

# 1 The Effect of Corporate Strategy and Capital Structure on 2 Performance of Banking Sector of Pakistan

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## 7 **Abstract**

8 The finance literate has widely discussed two important relationships: (1) Corporate strategy  
9 and firm performance (2) Capital structure and firm performance. However, most studies  
10 ignore the combined effect of corporate strategy and capital structure on firm performance.  
11 Our study tries to tackle this issue and uses sample from the listed companies in Pakistan  
12 which will prove the commonalities that exist between these domains of business research.  
13 This will help support the arguments of some researchers in the banking industry who have  
14 stressed the importance of assessing the firm's strategies using concepts in finance. The  
15 overall objective of this study is to test the viability of the "effect of corporate strategy and  
16 capital structure on firm's performance" using strategic management and corporate finance  
17 theory. The present study identifies the dimensions and variables using prior research within  
18 each of the constructs studied under the management and corporate finance domains, vis-a-vis  
19 corporate strategy, capital structure and firm performance.

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21 **Index terms**— Corporate strategy; Capital structure; Firm performance  
22 Several management researchers of the likes of Dill (1958), Chandler (1962), Lawrence & Lorsch (1967),  
23 Jurkovich (1974), Miles & Snow (1978), Porter (1980), Porter (1985), Drucker (1980), Drucker (1981),  
24 Hambrick (1981), Hambrick (1983), Dess & Davis (1984), Foss and Beard (1984), Mintzberg (1988), Miller  
25 (1986), Patel & Prahalad (1991), Otha & Valdamani (1995), and others have directly or indirectly made  
26 attempts to theorize the effects of single or multiple constructs, vis-a-vis the firm environment, strategy, and  
27 structure on firm performance. These efforts have led to the incremental development of the strategic management  
28 literature that stress on the relationships between the constructs mentioned above.

29 Some of the research work done in the late eighties was aimed at testing the model of Porter (1980) in terms of the effects of competitive strategy on firm performance.  
30 Other efforts of the likes of Schmelzer (1992) delved into firm structure and tried to explain the components of  
31 organizational structure that have an effect on strategy and performance of firms. What emerged from these  
32 individual research efforts was the concept of the "Coalignment Model". The theoretical underpinnings of the  
33 model explicate the co-alignment between the environment domain, competitive methods, core competencies,  
34 and firm performance, considered to be the recipe for firms' success. The key for superior firm performance is  
35 firm strategy formulation and implementation decisions (Hill and Jones 1995). It then became the paradigm that  
36 explains the effect of environment, corporate strategy, and structure on firm performance (Olsen et al., 1998).  
37 Chathoth 2007). The combined effect of corporate strategy and capital structure explain well for the difference  
38 in firm performance. The capital structure will have an impact on the overall performance of firms as tested.  
39 Therefore, capital structure should be given added emphasis for firms trying to add value to their stockholders'  
40 and bondholders' (Gi-Shian Su 2010).

41 This is important to mention that, complete "Coalignment Model," is only tested in hospitality industry  
42 while the impact of firm strategy and capital structure (only internal forces) on firm performance is tested for  
43 vietnam's listed companies of all kind and not any specific industry with considering only one control variable for

## 1 A) CORPORATE LEVEL STRATEGY CONSTRUCT

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45 industry. The results of this research contradicted from earlier researches' results due to firms' size & structure  
46 and customers' behavior. The performance of firms becomes the single most important construct that has been  
47 studied by management researchers, hospitality strategy researchers, as well as corporate finance researchers.  
48 Since performance objectives are what firms wish to accomplish, this construct will be scrutinized to reveal the  
49 key variables that represent it. The overall objective of a firm's existence is to continue to survive through the  
50 crests and troughs of the industry life cycle. And in order to do so, firms need to insure that the performance  
51 objectives are met consistently. Researchers have emphasized on various performance measures that range from  
52 stockholder satisfaction return on sales and gross operating profit. These measures also vary from accounting  
53 measures to market-based measures. This study will identify various performance measures by examining the  
54 work of researchers who have advocated the use of key performance variables, both accounting and market  
55 measures, which represent the outcome variables of a firm.

56 We want to test this model for Pakistani listed companies only for Banking Sector. Data will be collected  
57 from secondary sources that will enable effective testing of hypotheses. Since the model pertains to testing the  
58 effects of single and multiple dependent constructs/variables, i.e. corporate strategy on capital structure and  
59 their impact on firm performance; the unit of analysis will be the firm's corporate level for variables that pertain  
60 to corporate strategy, capital structure, and firm performance. We will use two dimensions of corporate strategy  
61 most relevant to capital structure i.e. growth and liquidity. The dimensions of corporate strategy, i.e. growth  
62 will be operationalized using sales growth and growth potential; and liquidity will be operationalized using the  
63 firm's investment in cash and marketable securities as a percentage of total assets. The capital structure of the  
64 firm will be operationalized using the debt ratio while firm performance will be operationalized using the two  
65 dimensions, cash flow (Free Cash Flow per share) and accrual returns (return on equity).

66 The present study is an attempt to test the model using theories in corporate finance and strategic management,  
67 which will also clarify the commonalities that exist between these domains of business research. This will help  
68 support the arguments of some researchers who have stressed the importance of assessing the firm's strategies  
69 using concepts in finance. The present study will identify the dimensions and variables using prior research  
70 within each of the constructs studied under the management and corporate finance domains, vis-a-vis corporate  
71 strategy, capital structure, and firm performance. Subsequently, the relationship between these constructs and  
72 dimensions will be tested for the dependencies between them through a priori hypothesized relationships. The  
73 unit of analysis will be the corporate level, and hence, the study will include corporate level data of banking  
74 sector. The research design will include cross-sectional data of banks averaged across an a priori defined time  
75 period. This will help address the lead and lag effects of variables across the time period. The overall objective  
76 of this study is to test the viability of the model tested by recent researcher using strategic management and  
77 corporate finance theory to find any discrepancies exist in behaviors of variables like debt, liquidity and firm size  
78 for particular service i.e. banking sector of Pakistan.

