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# THE STUDY ON CAPITAL STRUCTURE FUNDING STRATEGY AGAINST THE DEVELOPMENT OF FINANCIAL PERFORMANCE OF PUBLIC LISTED COMPANIES IN CHINA

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**A B S T R A C T**

The purpose of the current study had been aimed to provide the insight on the relevance impact for the capital structure funding strategy of the business in affecting the development of the financial performance of the public listed companies in China mainly focusing on the companies listed in Shanghai Stock Exchange (SSE) and Shenzhen Stock Exchange (SZSE). The previous studies had revealed the potential expectations of the outcome in the quantitative study to observe ethe positive correlation and relationship from the capital structure financing against the financial performance of the business. Through the quantitative study method, the research framework had been translating into the statistical testing output which observe the data input of debt equity ratio as the representation of the capital structure as independent variables while the financial performance as the dependent variable for the study had been represented by the profitability ratios including the gross profit margin, net profit margin, return one equity and return on asset. The results for the research had identified only the return on equity is being impacted from the designation of the capital structure funding but not applicable for other variables. The outcome of the study had concluded major disagreement from the initial literature review which create a fresh insight inducing the potential future study to further explore the relevance focus on the scope of study into different environment and target population of the study using the similar research framework for the purpose of future research.

**K E Y W O R D S**

Capital structure, financial performance, profitability ratio, China, public listed companies

## Introduction

Capital structure strategy refers to the mix of different sources of funding that a company uses to operate and grow its business. It involves determining the right balance between debt and equity to finance operations, investments, and expansions. The importance of the capital structure had been crucial for the organization in raising the necessary funding to drive the business growth and sustainability (Adesina, Nwidobie & Adesina, 2015). Based on the designation of the capital structure strategy, the capital structure had been contributed by the funding from debt and equity which will provide the balance in the injection of the source of funding (Ajibola, Wisdom & Qudus , 2018). The contribution of the ratio and proportion of the debt and equity had been importance to draw the cost of capital which will become the finance cost translating into the required rate of return for the organization.

The fundamental in addressing the capital structure strategy had manly provide the relevance focus into the achievement of the achievement in the cost of capital optimization where the composition of the debt and equity financing for a business organization will be crucial to address the cost of financing of the business (Chadha & Sharma, 2015). This will become the benchmark for the required rate of return that will become the guideline to accept projects to achieve higher return to cover the cost of financing within the business investment (Ngoc, Tien & Thu, 2021). The preference for the debt financing could be more beneficial for the weighted average cost of capital (WACC) but results in higher risk towards financial distress while the equity financing will provide higher financial stability but will observe higher cost of financing contributing to higher WACC for the organization (Naseem et al., 2017).

Moving on, the emphasize on the importance for the capital structure had been very crucial to address the risk management for an organization. The simple observation of the risk of business can be identified through the ratio of the debt and equity financing where the higher debt proportion will indicate the higher financial risk for the business (Ngoc, Tien & Thu, 2021). This is because that the inability for the business to cover the debt incurred will be importance where the failure for the repayment for the debt will potentially results in bankruptcy for the business (Oyedokun, 2018). In addition, the higher debt ratio will put into higher gearing ratio for the organization that will create lack of confidence towards the business resulting in the risk of having lack of access in obtaining new financing or higher cost of financing due to the higher risk in the business organization (Ramli, Latan & Solovida, 2019).

In addition, the capital structure strategy will create the visibility on the flexibility and agility for the business organization to manage the financial resources. This is extremely crucial for the business as the engagement in the equity and debt financing will need to be depending in the needs of the business (Naseem et al., 2017). For instance, the sudden need of cashflow to support new projects may result in the shift towards the incremental in the debt over the equity proportion as the funding could be only utilized for a certain period of time but not resulting in the long-term where using the equity funding may result in higher commitment of the cost of financing for the business where the underutilization of the equity financing in the long-term could translate into additional burden for the business organization and lowering the profitability of the business (Kumar, Colombage & Rao, 2017).

