

Impact of Capital Structure on Profitability: Evidence from Star Category Hotels in Sri Lanka

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Abstract

This study examines the impact of the capital structure on the profitability of the 25 registered hotels in the Sri Lanka Tourism Development Authority (SLTDA). The data on capital structure and profitability collected from audited annual reports (2011 to 2021), were analyzed using panel regression methodology and presented through descriptive statistics and models. Total debt to total assets, total debt to total equity and interest coverage ratio were used to measure the capital structure and return on assets and return on equity were used to measure the profitability of the firm. The study found no significant impact of debt to equity ratio and interest coverage ratio on the return on equity and return on asset. There is a significant impact of debt to asset and return on equity and the return on asset. These results concluded that there is an impact of capital structure on the profitability of the hotel industry in Sri Lanka.

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Key Words: Capital structure; Profitability; Registered Star Category Hotels in Sri Lanka

Introduction

Financing investment, and dividend decisions are the critical decisions that every company should make to conduct their businesses perfectly. Among them, financing decisions play an important role. It is very diverse and very competitive in the current scenario business. Managers should make better business-survival decisions. Capital structure is one of the significant concerns encountered by managers today (Arachchi, 2019). All companies should be capitalized on that name in a better capital structure. Only investors pay attention to how the business (capital structure) is organized from Financing. Many factors influence profitability. An organization's size, growth, liquidity and capital structure are some of the factors among them. The capital structure is most important in the firm's financial decision-making process and other resources (Leon, 2013). There is a connection between capital structure and profitability. Capital structure decisions are affected by the firm financial performance. For the company's very survival, the capital structure is crucial as it impacts the cost of capital and raises financial risk (Pinto & Quadras, 2016). Therefore, the managers should identify the relationship between capital structure and financial performance.

The planning of the capital structure, which seeks to maximize income and shareholder wealth, guarantees the optimal Leverage to the fullest extent feasibility to use debt must be within a company's capabilities. These are the main characteristics of the capital structure. The organization should be able to satisfy its commitments to pay the loan and interest payments when and when due, with the minimal potential risk of loss of control. Funds are required in

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order to operate and maintain a company. In company life, finance plays an important role. When funds are insufficient, the corporation loses, and the whole organization suffers if the funds are not adequately handled. As a result, an accurate evaluation of the organization's existing and future capital needs must be developed to create an optimal capital structure that allows the organization to operate its operations efficiently and without stress. The factors involved in selecting a capital structure are complicated, and the effects of each determinant on value are not always obvious. Research is designed to expose the effect and analyze the conflicting evidence in previous literature to establish the practical consequences of theories. This study examines how the capital structure impacts the profitability of hotel companies registered in the Sri Lanka Tourism Development Authority (SLTDA).

Most of the investors' decisions depend on profitability. The managers perpetually attempt to increase their make the most of several sources. They ignore the impact of capital structure when calculating profitability. They are solely concerned on the increasing gain in the direct method. Managers do not assume that the capital structure changes are affected by the gain. There are different relationships between capital structure and profitability (Addae et al., 2013). Therefore, it is essential to examine the changes in capital structure when designing strategies to improve financial performance. There are many arguments regarding the impact of capital structure on financial performance. Since conflicting results can be found in the world economy and Sri Lankan context.

Since many conflicting results can be found in the world economy and Sri Lankan context, even though, Nirajini and Priya (2013), found a positive relationship between capital structure and firm performance in trading listed companies (Pratheepkanth, 2011) and (Tharmila & Arulvel, 2013) found a negative relationship. Besides, Abeysekera and Studies (2019), found no significant association between capital structure components and the firm's financial performance in manufacturing companies. Sri Lanka needs further investigation and is examined in the hotel sector, bearing in mind its economic value and the resulting investments.

The Objectives of the Study

The study's overall objective is to investigate how capital structure affects the profitability of star hotels in Sri Lanka, and specific objectives are as follows.

