

# **Parametric Determinants of Borrowings in Indian Hotel Industry**

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## **Abstract:-**

This paper provides an empirical examination of the determinants of borrowings in hotel companies listed on Bombay Stock Exchange. A sample of 50 hotel companies listed on BSE was studied and it is revealed that the 'company size', 'return on capital employed' and 'non-debt tax shield' are the most important determinants of total debt ratio in hotel industry in India. While the 'collateral value of assets', 'company size' and 'return on capital employed' are the most important determinants of long term debt ratio in hotel industry in India. The paper has been divided into five sections i.e. backdrop, review of literature, research methodology, results and discussions followed by conclusions.

**Key Words:** Determinants, borrowing, Hotel industry, India

importance of the hotel industry in the Indian as well as the world economy it was considered necessary to put some light on the determinants of their borrowing decision. Thus the present paper is based on the sample of hotel companies listed in Bombay Stock Exchange to study determinants of borrowings in hotel industry in India.

## **Review of literature**

Bevan, Alan and Danbolt (2000) examined the dynamics in the capital structure for UK companies from 1991 to 1997. The study observed significant changes in the relative importance of the various debt elements over time, as well as changes in the relationship between gearing and the level of growth opportunities, company size, profitability and tangibility. It found that the nature of the credit market in UK has changed significantly during the 1990s, with large companies using less bank finance, and banks increasingly lending to smaller firms. At the same time, bank debt appears to have become more closely related to corporate profitability and collateral values. Bancel, Franck and Mittoo, Usha R. (2002) explored the link between theory and practice of capital structure. Preliminary analysis of the survey shows some interesting findings. It was found that financial flexibility, credit rating and tax advantage of debt are the most important factors influencing the debt policy while the earnings per share dilution is the most important concern in issuing equity.

Sapar Rao Jijo (2002) examined the determinants of the capital structure of non-financial firms in India based on firm specific data. A comparative analysis was done for pre-liberalization and post-liberalization periods. The sample firms for pre-liberalization period (1990-1992) were 498, and for post-liberalization period (1997-1999) was 1411. It was found that tax effect and signaling effect play a role in financing decisions where as agency costs effect financing decision of big business houses and foreign firms. Size of the firm and business risk became significant factors influencing the capital structure during post-liberalization period. Datta and Majumdar (2007) explained the determinants of capital structure choice using a sample of 149 large and madcap firms from the Indian corporate

## **INTRODUCTION**

The literature on corporate capital structure, its nature and determinants, enriched over time by quite a few number of empirical studies on the subject. In the past few decades the research articles on 'The Determinants of Corporate Borrowing', in the corporate finance literature has grown steadily. Empirical research on the said issue however has been largely confined to the developed economies and received inadequate attention in developing nations primarily because of the typical third world market imperfections. However since the mid 1980s and early 1990s, the institutional setup under which firms in these countries operated underwent substantial transformation, due to the policy of liberalization and globalization, consequent to which several empirical studies on the determinants of capital structure choice in the context of developing countries in general and India in particular (Bhaduri, 2002; Mahakud and Bhole, 2003; Bhole and Mahakud, 2004; Datta and Majumdar, 2006 etc.) has emerged. However till now we find some service industries which could not attract the researchers for working on determinants of borrowings i.e hotel industry. Due to increasing

sector over the period 2002-2006 using simple regression model. It was found that tangibility, profitability, growth opportunity, group affiliation and age were among the significant determinants of capital gearing. But for growth and age, the findings of this study largely reinforce the earlier trends of revelation. Abe, Thu and Rezaul (2008) examined the importance of firm-specific and country-specific factors in the leverage choice of firms from 42 countries around the world. It was found that firm-specific determinants of leverage differ across countries, while prior studies implicitly assume equal impact of these determinants. It was also found that there is an indirect impact of country-specific factors on determinants of leverage.

