THE INTERNATIONAL JOURNAL OF BUSINESS & MANAGEMENT

The Effect of Financial Leverage and Market Size on Stock Returns on the Karachi Stock Exchange: Evidence from Selected Stocks in the Non-Financial Sector of Pakistan

Dr. Sadaf Mustafa
Assistant Professor, Department of Commerce, University of Karachi, Pakistan
Atiya Saeed
Student of MS, Department of Commerce, University of Karachi, Pakistan
Ammad Zafar
Ph.D. Student, Department of Public Administration, University of Karachi, Pakistan

Abstract:
This paper studies the effect of financial leverage and market size of selected stocks on stock returns. Ordinary Least Square (OLS) regression models were used to test the relationship between the dependent and independent variables. The leverage of the selected sector was estimated from the Annual Financial reports covering a period of twelve years from 2014 to 2015 non-financial sectors listed in Karachi Stock Exchange. Furthermore, stock index prices of the selected stocks between 2004-2015 for non-financial sector are used to calculate stock return. Capital structure decisions are very important for any firm because they have a direct impact on firm value as well as shareholder's wealth. The positives or negatives of these decisions determine the future value of any business. Some studies discussed multiple outcomes or relation between stock return and leverage. Some studies reveal positive relationship between them, some review show negative outcomes and some has blended results. The study concluded that there is statistically significant direct relationship between size which is proxy of market capitalization and stock return (100 index prices). However, there is feeble and inverse relationship between financial leverage and stock return, and this relationship is not significant, so there is no statistically significant relationship between financial leverage and shareholders return.

Keywords: Financial leverage, market capitalization, ordinary least square, non-financial sector

1. Introduction

Finance is basic element for running, developing or acquire any business and necessary for achieving strategic plans. All companies of economy need investment for financing their assets (Hussain, Shahid, & Akmal, 2016). The capital structure of a firm refers to the funding mix. It mirrors the bases of external financing in the shape of debt, equity and internal financing through retained earnings (Mirza, Rahat, & Reddy, 2016). There are different ways for raising capital or financing the businesses. The basic ways of collecting capital are issuing shares and getting debts. Capital structure is a combination of long term, short term debts and equity. On the other hand, capital structure represents how a firm finance overall work performance by utilization different funds. It plays a vital role in making financial decision by the management (Hussain, Shahid, & Akmal, 2016). Given the importance of sources of funding, the capital structure of a firm is viewed as its financial muscle and its flexibility can enable firms to easily recourse to external financing (Mirza, Rahat, & Reddy, 2016).

Capital structure decisions are very important for any firm because they have a direct impact on firm value as well as shareholder's wealth. A firm's decisions regarding capital structure comprise of how to use sources of finds for capital investments. The positives or negatives of these decisions determine the future value of any business. "According to Myers (2001, p81), there is no universal theory of debt-equity choice, and no reason to expect one." (Sekar, Gowri, & Ramya, 2014). Different firms use different capital structures and it is a difficult task for a manager to decide what capital structure minimizes risk and cost while maximizing shareholder wealth and firm value. We know that optimal capital structure maximizes the market value and share price of the firm (Nadeem, Waheed, & Mahmood, 2016).

The use of debt in capital structure is not inherently considered bad since it increases the available financing that can be used to support growth and expansion. The key to use of leverage is that the firm is likely to generate superior revenues compared to its cost of debt financing and can service its debt commitments. Although, there is no optimal debt to equity proportion, the key is that the firm should hold as much debt as it can honour and which does not adversely impact its financial flexibility. If a firm is unable to pay its obligations, the creditors can force it to seek bankruptcy. Therefore, financial leverage is the key source of credit risk for a firm (Mirza, Rahat, & Reddy, 2016).