- To investigate the effect of capital on profitability in SLTDA registered star category hotels in Sri Lanka
- To investigate the Impact of optimal capital structure in SLTDA registered hotel
- To investigate the trends of capital structures practiced by the SLTDA registered hotel

Literature Review

Capital Structure

A company's capital structure is a combination of debt, equity, or a mix of both, and company's capital structure is then the quantity or arrangement of its liabilities (S, 2016). Leon (2013) stated that the firm's financial decision-making process and other resources are increasingly dependent on the firm's capital structure. The word "capital structure" refers to company's debt to equity ratio.

According to Mujahid and Akhtar (2014), "optimal capital structure is setting the most suitable mix between equity and debt financing for the firms that can contribute to overall performance and profitability by reducing the cost of capital normally referred to as Weighted Average Cost of Capital" (WACC). Because of the implications of such judgments and the organization's ability to deal with the competitive environment, making the ideal decision is vital. It is revealed

in (Othman, 2013) that the most excellently probable selection of debt and equity shares will maximize shareholders' wealth. By offering shareholders preferential treatment, companies might gain more wealth. As a result, investors' goodwill increases the firm's worth (Mujahid and Akhtr, 2014). Businesses' profitability affects their equity and investment prospects, while their debt affects them in the other direction.

Capital structure refers to a company's mix of debt and equity. The balance sheet of the company may reflect this. Businesses utilize both to fund their assets, day-to-day operations, and investments for the company's future growth. He went on to say that hybrid securities are yet another component of capital structure. When it comes to (Shubita and Alsawalhah, 2012), A firm's ability to deal with the competitive context relies heavily on clearly stated capital structure decisions. However, according to the study, the term "capital structure" refers to a combination of many securities. There are other ways to raise money for the company's fund. The balance of debt and equity that organizations use to finance their assets is one of the most critical financial managers' decisions. A company's market value can be increased by using various debt and equity ratios in the order when it clearly understands its capital structure (Chechet et al., 2013).

Debt to Equity Ratio

In finance, the debt-to-equity ratio (D/E) is a financial measure that illustrates the proportion of shareholders' equity and debt used to fund a company's property investments. This ratio measures the amount of money creditors loaned to the shareholders' fund. The debt-to-equity ratio is an independent variable used to assess a company's financial health. In order to determine a company's capital structure, this ratio is the most important.

Capital Structure Theories

Modigliani Miller Approach

Modigliani and Miller (1958) examined whether the structure of a company's capital was relevant or not. The Thesis of Irrelevance was the name given to this theory. Tax benefits and the potential for debt repayment must be completely offset. According to their hypothesis, the risk disadvantage must also be zero even if the tax benefit is zero. Because financial leverage has no effect on a company's market value, as the theory of capital structure irrelevance holds (Shubita and Alsawalhah, 2012), M and M investigated why the rate of return increased when the debt ratio was raised.

Trade-Off Theory

Trade-off theory states that an optimal capital structure is obtained when there are no advantages or disadvantages to debt. Trade –off theory suggests an optimum debt level or target level for tax savings and bankruptcy costs (Hull and Dawar, 2014). The organization's ideal capital structure must receive the best possible tax benefit.

Pecking Order Theory

This theory (Myers, 1984) states that there is no well-defined debt equity ratio and that enterprises decide their debt level based on external financing. The Pecking order theory (Fama and French, 2005) states that corporations use their internal funds and then issue debt or issue equity. Pecking order theory (Chen and Chen, 2011) states that managers prefer debt financing. Internally generated funds are given priority over externally generated ones, with debt taking precedence over equity in the hierarchy of funding sources used by managers.

Profitability

Financial success or profitability is a term used to describe the health of an organization's finances (Balasundaram, 2010). Ratios are most useful to the business's decision-makers. In today's business world, media coverage of corporate social behaviour directly impacts a company's financial performance. Traditional ways of measuring financial success can be replaced by fusing news articles and television commercials as indicators. Taani (2013, p. 24) stated that to gauge a company's financial performance, examine its ROA and ROE ratios. From 2005 to 2009, 45 Amman-listed manufacturing companies were studied as part of the research. Company's financial health can be assessed using ROE and ROA (Leon, 2013; Chukwunweike and Osiegbu, 2014). The researcher anticipated that ROA and ROE would be used as a profitability measure in this study.