Akhtar and Oliver (2009) examined whether there are systematic differences in standard leverage determinants for a sample of Japanese multinational (MNCs) and domestic corporations (DCs). The study found that on a univariate basis Japanese MNCs differ significantly on most variables relative to Japanese DCs. These variables include leverage, age, and collateral value of assets, free cash flows, foreign exchange risks, growth, non-debt tax shields, political risks, profitability and size. Business risks are not found to be significantly different between the two groups of organizations. When modeling capital structure and the determinants of capital structure we find that Japanese multinationals have significantly less leverage than Japanese DCs, and that multinationality is an important aspect of leverage for Japanese firms. Balboa, Marina, Marti, Jose and Tresierra, Alvaro, (2009) examined the capital structure determinants of VC-backed firms prior to the VC investment event. This study brought out that the structure of assets, size and growth opportunities have a positive impact on the debt ratio, whereas profitability had a negative impact. Conversely, it was found that only the structure of assets is positively related to the leverage ratio in non-VC-backed firms. Overall, there was stronger evidence on the Pecking Order Theory for VC-backed firms. Chikolwa (2009) examined the determinants of capital structure in 34 Australia's listed property trusts (A-REITs) for the period 2003-2008. It was found that profitability, growth opportunity, and operational risk are negatively related to leverage while size is positively related. Tangibility is found to be insignificant and property sector effects are inconsistent in various models.

Datta and Agarwal (2009) studied the determinants of capital structure in Indian scenario to verify whether any of the theories i.e. Trade-off theory, Agency Cost theory and Pecking-Order theory can characterize the Indian corporate financing. An empirical analysis of the capital financing pattern of 76 Indian firms has been done for the period 2003-2007, the period of

unprecedented growth of Indian economy. The results of this study indicate that pecking-order theory has emerged as a major feature of corporate capital structure. Some other determinants, however, have patterns of influences that match with the postulates of other two theories.

Majumdar (2009) studied the determinants of long term borrowing of Indian group affiliated manufacturing firms. It was found that tangibility and profitability does not provide any such evidence, findings especially in the context of firm size and its effect on long term borrowing indicate a major area of deviation. Similarly findings in the context of growth, uniqueness and alternative tax shield allow credence to existence of internal capital markets. Qigui, and Tian, (2009) analyzed the most recent financial panel data of Chinese listed firms, and conduct an empirical research on determinants of capital structure of Chinese SMEs, by comparing with the results from LSEs in Chinese capital market. The results suggest that there is a great difference between determinants of capital structure of SMEs and LSEs. Compared to LSEs, "size discrimination", pecking order theory, tax shield effect were found significant factors on the other hand the negative relationship between state subsidy and capital structure was found only in case of Small-sized firms.

## Research Methodology

### *Objectives of the Study*

The objective of this paper is to empirically analyse the various parametric determinants of borrowings in hotel industry in India.

*Hypothesis:* For the purpose to achieve the above objective the following hypothesis were established and examined for their validity:-

1. The levels of total debt and long term debt components in hotel industry are negatively related to company size, level of profitability, earning risk and non-debt tax shields ;
2. The levels of total debt and long term debt components in hotel industry are positively related to the level of growth opportunities, capital intensity and collateral value of assets.

### *Selection of Sample*

In order to comment on the determinants of borrowings in 'Indian Hotel Industry' in the perspective of the Indian economy, it is desirable to take into consideration all those companies which have significant market share. Keeping in mind this requirement it was decided to select top hotel companies on the basis of average sales, out of those which are listed on the Bombay Stock Exchange. Initially all the 61 companies of hotel industry, which were listed in BSE were selected. In the second stage on the basis of average sales top

50 companies were selected out of the above 61 listed companies. Those companies were also dropped, whose data were not available for any of the years of our study. Finally we were left with 50 companies to carry our study. The study covered a period from 2003 to 2009. The source of data was CMIE Prowess data base.

#### *Tools used for analysis of data*

The data collected from secondary sources was edited, classified and tabulated. The data so tabulated was analyzed with the help of statistical tools and techniques including, multiple regression model, ANOVA (F) and t-test.