Corporations use financial leverage to create flexibility, maintain access to capital markets, and buy back equity, and ultimately create shareholder value. Strategies differ from company to company but are always closely aligned to management's overall goals and objectives (Bhatti, Majeed, Rehman, & Khan, 2010)

This study defines the effects of financial leverage and market size on the capital structure in Pakistan non-financial sectors. Growth of 5.81 percent was enrolled in overall assets of non-financial companies listed on Karachi Stock Exchange (KSE) in 2015 over 2014 to reach at Rs. 6,618.13 billion. Overall liabilities (without equity) increased by 1.80 percent to touch Rs. 3,946.85 billion and an expansion of 12.36 percent was enlisted in shareholders' equity (Rs. 2,671.27 billion) in 2015 when associated with earlier year. Growth in overall assets during the year 2015 is chiefly credited to consistent increment of 7.28 percent development in public sector which contribute 28.36 percent share of overall assets and 5.24 percent development in private sector which donate 71.64 percent share of overall assets in 2015. Liabilities in private sector continued standing, however public sector recorded a growth of 6.00 percent in liabilities in 2015 over 2014. Private and public sectors posted huge YoY development in shareholders' value with 13.17 percent and 9.86 percent particular development in current year 2015 over earlier year 2014. Operational efficiency of capital market deciphered a reduction of 6.05 percent and 16.17 percent in sales of private and public sector respectively in 2015. Private sector companies improved the gross profit by 13.21 percent whereas, public sector companies recorded a decline of 27.02 percent in gross profit in 2015 when contrasted and the earlier year. Private sector companies in term of profitability grew significantly, posted a YoY growth of 39.79 percent in profit before tax and 47.33 percent in profit after tax for the year 2015 when compared with 2014.Alternately public sector companies recorded decay of 37.41 percent and 41.61 percent respectively in profit before tax and profit after tax during the period under analysis. (Financial Statements Analysis of Companies (Non-Financial) Listed at Karachi Stock Exchange, 2010-2015)We have selected non- financial companies (overall) listed in KSE during the data period 2004 to 2015,.

1.1. Problem Statement
Do financial leverage and Market size effect shareholder return in Pakistan?

1.2. Objectives of the Study
1. This research study intends to examine the effect of financial leverage on return for shareholders in Pakistan.
2. This research study intends to examine the effect of market size on return for shareholders in Pakistan.
3. This research study intends to serve as a guide for investors to assess the impact of financial leverage and market capitalization on return for shareholders in Pakistan

2. Literature Review
The existing day deal with capital structure postulate started by Modigliani and Mill operator (1958). M and M demonstrated that the valuation of the firm is free from its capital structure. They demonstrate their theory in light of various suppositions. They accept a flawless capital market (no exchange or bankruptcy costs; idealize data); firms and people can get at a similar financing cost; no burdens; and speculation choices aren't influenced by financing choices. Modigliani and Miller made two discoveries under these conditions. Their first "suggestion" was that the estimation of an organization is autonomous of its capital structure. That is, you can't change the extent of a cake by cutting it into various estimated pieces. Their second "recommendation" expressed that the cost of value for a utilized firm is equivalent to the cost of value for an un-utilized firm, in addition to an additional premium for monetary risk. That is, as use increments, while the weight of individual dangers is moved between various speculator classes, add up to hazard is saved and henceforth no additional esteem made (Raza, Zahoor, & Hussain). Of late, another evidence was displayed by Modigliani and Miller (1963) expressing that "cost of capital impact capital structure, and in this way impact the estimation of the firm by disregarding the improbable suppositions and considering that there exist taxes; which demonstrate that obtaining gives assess advantage that borrowing gives tax advantage, whereas the interest deducted from the tax will result tax shields, while reducing the cost of borrowing and maximizing the firm performance (Habib, Khan, & Wazir, 2016)

