

IMPACT OF LEVERAGE AND MANAGERIAL SKILLS ON FIRM PERFORMANCE

Syed Amad Nadeem¹, Abdul Waheed², Hamid Mahmood³

Foundation University Islamabad,
PAKISTAN.

¹amadnad@gmail.com, ²abdulwaheed@fui.edu.pk, ³hamidawan@fui.edu.pk

ABSTRACT

The purpose of this study is to investigate the effect of leverage and managerial skills on return for shareholders. The proportion of debt in the total capital structure of the firm is of particular importance in this study. Leverage is assessed by total debt and long-term debt. Managerial skills are assessed by education level and experience of the CEO of each company. Stockholder's return is measured by return on equity. In this study, I apply panel data analysis on a sample of 25 companies from the year 2009 to the year 2014. The companies have been chosen from agricultural sector in Pakistan. Results of panel data analysis indicate that there is a significant and positive relationship between total debt of a firm and return on equity. Similarly, the results indicate a significant and negative relationship between total debt of a firm and return on equity. Education level of CEO and experience of CEO are found to have a significant and positive relationship with return on equity. However, long-term debt shows a negative but significant relationship with return on equity. The results suggest that as the debt of a company increases, return for shareholders decreases. Similarly, if only long-term debt is increased, stockholders' return decreases. Hence, investors should consider factors such as total debt of a company and skill level of CEO when evaluating returns on equity.

Keywords: Capital Structure, Leverage, Managerial Skill, Return on Equity

INTRODUCTION

Financing decisions refer to how the firm finances capital expenditures. Capital structure refers to the mix of debt and equity in the firm's sources of funds (Matimelola, Bany-Arifin and Azman- Saini (2013)). The combination or mix of equity and debt influences the weighted average cost of capital (Tauseef, Lohano and Khan(2015)). Generally, capital structure consists of debt and equity only. The proportion of equity or debt to total capital is a strategic decision taken by top management of a firm according to several factors like the financial position of the firm, the ease of availing external sources of financing and the payout ratio of the firm. Capital structure decisions are very important for any firm because they have a direct impact on firm value. A firm's decisions regarding capital structure comprise of how to use sources of funds for capital investments. These sources of funds comprise short-term debt, long-term debt, preferred and common stock. Capital structure decisions are very important because they impact shareholder's wealth. 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 and Ramya (2013), p 446). 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.

We know from previous research that capital structure affects firm value. But an important aspect of this research is the fact that I intend to examine if skill level of upper management does have an impact on stock returns or not. Unlike the relationship between leverage and firm market value, the relationship between stock returns and managerial skills is not well established, but the grounding of this relationship can be found in Upper-echelon theory. Upper-echelon theory derives its roots from organizational and management science behavior. The theory argues that demographic attributes such as age, experience and education level of top management influences their strategic decisions. Furthermore the theory argues that top management is an important resource for the firm because of the influence that top managers have on firm's strategic decisions and success. Top management with high level of education and experience are capable of making high quality decisions which have a significant influence on the strategic direction a firm takes. The assumption underlying upper-echelon theory is the premise that level of education and experience are a basis for cognitive ability. Another important theory which relates performance of a firm with behavioral CEO features is the leader life cycle theory developed by Hambrick and Fakutomi (1991). According to this theory, a CEO life cycle comprises of five seasons; each of these seasons corresponding to distinct behaviors.

The global increase in the risk premium and shareholders' return during the recent financial crisis is partly attributed to the top management's use of excessive leverage. Previous studies have identified several factors such as leverage, price, book-to-equity ratio, tax and size as some of the variables which affect shareholder's return. Nonetheless, Managerial skills have been frequently omitted because it is difficult to measure. Pandey, 2005, and Jacobson, 1990, argue that it is vital to include unobservable firm-specific factors in the model to measure shareholder return. Additionally, the conclusions we draw from a model which does include unobservable firms-specific factors would be wrong. The role of specific unobservable factors in firms, in particular, has been omitted in the literature, but managerial skills could have a strong influence on shareholder return.