79 The underlying theme common to all strategy definitions given by different scholars like Chandler (1962),  
80 ??ofer & Shendel (1978), ??ompson & Strickland (1981), ??ourgeois (1978) and ??intzberg (1981) etc. is the  
81 ability of the organization to meet its objectives by directing its efforts in a resourceful manner, aligning them  
82 to the developments in the external environment. Having identified this theme in the definition of strategy, it  
83 becomes essential to identify whether each individual research domain within the field is a proponent of this  
84 ideology professed by eminent researchers. To do so, it is essential to pinpoint the orientations of the subdomains  
85 in the field of strategy.

86 The strategic management model suggests that intended strategy is an outcome of certain distinct actions  
87 taken by firms. These actions can be categorized as the product of a firm's external analysis and internal  
88 analysis (Hill & Jones, 1995). The external analysis is about understanding the firm's external environment to  
89 identify opportunities and threats. This analysis includes analyzing the firm's remote environment domain, task  
90 environment domain, and industry environment domain in order to identify the forces driving change and their  
91 impact on the organization during a given time period ??Olsen et al.1998). On the other hand, the internal  
92 analysis entails pinpointing what the strengths and weaknesses of the firm are in order to identify the quantity  
93 and quality of resources available to the organization (Hill & Jones, 1995). The concept that entails analyzing  
94 the firm's external and internal environment and subsequently identifying the appropriate strategy comes under  
95 the strategy formulation sub-domain of strategy research.

96 On the other hand, the sub-domain that deals with designing organizational systems and structures in order  
97 to put the strategy into action is termed as strategy implementation. Strategy choice is a component of strategy  
98 formulation that entails identifying the strategic alternatives in tandem with the firm's strengths and weaknesses.  
99 Since strategy is about identifying the appropriate courses of action, these alternatives vary depending on the  
100 hierarchical levels of the organization confirmed by, for instance, Hofer & Shendel (1979), who point out that  
101 strategy content varies with the level of organizational hierarchy. The hierarchical levels identified by various  
102 management theorists in the strategy domain are functional level, business level, and corporate level strategies  
103 (Hill & Jones, 1995).

### 104 1 a) Corporate Level Strategy Construct

105 The corporate level strategy entails decisions made by corporate managers to insure that company stakeholders  
106 are satisfied at all times. With this as the goal, the managers at the corporate level of company hierarchy

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107 decide to invest in business(es) that result in long-term profit maximization and increased returns to the firm's  
108 stockholders. Corporate strategies entail two distinct dimensions that include measures pertaining to growth  
109 (Zook & Rogers, 2001) and liquidity ??Kim et al., 1998). Corporate managers decide what businesses to invest  
110 in and how liquid the assets of the firm should be to maximize the value of the firm, both in the short and long  
111 term scenario. Corporate strategy entails top management's decision to invest in businesses, which they consider  
112 as the most value adding investments. It revolves around the basic premise of defining the firm's objective of  
113 which business(es) to be in ??Olsen et al., 1998). Corporate strategy influences all levels of strategy formulation  
114 including business and functional level, in that the decisions made at this level becomes the blue print of strategy  
115 formulation at the business level, which in turn influences the functional level. This does not mean that functional  
116 level and business level strategies do not influence corporate strategies. Even though there may be influence from  
117 both these levels of strategy formation on corporate strategy, it is how the corporation's top management defines  
118 the strategy of the company as a whole that will influence the company's strategy at various levels of its hierarchy.

## 119 **2 i. Growth**

120 Growth is considered to be one of the key benchmarks of success by practitioners in most industry settings.  
121 The banking industry setting is no different, in that firms within the industry have used this strategy as one  
122 of the key elements of success. Several researchers have suggested that growth strategies need to be managed  
123 well so that the firm can plan its orientation towards its market as well as its stakeholders appropriately. For  
124 instance, "aggressive and rapid growth could increase risk by straining a firm's human resources and its ability  
125 to develop efficient controls and an effective internal structure. Growth ought to be carefully managed while  
126 developing an internal structure that is capable of coping with that growth while maintaining control of the  
127 firm's operations" (Borde, 1998). Hill and Jones (1995) suggest that firms that grow through diversification into  
128 more unrelated business, will do so by sacrificing profitability, as the competencies of the company to produce  
129 adequate returns on investments in business ventures that they have little expertise in can lead to a decline in  
130 profitability. Furthermore, growth brings in positive return only to a certain extent, beyond which the firm's  
131 managers will sacrifice the wealth of its stockholders to achieve higher growth. By testing the relationship between  
132 firm growth strategies and performance, it would be clear if there exists a significant relationship between the  
133 two constructs.

134 Three measures of firm growth will be used in this study. The first measure, i.e. sales growth will capture  
135 increased sales through Mark-up/Return/Interest Income, Fee, Comm., and Brokerage Income. It is essential  
136 for both researchers and practitioners to find out if sales growth adds value to the firm, which will be tested in  
137 this study. The second measure, i.e. asset growth will capture the growth in market value of assets, which will  
138 indicate if a firm that adds to its asset base will at the same time add more value to the firm. The third measure,  
139 i.e. growth potential will capture the future growth of the firm, which will be captured by using the ratio of  
140 market value of assets to book-value of assets. Note that this measure will tell us about the growth opportunity  
141 set of the firm as a result of its investment strategy. The relationship between these measures and measures of  
142 the capital structure and firm performance constructs will help conceptualize the dynamics of growth strategy  
143 more comprehensively.

