TECHMIND RESEARCH
ISSN No. 2291-2118

International Journal of Research in Business and Technology
Volume 2 No. 2 May 2013

Leverage Decisions: A Case of Textile & Readymade Garments Industry of the Indian Corporate Sector

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Abstract-*This empirical paper attempts to study the leverage decisions of Textile & readymade garments industry of the Indian corporate sector. The study is limited to top 19 firms from Textile & readymade garments out of top 500 manufacturing firms selected on the basis of the turnover for the year 2004-2005 which covers the time span of eleven years commencing from 1995-96 to 2005-06. The study reveals that around half of the companies (47.29 percent) in this industry are in 0-100 percent capital structure range which means that these companies are using lesser amount of debt capital as compared to their own capital in their capital structure which is below the well-established standard range of 2:1 during the study period. It is found that one-third companies (33.50 percent) in this industry are in 100-200 percent capital structure range which means that these companies are using more amount of debt in their capital structure than their own capital but less than the well-established standard range of 200 percent (2:1) during the study period. Number of companies in this range is considerably more. It has been observed that around one-fifth companies (19.21 percent) in this industry are lying in more than 200 percent capital structure ranges during the study period. Such companies are using debt beyond the well-established standard range of 200 percent (2:1) during the study period. Number of companies in this range is considerably more. It is also observed that 5.42 percent companies in this industry are in 190 to 210 percent (1.90:1 to 2.10:1) capital structure ranges which are nearing to the well-established standard range of 200 percent (2:1) during the period under study. Thus, the study reveals that in this industry, around half of the companies are following low degree leverage, one-third of the companies are following moderate degree leverage and rest of the companies are following high degree leverage in their capital structure during the study period. Overall, Textile & readymade garments industry is following moderate approach of leverage in their capital structure during the study period.*

Key Words-Conservative; Liberal; Aggressive; Capital Structure

1. INTRODUCTION

The choice between debt and equity to finance a firm's assets involves a trade-off between of the company's rate of return on assets. The company has a legal binding to pay interest on debt. The rate of preference dividend is fixed, but preference dividends are paid when the company earns profits. The common shareholders are entitled to the residual income. That is, earnings after interest and taxes (less preference dividends) belong to them. The rate of equity is not fixed and depends on the dividend policy of the company." (Pandey, I. M., 2010, p 317-18). The excessive use of debt may endanger the survival of a firm, while a conservative use of debt may deprive the firm in leveraging return to equity owners. Therefore, in order to increase the advantage of debt capital and at the same time to save the firm from the financial and other risks, it is desirable to have a reasonable debt equity mix in the total capital structure. Thus, the decision regarding debt equity mix in the capital structure of a firm is of critical importance and has to be approached with a great care.

Every time when funds have to be procured, the financial manager weighs the pros and cons of various sources of finance and selects the most advantageous sources keeping in view the target capital structure. Thus, the capital structure decision is a continuous one and has to be taken whenever a firm needs additional finances. As the objective of a firm should be directed towards the maximization of the value of the firm, the capital structure, or leverage, decision should be examined from the point of view of its impact on the value of the firm. If the value of the firm can be effected by capital structure or financing decision, a firm would like to have a capital structure which maximizes the market value of the firm. So, the financial manager should plan an optimum capital structure for his company. The optimum capital structure is

obtained when the market value per share is maximum. Capital structure is the mix of debt, equity and preference securities that are used to finance a company's assets. Leverage is generally measured by the ratio called debt-equity ratio. This ratio indicates the relationship between the borrowed funds and owners' funds in the capital structure of a company.