In this study employ shareholder's return as the independent variable. Shareholder's return is measured as the ratio of net income to shareholder's equity. I will use total debt of a firm, measured as total debt divided by total assets, as the independent variable. Total debt divided by total assets, also called leverage, and has a positive relationship with shareholder's return. As a robustness measure, I have also used long-term debt to measure leverage. Long-term debt, too, has a negative relationship with shareholder's return. Education and experience are used as proxies for managerial skills. According to upper-echelon theory, managerial skills have a significant impact on firm output and, in that sense, they will impact return for shareholders.

The remaining part of this research has been organized as explained:

In the second section, I discuss relevant literature which shows relationships among capital structure and firm performance. In the third part, hypotheses are developed. Fourth part comprises of research methodology. In the fifth part I show tests and results. The study concludes with the sixth part which is followed by limitations and future study.

PROBLEM STATEMENT

Do leverage and managerial skills affect shareholder return in Pakistan?

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 managerial skills on return for shareholders in Pakistan.
3. This research study intends to serve as a guide for investors to assess the impact of capital structure and managerial skills on return for shareholders in Pakistan

LITERATURE REVIEW

The recent financial crisis which saw many firms go bankrupt and in turn increased returns required by shareholders was caused partly by the use of high debt. How leverage affects value of firm and shareholder's return has been a matter of debate in the world of literature. It started with Modigliani and Miller (1958) who argue that level of debt of a firm is independent of its cost of capital. In other words, the degree of leverage a firm uses does not, in fact, affect its weighted average cost of capital. The proposition was based on very simplistic assumptions. However, in the real world capital markets are seldom perfect. Many imperfections exist in the market, especially in developing countries which makes debt all the more pertinent.

Conversely, Modigliani and Miller (1963), in proposition two of their model, that leverage increases the cost of equity but that tax savings from debt is offset by the rising cost of equity of the firm. Their proposition, specifically, stipulates that cost of equity of a firm comprises of capitalization rate related to pure equity as well as a risk premium (Matemilola, *et al.*, 2013,). That implies the cost of equity of a firm is a linear function of debt-to-equity ratio. In other words, required return on equity is a function of financial leverage ((Matemilola *et al.*, 2013,).

Kraus and Litzenberger (1973) argue that there is cost of default or financial distress associated with debt. As the firm takes on more debt, the cost associated with the risk of default increases. According to this theory as the firm takes debt, the benefit from the interest tax shield increases. But at the same time the uncertainty associated with its ability to service future debt obligation increases and hence the risk of default increases. A firm will borrow until the marginal benefit from the interest tax shield equals the marginal cost of default. The firm will have reached optimal capital structure at this point because firm value will be maximum and the cost of weighted average capital a minimum.

Recent studies have concentrated more on the impact of financial leverage on financial performance. Vatavu (2015) analyze the capital structure of 196 companies in the manufacturing sector listed on the Bucharest stock exchange from 2003 to 2010. He uses return on assets as net income to total assets, and return on equity as ratio of net income to shareholder's equity. ROA and ROE were regressed over a group of variables such as debt, liquidity, risk etc. Their findings indicate the debt has a negative impact on ROA and ROE while shareholder's equity has positive impact on ROE. Based on the results, the more debt a company uses and more tangible assets they use, less efficient they are regarding shareholder's money. This is because the when managers take on debt they have to look at the interest of debt holders at the cost of shareholders' interest. Hamid, Abdullah and Kamaruzzaman (2015) examine the influence of capital structure on the profitability of 46 family and non-family firms using firm year observation of listed companies in Malaysia

over three years from 2009 to 2011. The findings show that debt ratio is positively and significantly related to profitability, in contrast to findings of Vatavu (2015). The findings also suggest that profitable firms depend on equity as their main financing option. The results confirm that an increase in leverage is associated with decrease in profitability. Tauseef *et al.*, 2015, examine the effect of debt financing on firm's financial performance, measured as return on equity. The authors use panel data of 95 textile companies in Pakistan from 2003-03 to 2007-08. The study uses firm-level panel data for the listed companies from textile industry of Pakistan for six years from 2002-03. Using a two-way regression model, they show that ROE increases with debt-to-equity ratio and reaches an optimal level before it begins to decline. The findings are consistent with the MM and trade-off theory which. Optimal debt-to-asset ratio is estimated at 56% for the textile industry, consistent with trade-off theory as well. The findings of the study also indicate that companies with debt have to bear interest costs which leave little net income for the firm.