**Multiple Regressions Model:** To establish the relationship between total debt ratio/ long term debt ratio and various other important theoretical determinants of borrowings Multiple Regression Model have been used. The total debt ratio/ log term debt ratio have been used as dependent variables and the variables such as Return on Capital Employed (ROCE), Company Size (Measured by Total Assets), Growth Opportunity (measured by annual Growth in Total Sales), Collateral Value of Assets, Capital Intensity, Earning Risk (measured by Interest Coverage Ratio and Non-Debt Tax shield were used as independent variables. Mathematically the model can be expressed in form of the following two equations:

$$TDR_{it} = \alpha + \beta_1 ROCE_{it} + \beta_2 CS_{it} + \beta_3 GTS_{it} + \beta_4 GFATARAT_{it} + \beta_5 ICR_{it} + \beta_6 NDTAXS_{it} + \beta_7 CV_{it} + \epsilon$$

$$And LTDR_{it} = \alpha + \beta_1 ROCE_{it} + \beta_2 CS_{it} + \beta_3 GTS_{it} + \beta_4 GFATARAT_{it} + \beta_5 ICR_{it} + \beta_6 NDTAXS_{it} + \beta_7 CV_{it} + \epsilon$$

Where:

$TDR_{it}$  = Average Total Debt Ratio in the time period t

$LTDR_{it}$  = Average Long term Debt Ratio in the time period t

$ROCE_{it}$  = Average Return on Capital Employed in the time period t

$CS_{it}$  = Average Company size in the time period t

$GTS_{it}$  = Average Growth in total Sales in the time period t

$GFATARAT_{it}$  = Average ratio of Growth fixed assets to total assets in the time period t

$ICR_{it}$  = Average interest coverage ratio in the time period t

$NDTAXS_{it}$  = Average Non- debt tax shield in the time period t

$CV_{it}$  = Average Collateral value of Assets in the time period t

$\epsilon$  = Error term

#### **Concepts and Definition of terms used:**

#### *Dependent variables*

In the literature the term “Leverage” can be interpreted in different ways. The specific choice of the term leverage depends on the objective of the research. In the present paper the two important measure of leverage the ratio of total debt and long term debt ratio was used. Total debt include all secured and unsecured loans and net total assets are the total assets excluding all the fictitious assets and revaluation reserves and debit balance of profit and loss account. As the market value of debt is dependent on so many exogenous factors, which are outside the control of an organization, book value better reflects the true value of the firm’s leverage. So, we take book value of debt as well as of net total assets. These variables were calculated by using the following formulas:

$$\text{Total Debt Ratio (TDRATIO)} = \frac{\text{Total Debt}}{\text{Net Total Assets}}$$

$$\text{Long Term Debt Ratio (LTDRATIO)} = \frac{\text{Long Term Debt}}{\text{Book Value of Equity}}$$

#### **Independent Variables**

**Non-debt tax shields (NDTS):** Tax based theory suggests that the major benefit of using debt financing is corporate tax deduction. The tax effects on financing decisions are examined following the non-debt tax shields argument of DeAngelo and Masulis (1980). They argue that firms can use other non-interest item such as depreciation, tax credit, and pension funds to reduce corporate tax payments. Therefore, firms that have higher non-debt tax shields are likely to use less debt. Let PBIT be the profit before interest and taxes, IP the interest payable, T the taxes paid, t the tax rate in the relevant year, PBT the profit before tax and NDTS the non-debt tax shields. Then the taxes paid are calculated as:

$$T = t (PBIT - IP - NDTS)$$

This implies,

$$NDTS = PBIT - IP - (T/t) = PBT - (T/t)$$

When scaled down to total assets,

$$NDTS = [PBT - (T/t)] / \text{total assets}$$

Where ‘t’ is maximum marginal tax rate applicable to a firm in the particular ownership group (depending upon whether the firm is a domestic company or a foreign company) as per the Finance Act of the relevant year.

**Company Size (CS):** Theoretically the relation between size and leverage is not clear. The relationship depends on what is proxy of size.

Many studies argue that larger firms tend to be more diversified and hence are less likely to go bankrupt. That is firm size can serve as an inverse proxy for unobservable credit risk. Further Fama and Jensen (1983) argue that larger firms tend to provide more information to lenders than smaller firms. Therefore, the monitoring cost should be lesser for larger firms. These arguments predict a positive relationship however, size may be inversely related to the level of information asymmetries between inside and outside investors (Rajan and Zingales, 1995). If this is the case then the larger firms may favor equity financing, which implies negative relationship. The measure of a firm's size used in this study is the total assets and negative relationship is postulated.