## 144 **3 ii. Liquidity**

145 According to Kallberg & Parkinson (1992), corporate liquidity is a strategy that top management pays attention  
146 to in connection to the management of the firm's assets. Firms typically manage their liquidity through resource  
147 allocation decisions that are directed towards more liquid assets (Kim, Mauer, and Sherman; 1998). The  
148 objective is to increase the liquidity of the firm but while doing so, managers may have to consider the pros  
149 and cons associated with the trade-off between investments in liquid or illiquid assets. Some authors, for example  
150 Huberman (1984), Ang (1991), and Myers and Rajan (1995) have provided explanation to the theory that more  
151 liquid assets may lead to agency problems as compared to less liquid assets. The literature on the investment  
152 preference of firms in liquid assets purports that either firms should hold large amounts of liquid assets (e.g. ??yers  
153 and Majluf, 1984) or no liquid assets (e.g. Jensen, 1986). According to John (1993), "liquid assets constitute a  
154 considerable portion of total assets and have important implications for the firm's risk and profitability". John  
155 (1993) points out that "the assets of a firm also have a natural categorization based on liquidity. Cash or cash  
156 like (marketable) securities are liquid assets. Long-term investments (such as plant and machinery) which may  
157 only produce liquid assets in the future may be called illiquid assets". Kim et al. ??1998) proposed that the  
158 relationship between the liquid asset holdings and the firm's growth opportunities may be positive. This notion  
159 is supported by Lakonishok, Shleifer and Vishny (1992), who argued that firms with large intangible assets would  
160 have higher costs of financial distress and therefore would invest more in liquid assets to minimize this cost. This  
161 is further supported by ??yers (1977), who also posited that maintaining excess liquidity may help in reduction  
162 of financial distress.

163 Kim et al. (1998) also proposed that investment in liquid assets is positively related to the return on liquid  
164 assets, while it will be negatively related to the current rate of return on investment in production. Also, the  
165 authors state that the future economic conditions affect investment in liquid assets. The better the future is in  
166 terms of investment opportunities, the more the investment will be in liquid assets. Also, Baskin (1987) pointed

## 4 B) THE CAPITAL STRUCTURE CONSTRUCT

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167 out that as the firm's debt ratio increases, the cost of funding the assets to maintain a higher level of liquidity  
168 increases, thereby reducing the level of funds that will be used to maintain higher levels of liquidity.

169 There are industry effects associated with liquidity. Different industries have different levels of liquidity to  
170 take care of operational requirements as well as managing the rate of return of the firm. Damodaran (1997)  
171 points out that the difference in how firms maintain different levels of liquidity position with respect to cash and  
172 marketable securities is reflected across industry groupings. This is reflected in the ratio of cash and marketable  
173 securities taken as a percentage of total assets, which Damodaran suggests is the case as the demand for cash  
174 and cash equivalents is different across industries. Because of the industry effects of liquidity strategy, the need  
175 to test the liquidity strategy of firms in the banking industry is warranted, as similar studies in banking research  
176 have not been conducted.

177 Lancaster, Stevens, & Jennings (1999) tested the industry effects of the "distinctive relationships between cash  
178 flow, accrual income and liquidity measures". The results supported the proposition that significant industry  
179 effects exist in many of the relationships. For instance, the authors found that industry differences exist in  
180 relationships between liquidity, accrual income, and cash flow. The authors point out that "these findings are  
181 consistent with other studies where industry effects are found in capital structure, risk, returns, and financial  
182 ratio patterns". However, they could not generalize the effects of cash flow from operations to have significant  
183 incremental explanatory power for change in static liquidity, which were found only in the case of manufacturing  
184 firms. This will be tested in the present study with respect to the sample of organizations, which will be service-  
185 industry based, i.e. banks within the banking industry.

### 186 4 b) The Capital Structure Construct

187 The capital structure of a firm involves two key components, i.e. debt and equity. Ross et al. (1999) point out  
188 that the goal of management is to maximize the market value of debt and the market value of equity. By doing  
189 so, the firm is able to maximize its total value. The optimal capital structure of the firm is one that minimizes  
190 the cost of capital. In other words, an optimal balance between the proportion of debt and the proportion of  
191 equity would result in the overall minimization of the cost associated with these components. Furthermore, it is  
192 essential that these costs are weighted across the various sources of funds to insure that the overall cost is the  
193 minimum.

194 Based on the basic concepts of the capital structure, firms' managers make decisions on what type of funds  
195 and at what levels in terms of magnitude, will lead to the overall minimization of the costs associated with  
196 procuring these funds. Therefore, the demand and supply of funds affect the capital structure, but at the same  
197 time, the riskiness associated with the firm's cash flows affects the capital structure. In other words, the more  
198 the volatility of the cash flows of the firm, the more will be the impact of this risk on the firm's ability to raise  
199 debt and/or equity. Therefore, it can be stated that the capital structure decisions are based on the impact  
200 of the external environment on the firm and the strategies the firms use to insure that the value of the firm is  
201 maximized. This would vary from period to period, from firm to firm, and from industry to industry. The capital  
202 structure decisions, which are dependent on the financing decisions of the firm, can be met using the firm's own  
203 cash flow to meet the requirements of capital spending and net working capital.

204 Therefore, firms with more retained earnings will typically use this source of funds as compared to debt or  
205 outside equity, which might decrease the leverage of the firm during those years when profitability and thus  
206 retained earnings are high. The fact reported above, that firms use internal sources of funds more to invest  
207 in new projects is validated by Donaldson (1961) and Myers (1984), who found that the funds that managers  
208 typically use as the first source to fund projects are internally generated, especially for positive NPV projects.  
209 The use of externally generated funds is never the first consideration, and within externally generated types of  
210 funds, debt is preferred over common stock. This concept brought forth the notion of the pecking order theory  
211 in corporate finance. Although debt financing is preferred over equity financing, it must be noted that as a result  
212 of financial distress and bankruptcy costs, firms typically do not fund the investments with debt alone. Ross et  
213 al. (1999) point out that firms that pursue high growth strategies will have lower levels of debt as compared to  
214 firms that pursue low growth strategies.