There are four unique theories about capital structure which mirror the impact of obligation on corporate benefit, in particular: Pecking order theory, the agency costs theory, tradeoff theory, and signaling theory. Jensen and Meckling exhibited their own particular hypothesis about ideal capital structure in 1976 and highlighted the issue of proprietor and manager relationship. Agency costs emerge accordingly of the connections amongst shareholders and managers, and those between obligation holders and shareholders (Jensen & Meckling, 1976). According to the Agency costs hypothesis, there are both positive and also negative impacts of obligation on productivity. If there should arise an occurrence of organization expenses of value amongst shareholders and supervisors, it has constructive outcome. Though; organization expenses of obligation amongst shareholders and creditor have negative impact on productivity. If there should arise an occurrence of organization expenses of value amongst shareholders and supervisors, it has constructive outcome Though; organization expenses of obligation amongst shareholders and creditor have negative impact on productivity. The Trade-off theory manages picking capital structure, i.e. what extent of obligation and value ought to an organization pick. As per Trade-off hypothesis, obligation financing can give tax cut, yet then again it additionally has a few costs like bankruptcy cost and budgetary misery cost and so forth. Signaling theory expresses that, the obligation; within the sight of irregular data, ought to be connected decidedly to profitability. (Habib, Khan, & Wazir, 2016).

2.1. Review of Empirical Studies

2.1.1. Positive Relationship between Leverage and Stock Returns

Current reviews have focused more on economic execution. Medeiros Paulo and Jose explore the effect of degree of operating leverage on stock returns from 2001-2004 of the firm recorded on the Brazilian Stock Market. The outcome demonstrates a positive and critical connection between these two factors. (Medeiros, Lustosa, & Dantas)

Hamada (1969) adopts a hypothetical strategy to looking into if Modigliani and Miller's second recommendation holds by examining the effect of capital structure on systemic risk of regular stocks. His decision is that the rate of return increments with the obligation proportion. In a later review made in 1972 utilizing information of U.S firms, he demonstrates that his postulation holds and sets up that there is a positive relationship amongst leverage and stock returns (Baker & Martin, 2011).

Masulis' findings are in accordance with Hamada's. In his 1983 review he examines the effect of leverage changes on stock returns. His outcomes propose that both firm value and changes in stock costs connect decidedly with changes in the obligation proportion (Masulis, 1983).

Bhandari (1988) demonstrates that normal regular stock profits for a month to month premise associate decidedly with yearly obligation to-value proportions. The relationship is watched both seeing firms of all divisions and assembling firms (specifically) (Bhandari, 1988).

2.1.2. Negative Relationship between Leverage and Stock Returns

Arditti (1967) inspects the connection amongst leverage and the geometrical average of returns for mechanical, railroad and utilities firms. He finds a negative connection between the factors, be that as it may it is factually insignificant. Arditti infers that the insignificancy might be an aftereffect of discarding danger factors that relates decidedly to return and contrarily to leverage (Arditti, 1967).

Hall&Weiss (1967) come over a negative connection amongst leverage and returns when exploring the connection between firm size and profitability. They test the 500 biggest mechanical firms and define stock returns as ROE after taxes (Hall & Wesis, 1967). Adami et al. (2015) investigate if there is any connection between capital structure and stock execution amid 1980 and 2008 for stocks listed on the London Stock Exchange. Their experimental outcomes demonstrate that obligation financing adversely affect stock returns. The outcomes are disclosed by speculators wanting to put resources into financially flexible firms and in this manner, produce higher returns when putting resources into low-utilized firms than high-utilized firms (Adami, Gough, Muradoglu, & Sivaprasad, 2015). Penman, Richardson and Tuna's (2007) decisions are in accordance with Adami et al.'s; market leverage associates adversely with stock returns. They recommend that the surprising relationship shows up because of a portion of the accompanying reasons: 1) there are estimation blunders in the use figures, 2) discarding hazard considers contrarily effect leverage and 3) the market misprices leverage (Penman, Richardson, & Tuna, 2007).Acheampong, Agalega and Shibu (2014) research the leverage effect on stock returns for manufacturing firms recorded on the Ghana stock trade between 2006-2010. They exhibit a factually significant result in which leverage adversely corresponds with stock return (Acheampong, Agalega, & Shibu, 2014).Muradoglu and Sivaprasad (2012) form portfolios utilizing obligation proportion as a reason for a venture methodology to confirm if there is a positive connection between stock returns and leverage. They arrive at the conclusion that putting resources into low leverage portfolios produces higher returns over the long haul and in this way that the Modigliani and Miller hypothesis does not hold (Muradoglu & Sivaprasad, 2012). George and Hwang (2010) find a negative connection between stock-return and leverage. They clarify the negative association with that there are different sorts of dangers in firms than leverage chance and that the higher return for low-utilized firms hence might be pay of such dangers (George & Hwang,, 2010).Besides positive and negative effect of obligation on gainfulness; blended outcomes were additionally found by different authors.