## Problem Statement

The problem statement for the current study had been addressed with the relevance scope to understand the impact of the capital structure for business organization in affecting the profitability of the business (Naseem et al., 2017). In other words, the financial performance for the business could be highly affected based on the capital structure funding of the business where the financing through different ratio of debt and equity could be posing different outcomes in the profit and loss statement which will affect the growth and learning for the business (Hang et al., 2018). However, this myth had been very doubtful as there is no strong evidence to post the current study to be proven by the study resulting in the need for the current study to address the topic of interest. This had then led to the designation of the objective of the research which is directing the investigation to identify the potential significant in the relationship between the capital structure funding against the profitability ratios of the business organizations.

## Literature Review

Gross margin reflected the company's ability to achieve a higher profit margin based on comparing the ratio between sales and cost of goods sold (Vtavu, 2015). This was crucial for the company to understand the ability to increase the company's profits based solely on the sale of goods without considering the other expenses and cost impacts in the company (Vtavu, 2015). Capital structure has rarely been linked to the contribution to gross margin development, but some studies suggest that increasing debt financing will improve leverage for the company to increase sales performance (Adesina, Nwidobie & Adesina, 2015). This is because debt financing offers a higher potential for raising loan funds that can be invested and converted into business opportunities in a shorter period of time.

In addition, net profit becomes part of measuring the company's net profit margin, where the company tends to focus on the remaining returns from investors that contribute to the company's value (Nassar, 2016). Sivalingam & Kengatharan (2018) mentioned that the company has made various expenditures where the capital structure of debt and equity is believed to influence the expenditures of the company, where higher expenditures could be caused by the lack of control over the capital structure. Contributing to this is the fact that stakeholders such as suppliers and vendors tend not to provide competitive offers to the company that has higher debt than equity, resulting in the company paying more than the average expenses of similar companies (Ajibola, Wisdom & Qudus, 2018).

The measurement of return on equity (ROE) has been largely determined by the value of the equity contribution within the company's capital structure. Based on a simple prediction, the higher equity should result in a higher return on the company's investment (Ramli, Latan, & Solovida, 2019). However, there is some evidence in previous studies that the high equity leverage ratio may have a negative impact on ROE financial performance, as the high equity capital may lead to over-funding of equity, resulting in failure to achieve a significant return on equity investment can (Ngoc, Tien & Do, 2021). Furthermore, Oyedokun (2018) emphasized that debt financing appears to be a cheaper financing as large companies tend to provide high levels of debt to finance large-scale projects, which results in a higher return on equity based on the net profit earned by the company.

Moving forward, Return on Asset (ROA) could refer to one of the basic financial performance metrics of a company that helps to understand the return based on the assets invested in the company (Chadha & Sharma, 2015). However, assets are derived from the capital structure of debt and equity, which determine the contribution of financing to the available assets (Mauwa, Namusonge & Onyango, 2016). There is evidence that capital structure influences flexibility and leverage in determining asset investments for the firm, which impact the firm's financial performance (Opoku-Asante et al., 2022). Based on the relevance concepts, the increase in both debt and equity is likely to influence the evolution of ROA performance, with some studies assuming that the higher equity contribution due to the company's sustainability capital financing is likely to lead to higher ROA in line with long-term goals of the company achieve (Mauwa, Namusonge & Onyango, 2016).

With this, the gap in the literature review had been identified where there is strong suggestion from the previous research papers within the similar scope of study pointing out the study towards the relationship between the capital structure against the movement of the profitability ratio which is interpreted equivalent with the financial performance of the business. Despite the many research papers pointing out the relevance outcome for the research, there is still lacking into the venture towards the Chinese companies which showed the lack of the exploration into the Asian region. In addition, the study had not provide the insight in relevance towards the development of the capital structure measurement using the debt equity ratio to reflect as the representation on the companies in the recent trend especially with the high uncertainty of the economic condition. This will definitely becoming a plus point to address the motivation of the current study which is crucial to identify the new knowledge from the outcome of the study targeting to narrow down the identified gap in the literature review for the scope of study.

