

Capital Structure and Firm Performance: Evidence from India

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ABSTRACT

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The review paper aim is to identify the status of existing studies conducted on capital structure and firm performance in the previous years. Furthermore, the study emphasises the gaps in the literature on capital structure and firm performance and also aim to identify scope of future research in this field. For this purpose, a systematic literature review is performed, wherein; literature ranging from theories of capital structure to studies in the area of capital structure and firm performance was reviewed. The outcomes of the study asserted that the relationship between the companies' performance and the financial leverage is mixed, inconsistent and varied. Also, it was found that the influence of capital structure on firm performance varied from country to country and industry to industry. In the context of India, it was observed that the literature pertaining to capital structure and firm performance is weak and unstructured. Therefore, this study suggested that future scholars must deeply examine the relationship between capital structure and performance of the firms belonging to different industries in India.

Keywords: Capital Structure, Firm Performance, Corporate finance, Capital Structure theories

1. Introduction

Capital structure is the most significant decision pertaining to the discipline of corporate financing and determines the way in which a firm finances its assets by integrating the equity and liabilities (Gul and Cho, 2019, p. 97). Capital Structure is determined as a blend of several types of sources for funding that a company sustains as per its decisions of funding. Similarly, firm performance can be identified as the organizational performance, the firm functioning, and the outcomes of its operations. Firm performance displays indicators of effectiveness and efficiency associated with the usage of all resources within a firm that can be evaluated in both the non-financial and financial aspects. As observed from the financial facet, performance can also be observed from the perspective of financial ratios like solvency, profitability, liquidity, and other significant ratios, however, the profitability ratio is the most important measure of firm performance. Some of the profitability ratios include Return on Assets (ROA), Return on Equity (ROE), and Return on Investment (ROI) (Surjandari and Minanari, 2019). Modigliani and Miller (1958) firstly proposed that in a rational market scenario, the capital structure is peripheral to the value of the firm. While Kraus and Litzenberger (1973) eased the tax premise in order to propound the theory of trade-off, which asserts that the firm governs

its capital structure via maintaining stability between the advantages procured from the tax shield and the costs of bankruptcy associated with debt financing. Similarly, Jensen and Meckling (1976) propounded the agency theory pertaining to capital structure, which affirmed that the expensive principal- agent conflicts are caused due to the dissociation of management and ownership. It states that the financing choice of a firm is impacted by the agency costs that are because of the conflicting interests between the agent and the principal. Alternatively, the pecking order theory (Myers and Majluf, 1984), a substitute of the agency theory suggested that the initial choice of a firm is to primarily utilize the internal financing through retained earnings; while the second preference is debt and the last choice of the firm for financing is equity (Li, et al., 2019).

2. Purpose of the Study

The literature obtained and the previous works of scholars pertaining to the capital structure have led to the emergence of an extensive debate regarding whether excessive leverage reduces or enhances the value or performance of a firm and the findings procured remain mixed (Aggarwal and Padhan, 2017; Altaf and Shah, 2021; Chadha, and Sharma, 2015; Farhan et al., 2020).

Certain researchers exhibit a positive correlation

pertaining to the performance of the firm and the financial leverage, although others have an opposite viewpoint. Thus, this review paper majorly aims to identify the status of previous research studies regarding capital structure and firm performance in the previous years. Furthermore, the study emphasises the gaps in the literature related to capital structure and firm performance and also aim to identify certain research questions for conducting further extensive research.

3. Literature Review

3.1 Capital Structure

Corporate finance is a mixture of several forms of external funds generally known as capital which are used to finance a business. It may include shareholder's equity, preferred stock, and debt and is mentioned in the balance sheet of the company (Takhumova et al., 2018). Locally and internationally, the interest of governments is growing in adopting and adhering to the best practices of internal control systems to ensure firms are best positioned to compete and to address the challenges posed by the world economy. In fact, the capital structure of an enterprise and the concept that debt may be seen as an essential tool for managers is key to the literature of finance and accounting as the managers must ensure minimized squandering of their company's resources.

