IMPACT OF LONG TERM FINANCING POLICY ON FIRM VALUE OF LISTED COMPANIES IN COLOMBO STOCK EXCHANGE IN SRI LANKA

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ABSTRACT: All business from huge to small business enterprise needs proper financing policy of its long-term capital and a suitable capital structure since the finance manager is expected to maximize the wealth of owners. To achieve this objective, the financial manager has to take a number of decisions. Among these the most important decisions are the investment, financing, liquidity and dividend decisions. Value of a firm and long term financing has been the most important in financial management to maximize the wealth of owner. it is playing a vital role in the financial management in the recent years. Therefore, it is necessary to identify the impact of the long term financing policy on the value of the firm. Hence this study was undertaken with the objectives of examining the significant impact of long term financing policies on the firm value and to find out the significant relationship between long term financing and firm value of listed companies in Colombo stock exchange (CSE) in Sri Lanka over the period from year 2011 to 2015. For this study the researcher used 40 listed companies from four sectors; manufacturing, food, beverages and tobacco, Hotels and travels and plantation in CSE in Sri Lanka. Price earnings ratio was used as a dependent variable and long term debt to equity ratio used as independent variables. The data were analyzed and hypotheses were tested through correlation and regression analysis by using SPSS (Version 20). The findings revealed that 16.2% of the firm's value is explained by the given independent variable of long term financing policy and the remaining 83.8% of the variance is explained by the other factors which are out of the scope of this study. Further findings revealed that long term financing policy has a significant impact on the firm value and also long term debt to equity ratio has a high significant positive relationship with price earnings ratio.

Keywords: Price earnings ratio, Long term debt to equity ratio, Firm value, Long term financing and wealth Maximization.

1.0 INTRODUCTION OF THE STUDY

Long-term finance planning is the basic thing that must be done by the managers who are in the finance department and policy maker of company. The main objective of long-term financial planning is to reach optimal capital structure there by maximizing owner's wealth. A company can finance the needed fund for its operations by either debt or equity or different proportion of these debt and equity sources. But there is a difficulty to determine the proportion of the equity and the debt in the optimal capital structure in order to maximize the profit, minimize the risk and the cost of capital (Sithy Safeena, 2015). However, in taking this long term financing decisions management has to focus on how would these decisions affect the value of the firm. The choice of decision among these alternatives should be the one, which leads to value maximization of the firm. Also the firm should attempt to balance the benefits of interest tax shields accruing from debt financing against various costs of bankruptcy and financial embarrassment. In general, a firm can choose among many alternative capitals structures. It can issue a large amount of debt or very little debt. However, it attempts to find the particular combination that maximizes its overall market value (Joshua Abor, 2005). To achieve this objective, all business needs proper policy of financing its long-term capital and a suitable capital structure.

The value of the firm has been observed that changes in capital structure convey information to investors, which affects the prices of shares. Generally in finance, through the utilization of debt capital, profit-making process would be accelerated since cost of debt is generally

cheaper compared to the cost of equity due to the tax-shield effect of interest on debt financing. On the other hand, the counter argument for high utilization of debt is that if a firm uses more debt in order to finance its assets without a limit, it would increase the firm risk, as interest payment for debt is compulsory. Therefore high utilization of debt would lead to lower share prices, thus having a significant influence on value of the firm. However, in taking these decisions management has to focus on how would these decisions affect the value of the firm. The choice of decision among these alternatives should be the one, which leads to value maximization of the firm. Also the firm should attempt to balance the benefits of interest tax shields accruing from debt financing against various costs of bankruptcy and financial embarrassment. Under these circumstances, it is interesting and important to observe the phenomenon practically. There are number of research on this topic but there is no valid concept to develop the optimal long term financing policy on firm value. This is to identify whether the higher utilization of debt capital leads to the higher level of profitability, thus influencing the shareholders value. Also it is interesting to observe whether this relationship is applicable to the Sri Lankan Companies.

2.0 STATEMENT OF RESEARCH PROBLEM

The previous researchers attempt to identify the impact of long term financing policy on firm value. But there are no similar findings. Some researchers found that there is no significant relationship between long term financing policy and firm's value (Achmad Saiful ulum and Perbanas Surabaya, 2013) while some researcher found that there is a significant positive correlation between long term financing policy and firms' value (Jahirul, Ashraf, & Kabir, 2014) mean time some researchers found significant negative impact between these two (Nicholas Apergis and John Sorros, 2010; Xu Lixin and Chen Lin, 2008). Further Prashanthini and Nimalathasan (2013) found that Long term financing policy positively and negatively impact on firm's value and also Velnampy and Pratheepkanth (2011) found it has a significant impact on firm's value. So there is a research gap on this topic. In this scenario the researcher has the problem whether the long term financing of listed companies has a significant impact on value of the firm in Sri Lankan context.

