Impact of Capital Structure on Firm Performance

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Abstract. The main focus of this essay is the relationship between capital structure and company performance. From three main angles, the research examines and explores how capital structure affects company performance. Previous studies were mostly focused on a specific field, lacking comparison from multiple perspectives. In order to obtain a more comprehensive understanding, this paper expands the key points of the research, mainly from the following perspectives: two different models for calculating the optimal solution (Modigliani and Miller Theory and Capital Asset Pricing Model), two representative industries (real estate industry and retail industry), and differences between countries (differences between developed and developing countries, and differences between developing countries, taking Iran and Malaysia as examples). The findings in this paper demonstrate that various models will produce various conclusions on the relationship between capital structure and firm performance, and various analytical vantage points will change capital structure and ultimately have an impact on firm performance.

Keywords: Capital structure; firm performance; real estate; retail Industry; developed and developing countries.

1. Introduction

Capital structure has been widely discussed in the field of economics and finance. The capital structure mainly includes self-owned capital, long-term liabilities and short-term liabilities. The analysis of how debt and equity capital are distributed is the core of capital structure. The profitability, asset operation level, solvency, and following development capacity of the business should all reflect the enterprise performance group. The main driver of high-quality and high-level economic development is firm performance. Companies in various industries have been pursuing the improvement of the company's performance, and whether the capital structure plays a key role in this process is a question worthy of consideration. The distribution of debt capital and equity capital by capital structure will affect the interests of creditors and shareholders, thus affecting the relevant economic behaviors and decisions of the company. These behaviors and decisions will further affect the company's performance.

There is evidence that previous researchers will improve the company's performance by adjusting the capital structure. For the benefit of the energy sector, Georgakopoulos et al. (2022) connected the effects of capital structure, corporate governance, and equity on company performance [1]. Through the use of return on assets and return on equity, Pouraghajan et al. (2012) looked at the asset structure of businesses that were listed on the Tehran Stock Exchange between 2006 and 2010. The findings demonstrate that lowering the debt ratio in the asset structure can boost the firm's profitability, boost shareholder wealth, and have a beneficial impact on the performance of the organization [2]. However, prior research lacked a multi-perspective investigation of the impact of capital structure on business performance and instead concentrated mostly on a few narrow areas. The three primary factors of diverse models, industry distinctions, and country differences will be used to assess the effect of capital structure on firm performance in this essay.

2. Models on Optimal Financial Leverage Decision

The focus and assumptions of the model are different. According to different models, capital structure has different degrees of influence on corporate performance.

2.1 Modigliani and Miller Theory

Modigliani and Miller (1958) proposed Modigliani and Miller Theory. Its primary meaning is that the value of the company has nothing to do with the capital structure when the corporate income tax is ignored. The fundamental tenet of the Modigliani and Miller Theory ignores the company's income tax in favor of an ideal capital market and unrestricted capital movement. The value of a firm is a manifestation of its performance. On the basis of this theoretical presumption, the capital structure will not have an impact on the performance of the firm, according to the Modigliani and Miller Theory definition. The premise put forth by this theory is, however, incredibly challenging to implement in the actual market. The real market does not have the conditions required by a perfect capital market, such as no transaction costs, no taxes, and information symmetry. Therefore, Modigliani and Miller Theory has limitations, which have been mentioned by many researchers before. Villamil (2008) mentioned that the impact of tax on the company is much more complex than that originally envisaged by Modigliani and Miller, and the impact of the tax is more important than expected [3]. The capital structure of the enterprises in the actual capital market will be tied to the firm value due to the Modigliani and Miller Theory's restrictions, and the firm performance indicated by the enterprise value will also be impacted by the capital structure.

2.2 Capital Asset Pricing Model

By Sharpe et al., the capital asset pricing model was proposed (1964). Qi (2022) discusses the capital asset pricing model's theory. The relationship between risk assets and their anticipated returns on the securities market is studied using the model [4]. The capital asset pricing model is a theoretical framework built on a number of presumptions, among them the ideality of the capital market, the availability of timely, adequate, and free market information, and the rationality of investors. These assumptions, like those of Modigliani and Miller Theory, are unrealistic for the real capital market. Different from Modigliani and Miller Theory, CAPM is very popular with investors and companies. This model has been widely used in portfolio decision-making and the calculation of equity cost. Correia and Cramer (2008) noted that it was discovered that the capital asset pricing model would be utilized to determine the cost of equity and debt-equity ratio in the study of South African listed businesses [5]. Effectively and accurately determining the influencing factors of the asset structure, as described above, can help the company improve the efficiency of resource allocation, thereby enhancing the company's enterprise value and performance. This shows that the capital asset pricing model has been recognized and plays a significant role in determining the asset structure. Correct decisions can also improve the company's performance to a large extent.