Inam and Mir (2014) examine the relationship between financial leverage and firm performance in fuel and energy sector of Pakistan. They use data of 12 companies as sample from annual reports and published financial statements. They use ROE, Return on capital employed, net profit margin, earnings per share before tax and earnings per share after tax as proxies for financial performance. Financial leverage is assessed by indicators using debt-to-equity ratio and gearing ratio. The results indicate high correlation of financial performance proxies with leverage, consistent with the findings by Vatavu (2015). Another study by Sekar *et al.*, 2014, examines the effect of leverage on Tata Motors. Using EBIT-EPS analysis, they find value of firm is positively correlated with its ROE, value of debt and equity. The results are consistent with earlier work by Inam and Mir (2014).

Wang, Liu and Lee (2014) examine the effect of firm investment on stock returns by using data from Chinese stock market. They employed Total asset growth (TAG) as a measure of overall firm investment. TAG is calculated as a percentage change in total assets on a yearly basis; they show an obvious investment effect on stock returns. Stocks with low investment have higher overall returns as compared to stocks with low investment. Investment effect has been shown to be stronger for firms with low debt. This suggests that there is at least some relation between stock returns and debt although the relationship is not very clear like Tahmoorespour *et al.*, 2015. Hamid, Fida and Zakaria (2013) analyze determinants of capital structure and stock returns. Applying a generalized method of moments model to a panel dataset for 100 non-financial firms for the period 2006-2010 on Karachi Stock Exchange (KSE), the authors show that both leverage and stock returns are inversely related to each other. The results show that there is negative relationship between stock returns and leverage. Senyigit and Ag (2013) analyze firms from Turkey and USA. They calculate average stock returns based on average of monthly returns for each company. Using OLS-pooled regression and GLS random effects model to examine relationship between P/B ratio, D/E equity ratio and stock returns, they find negative relationship between D/E ratio and stock returns.

Similarly, Ozdagli (2012) examines the relationship between stock returns of value firms and those of growth firms. The findings indicate that leverage, defined as debt-to-assets ratio, can affect value of firms.

Relation between size and shareholder's return

Similarly, Farhan and Sharif (2015) examine the effect of firm size on stock returns with time-variant factor of January and July. The study examines firms belonging to four major manufacturing sectors of Karachi Stock Exchange, namely automobile and parts, materials and construction, and pharmaceutical and bio-tech. They use monthly data which ranges from

the period January 2007 to 2013 inclusive, monthly closing price; KSE100 index values and market capitalization being the prominent variables under investigation. OLS and fixed effects are used in the model. Their findings indicate that size of firm is negatively and significantly related to the returns of firms in the sample. These findings are consistent with previous studies.

Mazviona, Winmore, Nyangara and Davis (2014) investigate the relationship between firm size and stock returns for firms listed on the Zimbabwe Stock Exchange (ZSE). The study focuses on the time period between June 2009 and July 2013. The use the regression method to analyze portfolio of stocks selected according to market capitalization of the firms. Data prior to 2009 is excluded because it consists of a period of hyperinflation. The sample covers 64 companies listed on Zimbabwe Stock Exchange. The findings indicate that estimated firm size is not significant at 5% significance level. The study shows that firm size has a positive yet insignificant effect on the companies between the periods June 2009 to July 2013. Contrary to empirical findings, the study also indicated that larger firms show higher risk-adjusted returns than smaller firms listed.

Chaibi, Alioui, and Xiao (2014) evaluate the firm size effect on risk return on American Stock Market. They selected daily traded values of the listed companies in Russell 3000 index period from 2010-2012. They establish a different size model by applying Sharp model and CAPM and select Ordinary Least Square (OLS) regression method for preparation of each 12 size group. Findings explain that small size firms have low risk adjusted returns and higher values firm perform better compare to small ones in Russell 3000 index market. The findings are inconsistent with previous studies.