Managers who choose well-designed internal control systems may best position themselves against the debt structure of their companies, and this consequently will reduce the possible conflict between managers and shareholders, thus reducing the chances of agency problems (Alabdullah, et al., 2018, p. 75). It is of paramount significance for the market economy to determine the development of capital, the optimisation of capital structures, the recognition of the optimum ratio of different sources and the quality of the management of resources. Adequate capital plays a key function in preserving an economic entity's performance throughout life, providing solvency, sustainability, and liquidity. Additionally, the quantity of equity directs the growth of the market for products and services and the possible enhancement of investing in the national economy. Capital structure optimization is one of the major and complicated challenges to be resolved via the company's financial management (Pavlova 2012; Gary et al. 2017; Tzabbar and Margolis 2017). The selected policy in this area impacts both the short and long-term financial sustainability of the enterprises

and enables them to prioritize and classify the sources of funding.

The optimal development of capital structures, i.e. the determination of the best equity-to-debt ratio, is a significant financial management challenge (Um, 2017; Chiou and Tucker, 2017). Bajaj, Kashiramka, and Singh (2020) had a similar perception and suggested that it is definitely one of the main problems for a company to maintain a good balance between equity and debt sources. An enterprise's capital structure affects future money sources, capital costs, risk characteristics, positions of liquidity, investor returns and corporate valuation. It is a well-explored area of financial decision making with important contributions by leading academicians in terms of capital structure theories. The key element of Modigliani and Miller's (1958) theory of irrelevance laid the framework for corporate financing decision-making. Many economists have followed their fundamental concept, and there have been a range of theories to resolve the dilemma of capital structure like pecking-order theory, signalling theory, trade-off theory, stakeholder's theory and more. In a recent study conducted by Tripathy and Asija (2017), the researchers tried to comprehend the influence of the financial crisis on the determinants (tangibility, profitability, liquidity, and size) of certain Indian firms' capital structure.

The study outcomes suggested that size and tangibility had a substantial impact on the decisions of the capital structure prior to the period of crisis. Moreover, from the results, it can be suggested that the probability coefficient is negative, affirming an inverse association with debt. Additionally, the research proclaimed that the theory of pecking order was found to be more suitable as compared to the other theories in identifying the factors that impact the decisions related to the capital structure of the Indian businesses. Another similar study was conducted by Sofat and Singh (2017) which aimed to identify the most important capital structure determinants for certain Indian manufacturing firms. The study findings asserted that variables like ROA, risks associated with businesses, and composition of assets are positively correlated to the debt ratio, however, the capacity of debt service and firm size were negatively associated with the debt ratio. Moreover, return on assets, business risk, and asset composition were found to be notable capital structure determinants, although, debt service capacity and firm size were

found to be trivial determinants.

3.2 Firm Performance

As discussed previously, Surjandari and Minanari (2019), described the firm performance as the organizational performance, the firm functioning, and the consequences of its activities. A company's performance exhibits measures of effectiveness and efficiency connected with the utilization of all resources inside a firm that may be assessed in both non-financial and financial terms. In financial terms, the performance is examined using financial ratios like solvency, profitability, liquidity, and other significant ratios, however, the profitability ratio is the most important measure of firm performance. Some of the profitability ratios include Return on Assets (ROA), Return on Equity (ROE), and Return on Investment (ROI).

Prahalathan and Ranjany (2011) believe that the concept of performance, in particular, because of its multifaceted significance, is a contentious subject in finance. The performance may be studied from both organizational and financial perspectives; the performance of an enterprise can be measured on the basis of factors including consumer satisfaction, growth, returns, and productivity. Financial performance (reflected in shareholder profit maximisation, asset maximisation, and profit maximisation) is dependent on the efficiency of the company. However, other researchers believe that the evaluation of financial performance is dependent on the residual income, return on investment, market capitalization, dividend per yield, earnings per share, growth in sales, price/earnings ratio, and more (Al-Homaidi, et al., 2019; Sheela, and Karthikeyan, 2012).

In this context, Kumari and Kumar (2018) tried to examine the factors from three streams, particularly, firm-level, industry level, and macro level, that determine the performance of a firm. The researchers found that the macro-level factors generally impacted all the firms and industries, however, the severity varied from industry to industry. Moreover, for the firm and industry level factors, mixed viewpoints were observed. On one hand, strategists and micro economists believe that industry size and structure are the most significant factors responsible for determining the profitability of a firm; while on the other hand, the resource-based perception asserts that the capabilities and internal resources of a firm lead to

deviation in the profits of the firm. Moreover, the researchers contemplated that the factors of firm-level own the capability to explain the heterogeneity pertaining to the industry, since firms belonging to different sectors vary in terms of domains like advertising expenditure, fixed assets, inventory, liquidity, and research and development. Similarly, Le and Phan (2017) conducted a study to identify the association between capital structure and firm performance in Vietnam using panel data pertaining to the non-financial listed companies from a time period of 2007 to 2012.