3. Capital Structure of Different Industries

Each industry has its characteristics that are different from other industries. These characteristics will lead to different capital structures of industries, and differences between capital structures will have different effects on firm performance. Degryse, de Goeij, and Kappert (2012) pointed out that industry heterogeneity plays an important role in driving capital structure [6]. As a very important component of capital structure, the capital debt ratio significantly impacts an industry's capital structure. This section primarily addresses the differences in the capital debt ratio between the two industries, as well as the effects of the capital structures of the two industries on firm performance, based on the features of the real estate industry and the retail industry.

3.1 Real Estate

The term "real estate industry" refers to a broad sector of the economy that incorporates numerous economic activities and uses land and buildings as its primary commercial assets. It works on the development, building, management, operation, upkeep, maintenance, decoration, and servicing of real estate. The development of land, the building of homes, the selling and leasing of land use rights, and home ownership are the key components of the real estate sector. The real estate industry is

characterized by large investment amounts, long development cycles, high financing demand due to the difficulty of capital management, and the need to pre-sale unfinished products.As a result, the real estate sector often has a greater debt ratio than other sectors. The real estate industry differs in a few ways from other sectors. The operation scale of real estate enterprises is usually relatively large. It takes a long period from the initial land auction to the final house delivery, which requires a large amount of capital. At the same time, because the real estate industry has been expanding, many enterprises continue to pour into the market, which will lead to a high asset-liability ratio in the industry. The asset-liability ratio of the real estate industry will be higher than that of other businesses since real estate is a capital-intensive business that needs a lot of cash flow to build associated projects. Most survey findings on the relationship between capital structure and company performance in the real estate sector indicate that there is a significant association between the two. Katharina et al. (2021) indicated that the evaluation and research results of the real estate industry in the Indonesia Stock Exchange from 2016 to 2019 showed that liabilities, company size, profitability, and other factors would affect the company value at the same time [7]. To investigate the influencing factors of stock return in Indonesia's real estate industry, Atidhira and Yustina (2017) used 35 companies as survey samples. They used the analysis technology of multiple linear regression and came to the conclusion that the debt-equity ratio has a positive impact on stock return [8]. Therefore, what was discussed above can conclude that the high asset-liability ratio unique to the real estate industry constitutes an asset structure that is significantly different from other industries. The asset structure of the real estate sector also affects the performance of firms in the sector.

3.2 Retail Industry

Retail refers to the business activities that provide goods or services to the final consumers. Therefore, retail refers to the industry in which retail enterprises provide consumer products and services. Retailers are facing the ultimate consumers, which means that their circulation will end once the commodities pass through the retail link. The most important feature of the retail industry is that the number of transactions is large, and the average transaction amount is small because the retail industry is basically faced with individual consumers. The market characteristics of individual consumers are a large number, wide range, and diverse demand structure. The essence of the retail industry is the cash flow cycle, so the retail industry mainly focuses on the flow rate of the cash flow cycle rather than the stock of goods and currency. The retail industry puts more emphasis on the circulation of cash than stock, which leads to a low barrier to entry into the retail industry. It does not require a large amount of investment or a high financing demand. Therefore, the retail industry usually does not have a high capital liability ratio. The relationship between capital structure and company performance in the retail sector can be confirmed. In order to better understand how capital structure affects businesses, Komarudin and Affandi (2019) looked at 21 retail companies that were listed on the Indonesian Stock Exchange between 2014 and 2016. The findings of the study demonstrate that capital structure significantly affects firm value [9]. The distinctive capital structure of the retail business, which is made up of a short transaction cycle and a relatively low capital liability ratio, has a direct bearing on how well retail industry enterprises function.

4. Capital Structure and Firm Performance in Different Countries

The majority of businesses around the world have been concerned about the link between capital structure and firm performance. However, the differences between countries will lead to differences in national economic policies and capital market environment. These variations will consequently have an impact on the capital structure, and various countries will have distinct relationships between capital structure and company performance.