215 The industry effects of capital structure are important to consider. ??itman (1984) pointed out that firms of  
216 industries that find liquidation costly would relatively use less debt. Other studies reveal that the debt ratios of  
217 high growth industries indicate that they are low, whereas industries with low growth prospects use more debt  
218 financing (Ross et al. 1999). The authors further point out that there are four important factors in the final  
219 determination of a target debt-equity ratio: (a) taxes, (b) types of assets, (c) uncertainty of operating income,  
220 and (d) pecking order and financial slack. The two reasons that directly apply to this study are: (1) type of  
221 assets, and (2) uncertainty in operating income. The type of assets influences the debt-equity ratio because of  
222 the financial distress concerns that managers have. Firms with large investments in tangible assets have lower  
223 costs of financial distress than firms with intangible assets. This is so because of the resale value of the tangible  
224 assets that can be more easily assessed as compared to intangible assets.

225 Firms with uncertainty in cash flows are more prone to financial distress, even with low levels of debt or no  
226 debt. Therefore, these firms typically rely on equity financing than debt financing to fund their investments in  
227 assets. Lowe, Naughton and Taylor (1994) point out that capital structure decisions are behavioral in nature

228 more than financial. Ross et al. (1999) also support this reasoning while stating that there are no straightforward  
229 formulae that help figure out the optimal capital structure of a firm in the real world.

230 c) The Firm Performance Construct A firm's performance can be measured in terms of its profitability and  
231 market performance. Typically, profitability is measured in terms of return on the capital invested in the business  
232 or return on the revenues generated during a given period. On the other hand, market performance is measured  
233 in terms of market indicators such as share price and dividend yield ratio. The objective of this study will  
234 be to operationalize those measures of performance that have been tested in past studies to have a significant  
235 relationship with the corporate strategy, and capital structure of the firm. Beard and Dess (1981) used return  
236 on investment as the measure of firm performance, which was used to test the relationship between corporate  
237 level strategies and firm performance using regression analysis. Results revealed that corporate level strategies  
238 influenced firm performance. Hall and Weiss (1967) used "Return on Assets" as the performance measure to test  
239 the relationship between firm size and profitability. Correlation analysis was used as the statistical method and  
240 results indicate that a negative correlation exists between firm size and profitability.

241 This study will incorporate both market performance measures as well as firm profitability measures to test the  
242 relationship between the corporate strategy, capital structure, and their impact on performance. The profitability  
243 of a firm can be measured to include the effects on two stakeholders, i.e. bondholders and stockholders. Since  
244 these two groups of investors have different perspectives on a firm's performance, it is essential to pinpoint which  
245 group will be benefited because of corporate strategy and capital structure decisions. Therefore, the performance  
246 construct will be operationalized to include measures that are a barometer of stakeholder satisfaction, categorized  
247 as two distinct types, i.e. accounting measures and cash flow measures. Indicators such as return on equity and  
248 return on assets are accounting measures which reflect stockholder satisfaction, and indicators such as free cash  
249 flow per share are financerelated ratios that may indicate bondholders' willingness to invest in the firm.

## 250 5 d) Relationship Between The Constructs

251 Growth strategies can be achieved through related or unrelated diversification strategies (Rumelt, 1974), which  
252 may in turn result in better firm performance, an outcome with mixed yet inconclusive results as far as past  
253 research in this area is concerned ??Hoskisson & Hitt, 1990). Moreover, according to Kim et al. (1998),  
254 industry effects may lead to different performance outcomes, vis-a-vis the relationship between growth and firm  
255 performance. Note that Hall & Weiss (1983) tested profitability to have a positive relationship with asset growth.  
256 The concept of growth in this case is based on firms' capabilities to increase their asset base in order to meet the  
257 market growth opportunities.

258 The relationship between liquidity and performance has been tested, which reveals a positive relationship  
259 between liquidity and cash flow measures, i.e. free cash flow (Kim et al., 1998). Ross et al. (1999) suggest  
260 that firms with higher growth potential will have lower debt as compared to firms that have a lower potential to  
261 grow. The strategy domain has witnessed research work pertaining to the relationship between firms' strategy  
262 and structure, pioneering as early as 1962 by Chandler, who suggested that structure follows strategy. Other  
263 studies that delved into corporate strategies include Ansoff ??1965). The relationship between growth strategy  
264 and performance has not been tested in the banking industry. The relationship between growth strategies and  
265 liquidity tested by Kim et al. ??1998) indicate that the direction of the relationship was positive. Higher growth  
266 strategy of firms will be based on a higher level of liquidity that such firms will have. The relationship between  
267 the growth strategy and the capital structure constructs was suggested by ??arton & Gordon (1987). The authors  
268 propose that a firm's sales growth rate will have a positive relationship to debt levels. This further indicates that  
269 if the environmental conditions are favorable for the firm's growth, debt will be used lesser to fund that growth  
270 than equity. On the other hand, Ross et al. ??1999) suggest that firms with high growth potential or from  
271 industries that grow at a faster rate have lower levels of debt as compared to firms from low growth industries.

272 The need to test proxies for growth in relation to firm performance is called for in the case of banks, as the  
273 industry has seen the use of this strategy as a primary vehicle of value addition. This notion is not yet proven to  
274 be the case, which needs to be tested for stakeholders of the industry to be certain about the outcome between  
275 growth and firm performance, and the level to which this strategy needs to be used. This will in turn help in the  
276 formulation and implementation of effective corporate and business level strategies.