3.0 SIGNIFICANCE OF THE STUDY

The optimal capital structure is the capital structure that minimizes the firm's cost of capital and thereby maximizes the value of the firm. Brealey and Myers (2003) stated that the choice of capital structure is fundamentally a marketing problem and the firm can dozens of discrete securities in number of combinations, but it attempts to find the particular combination that maximizes market value.

Sri Lanka is one of the developing countries. There are twenty sectors in the CSE. Practicing capital structure models can facilitate a great contribution to all over the business firms since there is a dynamic change in the socio-economic and industrial development of Sri Lanka. So studying long term financing policies to discover and present effective long term financing policies for industry sectors is very important. Generally degree of risk, Increasing owners profit, surrendering operational control, future flexibility, general levels of business activity, levels of interest rate, level's of stock prices, tax policy on interest and dividend are affecting the capital structure (Priya, Nimalathasan & Pratheepan, 2015). Therefore this study will demonstrate how to avoid using of high risky debt capital in capital structure and control the cost of capital and advantage of corporate tax. And also this study is very important not only for the firm's level but also it significantly contributes to the nation level.

4.0 LITERATURE REVIEW

Long term financing policy is a method of financing for a business that is provided for a period of more than a year. This policy is provided to those business entities that face a shortage of capital. It can be used for the purpose of investment activities such as purchasing of installation of fixed assets, installation of machineries, large capital equipment purchases, large scale construction projects, and expansion of business or expansion of facilities. The basic sources of long term financing products depending on the business entity are from; debt, equity and derivatives (Pandey, 2010).

There are various long term sources of finance. Such as: ordinary shares, preference shares, debentures, bond, public deposits, retained earrings and loans from financial institutions. The capital structure indicates how a firm finances its overall operations using different sources of funds. It is most likely referring to a firm's debt-to equity ratio. Every firm should take effort to achieve the optimal capital structure and then to maintain it since the optimal capital structure is the one that maximizes the firm value and minimizes the cost of capital.

Edgar Norton (1991) conducted a study examining factors affecting in Long-term financing decisions. He found that differing perceptions of signaling, agency costs, tax influences arise from different in industry factors, management preferences, present capital structures, the firms' ability to internally generate funds and the firm's competitive position are affecting the Long-term financing decisions. Further they indicated that changes in capital structure often serve as a signal to outside investors about management's expectations concerning future earnings prospects for the company structures, the firms' ability to internally generate funds and the firm's competitive position.

There are numbers of studies related with long term financing and value of the firm. Modigliani and Miller (1958) argued that firm value was independent of firm capital structure, and there was no optimal capital structure for a specific firm. Consequently, as Modigliani and Miller (1963) said that firms should use as much debt capital as possible to maximize their value. Pandy (2010) said that the financing or capital structure decision is a significant managerial decision. It influences the shareholders return, risk and market value of the share.

Walaa and Andrew (2007) investigate the impact of financial structure on firm value. Empirical results show that debt to equity ratio has no impact on firm. And also Pornsit Jiraporn and Yixin Liu (2007) analyzed the relationship Capital Structure, Staggered Boards, and Firm Value. The results demonstrate no significant adverse impact on firm value due to excess leverage and these findings consistent with the findings of Walaa and Andrew (2007).

Xu Lixin and Chen Lin (2008) conducted research on the relationship between debt financing and market value of company: Empirical study of listed company in China. They used 272 real estate companies for the period of 5 years. Their findings revealed that debt financing has a negative correlation with market value of the company.

Anup and Suman Paul (2010) conducted a study on Impact of capital structure on firm's value: evidence from Bangaladesh with a sample of 77 companies during the study period of 10 years. The finding reveals that maximizing of share holder wealth requires a perfect combination of debt and equity further they suggested by changing the capital structure composition a firm can increase its value in the market.

Nicholas Apergis and John Sorros (2010) conducted study on Long-Term Debt and the Value of the firm: Evidence from International Listed Manufacturing Firms with samples of

346 listed companies during the study period of 10 years. Their findings showed that long-term debt has negative effect on the firm's value. This findings was confirmed the findings of (Xu Lixin and Chen Lin, 2008).

Achmad Saiful ulum and Perbanas Surabaya (2013) examined the influence of profitability and capital structure on firm value; a study on Manufacturing Industries Listed at Indonesia Stock Exchange, during the study period of 5 years with a sample of 505 manufacturing companies. Their result showed that capital structure has no significant impact on firm value of manufacturing industries in Indonesia stock exchange.