Return on Equity

A company's ROE (return on equity) is defined as the number of money shareholders can expect to gain from a company's efficient use of its capital structure. The most critical metric for assessing a company's financial health is its return on equity (ROE). Using the management's capital structure effectively allows shareholders to earn a return on their investment (Soumadi and Hayajneh, 2012).

Return on Asset

Profitability is gauged by an organization's ability to maximize the value of its assets through a specific period. As stated previously (San and Heng, 2011) link between the company's financial health and its capital structure is revealed. It could be both positive and negative. "There is a relationship between firms' capital structure and corporate performance," according to the findings of this investigation.

Methods

Nature of the Study and Research Strategy

The portion of the dissertation "nature of the thesis" is usually the one in which the research design is set out and discussed. In other words, this would be a concise part of a study in which give the reader a basic further for this study researcher used a descriptive research approach. An overall plan for executing a research study is a research technique. A research strategy directs a researcher in preparation, implementation and tracking the analysis.

Population and Sample

This study concerned the consumer service sector SLTDA (Sri Lanka Tourism Development Authority) registered Hotels in Sri Lanka (38) as the population. Among the population, 25 SLTDA registered hotels have been selected considering the availability of annual reports for ten years.

Data and Data Collection

This study is based on the quantitative technique, which uses data that can be quantified and verified, and is amenable to statistical manipulation. Both independent and dependent variables use the secondary data obtained from audited annual reports from each company. Moreover, this study's data represents the ten years from 2011 to 2021. For the study, the researchers can only use the companies listed on or before the 1st of April in 2010 on the Colombo Stock Exchange (CSE).

Operationalization

Variables can identify two types the independent variable and dependent variable. According to the study, the independent variable is the capital structure, which uses debt equity ratio, debt to asset ratio, and interest coverage ratio. Profitability is the dependent variable. It can measure by using ROE and ROA.

Table 01: Operationalization Chart

Variable	Dimensions	Measurement Tool
Capital Structure	Debt To Equity Ratio	Total debt / Shareholders' Equity
	Debt Asset Ratio	Total liability / Total Asset
	Interest Coverage Ratio	Earnings Before Interest and Tax / Interest Expense
Profitability	Return on Equity	Net Income / Shareholder Equity
	Return on Asset	Net Income / Total Asset

Source; Tharmila and Arulvel, (2013)

Hypotheses

H1 – There is a significant influence of debt-to-equity ratio on the return on equity

H2 – There is a significant influence of debt to asset ratio on the return on equity

H3 – There is a significant influence of interest coverage ratio on the return on equity

H4 – There is a significant influence of debt-to-equity ratio on the return on asset

H5 – There is a significant influence of debt to asset ratio on the return on asset

H6 – There is a significant influence of interest coverage ratio on the return on asset

Independent Variables

This study's independent variable is capital structure, and debt to assets ratio debt to equity ratio, and interest coverage ratio are used to firm's capital structure.

Dependent Variable

In this study Return on Asset and Return on Equity use to measure the dependent variable.

Data Analysis

STATA software was used to analyze related data to find the relationship between capital structure and profitability, and descriptive statistics, correlation analysis and regression analysis were used to present such a relationship.

Panel Data Regression Analysis Equation

$$ROE = \alpha + \beta 1DER + \beta 2DAR + \beta 3ICR + \varepsilon$$

$$ROA = \alpha + \beta 1DER + \beta 2DAR + \beta 3ICR + \varepsilon$$

ROE= Return on Equity
 ROA= Return on Asset
 DER= Debt to Equity Ratio
 DAR= Debt to Asset Ratio
 ICR = Interest Coverage Ratio
 ε =Error term
 α =Intercept term
 β = Coefficient

Results and Discussion

The correlation between return on equity and debt to equity, return on assets and debt to equity, debt to equity and interest coverage, and debt to assets and interest coverage is negative.

Table 02: Correlation Analysis

	Return~y	Return~t	Debtto~y	Debtto~t	Intere~e
ReturnonEq~y	1.0000				
ReturnonAs~t	0.8827	1.0000			
DebttoEquity	-0.0158	-0.0268	1.0000		
Debttoasset	0.4463	0.2869	0.2031	1.0000	
InterestCo~e	0.0489	0.0154	-0.2525	-0.0918	1.0000

Source: STATA calculation

There is a positive relationship between the return on equity and the debt to assets; the return on equity and the interest coverage; the return on assets and debt to assets; return on assets and interest coverage, and the debt to equity and the debt to an asset.

