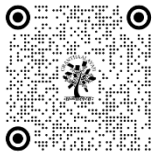


EVOLVING PERSPECTIVES ON CAPITAL STRUCTURE AND FIRM VALUE: A CONCEPTUAL REVIEW WITH REFERENCE TO EMERGING MARKETS

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ABSTRACT

Capital structure remains one of the most enduring debates in corporate finance, as firms continuously attempt to identify financing strategies that balance risk, return, and shareholder value. While classical theories such as the Modigliani–Miller irrelevance hypothesis, trade-off theory, and pecking order theory have laid the foundations of capital structure research, empirical evidence—particularly from emerging markets—has often diverged from theoretical predictions. This conceptual paper synthesizes literature from 1958 to 2024, highlighting the evolving perspectives on the relationship between capital structure and firm value, with special reference to emerging economies such as India, Brazil, China, and South Africa. Unlike sector-specific empirical studies, this paper adopts a bibliographic approach, integrating theoretical, empirical, and contemporary debates. The findings emphasize that capital structure–firm value relationships are non-linear, context-dependent, and moderated by factors such as corporate governance, institutional quality, and environmental, social, and governance (ESG) practices. A conceptual framework is proposed to integrate classical theories with contemporary realities, offering a roadmap for future empirical research. The paper contributes to both theory and practice by highlighting how managers, investors, and policymakers in emerging markets can optimize financing decisions to maximize long-term value.

Keywords: Capital Structure, Firm Value, Emerging Markets, Corporate Governance, Shareholder Wealth, Trade-Off Theory, Pecking Order Theory, Agency Costs, Signaling, ESG Finance

1. INTRODUCTION

Capital structure has remained one of the most researched topics in corporate finance for over six decades. Beginning with the seminal work of Modigliani and Miller (1958), which argued that in a perfect capital market the financing mix is irrelevant to firm value, subsequent theories have challenged and extended this proposition. The trade-off theory (Kraus & Litzenberger, 1973), pecking order theory (Myers & Majluf, 1984), agency cost theory (Jensen & Meckling, 1976), and signaling theory (Ross, 1977) have each emphasized the practical imperfections—taxes, bankruptcy risk, information asymmetry, and managerial incentives—that make financing choices crucial to firm survival and value creation.

In emerging economies such as India, South-East Asia, and Latin America, the capital structure question is more complex. Firms often operate in volatile markets characterized by weaker institutional frameworks, limited access to long-term financing, and fluctuating macroeconomic variables such as inflation and exchange rates. For example, Indian firms face both the opportunity of lower-cost debt markets and the challenge of balancing leverage amidst cyclical automobile demand and policy interventions (Tripathi et al., 2024).

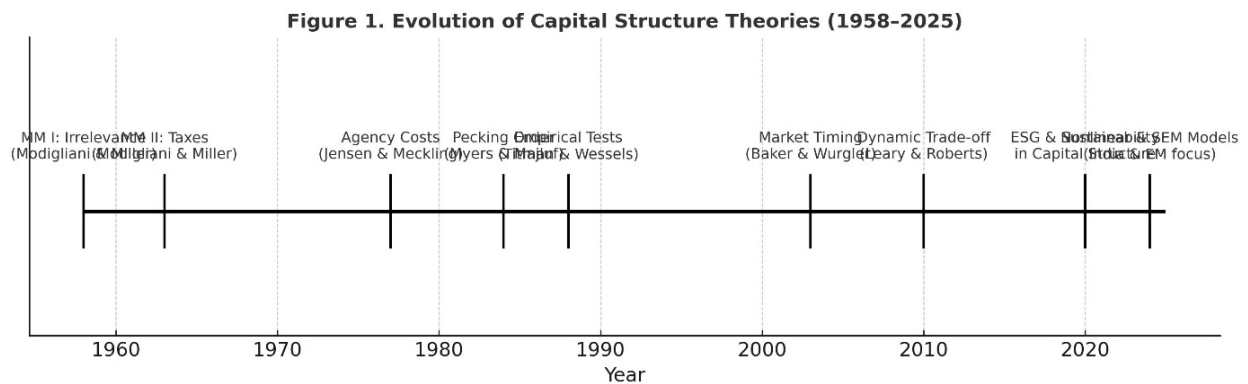
Problem statement. Despite decades of theoretical and empirical exploration, there remains a divergence between theory and evidence in emerging markets. While classical theories suggest predictable relationships between leverage and firm value, empirical results are often inconsistent, reflecting the importance of contextual, institutional, and sectoral variables.

