Impact of Capital Structure on Stock Return in Oil & Gas Sector of Pakistan

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Abstract
The given study investigates the influence of capital structure on the stock return in the context of oil and gas segment of Pakistan. For this purpose the analysis is conducted on 10 oil and gas companies operating in Pakistan on the basis of market capitalization over the period of 2005 to 2014. In order to inspect the impact of debt to equity and financial leverage on stock outcomes, the Correlation and regression models are used to test the results. This study has determined that the variation in capital structure does affect the stock return of oil and gas companies in Pakistan. Furthermore, Debt to equity ratio and financial leverage positively affect stock return. The Financial leverage and debt to equity positively affected the stock return and are showing significance with greater than 2 of "t" values and less than 0.05 of "p" values.
Keywords: Capital Structure, Stock Return, Debt to Equity, Financial Leverage.[1]

1. INTRODUCTION

The capital composition of an organization is a specific blend of an obligation (Debt), shareholders wealth (equity) and other different modes of funding an organization can utilize to finance its long-standing assets and development. The major partition in structure of capital is fundamentally in the middle of equity and debt obligations. The share of debt financing is calculated through ratio of leverage or gearing (Ilyas, 2008).

Ramadan and Ramadan (2015) concluded that in case of Jordan manufacturing firms, there is an inverse relationship between profitability and leverage and results were not consistent with trade off theory, indicated that Jordan manufacturing firms tend to issue more equity and make less use of debts to finance their operations. Moreover, the direct relationship between firms size and leverage was analyzed with trade off theory, indicated that the large firms make large use of debt rather than issuing equity.

There is a positive and significant relationship between the financial leverage and non-debt tax shields, R&D, industry mean average. Whereas agency cost, dividend payout ratio, tax rate, business risk and GDP growth negatively and insignificantly correlate with financial leverage component of the capital structure (Uddin, 2015).

The decisions of capital composition are influenced by theories such as trade off and packing order but the recent findings and experiential work expresses that the theory of market timing also takes special importance as executives are very impatient to take benefit from theory of market timing (Jahanzeb, 2013). According to Umar (2012), the debt and equity is one of the main financing options that most of the firms use to finance their operations. The long-standing financing of the firm is mainly through the utilization of an equity or debt obligations. The equity comprises of share premium, capital that is paid up, savings and the retained earnings whereas debt encompasses unsecured and secured debt, public and private debt, two-sided and syndicated debt of the company (David & Olorunfemi, 2010). A lot of exploration focused on the essential elements of capital breakdown yet many researches are still carrying out to figure out the variables influencing an organization's capital structure (Ilyas, 2008).

Researchers investigated the changes in leverage levels and demonstrated that they are insignificantly linked with simultaneous and future balanced returns. It is proposed that the funds produced inside may not be adequate. Therefore, debt financing may be the main choice for an organizational development and growth (Saleem et al, 2013). It has been understood that the associations offer more equity at the time of high business markets values, with respect to book & past business segment values but on the other hand they are more likely to rebuy the equity at the time of low business market value (Cai & Zhang, 2005). It has been viewed that the outcomes ensured for debt to equity are greatly persistent. Outcome, like the values of past market are solidly recognized by present structure of debt to equity. (Bakers, Malcolm & Wurgler, 2002). A structure of capital is a blend of a company's liabilities and equity. The plans of the capital structure are the critical part of business, and assumed as an essential part in firms' survival, execution, and advancement. Dimitrov & Jain (2005) clarify that there is an inconsequential connection between leverage and the return of stocks.

It has been discussed that the current presupposition of capital compositions instigated with the key findings of Modigliani & Miller (1958). They communicates that the valuation of the company is free from its business funding decisions in particular circumstances. Really, Modigliani and Miller pointed out that the structure of capital hypotheses must take in what circumstances the structure of capital is superfluous (Harris & Raviv, 1991). Titman (2001) summaries few real circumstances that create the Modigliani and Miller suggestion

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hold: No Distortional cost (Taxes), No Operational cost, No cost of Bankruptcy, Perfect assumptions of contracting, and Ideal and Absolute Market Assumptions

Cai & Zhang (2005) grasp that organizations offer excess of equity at time of high business markets, concerning book and past values of business market, at time of low business market value they rebuy the equity. It has been noticed that the following results for debt to equity is extremely persisting. An outcome, like past market values are generally discovered by current debt to equity framework (Dough puncher, Malcolm & Wurgler, 2002). Corridor et al., (2001) portrayed outcome seeing as advantages after the deductions connected with book estimation of capital while a pointer for debt.