277 The relationship between liquidity and capital structure of the firm was tested by Kim et al. (1998) who found  
278 that as the firm invests more in liquid assets, it will result in lower reliance on debt, and hence, will result in  
279 a lower debt ratio. This was confirmed by Baskin (1987), who reported that the relationship between debt and  
280 liquidity is negative. On the other hand, the relationship between debt structure and performance was reported  
281 by Capon et al. ??1990), who suggested that out of the 149 relationships reported using debt as the independent  
282 variable and firm performance as the dependent variable, 90 reported a negative relationship between firm debt  
283 level and performance. Shah (1994) demonstrated that changes in capital structure affects stock prices, which in  
284 some ways was confirmed by Harris and Raviv (1990), who suggested that there is a positive correlation between  
285 leverage and firm value. Note that liquidity strategy can be used by firms to increase their value, which needs to  
286 be tested in the context of the banking industry.

287 i.

### 288 6 Summary

289 The literature in strategic management and corporate finance pertaining to the definition and theoretical  
290 underpinnings of the constructs defined within the model i.e. "Effects of corporate strategy and capital structure  
291 on firm performance" from recent study. The constructs and their dimensions were identified and the variables  
292 that represent each dimension were explored in terms of the research that exists in the domains. The interaction  
293 between the constructs and variables in terms of the work done by researchers were explored to highlight the key  
294 relationships that will be used in the development of hypotheses, which will be explored in the following work.

### 295 7 a) Introduction

296 The focus of this chapter is to operationalize the constructs identified and described in the previous chapter.  
297 The following pages of this chapter include a description of the measures that represent the constructs; and  
298 subsequently hypotheses that capture the relationship between the constructs and variables will be developed.  
299 The hypotheses development will be aimed at capturing the relationship between the constructs. It is important  
300 to restate the research questions before the constructs are operationalized and hypotheses are developed. They  
301 include: 1. Do these corporate strategies significantly impact the capital structure of the firm, in that is the  
302 choice of capital structure of the firm dependent on corporate strategies? More specifically, do the dimensions  
303 of corporate strategy, i.e. growth and liquidity explain a significant amount of variance in the choice of capital  
304 structure? If so, what are these impacts in terms of the source of funds and their representation in the capital  
305 structure of the firm? 2. Is firm performance better explained by the alignment between the strategy and capital  
306 structure constructs? 3. Are growth strategies value adding strategies which result in improved firm performance?

307 b) Operationalizing the Constructs and Dimensions The Corporate Strategy Construct:

308 i. Growth Strategy

309 The first dimension of the corporate strategy construct is sales growth. Sales growth will be operationalized  
310 using the company's annualized sales growth for the period 2008 through 2011, which will then be averaged over  
311 the time period. The averaging of the firm's sales growth will help address the crests and troughs of growth the  
312 company may have had over the time period.

313 The second dimension of corporate strategy, i.e. asset growth will be operationalized by averaging the firm's  
314 market value of assets reported on a annual basis for the time period 2008 through 2011. Again, by averaging  
315 the market value of assets, the crests and troughs of firm's asset growth will be addressed.

316 The third dimension of corporate strategy, i.e. the firm's future growth potential will be operationalized using  
317 the firm's market value of assets divided by its book-value of assets ??Kim et al., 1998). This ratio signifies how  
318 well the firm manages its investment (Ross et al., 1999). This ratio is interpreted as: a ratio of above 1 implies  
319 good investment strategy on part of the firm's management, and a ratio of below 1 signifying poor investment  
320 strategy. Smith & Watts (1992) and Stohs & Mauer (1996) use this ratio as a proxy for growth options. The  
321 reasoning provided by the authors is based on the fact that the value of intangible assets is not reflected in the  
322 book-value of assets; therefore the ratio of market to book-value of assets would capture the growth options. A  
323 higher value of market-to-book-value of assets for the firm is an indicator of more growth options in the firm's  
324 investment opportunity set.

325 ii. Liquidity Strategy Liquidity will be operationalized using liquidity ratio ??Kim et al., 1998;John, 1993),  
326 which is the ratio of cash plus marketable securities to the book-value of assets. This ratio signifies the proportion  
327 of the firm's total assets that are highly liquid, which in turn reflects how well it manages its liquidity position  
328 on a period-to-period basis.

### 329 8 c) The Capital Structure Construct

330 The capital structure construct will be operationalized using the debt ratio ??Kim et. al, 1998), which is the  
331 firm's total debt divided by its total assets. Total debt of the firm will be calculated by including both long-term  
332 debt as well as current portion of long-term debt, reported in the current liability section of the balance sheet.

### 333 9 d) Firm Performance Construct

334 The performance construct will be operationalized using traditional measures of firm performance. These  
335 measures can be categorized into accounting measures and finance measures of performance. As detailed in  
336 Chapter 2, the accounting measures of firm performance include return on assets and return on equity. On the  
337 other hand, finance measures of firm performance include variables that capture the cash flows such as free cash  
338 flow per share and operating cash flow per share. This study will use both accounting measures as well as finance  
339 measures to test the effects of the constructs on firm performance. The measures that will be used will include  
340 return on equity that will represent the accounting measure of performance and free cash flow per share, which  
341 will represent the finance or cash flow measure of firm performance. The annualized data for these measures will  
342 be averaged over the time period 2008 through 2011. This will help in capturing the lead and lag effects between  
343 the performance construct and other constructs used in this study.

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## 344 10 e) Measuring control variable

345 Firm size is the control variable that is highly correlated with the dependent and the independent variables. The  
346 inclusion of the control variable will help reduce spurious relationships. This control variable will be adopted in  
347 the testing of the 6 models in this study. Firm size is measured by logarithm of market value of firm asset.