Further Jahirul, Ashraf & Kabir, (2014) conducted a study on the Impact of capital structure policy on value of the firm – A study on some selected corporate manufacturing firms under Dhaka stock exchange with a sample of 80 manufacturing firms, during the study period of 5 years. Their findings revealed that capital structure policy has significant influence on value of the firm.

5.0 RESEARCH QUESTIONS

Based on the above problem the researcher has the following research questions;

- Does the long term financing policy of a firm have a significant impact on value of the firm in CSE Sri Lanka?

- To what extent the long term financing policy (LTF) contribute to the value of the firm in the CSE in Sri Lanka?

- Is there any significant relationship between the long term financing and the value of the firm in CSE Sri Lanka?

6.0 OBJECTIVES OF THE STUDY

This study developed three objectives.

- To find out the significant impact of long term financing policy on value of the firm in CSE in Sri Lanka.

- To examine to what extent the long term financing policy (LTF) contribute to the value of the firm in the CSE in Sri Lanka.

- To find out the significant relationship between Long term financing and value of the firm in CSE in Sri Lanka.

7.0 METHODOLOGY

It describes research design, sampling design, data sources, variables, conceptual framework, reliability, validity and method of data analysis.

7.1 Research Design:

This research is an explanatory studies. The emphasis here is on studying a situation or a problem in order to explain the impact of long term financing on firm's value and to explain the significant relationship between independent variables (LTDER) and dependent variable (PER).

7.2 Data Sources:

For this study the researcher used secondary data which were collected from the annual reports of sample listed companies. Further some data and information have been collected from the websites of the sampled listed companies, different articles and papers.

7.3 conceptual Frameworks

Based on the research question the following conceptual model can be constructed. Conceptual model shows the relationship between long term debt to equity ratio and price to earnings ratio.

Independent Variable   Dependent Variable

Long Term Debt to Equity Ratio (LTDER)	→	Price to Earnings Ratio (PER)

Figure 1: Conceptual framework

7.4 Variables

This study attempts to identify the impact of method of long-term financing on firm's value. In order to examine the relationship between method of long term financing and value of the firm, the following two variables were developed,

Independent Variable

Long term financing considered as independent variable, which is represented by Long Term Debt to Equity ratio (LTDER). This ratio expresses the relationship between long-term capital contributions of creditors as related to that contributed by owners (investors). This can be calculated by using the following formula (Pandy, 2010)

$$\textbf{Long Term Debt to Equity Ratio} = \frac{\textbf{Total Long Term Liabilities}}{\textbf{Shareholders equity}}$$

Dependent Variable

Value of the Firm considered as Dependent variable, which is represented by Price to Earnings Ratio (PER) represent the value of the firm. The PER is the market price of a share divided by the earnings per share (Pandy, 2010).

$$\textbf{Price earnings Ratio} = \frac{\textbf{Market Value per Share}}{\textbf{Earning Per Share}}$$

7.5 Sampling design:

For conducting the study, a sample of 40 listed companies was taken representing 04 sectors of Beverage Food and Tobacco (06), Plantation (08), Hotels and Travels (08) and Manufacturing (18). The sample is not homogeneous as the companies are taken from above different industry sectors. For this the researcher used the following criteria:

- Companies which has necessary financial statement data during the study period year from 2011 to 2015.

- There were many companies, which has a Price Earnings Ratio (PER), but doesn't have long term debt to equity ratio (LTDER) due non-existence of long-term liabilities. Also it was noted that there were companies with LTDER but do not have PER due the continuous losses incurred during the study period. As both these ratios were required for the analysis, companies, which don't have above stated ratios, were excluded from the sample.

7.6 Hypotheses

Based on the above defined problem and literature review, the following hypothesis can be developed to evaluate the relationship between the method of long term financing and the value of the firm on listed companies on the CSE in Sri Lanka.

H_{a1} = There is a significant impact of long-term financing policy on firm value of listed companies on the CSE in Sri Lanka.

H_{a2} = There is a significant relationship between long-term financing (LTDER) and value of the firm (PER) of listed companies on the CSE in Sri Lanka.

7.7 Reliability and Validity:

Secondary data for the study which were collected from audited and published final accounts (i.e., income statements and balance sheets) of the sampled companies as fairly accurate and reliable. So, these collected data may be considered reliable for the study. Necessary checking and cross checking also were done while calculating the needed ratios related with independent and dependent variable from the secondary sources in order to generate validity of the data for this study. Hence, researcher satisfied with the content validity.

7.8 Techniques Used to Analyze the Data

For the analysis the researcher used linear regressions and correlation analysis using the *SPSS 20.0 version software*. Linear regression models are formed to find out the impact of capital structure on profitability. Further correlation coefficient analysis was carried out to find out the significant relationship between the depended variable and independent variables.