An outcome possesses the insignificance of leverage with an income through the stocks. There are various proxies that have been to explain the structure of capital with the view that they are correlated with omitted dynamics created by stock price changes (Welch, 2004).) It has also been observed that there is an insignificant link between leverage and stock outcomes (Dimitrov & Jain, 2005).

A new theory which is called market timing theory has been recently generated. Market timing is important to determine the companies' performance during proper financial structure (Baker & Wurgler, 2002). The theory states the market condition, perceptions and risk factors. It also suggests that when there is low cost of equity, companies offers equity or otherwise debt. The theory of market timing theory states that the managers need to be patient till the market conditions get better and shares give high return before equity issues and that prior to issue firms improve their performance (Miglo, 2010).

The signaling theory has also great importance because it suggests firms financing strategy in which high quality firms prefer to facilitate their capital by sending diverse signals to potential lenders. The potential lenders to farm businesses preferably issue loans to those farms that are having greater size, good prior record of income and profitability (Zhao, Katchova & Barry, 2004). Frank & Goya (2005) have recognized the differences in financing choices amongst firms such as private, small and large public firms. The Private firm is more likely to use income through retained earnings and debt from banks. Smaller public entities can make a use of equity financing whereas the bigger ones seem to use retained income and corporate bonds.

Many previous researches on capital structure were conducted on textile, cement other industries with the major emphasis on financial functionality. Whereas the given study investigates the influence of capital composition on return of company's stock in the sector of oil and gas in Pakistan. Many authors have examined determinants associated with capital structure by mainly focusing on size, development or growth, change in income, tax obligations, profitability, liquidity, ownership structure of companies whereas the current research sort out the association between capital composition and return on stock by taking into account the debt to equity and financial leverage. In the past studies, the time and size of sample selected was dissimilar while this study has considered past ten years data of ten companies in the oil and gas segment of Pakistan.

The main problem which is facing by the companies is to determine the optimal proportion of debt and equity. According to MM theory, which recognized the benefits of tax shield because debt may reduce the tax liability, but when companies are funded with the greater proportion of debt may decrease the shareholders wealth as they have to pay interest payments. Moreover the financing through greater proportion of debt may leads to bankruptcy risks due to high gearing or leverage ratios. Whereas if company decides to fund its operations with shareholders equity only may have to pay large amount of taxes due to an absence of interest payments and increase in net income.

The scope of this research is to examine consequence of capital composition upon stock return of 10 selected oil and gas companies. Furthermore, this study also investigate how firms in the sector of oil and gas can raise capital for the purpose of investments, both externally or internally and also investigate that if firms borrow new debt or offer new equity or mix of equity and debt then how it will affect the firm's return on stock.

The major objectives of the given study are to examine the technique firms breakdown their structure of capital. To look at the connection between composition of capital and return through stocks. To give direction to the financial specialist to put resources and invest in Pakistan oil and gas sector. To study the influence of debt to equity and financial leverage ratio on the stock return of a specific oil and gas firms.

2. LITERATURE REVIEW

Different organizations have different capital structure that is suitable for them. The basic goal of every organization is to increase the firm's value and its share price by minimizing the cost of capital. The adverse between debt to equity and return of a company was observed in Australia; Moreover, debt to equity ratio is negatively associated with the return of oil and gas companies. (Tahmoorespour, abbar & randajbaran, 2015). There is an inverse relationship between financial flexibility and dividend payout ratio, firm's financial leverage and its cash balance. It has also been investigated that if firm put more value to its financial flexibility will tend to have lower dividend payout. Moreover, the payment of dividend by preferring stock redemption has lower leverage ratios and more accumulated cash (Rahimi & Mosavi, 2016). The firm's market value is measured through value of stock of the company and debt in the market (Warusawitharana, 2014). It has been examined that the companies having less debt have more value in comparison to those companies with higher debt and these companies can also raise their value by preferring low portion of debt or almost zero debt (Psillaki & Daskalakis, 2009). There is a difference in the decision of capital structure between firms such as public and private firms. The firms which are private rely additionally on debt financing as compared to public firms (Brav, 2009). The decision and choice of capital structure may differ from country to country as well as from industry to industry (Muzir, 2011). Most of the studies get evaluated the actual theories of capital structure and they have identified that only few of the theories get much advocacy (Frank & Goyal, 2009).