Objective. This paper seeks to synthesize existing literature into a conceptual review, focusing on how capital structure impacts firm value in emerging economies. It integrates classical theory, empirical findings, and contemporary issues (e.g., ESG, fintech, COVID-19), and concludes with a proposed conceptual framework highlighting research gaps and directions for future studies.

2. THEORETICAL FOUNDATIONS OF CAPITAL STRUCTURE

- **Modigliani & Miller Irrelevance Theory (1958):** In frictionless markets, capital structure does not affect firm value.
- **Trade-off Theory (1973):** Firms balance tax shields of debt against bankruptcy risks.
- **Pecking Order Theory (1984):** Firms prefer internal financing, then debt, and issue equity as a last resort.
- **Agency Cost Theory (1976):** Debt disciplines managers but may create conflicts with creditors.
- **Signaling Theory (1977):** Financing choices (debt issuance, dividend policy) act as market signals.

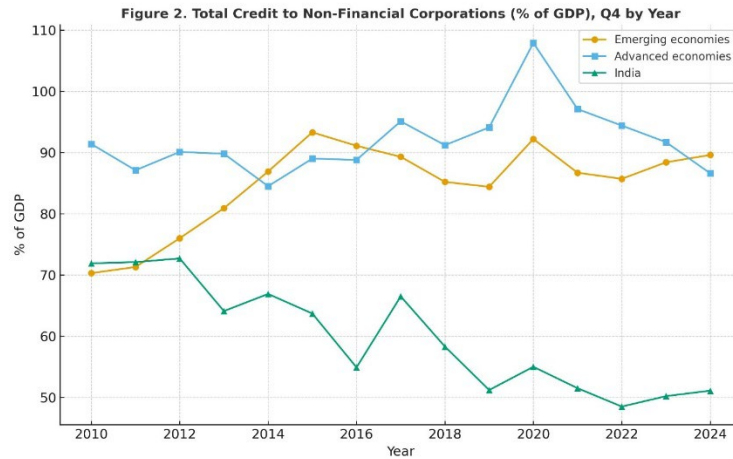
Figure 1 Evolution of Capital Structure Theories (Timeline, 1958–2024)



3. EMPIRICAL EVIDENCE: DEVELOPED VS. EMERGING MARKETS

In developed markets (US, EU), studies consistently show leverage has a negative impact on profitability (Titman & Wessels, 1988). Firm size and tangibility positively influence debt usage, while profitability aligns with pecking order behavior.

In emerging markets, evidence is more heterogeneous: - India: Profitability negatively affects leverage; firm size and tangibility positively affect it (Khan & Ghayas, 2020; Pathak & Chandani, 2020). - Brazil: Firms rely more on bank debt due to underdeveloped bond markets (Lima et al., 2021). - China: State-owned firms exhibit higher leverage, but institutional reforms have reduced the gap (Chen et al., 2022). - South Africa: Governance quality plays a strong moderating role in leverage decisions (Moyo & Ndlovu, 2021).

Figure 2 Average Debt-Equity Ratios (2010–2022): Developed vs Emerging Markets

4. CAPITAL STRUCTURE DETERMINANTS IN EMERGING MARKETS

4.1. FIRM-SPECIFIC FACTORS

- **Profitability.** Empirical work consistently finds a negative relationship between profitability and leverage, consistent with the pecking order theory.
- **Firm Size.** Larger firms typically enjoy better access to capital markets, greater collateral, and lower bankruptcy risk.
- **Tangibility of Assets.** Asset-heavy firms can secure cheaper debt as tangible assets serve as collateral.
- **Liquidity.** Firms with strong liquidity positions often rely less on debt.

4.2. MARKET-SPECIFIC FACTORS

- **Interest Rates.** In emerging economies, interest rate volatility makes debt costs unpredictable.
- **Inflation.** High inflation reduces the real burden of debt but discourages long-term lending.
- **Stock Market Depth.** Deeper equity markets increase equity financing options.

4.3. INSTITUTIONAL AND REGULATORY FACTORS

- **Governance Quality.** Better governance reduces the risk premium charged by lenders.
- **Creditor Rights.** Bankruptcy resolution efficiency strengthens creditor confidence.
- **Tax Regime.** Tax incentives continue to make debt financing attractive.