2.2. The Stock

In basic terms, a stock indicates to a participation in the ownership of an organization. Stock speaks to a claim on the organization's resources and income. The rate stake that a speculator holds is mirrored in the quantity of stocks the investor obtains from the organization's stocks. Consequently, the more shares that one secures, the more noteworthy his/her proprietorship rights in the organization. When one holds an organization's stock, it implies that individual is one of the numerous proprietors (shareholders) of the organization and all things considered has a claim (but generally little) to everything the organization retains. A speculator's share possession is signified by share certificate. That is a bit of paper which fills in as evidence to one's possession (Acheampong, Agalega, & Shibu, 2014). A normal stock just speaks to a possession enthusiasm for an enterprise. In this recent stage of business such declarations are hardly given the shareholder in light of the fact that the financier firms keep these records electronically also called holding offers "in road name". This is done trying to make the stock readily tradable. Disparately, in earlier where one needs to actually take a share certificate to the business keeping in mind the end goal to offer, now with only a tick on the mouse or even a telephone call; stocks can be effortlessly exchanged. (Brigham & Ehrhardt, 2014)

2.3. Return

Return alludes to the economic gain which receive by making a speculation. The way of the arrival relies on upon the type of the speculation. For example, an organization that finances in immovable assets and business operations expects returns as benefit, which might be measured on before –interest, before assessment or after duty premise, and as expanded money streams. A financial specialist who purchases conventional shares expects returns as profit installment and capital additions or share cost increments. Once

more, a financial specialist who purchases corporate securities expects normal returns as intrigue installments (Acheampong, Agalega, & Shibu, 2014).

2.4. Relationship of Risk and Return
At the point when an individual financier or an organization makes an investment, they visualize or presume a specific return. Conversely the genuine yield that these financiers get might be more noteworthy or lesser than what they anticipated. Risk has been characterized as the likelihood that the real return might be change in relation to the normal return. At the point when the real return get is more prominent than what was normal, financiers are contented. Then again, speculators, organizations, and finance managers will probably be stressed with the chances that the real return is not as much as the normal return. Accordingly, an unsafe speculation is one where there is a noteworthy probability of its real returns being lower or higher than its predictable return (Acheampong, Agalega, & Shibu, 2014).Investor finance for contribute for expected future returns, yet those profits can seldom be anticipated correctly as there will quite often be peril related with investment. Real or recognized returns will quite often differ from anticipated returns foreseen in the start of the speculation time frame. It is supposed that investors will incline toward projects with the most prominent anticipated return seemly to their risk avoidance (Bodie, Kane, & Marcus, 2008).
Risk in an economic framework can be understand as the level of vulnerability. Chance essentially is an expansive idea, and the risk relating to a speculator is altogether different to the risk a firm is presented to. The hazard return tradeoff in money related markets suggests that low levels of risk are related with low returns and that large amounts of risk infer significant yields. (Acheampong, Agalega, & Shibu, 2014).
Financial risk for a firm is normally connected with the type of financing. The more prominent the measure of obligation a firm uses to fund its operation, the higher the financial risk. This risk originates from the firm not having the capacity to meet its monetary commitments. (Acheampong, Agalega, & Shibu, 2014).