Table 03: Regression Analysis Return on Equity Vs Capital Structure

Source	SS	df	MS	Number of obs = 270		
Model	36.6086196	3	12.2028732	F(3, 266)	=	24.33
Residual	133.408172	266	.50153448	Prob > F	=	0.0000
				R-squared	=	0.2153
				Adj R-squared	=	0.2065
Total	170.016791	269	.632032681	Root MSE	=	.70819
ReturnonEquity	Coef.	Std. Err.	t	P> t	[95% Conf. Interval]	
DebttoEquity	-.0952124	.0577031	-1.65	0.100	-.2088253	.0184004
Debttoasset	1.35037	.1589448	8.50	0.000	1.03742	1.66332
InterestCoverage	.0127489	.0104782	1.22	0.225	-.0078819	.0333796
_cons	-.0209718	.0781396	-0.27	0.789	-.1748225	.132879

Source: STATA calculation

R square is obtained as 0. 2153.it suggested that the independent variable explains 21.53 percent of the variation in the dependent variable. Adjusted R square refers to the modification of R

Square that is Adjusted for the number of explanatories in a model. In order to the above table, adjusted R square value 0.2065.

The test statistic is the ratio mean square of the model divided by the mean square of the residual or error. The yielding $F(3, 266) = 24.33$ (F- value and degree of freedom) explains the overall statistical significance of the regression model. This indicates that the overall model applied can statistically significantly predict the dependent variable. Moreover, it is supported by the p-value of the model, which is 0.000 ($P < 0.05$), representing that the overall model is statistically significant. Hence regression model is appropriate. It indicates that the dependent variable has jointly influenced all the independent variables. According to the above table constant (intercept term = α) is - 0.0209. It means the value of the dependent variable (return on equity) is -0.0209 when all the independent variables each have zero value when holding all other factors constant.

Further, it can be concluded that by holding other factors constant, return on equity is expected to increase by about 1.350, when the debt to asset ratio increases by one unit. Also, return on equity will increase by about 0.0127 for a unit increase in interest coverage ratio when all other factors are constant. Also, the return on equity will decrease by about 0.0952 for a unit increase in debt-to-equity ratio when all other factors are constant.

Hypothesis testing

Hypothesis testing is done for the eight factors to check how the independent variables effect of the independent variable's effect on the dependent variable.

Debt to Equity

According to the table, the probability of debt-to-equity ratio is 0.100 ($0.100 > 0.05$). As the P-value is greater than the 0.05 level of significance, debt to equity ratio is not significantly contribute to the model. Hence the alternative hypothesis (H1) is rejected, and the null hypothesis is accepted (H0). That means the debt-to-equity ratio does not influence the return on equity.

Debt to Asset

According to the table, the probability of debt to asset ratio is 0.000 ($0.000 < 0.05$). As the P-value is less than the 0.05 level of significance, the debt to asset ratio is significantly contributed to the model. Hence the alternative hypothesis (H2) is accepted, and the null hypothesis (H0) is rejected. That means the debt to asset ratio influences on the return on equity.

Interest Coverage

According to the table, the probability of interest coverage is 0.225 ($0.225 > 0.05$). As the P-value is greater than the 0.05 level of significance, the interest coverage ratio is not significantly contributed to the model. Hence the alternative hypothesis (H3) is rejected, and the null hypothesis is accepted (H0). That means the interest coverage ratio does not influence the return on equity.

Table 04: Regression Analysis Return on Assets Vs Capital Structure

Source	SS	df	MS	
Model	16.4755673	3	5.49185576	Number of obs = 270
Residual	165.851358	266	.623501346	F(3, 266) = 8.81
Total	182.326925	269	.677795262	Prob > F = 0.0000
				R-squared = 0.0904
				Adj R-squared = 0.0801
				Root MSE = .78962

ReturnonAsset	Coef.	Std. Err.	t	P> t	[95% Conf. Interval]	
DebttoEquity	-.0871294	.0643379	-1.35	0.177	-.2138058	.039547
Debttoasset	.9069566	.1772208	5.12	0.000	.5580227	1.255891
InterestCoverage	.0043265	.011683	0.37	0.711	-.0186764	.0273295
cons	.0826345	.0871243	0.95	0.344	-.0889065	.2541754

Source: STATA Calculation

R square is obtained as 0.0904. It suggested that the independent variable explains 9.04 percent of the variation in the dependent variable. Adjusted R square refers to the modification of R Square that is adjusted for the number of explanatory variables in a model. In order to the above table, adjusted R square value 0.0801.

