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The Relationship Between Capital Structure and Firm Performance

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Abstract: The composition of the enterprise's entire capital is referred to as its capital structure. It is also referred to as a financial framework at this time. Not just long-term capital structures are included. Short-term capital structures are also included. It also includes dynamic capital structure in addition to static capital structure. Before this article, much research have studied and integrated the relationship between capital structure and company. This article hopes to absorb the results of past research and conduct a research expansion and give the view that belongs to this article. The research topic of this paper is the impact of capital structure on firm performance. This paper compares the impact of different companies through different capital structures and start with different types of companies to observe its capital structure. In this paper, a comparative analysis is mainly adopted, and the capital structure of companies in different types, different regions and social conditions is compared, so as to analyze the impact of the company's impact on the capital structure and finally conclude and give suggestions.

Keywords: capital structure, firm value, different industries and markets

1. Introduction

The capital structure of the company and its impact may be discussed in this paper, which also offers conclusions and recommendations. This article explains the impact of capital structure on the firm's decision-making and its situation. The capital structure of a firm is impacted by its nature and environment. The capital structure of the business will also have an impact on its operating environment and financial decisions.

When it comes to financial management and business financial analysis, capital structure is a crucial metric since it reveals the makeup of an organization's capital and the outcomes of its financing. Distinct enterprise financing strategies and financing ratios will produce distinct financing combination outcomes, as well as different effects on enterprise business decisions, performance, and value. Corporate governance is significantly impacted by how rationally an organization chooses its capital structure. Due to this, both domestic and international scholars have traditionally placed a high priority on the study of the connection between enterprise capital structure and business performance. Enterprises can lower capital expenses, maximize financial leverage, and boost the effectiveness of capital use by using reasonable and effective fundraising techniques and amounts [1].

By discussing the improvement or impact of the company's capital structure on its performance in various circumstances, the various situation of the capital structure such as the proportion of equity

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can be analyzed, corresponding to the industries and all kinds of the environment. From the analysis, it can be concluded that the optimal choice of the capital structure under all circumstances, so as to better make the company's leverage of choosing various types of capital and achieve more scientific decisions and operations, in order to obtain better performance.

A clear understanding and detailed analysis of the capital structure and reference to the environment can help the company to achieve good operation. Analysis of this is very important because capital structure formation is a difficult decision-making process. This article will collect information and samples widely, comprehensively analyze from multiple angles, and provide a reference opinion that can help the company to complete this complex decision. In this article, it will list and summarize the existing documents, and add its unique analysis. This article is divided into two main parts. The first part analyzes the capital structure of three representative types of companies and their impact of it so that the impact of different capital structures on companies in different industries and the company's appropriate capital structure can be inferred. The second part is to compare different countries and social conditions. Analysis from a macro perspective, so as to infer the optimal capital structure of the company's environment.

2. Theoretical Framework

Many theories have been analyzed for capital structure. Among them, the MM theory is one of the most representative theories. According to this theory, a corporation's current value is independent of how it is financed, and it makes investments based on how best to maximize its present value. Insofar as there are a set of presumptions from which these assertions flow, the MM theory is valid in a limited sense. There are no taxes or transaction fees, and all information is simultaneously and cost-free available to all market participants under these hypotheses, which are collectively referred to as perfect capital markets. The data either contains the expected values of the pertinent variables for the future or the parameters of their distributions. When uncertainty and risk aversion are taken into account, MM's major contribution to the field is the definition of the circumstances under which the ideal characteristics of a perfectly competitive market equilibrium under certainty hold [2].

According to the trade-off hypothesis, the advantages of debt tax shelters should be weighed against the price of financial difficulty. Enterprises can get the optimal point of the debt ratio, that is, the optimal capital structure. The enterprise has a target capital structure in the actual production and operation process, and the operator will continuously adjust the actual capital structure to approach the target capital structure while selecting the capital structure, leading to the relevant theory of dynamic adjustment of the capital structure being created [3].

The traditional theory holds that there is no optimal capital structure for enterprises, but if the actual financial situation of the enterprise is combined, there is in fact an optimal capital structure, which is consistent with the modified MM theory. Due to the strict assumptions of MM theory, it is difficult to apply it in practice, and it is difficult to seek a fixed value. In addition, due to the external factors of enterprises, such as capital prices, exchange rate fluctuations, and other factors. It is unrealistic to blindly pursue the specific points of the optimal capital structure. Dynamic range capital structures are ideal, and the adjustment of the financing structure can also be flexibly adjusted within a dynamic range by combining various factors [4].