**Profitability (ROCE):** A common measure of firm profitability is Return on Capital Employed (ROCE). Neither the financial theory nor a research has been able to provide satisfactory agreement as to how profitability affects the capital structure of the firm. Some researchers suggested that firms prefer retained earnings to debt financing and they prefer debt to new equity. While classical finance theory suggests that profitable firms should have higher debt levels than less profitable firms and a firm with high rate of earnings would maintain a relatively lower debt level because of its ability to finance itself from internally generated funds. This is consistent with the proposition that the management of firms desires flexibility and freedom from excessive restrictions often associated with debt covenants. The trade-off and pecking order theories diverge on the relationship between leverage and profitability. According to the trade-off theory, high profitability will increase tax shields and create an incentive for higher leverage. On the other hand, the pecking order theory posits that companies will use internal financing before external sources. Following Myers and Majluf (1984), a negative relationship between profitability and leverage is postulated in the present paper. The return on capital employed was calculated by using the following formula

$$\text{Return on Capital Employed (ROCE)} = \frac{PBDIT}{\text{Net worth} + \text{long term debt}}$$

**Growth Opportunities (GTS):** Previous studies have contradicted on the influence of growth opportunities on leverage. According to the trade-off theory, firms with a higher proportion of their market value accounted by growth opportunity will have lower debt capacity because in the case of bankruptcy the value of these opportunities is close to zero. Thus as per trade-off theory there is a negative relationship between growth opportunities and leverage. The reason is that the firms have

stronger incentives to avoid underinvestment and asset substitution that can arise from agency conflicts between stockholders and bondholders with greater growth opportunities. On the contrary, past empirical studies like Titman and Weasels (1988), Rajan and Zingales (1995) have reported positive relationship between leverage and growth opportunities. The pecking-order theory also supports this relationship. Thus in the present study annual growth in total sales has been taken as measure of growth and hypothesis of positive relationship between leverage and growth is postulated.

**Collateral Value of Assets (CV):** Most of the capital structure theories suggest that the type of assets owned by a firm in some way affects its capital structure choice. Issuing debt secured by assets with known values also avoids higher interest costs. For this reason, firms with assets that can be used as collateral may be expected to issue more long-term debt and hence total debt to take benefit of this opportunity. So in the present paper it is hypothesized that collateral value of assets is positively related to total debt and long term debt. The collateral value of assets was calculated by using the following formula:

$$\text{Collateral value of Assets (CV)} = \frac{\text{Accounts receivable} + \text{Inventory} + \text{Net fixed assets}}{\text{Total Assets}}$$

**Earning Risk (ICR):** Some researchers had argued in the past literature that a firm's optimal debt level is a decreasing function of the volatility in its earnings. The logic behind that higher the earnings variation implies higher bankruptcy risk, especially to creditors. Thus it was assumed that firm's earning risk will have a negative relationship to debt levels. In the present paper the ratio of operating income to interest expenses (Interest coverage ratio), was used as measure operating risk.

**Capital Intensity (GFARAT):** Increase in Capital intensity or employment of fixed assets implies increased risk of future earnings variations. Therefore the top management's desire to retain control of the firm, and the concern of creditors to limit risk of default, should result in lower debt levels for firms choosing automation over labor as the primary factor of production. On the other hand the traditional argument is the more capital intensive a firm is larger will be the need for long term debt by the firm due to larger financial requirements and it will also have access to assets which could be collateralized. So, it can be

assumed that capital intensity to be negatively related to short term debt and positively related to long term debt. This was calculated by using the following formula:

$$\text{(GFATARAT)} = \frac{\text{Gross Fixed Assets to Total Assets}}{\text{Total Assets}}$$

### Results and Discussion:

The results of regression for long term debt ratio as shown in the table 1 revealed that 'collateral value of assets', 'size of the firm' and 'return on capital employed' are the most important determinants of long term debt in the industry. The value of regression coefficients of these variables are seen as highest for most of the years. The value of regression coefficient of collateral value has positive sign during most of the years and found statistically significant. This suggests that the results of collateral value of assets, supports our hypothesis. The value of regression coefficient of company size has positive sign during most of the years and found statistically significant for four years out of seven years studied. This suggests that the results of company size showed contrary results to our hypothesis. It means larger firms tend to issue more debt than smaller ones. Similarly, the value of regression coefficient of return on capital employed has negative sign during most of the years. This suggests that return on capital employed supports our hypothesis. The value of regression coefficient of growth rate has positive sign during most of the years studied. This indicates that there