2.5. Leverage Measurement
The objective of a study has an essential influence on the measure of leverage. Thus, one should first think of what the objective of the study is. Total liabilities to total assets is the broadest definition of leverage, but this is not a good proxy for financial risk, since many balance sheet items included in total liabilities are used for transaction purposes rather than financing. (Rajan & Zingales, 1995) The next step after providing a definition of leverage is to decide on an appropriate measure. The previous papers written on this subject have a mixed attitude to the use of book value or market value. The use of either book or market value of leverage can yield different conclusions (Gomes & Schmid, 2010). The coefficients in the factor model may vary depending on whether book or market values are used (Sheridan & Wessels, 1988). As we will use market values of equity for estimating returns, one might argue that market values of debt would be better for any comparison. Although the use of market values of debt can have its advantages over book value, we have to consider what measures of debt are available. As book values are more readily available as opposed to market values, we are inclined to use the book values of debt this paper.

2.6. Debt to Equity Ratio (DER)
DER is a proxy for evaluating the level of leverage organization. An organization with high DER may give higher yields to its shareholders, in accordance with the hazard that is confronted by the organization contrasted with different organizations with lower DER (Acheampong, Agalega, & Shibu, 2014).
DER demonstrates a corresponding connection amongst debt and equity. A lower DER implies that total debt is moderately lower contrasted with total equity. The DER of an organization are assessed from a couple of viewpoints, to be specific (1) the DER of practically identical organizations, (2) At which business arrange the organization is in (new organizations have a tendency to have more obligation), (3) Company's strategy that considers the ideal level of obligation financing. An expected proxy for the risk of common equity of a firm is that company's (DER). An expansion in the DER of a firm expands the danger of its regular value, measuring hazard in any sensible way. (Bhandari, 1988).

2.7. Hypothesis Development:
- H1: As Financial Size increases so does Stock Return.
- H2: The higher the Market Leverage the lower the Stock Return.

2.8. Empirical Methodology
The empirical processes implemented for this paper are as discussed below.

2.9. Sources and Type of Data
This study used Secondary data. The data for the selected stocks were obtained from the Karachi Stock Exchange and State Bank of Pakistan database. Debt to Equity % and Market Capital of the selected sector were estimated from the Annual Publication of SBP covering a period of twelve years (i.e.2004-2015) sector. Furthermore, average monthly stock prices of the selected stocks between 2011-2015 for Karachi Stock Exchange listed companies only non-financial sector were used. Market capitalization of selected companies which are proxies for size were likewise sourced from the Karachi Stock Exchange Reports.

2.10. Empirical Model Specification

$SR^{it} = \alpha + \beta_1 LEVERAGE + \beta_2 SIZE + \varepsilon^{it}$ (1)

Where

R^{it} is the return for stock i in period t

α is the constant of the regression equation representing other factors that could have had an effect on the stock return

$\beta 1$, and $\beta 2$ are the co-efficient of the estimates

ε^{it} is the error term

2.11. Estimations of Model Parameters
  ➢ Dependent Variable

The estimation of the **Stock Returns** for the selected stocks was estimated using 100 index prices of Non- Financial Sector of Pakistan as a proxy.
  ➢ Independent Variable:
       Leverage estimated by DER% of the overall non-financial sector listed in Karachi stock exchange.

$$DER\% = \frac{Total\ Debt}{Total\ Share\ Holder\ Equity} *100$$

The data for the leverage estimations were extracted from the yearly published financial statements analysis of the Non-Financial Sector of Pakistan. Financial statements also covering the period from 2004-2015 were used. **Size** is the proxy of market capitalization of selected sector.