## Hypothesis Development

### Hypothesis 1

*H0: There is no significant impact from the debt equity ratio against the profitability ratio of gross profit margin in business.*

*H1: There is significant impact from the debt equity ratio against the profitability ratio of gross profit margin in business.*

### Hypothesis 2

*H0: There is no significant impact from the debt equity ratio against the profitability ratio of net profit margin in business.*

*H1: There is significant impact from the debt equity ratio against the profitability ratio of net profit margin in business.*

### Hypothesis 3

*H0: There is no significant impact from the debt equity ratio against the profitability ratio of return on equity in business.*

*H1: There is significant impact from the debt equity ratio against the profitability ratio of return on equity in business.*

### Hypothesis 4

*H0: There is no significant impact from the debt equity ratio against the profitability ratio of return on asset in business.*

*H1: There is significant impact from the debt equity ratio against the profitability ratio of return on asset in business.*

## Research Methodology

The structure of the quantitative analysis study, which will use quantifiable and measurable data, served as the foundation for the research methodology for the current study (Apuke, 2017). Without introducing any subjectivity of the researcher's judgment, the quantitative study's main advantage was that it gave results and findings based on statistical data output greater objectivity (Sharela, 2016). Additionally, quantitative research analysis enables the analysis of larger samples of data, resulting in a greater representation of the study's target population (Apuke, 2017). This acknowledges deductive reasoning as a research strategy that complements quantitative study, with deductive reasoning concentrating on using a logical approach from general concepts to precise conclusions and testing hypotheses (Cooper & Schindler, 2014).

The secondary data market will be used to transfer the data that was previously used through the primary source and is still available in the secondary data market, which will be the focus of the data collection process (Sekaran & Bougie, 2016). The secondary data market offers greater convenience in the data collection process, giving the secondary data collection method greater leverage in terms of time and resources (Apuke, 2017). The source of secondary data is the financial reports that are available in the annual reports of the chosen companies. The reasons supporting the selection from the public listed companies had increase the convenience in the data collection process where the financial information for public listed companies are highly accessible. According to Sekaran and Bougie (2016), the numerical data derived from the financial statements is ideal for quantitative study analysis using the statistical method.

The study's target audience is related to its goal and area of concentration, which are related to the development of financial performance of businesses in China, a country with a highly competitive business strategy environment. This primarily targets businesses in the consumer goods sector that are listed on both the Shenzhen Stock Exchange (SZSE) and the Shanghai Stock Exchange (SSE) (Apuke, 2017). This favors the convenience sampling approach, which selects the company samples at the researcher's convenience without expending unnecessary effort on the data collection process. 20 companies would be an adequate sample size, according to the previous quantitative study, to generate a useful quantitative analysis for the study.

In order to provide a useful quantitative analysis for the study, the data analysis for the quantitative study will concentrate on developing statistical analysis through descriptive analysis, factor analysis, reliability analysis, correlation analysis, and regression analysis (Sekaran & Bougie, 2016). This will become the benchmark to identify the fundamental analysis using the quantitative method study to test for the significant in the relationship between the independent variable and dependent variable as reference to the research framework for the research study. The use of the statistical software tool to produce the study's quantitative results is evidence for this (Cooper & Schindler, 2014). As a result, the hypothesis results are compared with the earlier findings of the literature review in order to arrive at the study's conclusion achieving the purpose and objective of the research (Saunders, Lewis, and Thornhill 2015).

## Results and Findings

The first step into the quantitative study had been verifying the reliability of the data set which include the collection of the secondary data from the annual report to compute the financial ratio including the gross profit margin, net profit margin, return on asset (ROA) and return on equity (ROE) as well as the debt equity ratio to represent the capital structure of the business. Therefore, the reliability test will be conducted to serve as the benchmark to test on the credibility and consistency of the data input for the current study.

***Table 1: Reliability Test Output***

| Number of Variables | Reliability Output |
|---|---|
| 4 | 66.40% |

The debt ratio, gross profit margin, net profit margin, ROA, and ROE variables reliability analysis results are presented in Table 1 for the data set. Table 1's results showed that Cronbach's alpha is 66.4%, which is, as previously mentioned, slightly below the benchmark. The previous study did note, however, that the primary data collection associated with the questionnaire study typically uses the 70% benchmark. The acceptance rate for the reliability analysis is set to 50% as the minimum bar for the secondary data to the historical data. Given this situation, it is acceptable to continue the quantitative analysis study because the reliability test for the current data remained above the minimum measurement value.