Firm's choices of capital arrangement and their sources of funding are essential in order to investigate how in underdeveloped nations the actual company's activities are financed (Joshua, 2008). Myer (1984) argue that firms are more likely to prefer internal financing as compared to external financing. According to pecking order theory of capital structure, it is concluded that the managers first choose retained earning then obligations in the form of debt and lastly equity to finance the company's operations.

Another decision which can be given importance aside from capital structure are such as project financing, policies regarding dividends, extended securities matters, finance related with mergers and also buyout. The key objectives of the financial managers are to maximize the shareholders' wealth by decreasing cost. The ideal composition of capital is accomplished at the point where capital cost comes to the minimal level (Shah & khan, 2007).

The theory of trade off (Modigliani and Miller, 1958; Scot, 1976) found that the companies with increased volatility confront higher chances of financial distress; therefore they should use low debt. It has also been found that volatility of stock return have unique information about future profitability. Generally, the firms with increased volatility reduce the future growth of earning (Chen, Wang & Zhou, 2014). Hussain & Sana (2011) examined the association between capital structure and stock prices and they found that it is an insignificant and negative association between capital structure and stock prices in case of cement sector of Pakistan.

Researchers have worked on findings and they have also formulated and tested the impact regarding capital makeup. There are many issues which are faced by the researchers while finding the suited variables for the capital composition Guad et al., (2005). The financing decisions put effect on capital composition, company's governance and their developments at micro level. (Green, Murinde & Suppakitjarak, 2002). The information related to capital structure can be gained from the financial institutions having similar operations in developed economies (Booth et al, 2001). It is important to understand that every country has difference in their setups, mainly with regards to their taxes and bankruptcy system, existing market and the impact or role of bank and securities.

In international market, the taxation on subsidiary and parent organizations of multinationals has an impact on the overall cost of equity and debt. In parent country, the dividends are again paid through corporate income after tax, but in parent countries double tax relief and non-resident withhold tax are not taken into account therefore the equity tax cost reflects the double tax relief and actual tax rates mainly followed by the parent countries (Huizinga, Laeven & Nicodème, 2006).

Capital compositions have direct impact on return from stock. Exploration illustrates that returns from stock have an influence on entire financial performance associated of the company. (Bhandari, 1988). Company's financial performance is specifically discovered with progressions with share price. In this new era, companies competently manage the lowest statistics of financial statements in order to report stable income for each single one of share and consequently return from stock (Hass, 2002). The market value that is linked with stocks determines the shareholder's wealth if the value of stocks in the market is greater than its face value (Chowdhury & Chowdhury, 2010). In the event when debt ratio progressions come about with a similar proportion in their returns, capital structure and stock returns stay adjusted (Corridor, 2001). Omidvar & Nodehi (2015) have also concluded that there is a significant association between the ratio of debt to equity and return on stock, market share and revenue maximization.

Wajid (2012) investigated the relationship between stock return and various important components of capital structure. For this purpose, the data of 69 textile companies were collected and by using ordinary square least model he concluded that the debt to equity proportion, ratio of return on shareholders' value, earning per share, the ratio of cash flows, and the time interest earned ratio have positive connection with return from the stock of the companies.

Debt is considered as one of major source of financial risk. Therefore, the investors who are rational and risk averse should claim a leverage premium that shows an expected significant relationship between return from stocks and company's leverage (Muthukumaran, 2012). Aydemir, Gallmeyer & Hollifield (2007) studied the influence of financial leverage on both market & firm level where company is exposed to unsystematic risk of the market. They concluded that when there is a constant rate of interest and risk price in the economy, financial leverage creates little variations in the volatility of stock return at market level and remain significant at the firm level. The variations also remain significant with variations in interest rates and risk price in the economy.

Financial Leverage & Stock Return

A financial leverage is a gauge of how much a business depends on debt in order to operate or we can say that leverage is a financial effect which cannot be obtained cogently (Lewis, 2002). There is a moderate relationship between leverage and performance (Simerly & Li, 2000). The Leverage also use to quantify the solvency of the company in terms of financial and to see how it manages its borrowings. When the credit rating is lower there is a high leverage (Mittoo & Zang, 2010). The leverage sometime shows a negative effect (Dang, 2011).

