How Firm Characteristics Affect Capital Structure? Evidence from Indian SMEs

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Abstract
We examine whether predictions of traditional theories of capital structure such as pecking order theory, trade-off theory and agency theory hold true for Indian SMEs. We conduct a panel data regression to study the effect of five firm characteristics such as profitability, growth opportunities, size, asset structure and operating risk on total as well as long-term and short-term debt which are used as proxies for capital structure decisions of SMEs. Our results provide evidence for the relevance of pecking order theory in explaining the behavior of Indian SMEs in case of short-term debt only. We observe a significantly negative relationship between operating risk of an SME and its financial leverage. This supports the applicability of trade-off theory implying that greater the operating risk faced by a firm, more inclined it is in reducing its leverage. We do not find any evidence for the applicability of agency theory.

Key Words: Capital Structure, Long-Term Debt, Panel Data Regression, Short-Term Debt, SMEs