is a positive relationship between growth rate and long term debt ratio, which supports our hypothesis. The value of regression coefficients of capital intensity and earning risk has negative signs during most of the years studied. This indicates that there is a negative relationship between long term debt equity and these variables, which supports the hypothesis. Similarly the regression coefficient of non-debt tax shield has positive values during most of the years under study. The above analysis is also supported by the value of coefficients of determinants  $r^2$  which ranges between 0.34 and 0.57. This indicates that the independent variables have been causing more than fifty per cent of the variation in dependent variable. The F values also indicate that independent variables are the important determinants of long term debt. Hence, it can be concluded that all exploratory variables have significant influence on dependent variable i.e. borrowings.

Table 2 displays the analysis of regression results for total debt ratio reveals that the 'size of the firm', 'return on capital employed' and 'non debt tax shield' are the most important determinants of total debt in the industry. The values of regression coefficients of these variables are to be the highest value for most of the years studied. The value of regression coefficient of company size has positive sign during most of the years and found statistically significant for three years out of seven years studied. This suggests that company size showed contrary results to our hypothesis.

**Table 1**  
**Determinants of long term debt Ratio in hotel industry**  
 $LTDR_{it} = \alpha + \beta_1 ROCE_{it} + \beta_2 CS_{it} + \beta_3 GTS_{it} + \beta_4 GFATARAT_{it} + \beta_5 ICR_{it} + \beta_6 NDTAXS_{it} + \beta_7 CV_{it} + \epsilon$

Year		ROC E	SIZ E	GROWTH	GFATARA T	RIS K	NDTAX S	CV	R <sup>2</sup>	ANOVA -F	Si g of F
2003	Regression Coefficients	-0.11	0.48	0.24	-0.16	0.11	-0.14	0.51			
	T-state	-0.32	2.10*	1.07	-0.63	0.44	-0.30	1.57	0.34	1.35	0.29
2004	Regression Coefficients	-0.23	0.13	0.19	-0.14	-0.10	0.91	-0.20			
	T-state	-0.45	0.46	0.88	-0.48	0.28	1.79	-0.62	0.34	1.16	0.38
2005	Regression Coefficients	-0.59	0.42	-0.11	-0.19	-0.03	0.25	0.76			
	T-state	-1.65	1.80	-0.51	-0.73	0.18	0.63	3.43*	0.43	2.16	0.08
	Regression Coefficients	0.00	0.55	0.21	-0.09	-0.12	-0.12	0.37			

	s										
2006	T-state	0.00	2.87**	1.16	-0.44	-0.45	-0.64	1.91	0.46	2.85	0.03
	Regression Coefficients	-0.34	0.54	-0.03	-0.14	0.03	0.08	0.35			
2007	T-state	-1.59	3.41*	-0.18	-0.71	0.17	0.41	2.25**	0.50	3.65	0.01
	Regression Coefficients	-0.14	0.51	0.14	-0.46	-0.16	0.10	0.27			
2008	T-state	-0.67	3.79*	0.92	2.93**	-0.74	0.68	1.90	0.57	5.14	0.00
	Regression Coefficients	-0.32	0.26	0.11	-0.14	-0.20	0.01	0.31			
2009	T-state	-1.79	1.33	0.42	-0.64	-0.84	0.07	1.78	0.37	2.14	0.07

Note: - \* & \*\* statistically significant at 5 and 10 % level respectively.

Similarly the value of regression coefficient of return on capital employed has negative sign during most of the years. This indicates that there is a negative relationship between return on capital employed and total debt ratio, which supports our hypothesis. Thus, it can be concluded that profitability of a firm is significantly and negatively related to the level of borrowings, which means that firms acted against the classical financial theory. In other words it can be inferred that firms which were most profitable either prefer retained earnings for growth or increase the equity in their capital structure.