## 348 11 f) Developing Hypotheses

349 Our model theorizes the relationship between the constructs vis-à-vis the strategy, structure, and firm  
350 performance. The previous sections have explained the relationships between constructs, and this section will  
351 develop and propose hypotheses using the variables stated in the previous section. This section is divided into  
352 subsections that develop hypotheses depicting the relationship between the independent variable and dependent  
353 variable.

## 354 12 g) Interaction between dimensions of corporate strategy

355 The corporate strategies as pointed out earlier include growth and liquidity strategies. The relationship between  
356 sales growth and liquidity is hypothesized to be positive. The higher the sales growth is, the higher the liquidity  
357 position would be. This is true if the percentage increased in sales growth is the same as that of liquidity measured  
358 in terms of cash and credit revenue. Given this assumption and the assumption that the cost structure of the  
359 firm will increase at decreasing rates when sales increases due to economies of scale ??Hill & Jones,1995), the  
360 relationship between the firm's sales growth and liquidity position will be positive. This leads to hypothesis 1(a):  
361 H1(a): There will be a significant positive relationship between sales growth and liquidity position. The following  
362 equation is used to test H1(a).  $Ld = a + b1(SaGr) + b2(FiSi) + e$  (1) Ld: Liquidity SaGr: Sales growth FiSi:  
363 Firm size The relationship between firm size and liquidity is hypothesized to be positive as bigger banks have to  
364 maintain more liquidity to operate well. The relationship between firm size and growth is also hypothesized to  
365 be positive. The logic used in this case is that bigger firms will focus more on growth strategies, which will also  
366 lead to higher potential for growth. Therefore, bigger firms will have higher sales growth, and growth potential  
367 as compared to smaller firms.

368 The relationship between the firm's growth potential and liquidity position will be positive ??Kim et al., 1998).  
369 This is because a firm with a higher growth potential would need to be more liquid in order to fund its operations  
370 and asset growth to meet the growth potential. Moreover, it is assumed that the firm's liquidity position will  
371 influence its market value, which in turn will increase its growth potential. This leads to hypothesis 1(b): H1(b):  
372 There will be a significant positive relationship between the growth potential of the firm and its liquidity position.  
373 Equation ( ??) is to test H1(b):  $Ld = a + b1(GrPo) + b2(FiSi) + e$  (2) Ld: Liquidity GrPo: Growth Potential  
374 FiSi: Firm size

375 In the case of debt ratio, it is posited that the relationship between firm size and debt will be positive. Since  
376 firms will use more debt to fund their growth, the ratio of debt to assets will increase as they grow. Therefore,  
377 bigger firms will have higher debt ratio as compared to smaller firms. Firms that pursue a high sales growth  
378 strategy will have a positive impact on performance ??Capon et al., 1990). Performance is measured by return on  
379 equity. Firms using assets efficiently results in both sales growth and increasing return on equity. The underlying  
380 assumption is that the firm's cost structure changes at the same rate of sales growth or at a decreased rate  
381 because of economies of scale (Hill & Jones, 1995). This leads to hypotheses 2: H2: There will be a significant  
382 positive relationship between sales growth and return on equity. The relationship between firm liquidity and  
383 return on equity is hypothesized to be positive.

384 Firms that are more liquid have more cash reserves and consequently incurs higher opportunity cost (Ross  
385 et al., 1999). But banks don't have to bear much opportunity cost due to immediately lending these reserves.  
386 This leads to hypothesis 3: H3: There will be a significant Positive relationship between liquidity and return on  
387 equity. We use equation ( ??) test H2 and H3  $ROE = a + b1(SaGr) + b2(Ld) - b3(FiSi) + e$  (3) ROE: Return  
388 on equity SaGr: Sales growth Ld: Liquidity FiSi: Firm size The relationship between firm size and return on  
389 equity is posited to be negative. Bigger firms may be more oriented towards meeting the goals of debt holders  
390 than meeting the stockholder needs. Moreover, since bigger firms will typically be oriented towards growth, such  
391 firms will grow at the cost of increased costs associated with growth, resulting in lower return on equity. Also, it  
392 is evident from financial theory that explains why firms use debt to grow as compared to equity, which also helps  
393 explain the negative relationship between firm size and return on equity. This was confirmed through the study  
394 by Hall and Weiss (1967), which revealed that a negative relationship exists between firm size and profitability.  
395 i) Corporate Strategy and Firm Performance (Free cash flow per share)

396 Firms with a greater potential to grow will have a negative relationship with free cash flow. This is supported  
397 by the argument that a firm with higher growth potential will have higher capital expenditures to fund the future  
398 growth (Barton & Gordon, 1988), which will lead to lower free cash flow per share. This leads to hypothesis  
399 4: H4: There will be a significant negative relationship between growth potential of the firm and free cash flow  
400 per share. Our model assumes liquidity has a positive impact on free cash flow per share. This is because the  
401 firm that pursues to increase its liquidity would typically increase its operating cash flows under the assumption  
402 that there is no significant change in the capital expenditure of the firm. This leads to hypothesis 5: H5: There  
403 will be a significant positive relationship between the liquidity strategy of the firm and free cash flow per share.

## 12 G) INTERACTION BETWEEN DIMENSIONS OF CORPORATE STRATEGY

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404 Equation (4) will be used to test H4 and H5.  $FCF = a - b1(GrPo) + b2(Ld) + b3(FiSi) + e$  (4) FCF: Free cash  
405 flow per share GrPo: Growth potential Ld: Liquidity FiSi: Firm size The relationship between firm size and free  
406 cash flow is posited to be positive since bigger firms may be able to manage their cash flow from operations as  
407 well as capital investments in a better way as compared to smaller firms. Bigger firms may achieve economies  
408 of scale in their capital investments, which may lead to lower costs associated with such investments. j) Capital  
409 Structure and Firm Performance Higher level of debt will have a positive impact on return on equity for banks  
410 which are primarily run on debts and earn from advancing further these debts and earn income, unlike other  
411 firms where increased debt level increases the debt services through increased interest expense, which lowers the  
412 net income available to share holders (Damodaran, 1997; Ross et al., 1999). This leads to hypothesis 6: H6: There  
413 will be a positive relationship between debt level and return on equity. Equation ( ??) is used to test H6.  $ROE$   
414  $= a + b1(DeRa) - b2(FiSi) + e$  ( ?? Note: The first column (No.) lists the numbers allotted to the measures in  
415 the second column, which correspond to the numbers in row 1 (third column through ninth column).