Welch (2004) investigated the instigated changes in capital structure when firms neutralize the stock return. His findings details that companies do little to become enable to reorganize their particular debt proportions for the influence of stock return growth. A positive and significant link flanked by leverage and return from stock is exceptional to usefulness, a class of risk that is very much regulated and highly concentrated to ratio of leverage (Muradoglu & Sivaprasad, 2012). The central benefit of debt is the cash savings that can be obtained through that tax-deductible of interest payments. The benefits of tax shields are non-altered via the market worth of money owing once it is offered (Banerjee, Heshmati & Wihlborg, 2000).

The leverage checks are attempted in the aid of Fama & French (1993) variables just like size, Bond-market factors, market to-book & surplus earnings of trade areas. Muradoglu & Sivaprasad (2008) explained the leverage to represent stock portfolios that detention the actual difference in stock yield enhanced in relation to several other resources pricing types. David & Olorunfemi (2010) conducted study to analyze the association between leverage and corporate performance of petroleum industry in Nigeria through analysis of panel data by means of fixed effect estimation. They established a positive and significant relationship among earning per share, leverage proportion and per share dividend was also positively related with leverage ratio.

Booth (2001) investigated capital combine alternative, specifically either employing obligation or shareholders wealth pertaining to put money into the companies in developing nations. Intended to achieve this intention statistics of 10 companies was considered and analyzed which designate that the wealth composition variables are related and pertinent to the mounting underdeveloped countries. The outcome also conveys that there will be a lower debt ratio if the company is more profitable. Furthermore, the external financing is expensive and evaded by the companies.

The worth of the enterprise securities measures the worth of corporation productive assets. The cost of ownership is the price that is certainly cut off through the expenditures. A regular kind of modification cost authorizes reduction of cost of ownership. Details from the US companies in recent years concludes that the there is a great deal of indefinable finances, mainly in preceding years (Corridor, 2001). It can also be concluded that a specific firm's structure of capital exhibit excellent properties which might not be normally apparent in combined dissection for many divisions (Shah & Hijazi, 2005).

The decision of debt to equity choices reflects the exchange between duty reductions of obligations, financial distress (Insolvency), and organizational cost. The interactions among financing and production decision affects the stationary allocation of firms and also their chances of existence (Miao, 2005). When progressions of debt ratio occur with identical proportions with their returns, capital composition and return from stock keep on attuned (Corridor, 2001).

Depending on the exploration carried out by Fama & French in 2000, they concluded that there are little discrepancies which are surfaced through the employ of two distinguished sizes of liability. The majority consistent investigation upon non-monetary listed enterprises throughout Pakistan had been ended by Shah, Atta & Hijazi (2004). They used the quantity of expense to compute money owing. The benefits of debt includes interest payments which are tax-deductible thereby provide savings of income. It has also been concluded that the benefits of tax shield are not modified by the market worth of the debt once it is offered (Banerjee, Heshmati & Wihlborg, 2000).

Cross-sectional researches (Hamada, 1972 & Hecht, 2002) have taken commercial organizations as an alternate intended for organizational risk. Welch (2004) examined that when firms counteract the return from stock can instigate changing in the capital structure. His findings showed that the companies do not perform very well to be able to reorganize their own proportions of obligations to impact the stock return expansions Yang (2010) investigated the data from the period of 2003 to 2005 in the Taiwan stock exchange and considering the principal objectives of explaining the components that might affect the capital arrangement and stock returns. The basic aim behind this exploration was to examine the effect of leverage ratio on the return from stock. The findings of the exploration validate the assumptions that the leverage has a major effect on return from stock & vice versa. It has also been concluded that the leverage proportion with abnormal returns are certainly insignificantly linked through investigating the connection flanked by unusual stock returns and ratio of financial leverage in Hong Kong stock exchange. (Michael, Set. Man & Wang, 2010). Drobetz and Pensa (2007) studied a sample size of 425 European companies and explained that the return through stock engage a high level of uncertainty as a consequence of various good reasons, for instance, the modification in leverage ratio is principally determined through stock return growth. The value of obligations in the form of debt is relatively unsympathetic to company's effectiveness.

Debt to Equity & Stock Return

Baker, Malcolm & Wurgler (2002) examined the United States stock exchange returns from the period of 1928 to 1997 and the analysis which was mainly concentrated around the debt and equity as prime variables to emphasis on market outcomes. Welch's (2004) found that the return from stock incorporates the key elements of debt to equity movements and where the company's decision in problem activities remains regularly unresolved.

