

Leveraged And Unlevered Firms Capital Structure And Stock Performance: A Systematic Literature Review

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Abstract:

This systematic literature review explores the relationship between capital structure and stock performance in terms of leveraged and unleveraged firms in emerging markets. Capital structure decisions involve the mix of debt financing and equity financing, which significantly impact a firm's financial health, stock returns, and market volatility. Leverage can amplify profits during favourable conditions but also increases financial risk, particularly during economic downturns. While traditional theories such as the Modigliani-Miller theorem and trade-off theory have provided foundational insights, empirical studies suggest that the impact of leverage varies across different markets, industries, and economic conditions. In emerging markets like India, factors such as regulatory environments, market maturity, and economic challenges further shape the capital structure-stock performance relationship. Pune, an important economic hub, represents a unique context for exploring this dynamic, but regional studies are sparse. This review synthesizes findings from high-quality studies on capital structure and stock performance, aiming to clarify how different capital structures affect stock performance, particularly for firms in Pune. The review highlights the dual impact of leverage, the importance of industry-specific factors, and the need for more regional studies, especially in emerging economies. It suggests that future research focus on regional variations, long-term implications of capital structure decisions, and the interplay between corporate governance, investor sentiment, and financial stability.

Keywords: Capital Structure, Stock Performance, Leverage, Leveraged Firm, Unleveraged Firm

INTRODUCTION

Capital structure, the mix of debt and equity financing within a company, plays a crucial role in shaping a firm's financial health and long-term strategic growth (Modigliani & Miller, 1958; Myers, 2001). Decisions about capital structure are fundamental as they determine a company's balance between financial leverage and financial stability. A company's use of debt, or leverage, can significantly influence its stock performance by affecting both risk and potential returns. Specifically, the leverage within a firm's capital structure is known to amplify gains when the company performs well but also increases financial vulnerability during downturns (Jensen & Meckling, 1976). This dual impact of leverage makes the study of capital structure and stock performance especially pertinent to investors, financial managers, and policymakers. Stock performance, reflected in measures such as stock returns, price volatility, and earnings per share (EPS), is influenced by a firm's capital structure in various ways (Brealey, Myers, & Allen, 2011). The relationship between capital structure and stock performance has attracted the attention of researchers globally, as it sheds light on how financial structuring impacts shareholder value (Harris & Raviv, 1991). Traditional theories, such as the Modigliani-Miller theorem and trade-off theory, have explored the cost-benefit dynamics of debt versus equity financing (Modigliani & Miller, 1958; Kraus & Litzenberger, 1973). However, empirical studies have demonstrated that leverage impacts are context-dependent and vary by market, industry, and economic environment (Fama & French, 2002).

In emerging markets, including India, the relationship between capital structure and stock performance exhibits distinct characteristics due to unique regulatory conditions, market maturity, and economic

challenges (Chakraborty, 2010). Although capital structure studies are well-represented in developed markets, fewer studies have examined this relationship in the context of Indian firms, particularly at the city or regional level (Pandey, 2015). Pune, a major economic hub in India, presents an interesting case for study, with its diverse industries and rapidly expanding corporate sector. Despite Pune's economic importance, limited research explores the capital structure of firms here, especially comparing leveraged and unleveraged firms in terms of stock performance. This systematic literature review (SLR) seeks to synthesize findings from recent studies on capital structure and stock performance with a specific focus on leveraged and unleveraged firms. Through a systematic selection of high-quality studies, this review aims to clarify how different capital structures impact stock performance and what implications these effects hold for firms in Pune. The review will also identify trends, notable findings, and gaps within the literature, providing a foundation for further research.

