively traded firms in stock exchange etc.

7.Though this study reveals that capital structure has impact on the market value of a firm but market firm value may not only dependent on the fundamental financial information of the company, there may be some qualitative factors like: decision of the management, level of good governance, investors psychology, market condition, business cycle, etc may affect firm value. Thus further study can be conducted including these factors to find out more realistic result on this issue.

8. This study is mainly concentrated on companies representing manufacturing, hotel and trading industries. There is need to conduct a study on financing policy by all industry.