***Table 2: Correlation Analysis Test***

| Variable | Debt Equity Ratio | |
|---|---|---|
| | Pearson Correlation Coefficient | Remarks |
| Gross Profit Margin | -0.406 | Moderate Negative Correlation |
| Net Profit Margin | -0.376 | Weak Negative Correlation |
| Return on Equity | 0.540 | Moderate Positive Correlation |
| Return on Asset | -0.215 | Weak Negative Correlation |

The correlation analysis between the dependent variables of gross margin, net margin, ROE, and ROA and the independent variable of leverage ratio is shown in Table 2. According to the findings, the correlation between debt ratio and gross margin, net margin, and ROA was observed; however, because the observed p-value was higher than the tolerance limit of 5%, none of the negative correlations had any discernible effects. The finding was different, though, for the relationship between debt ratio and return on equity, where there is a moderately positive correlation that becomes significant when the p-value is below the tolerance threshold of 5%. This indicated that there is a negative correlation between the two variables as only ROE was still relevant and significant in the change in movement with leverage ratio.

***Table 3: Regression Model Output***

| Dependent Variable | Debt Equity Ratio | |
|---|---|---|
| Independent Variable | p-value test | Remarks |
| Gross Profit Margin | 0.068 | Not significant |
| Net Profit Margin | 0.093 | Not significant |
| Return on Equity | 0.012 | Significant |
| Return on Asset | 0.349 | Not significant |

Regression analysis is a crucial part of any quantitative study because it is the primary analysis used to determine whether the relationship between the independent and dependent variables is, as the study's research framework suggests, meaningful. In order to draw conclusions about the outcome of the results and the results of the study, the regression analysis's outcome serves as a crucial benchmark for testing the hypothesis put forth in the literature review. The single regression model is additionally preferred in the quantitative approach where the single independent variables are used to test against each individual dependent variable as specified in the research framework.

Based on Table 3's findings, it is clear that only the return on equity variable has a p-value test that is less than the tolerance level of 5%, indicating that there is strong evidence to support the conclusion that the capital structure's debt to equity ratio has a significant influence on how the return on equity for the business organization moves. However, the regression analysis's similar observation for the remaining dependent variables, such as gross profit margin, net profit margin, and return on asset, failed to find any evidence of a significant influence from the debt equity ratio of the capital structure funding of the company.

## Discussion

Based on the outcome of the study, there is a major disagreement in the current results and findings against the previous suggestion arise from the literature review. The development of the hypothesis had supported the potential findings to indicate the presence of the significant impact from the capital structure of the debt equity ratio against the financial performance for the business. However, the current outcome of the study had only observed the significant evidence to point out for debt equity ratio against the return on equity but not for other profitability ratio as demonstrated through the quantitative study. As reference to the hypothesis development, only the hypothesis 3 is accepted for the current research which posed the evidence that there is still lacking research to support the solid indication for the positive impact of the capital structure against the financial performance of the study. In another perspective, there could be other factors that come into play affecting the current outcome of the study such as the Chinese market as well as the period of study which can be further investigated through future research to explore the similar research framework through a different research population and environment. However, that will not provide any change towards the current disagreement from the outcome for the current study. Therefore, the revisit into the relevance scope of study may provide significant insight for the academic for the topic of interest.

## Contribution of Study

This study had been an eye opener where the current outcome of the study had been rather surprising showing the opposite of the suggestion from the hypothesis drawn from the initial literature review. This had created the new perspective into understanding the capital structure strategy from business in the designation to affect the profitability and financial performance of the business organizations. The outcome of the study definitely provide solid evidence for the research framework to identify the new findings that will close down the gap identified within the academic studies. Besides, the outcome of the study had been creating the fresh perspective for the investors in judging the capital structure funding including the debt equity ratio and gearing ration as part of the major consideration when determining the potential earnings and return for the business. Furthermore, the outcome in the current study contributes new knowledge to the management of the business organizations especially in China where the companies will be more seeking into the development for the capital funding stray to drive the business growth for the future.

## Conclusion

The outcome of the study had strongly concluded that the capital structure strategy for the business may not be likely to affect the financial performance of the business which had been evidenced from the quantitative study in the current research paper. The outcome may not be favourable or desired from the initial expectations of the study but still pose a significant finding to oppose the finding from the previous research papers. The outcome for the current study should be highly viewed as a n opportunity within the academic study to further explore in the similar observation and concept to understand the potential changing trend of the business strategy and capital structure funding for the business. The insight achieved from the current study is definitely valuable to provide fresh perspective to further explore the scope of study to understand the variability in the factors affecting the financial performance of the business creating the opportunity to extend the current scope of study in the future research.

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