2.12. Presentation of Results, Analysis and Discussion

	LOG(STOCK_RETURN)	LOG(SIZE)	LEVERAGE
Mean	9.418845	15.03446	154.4125
Median	9.424814	15.03972	162.5
Maximum	10.44578	15.81983	200
Minimum	8.571526	14.16728	13.75
Std. Dev.	0.543989	0.492244	51.82481
Skewness	0.503652	0.051658	-1.727622
Kurtosis	2.695801	2.31825	5.584759
Jarque-Bera	0.5536	0.237728	9.309846
Probability	0.758206	0.887928	0.009515
Sum	113.0261	180.4136	1852.95
Sum Sq. Dev.	3.255159	2.665343	29543.92
Observations	12	12	12

Table 1: Descriptive Statistics

As highlighted in Table 1, Stock return has the largest standard deviation of approximately 54.39. This implies that different sector in non-financial area differ to some extent in terms of their return. The associated standard deviation of leverage 49.22% is the lowest among the three variables. This signifies greater similarities in the level of debt as far as the companies in selected sector are concerned. The mean leverage ratio in the non-financial sector as shown in Table 1 is 154.415 which signifies higher debt levels in the sector.

2.13. Econometric Results

This section provides the regression results by using time series data estimation for the hypothesis developed in previous section. By applying OLS method following results are obtained.

Dependent Variable: LOG(STOCK_RETURN)				
Method: Least Squares				
Sample: 2004 - 2015				
Included observations: 12				
Variable	**Coefficient**	**Std. Error**	**t-Statistic**	**Prob.**
C	-7.224504	1.187518	-6.0837	0.0002
LOG(SIZE)	1.114722	0.082111	13.57578	0
LEVERAGE	-0.000751	0.00078	-0.96236	0.361
R-squared	0.959739	Mean dependent var		9.418845
Adjusted R-squared	0.950793	S.D. dependent var		0.543989
S.E. of regression	0.120672	Akaike info criterion		-1.17917
Sum squared resid	0.131055	Schwarz criterion		-1.05794
Log likelihood	10.07502	Hannan-Quinn criter.		-1.22405
F-statistic	107.2718	Durbin-Watson stat		2.101112
Prob(F-statistic)	0.000001			

Table 2: Regression Output

The Table demonstrate the result for the regression analysis. The R^2 show that only 96% of the variation in the dependent variable (for Time series data, an R^2 of 0.5 or more is said to be great and adequate for investigation)). The rest of the 4% variety is clarified by different components excluded in this model. The adjusted R^2 is marginally lower then unadjusted R^2. The F- Statistics show the legitimacy of the model as it 107% is well above its Prob (F- Statistics) 0.000001.

Analysis the outcome for the impact of independent variable on dependent variable we find that size is positively correlated with stock return. Size has turnout to be the most statistically significant determinant of stock return in context of Pakistan non-financial sector which implies 1% expansion in market capitalization cause 111% expansion in stock return. This approve our prior hypothesis about size.

Leverage is negatively correlated with return of stock. However, we don't discover much confirmation that this relationship is measurably significant in this manner we reject null hypothesis. The associated T-values is less than 2. This show that firms in non-financial sector of Pakistan have high leverage consumption.

3. Conclusion

This paper inspected the connection between expected stock returns, size, and leverage of non-financial firms listed in the Karachi stock exchange. The paper used Ordinary Least Square Regression Model method to appraise the coefficients of the factors. The paper found that Size (Market Capitalization) has a critical connection exists between stock returns. The overall findings show that there is not critical impact of financial leverage on stock return. The review equally reasons that there may be other non-quantitative elements which may prompt invalidate the effect of financial leverage on shareholders return like recession, competition and government strategy. It is vital to note that money related use is a theoretical system and there are uncommon threats and costs essential with financial leverage. In fact, there can be no confirmation that a Financial Leverage will be fruitful amid any period in which it is utilized. The paper additionally confirmed that the connection amongst size and stock returns is essentially positive.

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