416 standardized coefficient of 0.42 is significant at  $p = 0.00013$ . This supports the hypothesis that there will  
417 be a positive relationship between growth potential and liquidity. The control variable is also significant with  
418  $p=0.0012$ . Therefore, the hypothesis 1(b) is accepted. Results of estimated equation 2 (see table 3) shows that  
419 the overall model is significant with  $p = 0.0001$ . Furthermore, the  $r^2$  of the model indicates that 65 percent  
420 of the variance in liquidity is explained by the growth potential and firm size of the firm. The Reported about  
421 the estimated equation 3, the results indicate that the overall model is significant at  $p = 0.00011$ . The  $r^2$  for  
422 the model indicates that 43 percent of the variance in the return on equity of the firm is explained by corporate  
423 strategies. The coefficient for sales growth is 0.49, significant at  $p = 0.00013$ . However, liquidity with a coefficient  
424 of 0.64 is highly significant at  $p = 0.012$ . The direction of relation between return on equity and sales growth  
425 is positive indicating that the higher the level of sales growth, the higher will be the firm's return on equity.  
426 Control variable is significant at  $p = 0.00014$ . The relationship between return on equity and firm size is negative  
427 indicating that the higher the level of firm size, the lower will be the firm's return on equity. Therefore, the  
428 hypothesis H2 and H3 both are accepted means there is significant relationship between return on equity and  
429 both corporate strategies.

430 Equation 4 identifies the relationship between Free cash flow per share and corporate strategy, i.e. growth  
431 potential and liquidity. Results indicate that the overall model is significant at  $p = 0.00013$ . The  $r^2$  for the model  
432 indicates that 79 percent of the variance in the free cash flow per share of the firm is explained by corporate  
433 strategies. The coefficient for growth potential is -0.55, significant at  $p = 0.0001$ . Liquidity with a coefficient of  
434 0.71 is significant at  $p = 0.0015$ . The direction of relation between free cash flow per share and growth potential  
435 is negative indicating that the higher the level of growth potential, the lower will be the firm's free cash flow per  
436 share. However, the direction of relation between free cash flow per share and liquidity is positive. Again the  
437 control variable is significant at  $p = 0.00011$ . The relationship between free cash flow per share and firm size is  
438 positive indicating that the higher the level of firm size, the higher will be the firm's free cash flow per share.  
439 Therefore, the hypotheses H4 and H5 are accepted.

440 In equation 5, results indicate that the overall model is significant at  $p = 0.0001$ . The  $r^2$  for the model indicates  
441 that 58 percent of the variance in the Return on equity of the firm is explained by capital structure strategy.  
442 The coefficient for debt ratio is 0.67, significant at  $p = 0.015$ . The direction of relation between Return on equity  
443 and debt ratio is positive indicating that the higher the level of debt ratio, the higher will be the firm's Return  
444 on equity as same debt becomes the ultimate source of income for shareholders. Size as a control variable, with  
445 a coefficient of -0.48 is significant at  $p = 0.001$ . The relationship between Return on equity and firm size is also  
446 negative indicating that the higher the level of firm size, the lower will be the firm's Return on equity. Therefore,  
447 the hypothesis H6 is accepted.

448 The empirical results of equation 6 show that the overall model is significant at  $p = 0.00014$ .

449 The  $r^2$  for the model indicates that 67 percent of the variance in the Return on equity of the firm is explained  
450 by corporate strategies and capital structure. The coefficient for growth potential is 0.42, significant at  $p =$   
451 0.00012. ear for debt ratio is 0.62, significant at  $p = 0.017$ . The direction of relation between Return on equity  
452 and debt ratio is positive indicating that the higher the level of debt ratio, the higher will be the firm's Return on  
453 equity. Size as a control variable, with a coefficient of -0.48 is significant at  $p = 0.002$ . The relationship between  
454 Return on equity and firm size is negative indicating that the higher the level of firm size, the lower will be the  
455 firm's Return on equity. Therefore, the hypothesis for H7 is accepted. Beside that, the results also reveal that  
456 this is the best model which explains 67% (corporate strategy, capital structure, firm size), as compare to other  
457 incremental models that explain 58% (capital structure, firm size) and 43% (corporate strategy, firm size) of the  
458 variance in firm performance (ROE).

459 The most important finding of this study is that the combined effect of corporate strategy and capital structure  
460 explain well for the difference in banking industry performance. Further more, the liquidity strategy is highly  
461 found to be significantly correlated to firm performance unlike other firms as indicated by Gi-Shian Su(2010),  
462 because the whole banking industry is based on earning through borrowing and lending concept, so they should  
463 put their efforts in boosting liquidity along with focusing on management if they pursue firm performance.

464 Our study concludes the capital structure will have an impact on the overall performance of banks as tested.  
465 Therefore, capital structure should be given added emphasis for firms trying to add value to their stockholders'  
466 and bondholders'.

467 Moreover, the relationship between growth potential and liquidity is positive for all size of banks. This result  
468 contradicts with the findings of Kim et al. (1998), Chatthoth(2002), and Gi-Shian Su(2010). The reason for this  
469 contradiction is that every size of bank must have to maintain liquidity all time whether growing at bigger scale  
470 or smaller scale and making capital expenditures. The relationship between debt and return on equity is posited  
471 to be positive for banking industry unlike other firms because debt is the basic source of income for the banks  
472 and equity holders which is to be further lent or invested in other projects to boost net income. Due to the same  
473 reason the relationship between debt and growth potential for banking industry is found positive unlike other  
474 firms.