Long-Term financing is closely linked up with the capital structure trends as reflected by the debt-equity ratio in various industries. Various all India financial institutions generally observed the debt-equity norm of 2:1 for financing the firms in private sector. Relaxation is made in certain cases e.g. in the case of capital-intensive industries like fertilizer, aluminum, petrochemical, electricity supply undertakings, steel and cement plants of the private sector, the permitted ratio is around 3:1. In the case of the shipping industry, the ratio of 6:1 or even higher is permitted. The experience in developed countries is quite fascinating. The ratio seems to have around 2:1 in Europe and U.K, and 4:1 in Japan implying very little reliance on owners' equity. However, this ratio is 1:2 in U.S.A., implying more reliance on owners' equity. Thus, the optimal capital structure should be decided ethically which will contribute to the stakeholders' wealth. It is well recognized by the government that a standard norm with regard to debt-equity ratio for all industrial units is neither desirable nor practicable as conditions differ from industry to industry and from unit to unit within industry. However, the choice between debt and equity from the point of view of shareholders as well as from the point of view of lenders is an important one and it will be useful to list the special advantages of either form of capital relative to the other.

- The greater use of debt, where the interest rate is lower than the average rate of return on the investment, increases the net return to equity shareholders.
- Higher debt does not impair the control of shareholders over the enlarged operations of the company.
- Deductibility of the interest on debt before computing profits charge to tax, as against payment of dividends out of profits after tax, implies an effective lowering of the tax rate on a company more or less in proportion to the extent to which debt is substituted for equity in the company's financing pattern.
- Debt is cheaper source of finance, cost of debt is lower than cost of preference share capital as well as equity share capital because the debt holders are the first claimants on the firm's assets at time of its liquidation. Similarly, they are the first to be paid their interest before any dividend is paid to preference and equity shareholders. Interest paid to the debt holders is an item chargeable to profits of a firm.

But, debt is riskier. It enhances the financial risk. Also, if interest and principal payments on debt are not promptly met when due, bankruptcy, loss of control for the owners may occur. It will turn out that use of some debt by the firm is desirable and a strong case can be made for the existence of an optimal capital structure, or debt/equity mix. Finally, the conclusion that some debt, but not 100 percent debt financing, is optimal will be reached by introducing various market imperfections. As far as preference share capital is concerned, it offers benefits only if the profits are available to the issuing company. Preference shareholders bear the risk being the owner of the company. At the same time, preference capital is used as a part of owners' stake for trading on equity.

The main purpose of a firm for using financial leverage is to magnify the shareholders' return under favourable economic conditions with the ultimate aim of increasing the value of each share. Value of share will increase if

i. earnings per share or return on equity capital increases at rate higher than the increase in cost of equity capital,
ii. cost of equity capital remains constant and the earnings per share or return on equity increases,
iii. cost of equity capital decreases and earnings per share or return on equity increases or remains constant.

The role of financial leverage in magnifying the return of the shareholders is based on the assumptions that the fixed charges funds such as preference share capital, debentures and term-loans can be obtained at a cost lower than the firm's rate of return on its total assets. Thus, when the difference between the earnings generated by assets financed by the fixed charges funds and costs of these funds is distributed to the shareholders, the earnings per share or return on equity capital increases. It will contribute towards shareholders' wealth if cost of equity capital increases at a lower rate. However, earnings per share or return on equity will fall if the company obtains the fixed charges funds at a cost higher than the rate of return on the firm's assets. It should be therefore clear that earnings per share, return on equity capital and cost of equity share capital are the important figures for analyzing the impact of financial leverage." (Pandey, I. M., 2010, p. 320).

The paper is organized into five sections. Section I provides the introduction about the financing pattern, leverage and capital structure. Section II deals with data source, sample size & research methodology to be followed in the study. Section III presents reports and analysis of the empirical results of the study. Section IV summarizes and concludes the study. Section V describes the suggestions & scope for further research.