The value of regression coefficient of collateral value has positive sign during most of the years and was found statistically significant for three years. Thus it can be inferred that the results of collateral value of assets, supports our hypothesis. The value of regression coefficient of growth rate has positive sign during most of the years studied. This indicates that there is a positive relationship

between growth rate and total debt ratio, which supports the hypothesis. Thus it can be inferred that growing firms tend to use more debt. The value of regression coefficients of capital intensity and earning risk have negative signs during most of the years studied. This suggests the results of these variables support our hypothesis. The above analysis is also supported by the value of coefficients of determinants  $r^2$  which ranges between 0.33 and 0.67. This indicates that the independent variables have been causing more than fifty five per cent of the variation in dependent variable. The F values also indicate that independent variables are the important determinants of total debt. Hence, it can be concluded that all exploratory variables have significant influence on dependent variable.

Table-2  
Determinants of total debt ratio in Indian hotel industry

$$TDR_{it} = \alpha + \beta_1 ROCE_{it} + \beta_2 CS_{it} + \beta_3 GTS_{it} + \beta_4 GFATARAT_{it} + \beta_5 ICR_{it} + \beta_6 NDTAXS_{it} + \beta_7 CV_{it} + \epsilon$$

years		ROCE	SIZE	GROWTH	GFATARAT	RISK	NDTAXS	CV	R <sup>2</sup>	ANOVA-F	Sig of F
2003	Regression Coefficients	0.460	0.462	-0.112	0.506	-0.201	-0.582	0.350	0.332	1.135	0.390
	T-state	1.251	1.887	-0.495	1.830	-0.785	-1.111	0.849			
2004	Regression Coefficients	0.70	0.57	0.19	0.35	-0.44	-0.54	0.19	0.36	1.37	0.28
	T-state	1.37	2.26**	0.93	1.27	-1.36	-1.06	0.61			
2005	Regression Coefficients	-0.48	0.82	0.42	-0.28	0.29	0.54	0.47	0.67	5.74	0.00
	T-state	-1.75	4.63*	2.65**	-1.40	2.11*	1.81	2.79*			
2006	Regression Coefficients	-0.23	0.58	0.09	-0.18	0.00	0.15	0.35	0.48	2.91	0.03
	T-state	-0.66	3.08*	0.54	-0.82	0.01	0.64	1.79			
2007	Regression Coefficients	-0.25	0.32	0.08	-0.17	-0.34	0.47	0.35	0.40	2.49	0.04
	T-state	-1.24	1.87	0.46	-0.79	-1.93	2.06**	2.16**			
2008	Regression Coefficients	-0.31	0.28	-0.14	-0.17	0.04	0.25	0.34	0.39	2.79	0.02
	T-state	-1.39	1.81	-0.89	-1.05	0.16	1.49	2.08**			
2009	Regression Coefficients	-0.21	0.24	0.26	-0.10	-0.30	-0.09	0.07	0.22	1.30	0.28
	T-state	-1.19	1.22	1.02	-0.43	-1.27	-0.52	0.40			

Note:- \* & \*\* statistically significant at 5 and 10 % level respectively.

## Conclusions

Thus on the basis of above analysis it can be concluded that the 'company size', 'return on capital employed' and 'non-debt tax shield' are the most important determinates of total debt ratio in hotel industry in India. While the 'collateral value of assets', 'company size' and 'return on capital employed' are the most important determinates of long term debt ratio in hotel industry in India. The regression coefficients of these variables have the highest value for most of the years under study. In Case of total debt ratio the value of regression coefficient of company size has positive sign during most of the years. It is found statistically significant for three years out of seven years studied. This suggests that the company size showed contrary results to our hypothesis. Similarly the value of regression coefficient of return on capital employed has negative sign during most of the years. Thus it can be inferred that the results of return on capital employed supports our hypothesis. In case of long term debt ratio the value of regression coefficient of collateral value has positive sign during most of the years and found statistically significant for three years. This indicates that the result of collateral value of assets supports our hypothesis. The value of regression coefficient of growth rate has positive sign during most of the years under study. Similarly the value

of regression coefficient of non-debt tax shield has positive sign during most of the years studied. In case of both long term and total debt ratio the value of regression coefficients of capital intensity and earning risk have negative sign during most of the years studied. This indicates that results of these variables, supports our hypothesis. The results of the present study are found consistent with the Kakani and Reddy (1998) in few aspects. Hence, it can be concluded that profitability of a firm is significantly and negatively related to the level of borrowings, which means that firms acted against the classical financial theory. In other words it can be inferred that firms which were most profitable either prefer retained earnings for growth or increase their equity in their capital structure.

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