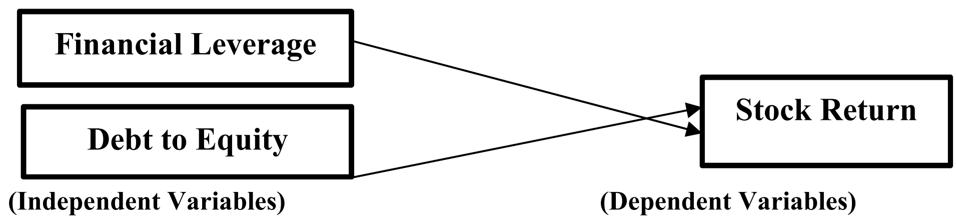
It is often realized the organizations seem to be more partial towards offering equity when their particular quantities of market values are excessive, as for book and prior market values, and rebuys equity at time when their specific market values are less. Companies' present a structure of capital is highly relevant to pervious market values. It is suggested the theory of capital structure which is based on the assumption that capital composition is an aggregate outcomes of previous attempts to equity market (Baker, Malcolm & Wurgler, 2002). In underdeveloped nations, the control on the securities prices in the capital markets along with the government led credit projects may significantly affect corporate funding arrangements (Booth et al, 2001).

Sung (2009) described an association between obligations to equity ratio and gave a chance to companies regarding savings. This particular inquiry had been done in China, which indicated that the firm in this area has a tendency to access less opportunities of investment. The choice regarding issuance of debt and equity are often shaped on the basis of risk disclosure. The blend of financing choices may distinct the transnational and domestic organization. The examination of vibrant economy shows that in a cross-section the connection between leverage and size is positive and therefore fixed cost of financing promote the relationship of the formalized size gearing. Therefore, the relationship varies the sign if we govern the presence of unleveled companies (Kurshev, Ilya & Strebulaev, 2006). The capital construction and corporate funding literature is stuffed with diverse models but few gives a complete description (Frydenberg, 2004).

Unquestionably, the debt policy is one of the important part of capital structure. The possibility of financial crisis increases due to excessive corporate that ultimately result in financial instability. There may be probability of financial distress due to leverage. Georage & Hwang (2010) found a negative relationship between stock return and book leverage. As per their studies it has been concluded that the firms that endure most (slightest) in financial distress look after low (high) leverage. In this manner, the return premium to low leverage companies is relatively high and the leverage companies give a compensation to meet the cost of financial distress. Penman et al (2007) investigated the book-to-value impact of return on stock by representing leverage.

In Pakistan, the primary thorough study concerned with the causes of capital arrangement on stock return of non-financial organizations of Pakistan was conducted by Shah & Hijazi (2004). That study was constrained to non-money related firms only and was engaged around almost six years of figures, and by updating the data the results might be advanced.

Theoretical Framework



Hypothesis Development

H_1: Financial leverage is significantly and positively correlated with stock outcomes
H1o: Financial leverage is an insignificantly correlated with stock outcomes
H_2: Debt to equity is significantly and positively correlated with stock outcomes
H2o: Debt to equity is negatively correlated with stock outcomes

3. RESEARCH METHODOLOGY

Sampling Method

The analysis of correlation and regression are used for the purpose of investigating and measuring the relationship among the predictor and dependent variables. The measurable findings are examined by using SPSS and the final results are construed in the wake of testing the hypothesis.

Population
A population considered for this research is a total of 16 oil and gas companies which are registered at stock exchanges of Pakistan.

Sample Size
To fulfill the main purpose of this research, the data will be collected from the proposed sample size of 10 oil and gas companies of Pakistan. These are:

- ✓ Pakistan state oil
- ✓ Mari Gas company
- ✓ Sui Southern Gas Company
- ✓ Pakistan oilfield limited
- ✓ Pakistan Petroleum Limited
- ✓ Pakistan Refinery Limited
- ✓ Attock Refinery Limited
- ✓ Attock Petroleum Limited
- ✓ Oil and Gas Development Company Limited
- ✓ Shell Pakistan Limited

Sampling Techniques
In this paper, the secondary data of 10 oil and gas companies are taken to explore the link between capital composition and return through stock. The sampling technique used for this purpose is simple random sampling.