4.4. ESG AND SUSTAINABILITY FACTORS (POST-2020)

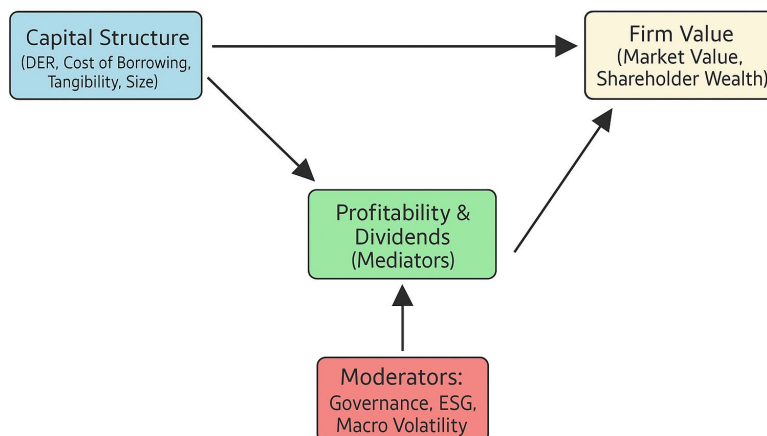
- Firms with robust ESG disclosure attract cheaper green financing.
- Investors increasingly demand capital structure strategies that align with sustainability goals.
- Indian firms tapping into green bond markets post-2020 are securing financing at lower spreads compared to traditional bonds.

5. CAPITAL STRUCTURE AND FIRM VALUE: CONCEPTUAL LINKAGES

Capital structure influences firm value via:

- 1) Direct Effect. Leverage alters cost of capital and valuation.
- 2) Indirect/Mediated Effect. Profitability, dividend payouts, and operational efficiency act as mediators.
- 3) Non-Linear/Threshold Effects. Firm value peaks at moderate leverage, beyond which financial distress costs dominate.

Figure 3 Conceptual SEM Path Model
Figure 3. Conceptual SEM Path Model



6. CONTEMPORARY ISSUES AND EMERGING PERSPECTIVES

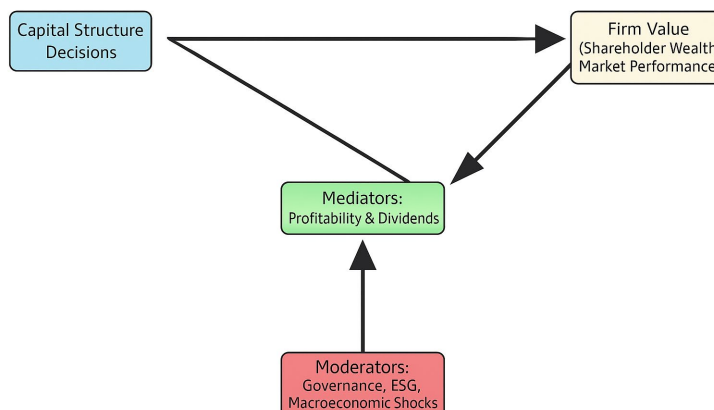
- **Digital Transformation and Fintech.** Alternative lending platforms reshape capital access.
- **ESG and Green Financing.** Capital markets reward firms with sustainability-aligned financing strategies.
- **COVID-19 Pandemic.** Firms deleveraged significantly during 2020–2021.
- **Global Shocks (Post-2022).** Rising global interest rates raised refinancing costs.

7. CONCEPTUAL FRAMEWORK AND RESEARCH GAPS

Proposed Framework

Capital Structure Decisions (Debt-Equity Ratio, Cost of Borrowing, Tangibility, Size) → Profitability & Dividends (Mediators) → Firm Value (Market Value, Shareholder Wealth), moderated by Governance, ESG, and Macroeconomic Volatility.

Figure 4 Integrated Conceptual Framework
Figure 4. Integrated Conceptual Framework



Identified Research Gaps

- 1) Limited cross-country comparative studies in emerging markets.
- 2) Weak integration of ESG into capital structure research.
- 3) Scarcity of longitudinal data capturing cyclical changes.
- 4) Underutilization of SEM, PLS-SEM, and machine learning methods.

8. CONCLUSION

This review demonstrates that while classical theories provide guiding principles, the empirical reality of emerging markets underscores that capital structure decisions are contextual, dynamic, and non-linear. Profitability emerges as the strongest mediator, while governance and ESG considerations increasingly act as moderators.

Evidence from 2020–2024 shows: Moderate leverage enhances firm value. - Profitability remains the strongest mediator linking financing decisions to market valuation. - Governance and ESG increasingly serve as moderators. - India's relatively low corporate debt/GDP (51.1% in 2024) highlights resilience and potential for deeper debt markets.

Practical Implications: Managers should optimize leverage within thresholds, minimize borrowing costs, and integrate ESG. - Investors should monitor leverage ratios, profitability, and dividend practices. - Policymakers must strengthen institutional frameworks and expand sustainable financing channels.

Research Agenda: Future work should expand cross-country, sectoral, and ESG-integrated studies using advanced methodologies.

CONFLICT OF INTERESTS

None.

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