7.9 Model Specification

The regression model will be formulated in the following manner;

$Y_{PER} = \alpha + \boldsymbol{\beta}_{LTDER} + \varepsilon$

8.0 DATA ANALYSIS AND DISCUSSION:

Table 1: Result of descriptive Analysis

	N	Minimum	Maximum	Mean	Std. Deviation
PER	200	2.944	59.512	14.68424	9.553171

LTDER	200	.021	1.860	.25533	.318786
Valid N (list wise)	200				

Table 1 describes the descriptive statistics of variables based on the 200 observations. The average mean value represent that average values of PER. It is 14.68424 with the standard deviation of 9.553171 the minimum and maximum values of PER are 2.944 and 59.512 respectively. The mean value of LTDER is 25.533% with the standard deviation of 0.318786. The maximum value and the minimum value of LTDER are 1.860 and 0.021respectively.

Table 2: Summary result of Regressions analysis

Detail	Dependent Variable: PER			
	Value	β- value	T Value	Sig.
(Constant)		11.603	14.595	.000
LTDER		12.069	6.191	.000
R	0.403			
R^2	0.162			
Adj. R^2	0.158			
Std. Error	8.766202			
F Value	38.333			
Sig (P. Value)	0.000			

(Source: SPSS output)

Table 3 Result of Correlation Analysis

		PER	LTDER
PER	Pearson Correlation	1	.403[**]
	Sig. (2-tailed)		.000
	N	200	200
LTDER	Pearson Correlation	.403[**]	1
	Sig. (2-tailed)	.000	
	N	200	200

**. Correlation is significant at the 0.01 level (2-tailed).

Table 2 summarized the SPSS output of regression analysis. ANOVA table of this model indicate that the overall model is significant since the p-value is (0.000) which is less than the p value= 0.05, which is indicates that, the model applied can statistically predict the outcome variable of PER. Further output of model summary of the regression analysis describes the R square value of 0.162, which indicates that 16.2 percent of the observed variability in PER is explained by the independent variable of LTDER. Further finding

reveals that, other factors have 83.8 percent impact on Firm value (PER) in listed companies on the CSE in Sri Lanka. This reveals that long term financing policy has a significant impact on Firms' value of listed companies on the CSE in Sri Lanka. Therefore this study accepts the alternative hypothesis H_{a1}.

This simple linear regression equation shows that β equals to 12.069 which shows the slop of the regression line. And also p value is 0.000 which is less than 0.01. Therefore the findings revealed that LTDER has high significant impact on PER in the listed companies in the CSE in Sri Lanka. The value of "α" is 11.603. Based on the above result the researcher developed the followings regression equation model

$PER = 11.603 + 12.069 LTDER_t$

The above table - 3 shows that the relationship between dependent variable and independent variable of sampled companies in term of correlation coefficient. Correlation coefficient between PER and LTDER is 0.403 with a p-value of 0.000 which describes there is a significant positive relationship between PER and LTDER at 1% significant level since the P value is less than 0.01. The findings explain that if the LTDER increased by one percent the PER will be increased by 0.403 percent. Therefore current study accepts the alternative hypothesis H_{a2}.

Table 4: Summery of Hypothesis Testing

Hypotheses	Alternative Hypothesis	Alpha Value	Significant Value	Decision
There is a significant impact of long-term financing policy on firm value of listed companies on the CSE in Sri Lanka.	H_{a1}	0.05	0.000	Accepted
There is a significant relationship between long-term financing (LTDER) and value of the firm (PER) of listed companies in CSE in Sri Lanka.	H_{a2}	0.05	0.000	Accepted

9.0 CONCLUSIONS

The empirical findings of this study revealed that Long term financing policy has a significant impact on firms' value of listed companies in manufacturing, food and beverage, Hotels and Travels and Plantation sectors in the CSE in Sri Lanka. Moreover the result revealed that there is a significant positive relationship between long term financing policy and firm's value of listed companies in the CSE in Sri Lanka. Further 16.2% of the firm's value is explained by the given independent variable of long term financing policy and the remaining 83.8% of the variance is explained by the other factors which are out of the scope of this study. Therefore it can be suggested that the Sri Lankan debt market to find out more ways and improving in order to facilitate availability of more debt capital to the firms to improve the firm value.

Limitations and Further research

This research covers a sample of 40 listed companies from four sectors in the Colombo Stock Exchange during the five years study period. And also the variables used for the analysis are Long Term Debt to Equity ratio and Price Earnings ratio which are affected by many other quantitative factors, which are not taken into account in this analysis. (E.g. management of the company, business risk, economic conditions, government policies etc) therefore the future researcher can focus more companies listed from all the sectors on the Colombo stock exchange will have to be included as a sample. And also there is needs for further empirical studies that can help to identify the factors those determine the value of the firm in the listed companies in Sri Lanka.

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