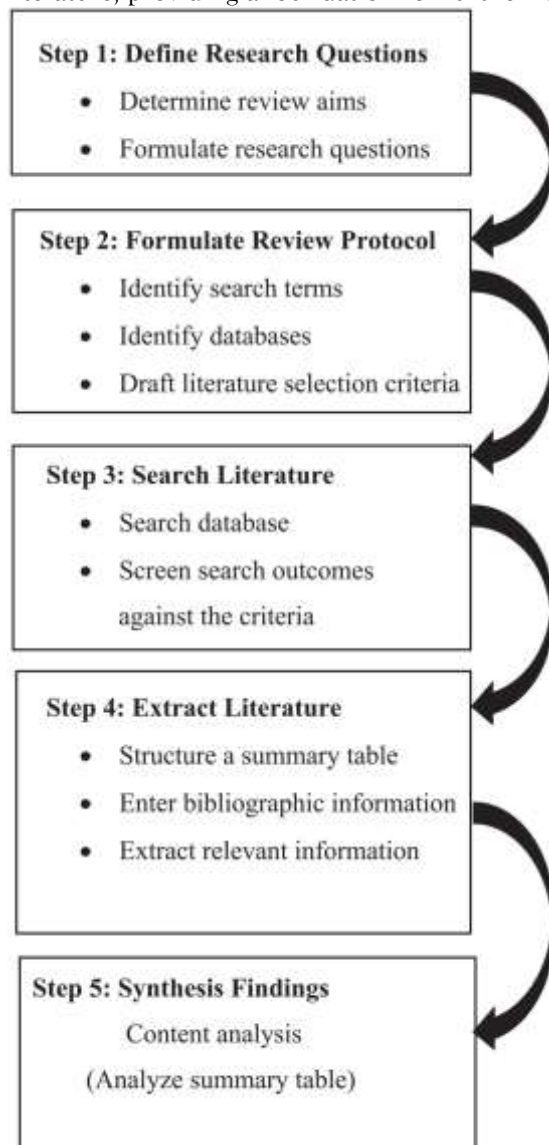


Figure 1. SLR process.

Ref: <https://journals.sagepub.com/doi/full/10.1177/21582440211007117>

The primary objectives of this review are as follows:

- To analyse how different capital structures, affect stock performance across various metrics, such as stock returns and market volatility.
- To compare the stock performance of leveraged versus unleveraged firms.
- To identify the unique factors influencing this relationship in Pune's economic environment.

This SLR aims to offer practical insights into capital structure decisions, especially for firms in emerging markets, and to guide investors, financial managers, and researchers. Additionally, it seeks to address

existing gaps by highlighting areas where further research can enrich understanding of capital structure's impact on stock performance in similar contexts.

METHODS:

We have used a PRISMA (Preferred Reporting Items for Systematic Reviews and Meta-Analyses) to select research papers. This method involved a structured process of identification, screening, eligibility assessment, and inclusion. Initially, a comprehensive search of databases was conducted to identify studies related to capital structure and stock performance. Duplicates were removed, and remaining studies were screened based on relevance. The eligibility of each study was then assessed, with only those meeting specific inclusion criteria (such as relevance to the topic, methodological rigor, and publication quality) being included in the final review.