The study findings suggested that the firm performance is negatively associated with the debt ratios. The findings were found to be in contradiction to the developed nations since most of the studies indicated that a positive association existed between company performance and decisions of capital structure in developed nations. The findings further revealed that in an emerging economy such as Vietnam, the advantages of debt due to tax savings may be smaller than the costs of financial distress. A strong information asymmetry and a poorly established financial system further limit the monitoring and evaluation role of debt.

Another study was conducted by Sheikh and Wang (2013) which aimed to affirm the influence of capital structure on the nonfinancial firm's performance in Pakistan. The study findings revealed that all capital structure metrics (i.e. long and short-term debt ratio, total debt ratio) are adversely correlated to ROA in all regressions, according to empirical data tests. As a result of this, the pooled OLS model shows a negative relationship between the total debt ratio and long-term debt ratio with the market-to-book ratio, whereas fixed effects models showed a positive relationship between total debt ratio, long-term debt, and market-to-book ratio. In all regressions, the short-term debt ratio was found to be positively correlated with the market-to-book ratio, although the correlation was negligible. A negative correlation between capital structure and performance suggested that agency difficulties may cause businesses to employ greater than necessary levels of debt in their capital structure. An extensive level of debt can enhance the power of the lender over the managers, resulting in less effective management and a detrimental impact on the firms performance.

3.3 Theoretical Perspective

The appropriateness of the capital structure is an essential choice for any company, as it is not only based on the necessity of maximizing shareholder profits, but also on the need to guarantee that the company is able to cope with its competitive surroundings. There have been varying perspectives over time about the optimum financial structure.

2.3.1 Modigliani Miller Value-Irrelevance Theory

The earliest theory regarding capital structure was given by Modigliani-(MM) Miller. Mm's proposition suggested that the value of a firm is irrelevant to the financing decisions and the capital structure. Modigliani and Miller asserted that the firm value is discounted free cash flow till present with the associated rate of return. When depreciated at the optimum capital cost, free cash flow surpasses the cash flow required to finance all projects with positive net present values. However, this theory has been proposed under perfect conditions on the capital market (Modigliani and Miller, 1958).

3.3.2 The conventional Trade-off theory

Modigliani and Miller clearly recognized the tax shield as a driver of the capital structure in the MM proposal. The benefits of the tax shield were thereafter realized to a large degree to be outweighed by the cost of financial difficulty. The tax shield is, however, a noticeable element but not the cost of financial difficulty. So, in order to be safer, businesses maintain the margin of security before using tax shields. Thus, tax shield advantages are weighed against financial distress costs. This theory is considered the conventional trade-off theory.

3.3.3 The Pecking Order Theory

The Pecking Order Model or the Pecking Order Theory is associated with the capital structure of a company. The theory was proposed by Stewart Myers and Nicolas Majluf (1984) and suggested that the managers exhibit a hierarchy while incorporating the financing sources. The theory of pecking order depicts that the managers exhibit the following sources of preferences in order to fund an opportunity for investment: initially via the retained earnings of the company, the next option is to gain funding through debt and finally adopting equity financing as the last option.

3.3.4 Agency Theory

As per Jensen and Meckling (1976), and Jenson

(1986) the agency theory is based on the conflict of interest between shareholders, managers and debtholders in a firm. There are two types of conflicts, one a conflict between shareholders, managers and debtholders, and second a conflict between shareholders and managers. These conflicts results in costs to be borne by the firm and these costs are called agency costs. As per the agency theory, the firm should select such a capital structure (i.e use debt to that extend) which minimize the agency costs faced by the firm and maximizes the shareholders wealth. So the capital structure which minimises the agency costs is the optimal capital structure for the firm.

3.4 Impact of Capital Structure and Firm Performance

Twaresh (2014) conducted a research study to evaluate the effect of capital structure on Saudi Arabian non-financial companies' performance. For this purpose, regression along with econometric analysis was employed and the data was gathered from 74 non-financial companies from 2004-2012. The research portrayed the impact between the 3 aspects of capital structure (that is total debt (TD), long-term debt (LTD), and short-term debt (STD)) and the performance of the firms based on return on equity (ROE) and return on assets (ROA). From the research's outcomes, it was clear that ROA was significantly impacted by TD, LTD, and STD.