Shafana, Rimzia and Jariya(2013) investigate the behavior of expected stock returns with respect to size and book-to-market equity in Sri Lanka. They apply Fama-Macbeth(1973) procedure to a sample of 12 companies out of 25 companies listed on Milanda price index in base year 2005 on Colombo stock exchange. They only take into account companies with positive book values. Their findings indicate that book-to market equity has a significant negative relationship with respect to stock returns whereas firm size does not have a significant relationship with stock returns. Tahir, Sabir, Alam and Ismail (2013) analyze the effect of Market capitalization, Sales Growth, Earnings per share and book-to-Market value on 307 listed firm from financial and non-financial sectors. They find that Market capitalization has a positive effect on stock returns. The study provides supporting evidence for the impact of size of firm on stock returns.

Effect of Taxes

Matemilola *et al.*, 2013, investigate the effect of leverage and managerial skills on shareholder's return. They use fixed effects panel regression that accounts for managerial skill factor are used. Analyzing a sample of firms from Bursa Malaysia and excluding financial and non-financial firms, they find a positive relationship between total debt and stock returns. The findings indicate an insignificant relationship between tax rate and shareholder's return.

Similarly, Matemilola *et al.*, 2012, examine the effect of leverage on shareholder return for a sample of companies listed on the South African stock exchange. Using GMM method to test the relationship, they find an insignificant relationship between tax rate and shareholder return.

Hypothesis Development

The literature shows mixed evidence on the relationship between leverage and value or stock returns. On the bases of the literature review the study has following hypothesis.

- H1) There is a significant relationship between total debt and stockholder's return
- H2) There is a significant relationship between long-term debt and stockholder's return
- H3) There is a significant relationship between managerial skills and shareholder's return

DATA AND METHODOLOGY

Data

The sample consists of firms listed on Karachi Stock Exchange (KSE). The data related to measures of debt and shareholder's return has been obtained from balance sheet analysis published by State Bank of Pakistan for the period 2009-2013. Those companies have been included which have listed on the Karachi Stock Exchange (KSE) from the period June 2009 to July 2014. Only those firm have been included which can be included in the agriculture sector. Examples of these firms include firms in the fertilizer, sugar and jute sector. Agriculture sector has been chosen because it is the largest contributor to the countries' Gross Domestic Product. However, to derive the final sample, some restrictions have been imposed. Firstly, I have use annual data of 25 companies listed on Karachi Stock exchange from 2009 to 2013. The companies are primarily from agriculture sector as already discussed. This simple criterion has been chosen because these companies listed on Karachi Stock Exchange (KSE) are sector leaders and this will give us insight into performance of sector leaders. Secondly I have used time-series data of companies' management experience and education level. I have collected data on education level and management experience of CEOs of the selected companies for the time period ranging from 2009-2014. In order to measure the effect of managerial skills on shareholder's return, I apply panel data analysis. Thirdly, as part of the sampling process, I have excluded financial firms.

I have collected data related to managerial skills from published annual reports and official websites of firms in the agriculture sector listed on Karachi Stock Exchange (KSE). The data is for the financial year ending the year 2014.

In this research, data from balance sheet and income statements of the selected companies has been taken from published financial statements and balance sheet analysis. This is in line with past studies on capital structure. The measures of equity and debt used are in line with Matemilola et al., 2013, and Tauseef et al., 2015.

METHODOLOGY

To investigate the effect of leverage and managerial skills, panel data analysis that accounts for managerial skill factor is appropriate. Panel data analysis and random effects model provide better econometric estimates. Moreover, it is difficult to observe differences across different firms. Panel data analysis provides a technique to control for variables which do not vary with time because of firm-specific factors. Moreover, Hausmann test supports random effects model for panel data.

All explanatory variables are exogenous in my model; and consequently they are not correlated with any firm-specific factors. We further assume if that, managerial skills interact with other explanatory variables at all, their impact on shareholder's return will be absorbed

by my random effects model. The model that I use in this study has originally been adopted from Matemilola et al., (2013). I will use the same model but with some modifications. I have excluded price-to-book ratio from the equation ignored fixed affects of year and industry because the study is time-series and is based on a specific industry.

$$ROE_{i,t} = \beta_1 + \beta_2LTDTA_{it} + \beta_3DEBTTA_{it} + \beta_4TA_{it} + \beta_5TAXRATE_{it} + \beta_6CEOEDU_{i,t} + \beta_7CEOEXP_{i,t} + \mu_{it}$$

ROE_{it} = Return on equity of firm i at time t.