3. Different Industries

3.1. Labor-Intensive Industry

A company's capital structure describes how it finances its assets, whether through internal resources, debt, or a combination of the two. It's a fundamental aspect to understand the firm’s operations and its financial risks. The relationship between the performance and capital structure of labor-intensive

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companies is both complex and multi-dimensional. Labor-intensive companies are those where the proportion of labor or workforce in the total cost of production is significantly high. They are often found in industries like construction, textile, agriculture, or hospitality. There can be a critical link between the performance of a labor-intensive company and its capital structure. Since labor-intensive companies rely heavily on the workforce, their performance is highly influenced by human capital (employee skills, experience, etc.), employee morale, and work efficiency. Therefore, ensuring stable cash flows and maintaining a balanced capital structure to meet payroll and other operational cost demands becomes pivotal. If such a company is heavily leveraged, i.e., it has more debt in its capital structure, it may strain company reserves during periods of economic stress or downturns, making it harder to meet its debt obligations, let alone maintain operational expenses. On the contrary, a company with more equity in its capital structure may display more resilience amid these challenges because it is less burdened by fixed debt-repayment commitments.

However, a well-structured debt in the capital can also act as a disciplinary tool for the management of a labor-intensive company, leading to more efficient operations and better performance. This is because debt holders (creditors) often require regular financial audits and have a say in the management decisions, demanding efficient running of the company. In conclusion, the relationship between capital structure and the performance of labor-intensive firms is nuanced and it can be influenced by several factors including the economic conditions, industry traits, the company's operational efficiency, and financial risk appetite.

3.2. Capital-Intensive Industry

The relationship between the performance and capital structure of capital-intensive companies can be nuanced and complex. Capital-intensive companies are those that require a significant amount of capital investments to produce goods or services. These investments are often in the form of machinery, buildings, and infrastructure. This category often includes industries such as manufacturing, telecommunications, transportation, and utilities. In capital-intensive industries, the capital structure can greatly influence company performance. The requirement for heavy machinery and infrastructure usually means substantial upfront costs and long-term financial commitments. Therefore, these companies often rely on a higher proportion of debt in their capital structure to finance these significant investments. If managed correctly, using debt can improve the performance of a capital-intensive company by providing the necessary capital for growth-enhancing investments, without diluting company ownership. Moreover, the interest paid on the debt can be tax-deductible, improving overall earnings.

However, a heavily debt-based capital structure also comes with high financial risk. Capital-intensive companies often have high fixed costs and operating leverage. During economic downturns, reduced demand can significantly impact their earnings before interest and taxes (EBIT), leading to difficulties in meeting debt obligations and can even lead to bankruptcy. A capital-intensive business that relies more on equity financing, on the other hand, may have a lower risk of financial difficulty but may also have a higher cost of capital because equity holders often demand a larger return than debt holders.

In conclusion, the relationship between the capital structure and the performance of capital-intensive companies is strongly influenced by the company's ability to manage financial risks, the economic cycle, industry attributes, and the composition and cost of capital. The proper balance among these factors can lead to optimal performance.

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3.3. Innovative Industry

The relationship between the performance and capital structure of technology innovation companies is particularly unique, bearing in mind their specific operational and financial characteristics. Technology innovation companies are those that utilize advances in tech and pioneering methodologies to create new products, and solutions, or to substantially improve existing ones. These can be found across sectors like Software as a Service (SaaS), biotech, artificial intelligence, financial technology and more.

The capital structure in this context is the blend of debt, equity, and internal funds used to finance the company's operations and growth [5]. It represents an integral part of a firm's financial strategy. In the context of innovation-driven tech companies, such firms are often characterized by high risk and high growth potential, and their performance can be significantly influenced by their capital structure. Early-stage tech companies typically rely heavily on equity financing, specifically venture capital, due to the high-risk nature of their operations, the lack of hard assets that could be used as collateral for debt, and their generally limited cash flows. Performance at this stage is often measured not by profits, but by growth in user base, product development progress, or technology patent filings. As these companies mature and stabilize, achieving consistent revenues and potential profits, they might begin to take on more debt in their capital structure. Debt can provide a lower cost of capital due to tax benefits, and at this stage, the company may have more ability to meet these debt obligations. This shift can enhance the financial performance of the company, in terms of metrics such as return on equity.