4. RESULTS & DISCUSSION
Table 4.1:

Variables	Financial Leverage	Debt to Equity	Stock Return
Financial Leverage	1	.479**	.376**
Debt to Equity	.479**	1	.457**
Stock Return	.376**	.457**	1

** Correlation is significant at the 0.01 level (2 - tailed)
N=100. Stock Return = Dependent Variable. Financial Leverage and Debt to Equity = Independent Variables.

The above table shows the nature of relationship between each variable in either positive or negative form. The first independent variable that is financial leverage (FL) has a significant impact on stock return with the correlation of .376** which represents a moderate degree of positive correlation which means that returns from stock are positively influenced by financial leverage. The above relationship also shows that if financial leverage ratio is well managed can increase the stock returns. Another independent variable that is debt to equity is also showing a significant and positively correlation of .457** with stock return. By enhancing the debt to equity, stock returns will also be raised. Debt to equity ratio has more significant correlation on return from stock as compared to financial leverage.

Table 4.3

Predictors	Outcomes		
	Beta	t	p
Financial Leverage	.204	2.023	.046
Debt to Equity	.359	3.562	.001

N=100, F= 15.369, R Square = 0.241, Dependent variable = Stock Return

The above table represents the regression coefficients of the predictor variables such as financial leverage and debt to equity on the dependent variable i.e. stock return. Capital structure components such as financial leverage, debt to equity (FL & DE) have a combined impact of 0.241 on stock return which shows that an independent variables of this study only impact 24 % to measure the overall impact of capital structure on stock return which is quite less due to non-consideration of some other important variables that could be a part of capital structure and plus limited research and resources. The above table also shows that according to their combine impact 24% variables are important to determine impact of capital structure on stock return and remaining 76% can be covered by adding more variables. Financial leverage and debt to equity are showing significance with greater than 2 of "t" values and less than 0.05 of "p" values. The relative contribution of financial leverage and debt to equity is .204 and .359 respectively.

The composition of capital is basically designed to fulfill the equity shareholders interest. Instead of receiving the entire funds from shareholders, a substantial portion of long term funds can be acquired as a loan in the form of bonds, debentures any long term securities by paying interest on them. Although the payment of interest charges is taken as an expense to the company. In order to serve the purpose of identifying the impact of capital structure on stock outcomes, the components of capital structure such as financial leverage and debt to equity are considered. On the basis of financial leverage and debt to equity ratios, we can examine how the capital structure of the firm affects their stock performance. The analysis has been done in the form of correlations and regressions to test to examine the stock return of the oil and gas companies in Pakistan when they bring any changes in their capital structure decisions and policies. Moreover, the changes in the interest rates, taxes and economic conditions of the country. The correlation and regression analysis of Debt to equity was more significant as compared to financial leverage which shows that it is one of the most important variables that should be considered while studying the impact of capital structure on stock return. There are several factors that companies take into account such as cost of capital, credit rating, economic condition, investors perception, default risk, market timing etc. The above results that have been shown in this study demonstrate that the financial leverage and debt to equity ratios do positively impact on stock

5. CONCLUSION

This study has investigated the effect of capital composition on stock outcomes of oil and gas companies in Pakistan. To the extent anybody is concerned; this study is an exploratory investigation on whether the structure of capital is worth pertinent to the equity financial experts in the oil and gas sector of Pakistan or not. The discoveries of Modigliani and Miller's (1958) have been discussed into an approach of investment by measuring stock benefits for portfolios of leverage in the compound division. The outcomes have been appeared with the aim of how leverage can illuminate returns from stock. There is more likely to gain return on stock by employing resources in the companies listed in oil and gas segment with use of an optimal financial leverage. The oil and gas sector standout the most important segment of the economy. The consequences of given study gives a valuable and significant structure to financial specialists and investors who are interested to invest in the oil and gas sector of Pakistan with the purpose of obtaining stock benefits for their equity project. Furthermore, after the findings and results of this study it is also concluded that the financial leverage and debt to equity ratios are not enough to study the true perfection of impact of capital structure on stock return. There are several other variables that need to be considered while determining the capital structure impact on stock return such as ownership structure, liquidity, size, profitability etc. It is also concluded that the stock return is one of the most order determinant of debt ratio, as it is the only well understood influence of debt ratio dynamics and the main benefit of increased debt is an increase in the benefits from interest expense as it lower down the taxable income.

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