2. DATA SOURCE, SAMPLE SIZE & RESEARCH METHODOLOGY

In order to examine the leverage decisions of Textile & readymade garments industry of the Indian corporate sector, the firm level panel data is taken into consideration and it is collected from the corporate data base PROWESS

maintained by the Center for Monitoring the Indian Economy (CMIE). This database contains the detailed information on the financial performance of all the public listed companies in all the segments in India, compiled from various sources such as profit and loss accounts and balance sheets, stock price data, the annual reports etc. The database also contains background information including ownership pattern, products, profit, plant location, new investment and so on for the companies. This is a reliable source of information and many researchers in India have used the data for their empirical analysis. The data used in the analysis consists of the manufacturing firms listed on the Bombay Stock Exchange (BSE). We have also restricted our analysis to firms that have no missing data continuously for eleven years. So the sample size is a function of available data. Finally, we ended up with top 19 firms from Textile & readymade garments industry of the Indian corporate sector out of the list of top 500 private sector manufacturing firms published in the Business Today, on the basis of sales turnover for the year 2004-05. So, these top 19 firms from Textile & readymade garments industry constitute sample for our empirical study. The study covers time span of eleven years commencing from 1995-96 to 2005-06.

In the present study, the ratio of total borrowings to net worth is being used for measuring the capital structure (debt–equity ratio) of a firm. Here, borrowings include all forms of debt-interest bearing or otherwise. All secured and unsecured debt is included under total borrowings. Thus, total borrowings include debt from banks (short term as well as long term) and financial institutions, inter-corporate loans, fixed deposits from public and directors, foreign loans, loan from government, etc. Funds rose from the capital market through the issue of debt instruments such as debentures (both convertible and non-convertible) and commercial paper are also included here while net worth includes equity share capital, preference share capital and reserve & surpluses minus revaluation reserves & miscellaneous expenses not written off. Preference share capital is irredeemable in nature. So, it is considered as a part of net worth. Short-term borrowings are included in the debt or total borrowings because it is observed that short-term borrowings are being used as a long-term source of finance in the Indian contest. The capital structure has been divided into thirty one ranges during the period for empirical study. Further these capital structure ranges are classified into four broader categories – i.e. 0-100 percent, 100-200 percent, 200-300 percent and more than 300 percent for analytical analysis.

3. EMPIRICAL RESULTS

Table reveals information related to companies (6.48 percent of the total number of sample companies) lying in Textile & readymade garments industry which includes 203 observations from the years 1995-96 to 2005-06 over a period under study. Capital structure wise analysis reveals that highest number of companies (8.37 percent) is in more than 300 percent capital structure range, followed by 7.88 percent of companies in 50-60 percent capital structure range, while no company is lying in 280-290 percent capital structure range during the period under study. Yearly analysis reveals that highest number of companies (22.22 percent each) is in 50-60 percent and more than 300 percent capital structure ranges in the year 2000-01. It may be noted that 47.29 percent companies are in 0-100 percent, 33.50 percent companies in 100-200 percent, 10.84 percent companies in 200-300 percent and 8.37 percent companies in more than 300 percent broadly classified capital structure ranges during the period under study. So, it has been observed that nearly half of the companies (47.29 percent) in Textile & readymade garments industry are in 0-100 percent capital structure range. It means that in this industry, such companies are following conservative approach of financing through debt. These companies are using lesser amount of debt in their capital structure as compared to even their own capital also, although it is a cheaper source of finance. Similarly, it has also been observed that one third of the companies (33.50 percent) are in 100-200 percent capital structure range. Such companies are following liberal approach of financing through debt. These companies are using more amount of debt in their capital structure than their own capital but less than the well established standard range of 200 percent (2:1). It has been observed that around one fifth of the companies (19.21 percent which means that 10.84 percent in 200-300 percent and 8.37 percent in more than 300 percent capital structure ranges) are in more than 200 percent capital structure ranges. It means that such companies are using debt freely as a source of finance. Such companies are using debt beyond the well established standard range of 200 percent (2:1). But, in this industry, only 5.42 percent companies are in 190 to 210 percent (1.90:1 to 2.10:1) capital structure range which is near to the well established standard range of 200 percent (2:1) during the study period. Under 200-300 percent capital structure range, nine sub capital structure ranges are having less than 2 percent companies, each, respectively. There is no company in any sub-range of 200-300 percent broader capital structure range during 2004-05. However, during 2000-01 and 2005-06 only a small number of companies are lying in one particular sub capital structure range. It has also been observed that there are a certain percentage of companies in highest capital structure range, i.e. more than 300 percent, in all the years study period. Overall, it is found that nearly half of the companies in Textile & readymade garments industry are using lesser amount of debt in their capital structure during the study period.