475 The relationship between liquidity and return on equity was tested to be highly significant. This finding  
476 confirms the finding of Kim et al (1998) who found that there is a positive relationship between these ratios, but  
477 contradicts the finding of Gi-Shian Su(2010) who found insignificant relationship between liquidity and return  
478 on equity. Besides that, our finding is also different from Baskin (1987) who pointed out that there is a negative  
479 relationship. The rationale for our conclusion of the highly significance is debt being the basic source which  
480 becomes or boosts the liquidity of banks and ultimately become the source of increasing the return of the equity  
481 holders being invested in different projects.

482 Another finding of this study is there is not much relationship between liquidity and sales growth. Hence, if  
483 firms adopt the sales growth strategy, they usually end up with customers delaying their payments, but banking  
484 industry even after delay of payments by creditors; don't face much liquidity problem due to frequent deposits  
485 by customers and regular checks by state bank of pakistan. Most strong reason of this concluded by discussion  
486 with practitioners is the Pakistani bank customers' behavior toward plastic money as they don't like much using  
487 it. Perhaps this is the primary reason of Pakistani banks being not much affected by 2008 US banking system's  
488 failure, while following US banking model.

489 This liquidity and sales growth relationship might be proved significant for other countries' banking system  
490 where customers' trend is more toward utilizing plastic money, which is needed to be tested.

491 Our study only focus on internal forces that affect firm performance; macroeconomic environment and law  
492 were ignored. Besides, our model included only one control variable i.e. firm size. <sup>1</sup>

493 h) Corporate Strategy and Firm Performance (Return  
494 on Equity)  
495 Year

496 Figure 1:

497

498 <sup>1</sup>© 2012 Global Journals Inc. (US)

The tested result of this model will explain the combined affects of corporate strategy and capital structure on firm performance i.e. performance of banking industry of Pakistan, which has ever found in previous researches.

The criteria for sample selection includes: (a) the audited financial statement should have been published in 2008; (b) each firm should be traded on one of the two exchanges, i.e. Karachi Stock Exchange,

Table 1 : Correlation Matrix

		1	2	3
1	SaGr (Sales growth)	1.00		
2	GrPo (Growth potential)	- .036	1.00	
3	Ld (Liquidity)	- .424** .38		1.00
4	DeRa (Debt ratio)	.61 .356		.79
5	FiSi (Firm size)	.453** .284		.371**
6	ROE (Return on equity)	.534** .312**		.437*
7	FCF (Free cash flow per share)	.75 - .523**		.28**

\*\* Correlation is significant at the 0.01 level (2-tailed).

\* Correlation is significant at the 0.05 level (2-tailed).

ROE: Return on equity

DeRa: Debt ratio

FiSi: Firm size

k) Corporate strategy, Capital performance

In our final model, we explore strategy and Capital structure. This leads to hypothesis 7:

H7: Independent variables of strategy and Capital structure amount of variance in return of corresponding equation (6) is:

$$ROE = a + b1(GrPo) + b2(Ld) + e \quad (6)$$

ROE: Return on equity

GrPo: Growth potential

Ld: Liquidity

DeRa: Debt ratio

[Note: or]

Figure 2:

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**2**

Equation	Independent measures	Tolerance	VIF
2 $Ld = a + b1(GrPo) + b2(FiSi) + e$	GrPo	.754	1.33
	FiSi	.643	1.56
3 $ROE = a + b1(SaGr) + b2(Ld) - b3*FiSi + e$	SaGr	.874	1.14
	Ld	.885	1.13
	FiSi	.679	1.47
4 $FCF = a - b1(GrPo) + b2(Ld) + b3(FiSi) + e$	GrPo	.737	1.36
	Ld	.863	1.16
	FiSi	.634	1.58
5 $ROE = a + b1(DeRa) - b2(FiSi) + e$	DeRa	.956	1.05
	FiSi	.652	1.53
6 $ROE = a + b1(GrPo) + b2(Ld) + b3(DeRa) - b4(FiSi) + e$	GrPo	.794	1.26
	Ld	.837	1.19
	DeRa	.936	1.07
	FiSi	.728	1.37

*[Note: \* We do not report the results of analysis equation 1 because there is no correlate between Sales growth and Growth potential. (see table1) ]*

Figure 3: Table 2 :

**3**

Figure 4: Table 3 :

Equation	Model F	Model P-Statistic	Mode R2	Mode R2	Adjusted Measures	Independent P-Value	Co-efficient	Standardized beta weight
2 Ld = a + b1(GrPo) + b2(FiSi) + e	834.75****	0.0001	.65	.60	GrPo	0.00013	.42****	
3 ROE = a + b1(SaGr) + b2(Ld) - b3*FiSi + e	325.94****	0.00011	.43	.42	SaGr	0.00013	.47****	
4 FCF = a - b1(GrPo) + b2(Ld)	78.8****	0.00013	.79	.77	GrPo	0.0001	-.55****	
2012 b3(FiSi) + e					Ld	0.0015	.71**	
					FiSi	0.00011	.43****	
5 ROE = a + b1(DeRa) - b2(FiSi) + e	42.74****	0.0001	.58	.51	DeRa	0.015	.67*	
2 6 ROE = a + b1(GrPo) + b2(Ld) + b3(DeRa) - b4(FiSi) + e	217.783***	0.00014	.67	.53	GrPo	0.00012	.42****	.73*
					Ld	0.022		
					DeRa			
					FiSi	0.017	.62*	
						0.002	-.48**	

Figure 5:

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