LTDTA_{it} = Long-term to total assets for firm i at time t

DEBTTA_{it} = Total debt to total assets for firm I at time t

TA_{it} = Total assets

TAXRATE_{it} = Effective tax rate of firm I at time t

CEOEDU_{it} = Education level of CEO

CEOEXP_{it} = Experience level of CEO

Shareholder's return (SR) is represented by return on equity which is calculated as net income divided by shareholder's equity. Total debt (TD) is calculated total debt divided by total assets. Long-term debt represents long-term debt divided by total assets. Size equals the log of total assets of firm i. Effective tax rate is calculated as tax liability divided by taxable income.

Education level of CEO is measured using the following scale.

3= Bachelors degree

4= some graduate school

5= Masters degree

Variables

Shareholder's return is the dependent variable in this study. It is calculated as net income divided by shareholder's equity.

Independent variables are Total debt and long-term debt. Total debt is calculated as total debt divided by total assets. Long-term debt is calculated as long-term debt divided by total assets.

Control variables

Size equals the log of total assets of firm i. Tax represents the effective tax rate (calculated as tax liability divided by taxable income).

Matemilola et al., (2013), argue that observable demographic attributes like education level and experience shape values of top management; hence they can be used as proxies for cognitive ability of managers. Cognitive ability refers to the ability attached to alternate decisions which influences future outcomes or future output of a firm. They use average education level and average years of experience as a proxy for managerial skills. Similarly, Kweh, Ting and Azizan (2015) use education level as a proxy to measure the impact of CEO characteristics on firm leverage in Malaysia. Hence, in this study, I use average education level and average number of years of a CEO as measures of managerial skills.

RESULTS AND DISCUSSION

Descriptive statistics

The table below show descriptive statistics for 149 observations.

Table 1. Descriptive Statistics

	<i>CEO EDU</i>	<i>CEO EXP.</i>	<i>DEBTTA</i>	<i>LTDTA</i>	<i>TA</i>	<i>TAXRATE</i>	<i>ROE</i>
<i>Mean</i>	3.704698	17.88591	0.327113	0.203528	4573122.	33.97424	11.32858
<i>Median</i>	3.000000	17.00000	0.252154	0.123285	1528975.	16.93102	10.34000
<i>Maximum</i>	5.000000	40.00000	1.519047	1.169080	49646470	579.7188	360.6465
<i>Minimum</i>	3.000000	2.000000	0.000000	0.000000	21919.00	-86.04369	222.1400
<i>Std. Dev.</i>	0.919043	8.243368	0.308410	0.219516	9101361.	84.70026	57.37023
<i>Skewness</i>	0.616427	0.612228	1.259574	1.330936	3.398716	4.577379	1.695198
<i>Kurtosis</i>	1.476319	3.244856	4.288830	4.901453	14.52826	26.98964	18.45730
<i>Jarque-Bera</i>	23.84952	9.680326	49.71131	66.43592	1111.949	4093.231	1554.709
<i>Probability</i>	0.000007	0.007906	0.000000	0.000000	0.000000	0.000000	0.000000
<i>Sum</i>	552.0000	2665.000	48.73985	30.32562	6.81E+08	5062.162	1687.959
<i>Sum Sq. Dev.</i>	125.0067	10057.06	14.07728	7.131695	1.23E+16	1061772.	487118.9
<i>Observations</i>	149	149	149	149	149	149	149

According to the table 1, ROE has average increased 11.32 percent over the year and their deviation from the mean is 57.32. Taxrate has average increased by 33.97 percent each year.

Econometric Results

This section provides the regression results by using panel data estimation for the hypothesis developed in previous section. By applying random effect model following results are obtained.

There is significant impact of long term debt to total assets (LTDTA) and total debt to total assets (DEBTTA) on ROE. The results of other variables included in the model such as CEO education, CEO experience and total assets are also significant with the ROE, but results of tax rate is not significant.

In the above table, long term debt to total assets and total debt to total assets are significant because their probabilities are less than 1 percent and t-statistics is greater than 2.