Table-%age Distribution of 19 Companies under Textile & Readymade Garments Industry

Capital Structure (%)	Year											Avg.
	1995-96	1996-97	1997-98	1998-99	1999-00	2000-01	2001-02	2002-03	2003-04	2004-05	2005-06	
00-10	5.88	0	0	0	5.26	5.56	5.26	5.26	5.26	0	5.26	3.45
10 20	0	0	5.26	0	0	0	0	0	5.26	5.26	0	1.48
20-30	0	11.11	0	11.76	0	0	10.53	5.26	0	0	0	3.45
30-40	11.76	0	5.26	0	10.53	5.56	5.26	10.53	5.26	5.26	5.26	5.91
40-50	5.88	16.67	5.26	11.76	5.26	0	5.26	0	10.53	10.53	0	6.40
50-60	0	5.56	10.53	0	0	**22.22**	10.53	15.79	0	5.26	15.79	7.88
60-70	11.76	0	0	0	5.26	5.56	0	10.53	5.26	5.26	10.53	4.93
70-80	0	0	0	5.88	0	5.56	5.26	0	15.79	5.26	0	3.45
80-90	5.88	0	5.26	11.76	5.26	5.56	0	5.26	0	10.53	0	4.43
90-100	0	11.11	5.26	5.88	10.53	0	5.26	5.26	15.79	5.26	0	5.91
100-110	11.76	0	10.53	0	5.26	0	10.53	5.26	5.26	10.53	10.53	6.40
110-120	0	11.11	0	5.88	5.26	0	5.26	5.26	5.26	0	15.79	4.93
120-130	0	11.11	5.26	0	5.26	5.56	10.53	10.53	0	5.26	0	4.93
130-140	5.88	0	10.53	0	0	5.56	0	0	0	5.26	0	2.46
140-150	0	0	5.26	0	5.26	0	0	0	5.26	10.53	15.79	3.94
150-160	0	0	0	0	0	0	0	0	5.26	0	5.26	0.99
160-170	0	5.56	0	17.65	0	0	0	0	0	5.26	0	2.46
170-180	5.88	0	5.26	0	0	0	5.26	0	0	0	0	1.48
180-190	5.88	0	0	0	5.26	0	5.26	0	0	0	0	1.48
190-200	**11.76**	**11.11**	**0**	**5.88**	**0**	**11.11**	**0**	**0**	**0**	**5.26**	**5.26**	**4.43**
200-210	**0**	**0**	**0**	**0**	**5.26**	**0**	**0**	**0**	**5.26**	**0**	**0**	**0.99**
210-220	0	0	0	0	5.26	0	0	5.26	0	0	0	0.99
220-230	0	5.56	0	5.88	0	5.56	0	0	5.26	0	0	1.97
230-240	0	0	0	0	5.26	0	5.26	0	0	0	0	0.99
240-250	0	0	5.26	5.88	0	0	0	5.26	0	0	5.26	1.97
250-260	5.88	5.56	10.53	0	0	0	0	5.26	0	0	0	2.46
260-270	0	0	0	0	0	0	5.26	0	0	0	0	0.49
270-280	5.88	0	0	0	0	0	0	0	0	0	0	0.49
280-290	0	0	0	0	0	0	0	0	0	0	0	0
290-300	0	0	5.26	0	0	0	0	0	0	0	0	0.49
>300	5.88	5.56	5.26	11.76	15.79	**22.22**	5.26	5.26	5.26	5.26	5.26	**8.37**
Total %	100	100	100	100	100	100	100	100	100	100	100	100
0-100	**41.18**	**44.44**	**36.84**	**47.06**	**42.11**	**50**	**47.37**	**57.89**	**63.16**	**52.63**	**36.84**	**47.29**
100-200	**41.18**	**38.89**	**36.84**	**29.41**	**26.32**	**22.22**	**36.84**	**21.05**	**21.05**	**42.11**	**52.63**	**33.50**
200-300	**11.76**	**11.11**	**21.05**	**11.76**	**15.79**	**5.56**	**10.53**	**15.79**	**10.53**	**0**	**5.26**	**10.84**
>300	**5.88**	**5.56**	**5.26**	**11.76**	**15.79**	**22.22**	**5.26**	**5.26**	**5.26**	**5.26**	**5.26**	**8.37**