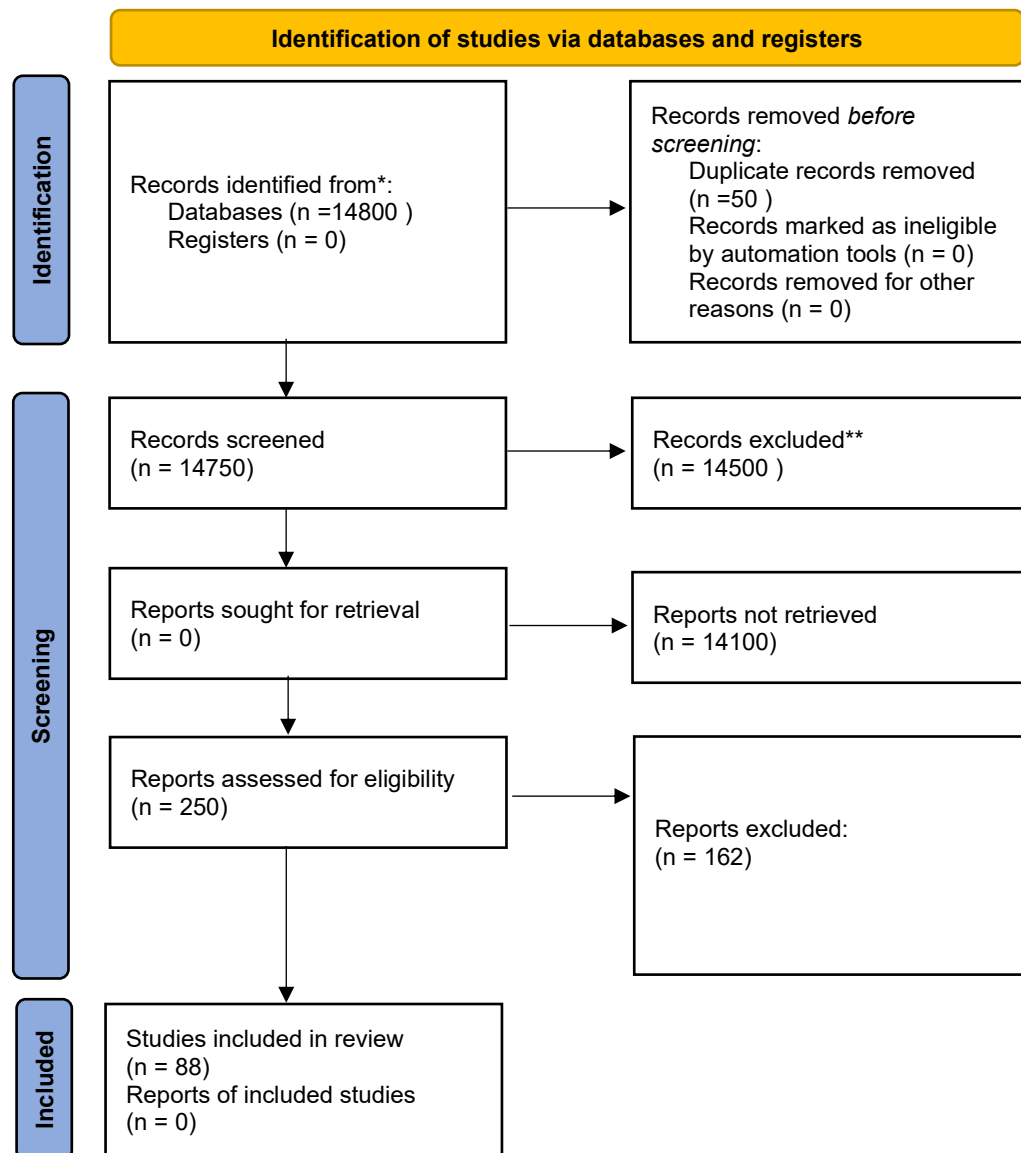


Figure 2. PRISMA flow chart (Self-created by Author)

Ref: https://libguides.mq.edu.au/systematic_reviews/prisma_screen

The data for this systematic literature review (SLR) on capital structure and stock performance was collected from reputable databases, including Google Scholar and Scopus. The review focused on key keywords such as capital structure, stock performance, leveraged firms, and unleveraged firms. Initially we have identified 14,800 research papers. Post excluding 50 duplicates, a total of 14,750 research papers were screened and 14500 papers were excluded which are not closely relevant to the study. At the final

screening stage, the total 162 studies were excluded after the eligibility screening process and only 88 papers found more relevant for the study which taken in to the consideration for final review. The studies selected cover research published over the last two decades.

FINDINGS

The systematic literature review on capital structure and stock performance highlights the significant role leverage plays in shaping a firm's financial performance, particularly in terms of stock returns and market volatility. Debt financing, or leverage, is found to have a dual effect. At the other side, it can enhance profitability in favourable market conditions by amplifying gains, as companies with higher leverage often benefit from tax advantages and higher capital for its expansion. Henceforth, leverage increases the financial risk, especially during periods of economic downturn or market instability. In such circumstances, firms with high debt levels may face difficulties in meeting their financial obligations, leading to greater stock price volatility and, potentially, a decline in stock performance.

The relationship is influenced by several factors between capital structure and stock performance including the type of industry, prevailing market conditions, and the overall economic environment. For instance, capital-intensive industries, such as manufacturing or infrastructure, typically use higher levels of debt, and this leverage can be beneficial in periods of economic growth. In contrast, firms in sectors like technology or services, which rely more on intellectual capital and innovation, generally maintain lower levels of debt to minimize financial risk.

Emerging markets, such as India, present unique dynamics in this relationship due to varying regulatory conditions, market maturity, and economic challenges. Research suggests that firms in these markets may experience different impacts from leverage compared to firms in more developed economies, largely due to differences in market structure and investor behaviour.

There is one significant gap identified during the analysis is the similar study haven't conducted before on the capital structure of firms at the regional level, particularly in cities like Pune. Despite its growing economic importance, existing studies have discussed on how the capital structure of such firms in such regional hubs influences their stock performance, presenting an opportunity for future research.

Suggestions & Recommendation:

Future research should focus on understanding the regional variations in capital structure decisions, particularly within emerging markets, to examine how local economic conditions, regulatory frameworks, and market maturity influence stock performance. In particular, studies could investigate the impact of different capital structures across a broader spectrum of industries to better capture the sector-specific effects of leverage. Longitudinal studies would also be valuable, as they can track the long-term consequences of various capital structures on firm performance, stock volatility, and market behaviour over time. Additionally, researchers should explore the interplay between corporate governance, capital structure, and investor sentiment, particularly in rapidly growing economies like India, where these factors may have a more pronounced effect on financial outcomes. For practitioners, financial managers in emerging markets need to weigh the risks and benefits of leverage carefully, recognizing the potential for higher returns but also the increased vulnerability during periods of economic instability. It is crucial for firms to maintain flexible capital structures that can adjust to changing market conditions and to implement comprehensive risk management strategies to mitigate the adverse effects of financial leverage. Policymakers should focus on strengthening regulations to enhance transparency and stability in financial markets, ensuring that firms can make informed capital structure decisions. This regulatory framework can reduce the negative impacts of excessive leverage on stock performance and protect market integrity, especially in markets characterized by high growth and volatility. By addressing these aspects, both researchers and practitioners can present to a more nuanced knowledge of capital structure and decisions in emerging markets, promoting sustainable growth and stability.

CONCLUSION

This systematic literature review underscores the significant of capital structure's impact on stock performance, particularly with dual effect of leverage on profitability and financial risk. The review highlights key insights for financial managers, investors, and policymakers, particularly in emerging

markets where regional economic factors plays an important role in developing the relationship between capital structure and stock performance. Future research should continue to explore these dynamics, focusing on regional and industry-specific variations, and further suggestions to investigate the long-term opportunities of capital structure decisions on firm growth and market stability.

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