The results of CEO education, CEO experience and total assets are also positive and significant. The results also suggest that the coefficient tax rate is positive but not significant. The LTDTA is insignificant with their dependent variable. The coefficient of LTDTA is -2.61597, it means that with one unit increase in LTDTA, there is 2.61% decrease in ROE. The coefficient of DEBTTA is 3.72231, it means that with one unit increase in DEBTTA, there is 3.7% increase in ROE, where as its t-stat (2.17405) and p-value (0.0320) are

significant. The coefficient of TA is 1.22; it means that with one unit increase in TA, there is 1.22% increase in ROE, where as its t-stat (1.46) and p-value (.0520) are insignificant. The coefficient of CEO education is 5.23199; it means that with one year increase in education of CEO, there is 5.23% increase in ROE, where as its t-stat (2.037) and p-value (.017) are significant. The coefficient of CEO experience is 4.47; it means that with one year increase in education of CEO, there is 4.47% increase in ROE, where as its t-stat (2.23) and p-value (.013) are significant.

The (coefficient of determination) R-squared value of the model is approximately 49 percent, indicating that 49 percent change in the dependent variable is explained by the independent variables. The 51 percent disparity in the dependent variable is not elucidated by the independent variables due to additional factors, this model failed to capture. While the value of Durbin Watson test for the model is 1.03. Finally, the F statistics is significant which shows the model is stable and reliable. The results are also estimated through common coefficient setting and found to be quite similar with the fixed effect estimation. The results of Hausman test and common coefficient are in Appendix.

On the basis on the results, the study rejects the null hypothesis and accepts the alternate hypothesis that there is significant relationship between shareholder’s return and total debt. Similarly the study reject the null hypothesis and accept the alternate hypothesis that there is a significant relationship between long-term debt and shareholder’s return. Similarly we accept the alternate hypothesis that there is a significant relationship between CEO education level and shareholder’s return. We also accept the null hypothesis that there is a significant relationship between CEO experience and shareholder return.

Hausman Test

The result of Hussman test shows that random effect model have applicable for this study. The results of random effect model are as follow.

Table 2. Correlated Random Effects - Hausman Test

Equation: Untitled				
Test cross-section random effects				
Test Summary		<i>Chi-Sq. Statistic</i>	<i>Chi-Sq. d.f.</i>	<i>Prob.</i>
Cross-section random		16.237563	6	0.0125
Cross-section random effects test equation:				
<i>Variable</i>	<i>Coefficient</i>	<i>Std. Error</i>	<i>t-Statistic</i>	<i>Prob.</i>
LTDTA	-2.61597	1.54397	-1.6943	0.0579
DEBTTA	3.72231	1.27182	2.92675	0.032
TA	1.222514	0.830456	1.4606	0.1896
TAXRATE	0.053366	0.054242	0.98356	0.3272
CEOEDUCATION	5.23199	2.31818	2.25693	0.0117
CEOEXPERIENCE	4.472785	2.011103	2.23237	0.0134

Effects Specification

Cross-section fixed (dummy variables)

R-squared	0.520856	Mean dependent var	6.766361
Adjusted R-squared	0.399039	S.D. dependent var	19.80593
F-statistic	4.275742	Durbin-Watson stat	1.484022
Prob(F-statistic)	0		

CONCLUSION

This study contributes to existing knowledge about the relationship between capital structure and shareholder’s return. It is the first study of its kind which measures the impact of managerial skills on shareholder return in Pakistan. The results have been interpreted keeping in mind the nature of the study. The results suggest that increasing the level of total debt of a firm increases the return of equity of shareholders. Conversely, increase in the level of long-term debt alone decreases return on equity. On the other hand the results indicate a strong relationship between managerial skills and shareholder return. According to our results, increase in the education level of CEO increases return on equity. Similarly, an increase in the number of years of management experience also increases the return for shareholders. Firms should employ CEOs with high education levels and high management experience because that leads to a higher return for shareholders. Similarly, the firm should prefer debt to other forms of financing. However increasing long-term debt alone increases shareholders’ equity. Hence firms should increase short-term debt and long-term debt proportionately so that shareholders can enjoy a positive return because of increase in total debt. At the same time, the results indicate that investors should invest in firms which have CEOs with high levels of education. At the same time, the results suggest investors should invest in companies which have CEOs with high level of management experience. The findings also suggest that investors should buy the stock of companies which have higher levels of debt in their capital structure.

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