The test statistic is the ratio mean square of the model divided by the mean square of the residual or error. The yielding $F(3, 266) = 8.81$ (F-value and degree of freedom) explains the overall statistical significance of the regression model. This indicates that the overall model applied can statistically significantly predict the dependent variable. Furthermore, it is supported by the p-value of the model, which is 0.000 ($P < 0.05$), representing that the overall model is statistically significant. Hence regression model is appropriate. It indicates that the dependent variable has jointly influenced all the independent variables.

The above table's constant (intercept term = α) is 0.0826. It means the value of the dependent variable (return on asset) is 0.0826 when all the independent variables have zero value when holding all other factors constant. Further, it can be concluded that by holding other factors constant, return on asset is expected to increase by about 0.906, when the debt to asset ratio increases by one unit. Also, return on an asset will increase by about 0.0043 for a unit increase in interest coverage ratio when all other factors are constant. The return on an asset will also decrease by about 0.0871 for a unit increase in debt-to-equity ratio when all other factors are constant.

Hypothesis testing

Hypothesis testing is done for the eight factors to check how the independent variables affect the dependent variable.

Debt to Equity

According to the table, the probability of the debt-to-equity ratio is 0.177 ($0.177 > 0.05$). As the P-value is greater than the 0.05 level of significance, the debt-to-equity ratio is not significantly contributed to the model. Hence the alternative hypothesis (H_4) is rejected, and the null hypothesis is accepted (H_0). That means the debt-to-equity ratio does not influence the return on assets.

Debt to Asset

According to the table, the probability of debt to asset ratio is 0.000 ($0.000 < 0.05$). As the P-value is less than the 0.05 level of significance, the debt to asset ratio is significantly contributed to the model. Hence the alternative hypothesis (H_5) is accepted, and the null hypothesis (H_0) is rejected. That means the debt to asset ratio influences on the return on assets.

Interest Coverage

According to the table, the probability of interest coverage ratio is 0.344 ($0.344 > 0.05$). As the P-value is greater than the 0.05 level of significance, the interest coverage ratio is not significantly contributed to the model. Hence the alternative hypothesis (H_6) is rejected, and the null hypothesis is accepted (H_0). That means the interest coverage ratio does not influence the return on assets.

The results are consistent with those (Mujahid & Akhtar, 2014), (Abor, 2005), (Ebaid, 2009) who pointed to a positive relationship between capital structure on profitability. Nirajini & Priya, 2013, also pointed out a positive relationship between capital structure and financial performance of listed Trading companies in Sri Lanka. The study used the scholars from 2006 to 2010 financial years. Also, (Leon, 2013) explained that there is no significant relationship between Leverage and ROE. The study of (Ahmad, 2014), and (Gupta, 2015) shows a negative relationship between the debt-equity ratio with return on equity, and returns on asset. Ahmad, (2014) also related to the ICR relationship capital structure on profitability of cement sector of Pakistan. The scholars were used from 2005 to 2010 financial years in the study. Further, (Pratheepkanth, 2011) identified the negative relationship between capital structure and financial performance.

Conclusion

According to the study, the correlation between return on equity and debt to equity, return on assets and debt to equity, debt to equity and interest coverage, and debt to assets and interest coverage is negative. There is a positive relationship between the return on equity and the debt to assets; the return on equity and the interest coverage; the return on assets and debt to assets; return on assets and interest coverage, and the debt to equity and the debt to asset. Further, the study found that there is no significant relationship between debt-to-equity ratio and interest coverage ratio on the return on equity and return on asset. There is a significant relationship between debt to asset and return on equity and the return on asset. These results concluded that there is an impact of capital structure on the profitability of the hotel industry.

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