However, in the case of ROE, it was found that only LTD was responsible for affecting ROE. Furthermore, the study indicated that the size of the firm considerably affected the performance of the firm, since ROA was affected as a dependent factor. Awais et al. (2016) suggested that the decisions that the management of any organisation takes pertaining to the capital structure are of immense importance as they assist in improving the profits of the shareholders and any company's performance. Awais (2016) along with other researchers tried to identify the influence of the firm's capital structure on the performance of certain non-financial firms listed on the stock exchange in Pakistan. The data collected was assessed using STATA and the association between the aspects of capital structure (LTD, STD, and TD) and performance of the company's variables (like ROA, ROE, EPS and Tobin's Q).

The results of the research indicated that total debt and total assets had a notable impact on the performance of a firm. In the context of India, Khan (2012) assessed the association among the performance of the

businesses, the capital structure, and the equity ownership for 438 firms in India that were listed on BSE from 2005-2012. The study employed sophisticated methods of analysis, data envelopment, and panel data evaluation.

The findings of the study were found to be in line with the model of agency cost and the researchers could not proclaim any notable influence of efficiency pertaining to leverage. The study also asserted nonlinearity in the association between the performance of the companies and the capital structure ownership type. The efficiencies of the firms were found to decrease considerably during the study period at the time of recession. Another similar and recent study conducted by Dao, and Ta (2020) aimed to affirm the relationship pertaining to businesses' performance due to the capital structure employed.

The study adopted the method of secondary data analysis to draw crucial conclusions. The study involved the use of 32 reviews and journals and almost 50 papers. The study findings suggested that the performance of a company is detrimentally impacted by the decisions pertaining to capital structure, which shows it draws its implications from the theories of the pecking order, agency costs and trade-off theory.

Mathur et al. (2021) analysed the significance of correlation between capital structure decisions and financial performance on the pharma companies of India listed on BSE 500, the effect of expenditure of R&D on the financial performance of the company and also the moderating impact of intensity of competitiveness between the firm performance and capital structure. The study employed panel data analysis and OLS for drawing inferences. From the results of the study, it was affirmed that an elevated debt ratio is detrimental for the accounting performance of the chosen pharma companies and also the factor of competitiveness negatively moderates the association between the performance of the firm and the capital structure.

Sinha (2017) aimed to identify the relationship between the firm value and the decisions pertaining to capital structure. The study was conducted on 11 power firms that were listed on BSE and the study was conducted over the time phase of 2007-15. Several financial and statistical measures were taken into account like the depreciation, firm value, tax ratio,

Tobin's Q and the debt-equity ratio was utilised for calculating leverage. Consequently, the results of the panel data analysis suggested that there existed a negative impact of leverage on the value of the company. Although, the study proclaimed that the other aspects were not affected due to the level of debt present within the capital structure of the firm.

Similarly, Aggarwal and Padhan (2017) assessed the impact of firm quality and capital structure on the value of a company with special reference to the hospitality corporations listed on the BSE index in India. The variables whose impact was tested on the value of the firm were size, leverage, tangibility, profitability, liquidity, inflation, GDP, and liquidity. Consequently, the study results depicted a notable association between the value of the firm with the liquidity, leverage, company quality, economic growth and size. The outcomes of the study also suggested that the theory of Modigliani miller does not hold true for the Indian hospitality industry.

Research Gap A company & capital structure is one of the most crucial decisions it makes. Moreover, the identification of the firm & optimal capital structure is one of the most essential aspects to consider during decision-making regarding the capital structure. From the studies conducted previously, it can be suggested that evidence pertaining to the correlation between the companies performance and the financial leverage are mixed, inconsistent and varied. In addition, there are just a few studies concerning emerging nations like India that experimentally investigate this link.

The current study adds to the existing body of knowledge regarding the impact of financial leverage on business performance by amassing the findings of different scholars within a single study frame. Also, as per the critical review of literature, it was found that not much literature is present that aims to identify the factors related to the firm which impact the financial decisions of the firms. Therefore, the current paper aims to comprehend and review the status of research studies regarding capital structure and firm performances conducted in the previous years and highlight the gaps in the available literature on optimal capital structure and firm performance. The study also comprehends the various theories associated with the capital structure and firm performance like the Agency theory, Modigliani Miller, the trade-off theory, and the pecking order theory.

4. Research Methodology

The current study has adopted a systematic review of literature in order to accomplish the proposed outcomes of the current study. According to Dewey and Drahota (2016), a systematic literature review (SLR) discovers, organizes, and rigorously inspects material in order to address a clearly stated issue. Before the systematic review is done, the criteria should be explicitly established in a well-defined procedure or strategy. It is a transparent method of research or thorough search that spans various databases and academic journals and can be duplicated by other scholars.