4. SUMMARY AND CONCLUSIONS

The paper analyses the leverage decisions of Textile & readymade garments industry of the Indian corporate sector. The study is limited to top 19 firms from Textile & readymade garments industry out of the top 500 private sector manufacturing firms selected on the basis of sales turnover for the year 2004-2005, published in Business Today, which covers time span of eleven years commencing from 1995-96 to 2005-06. The following are the conclusion and findings of the leverage decisions of the top 19 firms from Textile & readymade garments industry of the Indian Corporate Sector.

1. It is found that around half of the companies (47.29 percent) in Textile & readymade garments industry are in 0-100 percent capital structure range during the period under study. So, it means that in this industry, such companies are using low degree leverage in their capital structure during the period under study. These companies are using lesser amount of debt capital as compared to their own capital in their capital structure which is below the well-established standard range of 2:1 during the study period. However, debt capital is a cheaper source of finance, thus, the use of debt may maximize the value of wealth of shareholders.
2. It is found that one-third companies (33.50 percent) in this industry are in 100-200 percent capital structure range during the period under study. So, in this industry, such companies are using moderate degree leverage in their capital structure during the period under study. So, it means that these companies are using more amount of debt in their capital structure than their own capital but less than the well-established standard range of 200 percent (2:1) during the study period.
3. It is found that the only 5.42 percent companies in this industry are in 190 to 210 percent (1.90:1 to 2.10:1) capital structure ranges which are approaching to the well-established standard range of 200 percent (2:1) during the study period.
4. It has been observed that around one-fifth companies (19.21 percent means 10.84 percent in 200-300 percent and 8.37 percent in more than 300 percent capital structure ranges) are lying in more than 200 percent capital structure ranges during the study period. Thus, in this financing pattern, such companies are using debt freely as a source of finance during the study period. Such companies are using debt beyond the well-established standard range of 200 percent (2:1) during the study period. However, the number of companies in these capital structure ranges is considerably more representing high degree leverage.

To sum up, the study reveals that in this industry, around half of the companies are using low degree leverage, one-third of the companies are using moderate degree leverage and rest of the companies are using high degree leverage in their capital structure during the study period. Thus, Textile & readymade garments industry is following moderate approach of leverage in their capital structure during the study period.

5. SUGGESTIONS & SCOPE FOR FURTHER RESEARCH

Debt and equity are the backbone of the business world. Equilibrium is needed between them in order to maximize the value of a firm consequently the wealth of shareholders. In the present study, mixed response of financing through debt in all the firms of Textile & readymade garments industry of the Indian Corporate Sector is observed. Thus, Textile & readymade garments industry is following moderate approach of leverage in their capital structure during the study period. Further research can be carried out for finding out the factors which are responsible for such financing behaviour of firms of these industries of the Indian corporate sector in planning their capital structure. So, a financial manager should consider a number of factors to set an optimal capital structure for a firm giving considerable weight to earning rate, collateral value of assets, age, cash flow coverage ratio, non-debt tax shield, size (net sales), dividend payout ratio, debt service ratio, cost of borrowing, corporate tax rate, current ratio, growth rate, operating leverage and uniqueness (selling cost/sales) etc. India is blended with full of laws. There is no need to create new laws. The need is to change mind set of the Indians. Thus, there is a need of developing such an ethical culture in the corporate sector which is to be based upon the teachings of ancient Indian Wisdoms which will develop the capital market to the fullest extent with the fullest faith and will lead to contribute to the wealth of shareholders.

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