Advanced science and technology, on the other hand, can lower business costs, increase market competitiveness, and boost performance, but there is a certain lag because research and development can be a lengthy process with unpredictable results. Additionally, it is frequently challenging for R&D investments to bear fruit quickly enough to benefit businesses significantly [6]. Too much debt can increase the risk of financial distress, which could be detrimental to the company's performance, especially during periods of economic downturns or if the company's growth prospects don't materialize as expected. Therefore, technology innovation companies should carefully consider the balance between risk, return, and the cost of capital in their financing strategy to optimize their performance. In conclusion, the capital structure and performance relationship of technology innovation companies reflects their operational peculiarities, stages of development, and the volatile and uncertain nature of their market environment.

4. Different Markets

4.1. Comparison Between Developed Countries and Developing Countries

The comparison between the capital structures of American and Chinese companies can provide intriguing insights. Although every company is unique in its ways, generalized observations can be discerned within the regional context.

American companies are inclined towards a mixed capital structure. The foundational principle adhered to by these companies, and reinforced by the M&M theorem, is that a company's value is independent of its capital structure to a large extent. Hence, companies diversify their sources of funds, ranging from equity to different types of debt securities, such as bonds, debentures, loans, etc. This multiplicity lends a certain level of flexibility and allows them to employ financial leverage optimally based on the prevalent market conditions, business phase, or sector peculiarities. Corporate governance and decisions about capital structure are also strongly influenced by comprehensive legal provisions and strict regulations to protect the interests of shareholders and creditors.

Conversely, Chinese companies' capital structures are predominantly oriented toward debt. This bias towards debt can be attributed to the nation’s historically bank-based financial system and policies, where bank loans have been a prominent source of financing. Despite legislative efforts to develop equity markets, they're used less, partially due to the higher costs of capital associated with raising equity. Moreover, Chinese companies often resort to informal financing sources in response to the strict bank loan conditions, thereby complicating the capital structure. While the Chinese government has increasingly been promoting transparency and corporate governance, the environment is still evolving, with varying levels of adherence across companies.

A remarkable aspect where these two differ significantly is the role of physical assets. Chinese companies typically have a higher proportion of fixed assets, which can be leveraged to secure more debts, whereas many American companies, especially in the IT and service sectors, rely less on physical assets, reflecting a more knowledge-based capital structure. China's financial development is somewhat behind that of developed nations, and small and medium-sized businesses typically face funding challenges [7]. Another distinction arises in the role of foreign capital. American companies are highly open to foreign investments and offer great opportunities for international investors, while Chinese firms tend to have a protective approach, with foreign capital playing a comparatively smaller role.

In summary, while American companies display a balanced blend of equity and debt, Chinese firms lean heavily towards debt due to certain structural and policy directions. Therefore, investors must comprehend these regional patterns in capital structure, which can significantly impact business performance and risk profile when making international investment decisions.

4.2. Comparison among Developing Countries

Comparing the capital structure of companies in China and other developing nations can reveal unique perspectives on their specific economic policies, financial habits, and business attitudes. While one must bear in mind that these are generalized observations, they offer a baseline from which individual corporate behaviors can diverge.

Chinese companies predominantly rely on debt, primarily bank loans, for their capital structure. The historical prevalence of a bank-based system and Chinese policies have played significant roles in shaping this bias. This debt inclination is also reinforced by the fact that Chinese enterprises usually have a higher proportion of fixed assets, which they use as collateral for securing the debt. Informal financing sources are also regularly employed, due to the strict conditions surrounding bank loans. Although efforts have been made to develop equity markets in China and enhance corporate governance, the use of equity as a source of finance is comparatively less, partially due to the higher cost of rising equity in the country. The production and operation activities of enterprises need a steady flow of funds. Recently, the debt ratio of the majority of small and medium-sized enterprises continues to increase, relying on bank loans or private loans for blind expansion, this highly leveraged business model can easily trigger the capital chain of enterprises breaks, plunging businesses into crisis [8].