4.1 Differences Between Developed and Developing Countries

The research on the relationship between capital structure and enterprise performance has produced inconsistent results due to the disparities in economic development between developing and industrialized nations. Developed nations have a high per capita GDP, advanced industry, research, and technology, as well as good social welfare. They also have a comparatively high level of economic and social development. Therefore, the economic scale of developed countries is usually more extensive than that of developing countries. However, the economic scale of developing countries, due to the incomplete establishment of the industrial system and the lack of a stable basis for development, makes it difficult to expand the national economic scale, which will also lead to information asymmetry in the market and underdeveloped financial systems. Le and Phan (2017) noted that research on how capital structure affects company performance in industrialized nations demonstrates a favorable association between the two. Vietnam, a typical developing nation, has similar research findings to the majority of emerging markets when it comes to the study of the connection between capital structure and company performance in developing nations. The finding is that capital structure and firm performance are not correlated positively [10]. In the more developed and ideal market environments of developed nations, capital structure and firm performance are positively correlated, and rising debt ratios will have a favorable effect on rising firm performance. Relatively high debt in developing countries may exert tremendous pressure on companies in economies with inefficient economic activities and markets. It accurately captures the distinction between developed and developing countries in the relationship between capital structure and firm performance. The foregoing data and analysis, however, clearly show that there is a significant link between capital structure and company performance.

4.2 Differences Among Developing Countries

Although developing countries have relatively backward economic and technological levels compared with developed countries, they have their advantages and disadvantages, and there are noticeable differences in political and economic systems. These differences will lead to different capital structures in the capital markets of different developing countries. Therefore, the positive and negative association between capital structure and business performance will be influenced by the disparities across emerging nations.

The findings of Le and Phan's (2017) study demonstrate that capital structure and company performance in emerging nations have a negative relationship [10]. It is necessary to create indicators to gauge the capital structure and company performance in order to more thoroughly understand the relationship between the two. The overall debt ratio, short-term debt, and long-term debt all serve as capital structure measurement metrics. The indicators for measuring firm performance include equity, return assets, and earnings per share. In developing countries, there is not only a negative correlation between capital structure and enterprise performance, but also some positive correlations that can be seen, according to a comparative study using capital structure measurement indicators and enterprise performance measurement indicators as independent variables and dependent variables. At the same time, these relationships are different in different developing countries. An examination into the relationship between Iranian company capital structures and firm performance was done by Chaganti and Damanpour in 1991. They demonstrated that there was a substantial positive link between EPS and business performance using 320 companies gathered from the Tehran Stock Exchange as a sample. On the other hand, there was a positive association between capital structure and return on assets [11]. The idea that capital structure is favorably connected with company success is reinforced by the positive correlation findings between earnings per share as a specific measure of capital structure and firm performance. Salim and Yadav (2012) took Malaysian companies in developing countries as the research sample. They concluded that the EPS was negatively correlated with firm performance in Malaysia's construction industry, industrial products, real estate, services, and six other sectors. Additionally, there is a bad correlation between capital structure and corporate performance metrics like ROA and ROE [12]. In Malaysia, there is a negative correlation between

capital structure and firm performance; this is not the case in Iran. This demonstrates that, despite the fact that both are developing nations, the findings of the study on the connection between capital structure and business performance will vary between the two nations.

5. Conclusion

This essay examines the relationship between capital structure and company performance from the perspectives of three key variables: model, industry, and country. First, it has been demonstrated that different models will arrive at different conclusions when used to investigate the relationship between capital structure and firm performance by mentioning and analyzing Modigliani and Miller theory, as well as associated assumptions and applications of capital asset pricing models. Second, varied industrial capital structures will result from different industry features, which will also affect how different capital structures affect firm performance. To substantiate this assertion, the real estate and retail industries—two with ostensibly distinct characteristics—are reviewed. Finally, the capital structure and the relationship between capital structure and company performance will be influenced by a nation's economic climate and policies. This essay investigates how developed country capital structures affect business performance in relation to various levels of national development. Iran and Malaysia are used as two examples of developing nations to illustrate the effects of regional diversity on the relationship between capital structure and firm performance.

When the research techniques and objects are diverse, the findings from the three aforementioned perspectives demonstrate that it is impossible to reach a consensus regarding the relationship between capital structure and company performance. The research findings, however, are constrained because this paper concentrates on the one-way causal relationship between capital structure and business performance. It is necessary to conduct more two-way analysis between capital structure and firm performance. Future surveys can expect to find a mutual relationship between capital structure and company performance as variable factors.

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