The method of SLR entails devising a well-thought-out research strategy that emphasises on a certain topic or answers a certain query. Within defined periods, the review specifies the sort of material explored, evaluated, and presented. The evaluation must contain the search techniques (like the search dates, platforms and databases), search keywords and the limitations of research. Moreover, coverage, accessibility, equality, focus, integration, clarity and transparency are the seven main criteria outlined by Pittway (2008) for quality systematic literature reviews. In the current study, the systematic literature review is performed in several steps, initially, the research problem was identified, secondly, the review protocol was validated and reviewed, next, the literature was identified, which was followed by the screening of the identified literature for inclusion. Moreover, these steps were then followed by evaluation of quality, extraction of relevant data, analysis and synthesis of the crucial data and ultimately drawing the inferences.

5. Findings and Discussion

As identified in the literature review section, Takhumova et al. (2018) identify capital structure as a mixture of several external funds like shareholder's equity, preferred stock, and debt in order to finance a company. Moreover, from the extensive review of literature, several definitions of firm performance were also recognised. According to Surjandari and Minanari (2019) firm performance can be determined as the organizational performance, the firm functioning, and the consequences of its activities. A company's performance exhibits measures of effectiveness and efficiency connected with the utilization of all resources inside a firm that may be assessed in both non-financial and financial terms. On the other hand, Prahalathan and Ranjany (2011)

suggested that the performance may be studied from both organizational and financial perspectives and the performance of an enterprise can be measured on the basis of factors including consumer satisfaction, growth, returns, and productivity.

Several theories were also determined in the context of capital structure and firm performance. These included Value-Irrelevance Theory, the Conventional Trade-off theory, the Pecking Order Theory, and the Agency Theory. The Value-Irrelevance Theory suggested that the performance of an enterprise is independent of the financing decisions and the capital structure decisions, while the Conventional Trade-off theory affirms that tax shield advantages are weighed against financial distress costs. Additionally, the Pecking Order Theory states that in order to fund an opportunity, firstly the retained earnings of the company are utilised, the next option is to gain funding through debt and finally adopting equity financing as the last option.

Finally, it was propounded that according to the Agency Theory, the optimal capital structure is which minimises the agency costs faced by the firm and maximises the shareholders wealth. Additionally, while assessing the impact of Capital Structure and Firm Performance it was found that there existed a mixed belief regarding the same. Some of the scholars were of the perception that the performance of a company is detrimentally impacted by the decisions pertaining to capital structure (Dao, and Ta, 2020). While others had a perception that a notable association existed between the value of the firm and the liquidity, leverage, company quality, and economic growth (Aggarwal and Padhan, 2017). Moreover, it was also found that the influence of capital structure on firm performance varied from country to country and industry to industry. For instance, it can be observed that the study conducted by Twairesh (2014) affirmed that ROA was significantly impacted by TD, LTD, and STD.

However, in the case of ROE, it was found that only LTD was responsible for affecting ROE for non-financial firms in Saudi Arabia. While in the context of India, Khan (2012) asserted that there did not exist any notable effect of efficiency pertaining to leverage and the results were in line with the model of agency cost. The study also found non-linearity in the correlation between the performance of the companies and the capital structure ownership type.

6. Conclusion

The analysis suggests that the correlation between the companies performance and the financial leverage is mixed, inconsistent and varied and the effect of capital structure on companies' performance varied from country to country and industry to industry. In the context of developing economies like India, it was found that the literature pertaining to capital structure and firm performance is unstructured. Thus, future studies must be conducted with the objective of evaluating the impact of capital structure decisions on the performance of the firm in different industries in India.

The current review has tried to compile the varied perceptions of different scholars regarding the same and examined the status of research studies associated with the domain of capital structure and firm performance in the previous years and has consequently highlighted the significant gaps in existing literature related to capital structure and firm performance.

The study has also tried to affirm the various theories associated with the capital structure and firm performance like the Agency theory, Modigliani Miller, the trade-off theory, and the pecking order theory. The current review will lay a strong basis for future research of similar kinds that are needed to achieve progress and solve numerous difficulties and challenges associated with the financial decisions pertaining to capital structure and firm profitability. The research study will add to the current literature by attempting to introduce fresh insights into the domain of optimal capital structuring.

7. References

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