However, the study reveals that since China entered the stage of forced deleveraging, the company’s deleveraging efforts have started to pay off. Policy pressure has a substantial impact on the deleveraging effect of state-owned businesses, whereas the capacity of non-state-owned businesses to adopt changes has a considerable impact. Companies have reduced leverage by repaying liabilities and adjusting the scope of consolidated statements, and in non-state-owned enterprises, ways to issue additional shares and reduce dividend payments have also been found. At the same time, the deleveraging policy reduces the value of enterprises in the short term, resulting in insufficient investment. Studies have shown that the implementation of the deleveraging policy has been effective and has made great progress, but in the process of implementation, it is still necessary to be vigilant

against the "secondary risks" brought by deleveraging, balance the relationship between preventing and resolving major risks and reform, development and stability, and gradually move towards stable leverage [9]. Among private enterprises with diversified debt, the impact of debt structure on enterprise performance is more obvious. At present, there is room for improvement in the debt term structure of private enterprises, borrowing by financial institutions, and the overall situation. In general, the liquidity of private enterprises depends on short-term liabilities, and the trust of enterprises in long-term liabilities needs to be improved. The debt term structure needs to be improved, the financing channels of private enterprises need to be expanded, the attention paid to corporate bond financing is not enough, and the diversified debt financing of private enterprises is still developing [10].

In contrast, companies in other developing nations demonstrate a more varied use of capital structure sources. Owing to less developed financial markets and institutions, external finance, especially bank loans, can be harder to procure. As a result, these companies often rely heavily on internally generated funds, such as retained earnings. When they do raise external capital, there tends to be a significant dependence on borrowings from the informal sector. In these economies, equity markets are generally underdeveloped, constituting a tiny segment of their capital structure. The role of foreign capital also varies significantly. While many developing nations welcome foreign direct investment (FDI) and foreign portfolio investment (FPI), Chinese firms have historically shown more skepticism toward such inflows. It could be further noted that state ownership plays a more prominent role in Chinese companies' capital structure, given China's hybrid socialist-market economic system. This contrasts with companies in other developing nations where private ownership is generally more common.

In conclusion, while Chinese companies tend to favor bank debts, other developing nations show a mixed usage differentiated towards internal financing and informal borrowings. Such differences reflect the countries' economic policies, maturity of their financial markets, and cultural attitudes towards risk and ownership. Recognizing the regional tendencies of capital structure can help investors make informed decisions and understand the risk-return profile of their cross-border investments.

5. Conclusion

All in all, the capital structure has a strong relationship with the company's operation and performance. The optimal asset structure of various types of companies is different, and companies in different regions are affected by the social conditions and economic policies of their location, and the capital structure that should be arranged is also different, and it would like to make some general recommendations for reference, as follows.

(1) Enhance the core competitiveness of enterprises, strive for excellence in core business areas, and always adhere to the dominant position of the core business. Only by improving the core competitiveness can promote the healthy development of enterprises, and must always attach importance to and adhere to the main position of the core business.

(2) When the remaining resources are exclusive resources, the enterprise should adopt equity. Financing reduces debt leverage and optimizes capital structure; Conversely, debt financing is used to appropriately increase the debt ratio. Only the rational use of the remaining resources of the enterprise can create greater benefits for the enterprise. Due to its irreplaceability, proprietary resources have weak liquidity and cannot withstand the company's debt crisis. In this case, the creditor will reverse adjust the debt financing. At the same time, when the level of asset exclusivity is high, equity financing can save financing costs and achieve better financing results.

(3) Carefully choose the timing and degree of diversification according to the general environment. If necessary, a company separation can be carried out. Externally, it should adapt to the economic

situation, and internally it should start from the actual situation of the enterprise, choose the appropriate time, and control the degree of diversification. In addition, separate companies can also be used to grasp the effect to avoid internal contradictions caused by management confusion and inconsistent development direction, so as to allocate company resources more reasonably and avoid waste of resources.

(4) To improve the capital structure of an enterprise, it is crucial to determine a reasonable asset-liability ratio that balances leverage and financial risks. Additionally, optimizing the debt structure by adjusting the ratio between short-term and long-term liabilities helps alleviate debt repayment pressure and minimize financial risks. Moreover, expanding financing channels through innovative methods and diverse sources of funds ensures adequate capital while reducing financing risks. These measures collectively enhance the enterprise's operational capabilities and promote its sustainable development.

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