

OPTIMIZING CAPITAL STRUCTURE TO IMPROVE CORPORATE FINANCIAL PERFORMANCE

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Abstract

The purpose of this study is to investigate how optimizing the capital structure can enhance a company's financial performance. This study gathers and examines information from numerous pertinent theoretical and empirical sources using the literature research approach in order to gain a thorough grasp of the connection between capital structure and corporate financial performance. The findings indicate a positive relationship between the financial success of the business and capital structure optimization. The implementation of the optimal proportion of debt and equity is proven to be able to reduce the cost of capital, while optimizing the rate of return on investment (ROI) and return on equity (ROE). However, research also indicates that the suitability of capital structure is highly dependent on industry context, firm characteristics, and market conditions. Thus, companies need to adjust their capital structure strategy by considering these factors to achieve optimal financial performance improvement.

Keywords: Optimization, Capital Structure, Corporate Financial Performance.

Introduction

The ability of the business to sustain and enhance its financial performance is essential in the fast-paced, cutthroat world of business. The capital structure of the organization is one crucial factor that greatly affects financial performance. (Dignam & Lowry, 2020). The arrangement of debt and equity in a company's financing is referred to as its capital structure. Management must exercise strategic judgment when determining the appropriate ratio of debt to equity in the capital structure because it has significant effects on the risk and return of the business. (Roach, 2023).

A number of theories have been developed to explain how companies should optimize their capital structure to achieve maximum value (Dignam & Lowry, 2020). The

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Trade-Off Theory, for example, suggests that firms should balance between the tax benefits of debt (tax shield) and the increased bankruptcy costs resulting from excessive debt use. On the other hand, Pecking Order Theory suggests that firms have certain preferences in the selection of financing sources, starting from the use of internal funds, followed by debt, and finally external equity, depending on the cost of asymmetric information (Moore, 2020). While these theories offer general guidance, practice in the field shows wide variations in their application, suggesting the existence of other factors that influence capital structure decisions (French, 2021).

The balance between debt and equity that businesses utilize to fund their operations and expansion is known as their capital structure, and it is a crucial issue in corporate finance. Decisions regarding capital structure are critical as they affect the overall cost of capital and financial risk of the firm, which in turn impacts the value of the firm and the rate of return for shareholders (Roach, 2023). An optimal capital structure is able to reduce financing costs and maximize firm value by achieving a balance between risk and return. In a competitive business environment, a firm's ability to manage its capital structure efficiently becomes an important issue that can determine the survival and growth of the business in the long run (Roach, 2022a).

Optimizing the capital structure is not just about finding the right proportion of debt and equity, but also about tailoring the financing strategy to support the firm's investment decisions while managing risk. This includes assessing market conditions, interest rates, shareholder expectations, and the Company's risk profile (Roach, 2022b). An effective capital structure can provide flexibility for companies to pursue growth opportunities and new investments without disproportionately increasing financial risk. Furthermore, in the face of economic uncertainty and changes in the business environment, a dynamic and responsive capital structure is key in maintaining financial stability and enhancing the Company's competitiveness (Hannigan, 2021a). Thus, prudent capital structure management is not only relevant for achieving short-term financial goals, but also important in planning and ensuring the sustainability of the company's growth in the long term (Hannigan, 2021b).

In the realm of corporate finance, there is constant discussion and analysis regarding the connection between capital structure and corporate financial performance. From a theoretical perspective, leverage (the use of debt in the capital structure) can benefit a company up to a certain point, thanks to its leveraging effect that raises Return on Equity (ROE) if the company manages to invest the funds from the debt at a higher rate of return than the cost of debt (Hannigan, 2021c). However, using too much debt also increases financial risk, which can be detrimental to the company. This is due to increased finance costs and potential liquidity pressures, especially in volatile market conditions, which can ultimately reduce the profitability and overall financial performance of the company (Alatrsh, 2020).

Empirical studies on the link between capital structure and financial performance show mixed results, reflecting the complexity of this relationship which is influenced by many factors, including industry conditions, firm characteristics, and macroeconomic conditions (Akbar & Ediwarman, 2022). Some studies find that a certain level of debt can motivate management to operate more efficiently, maximizing firm value and thus improving financial performance (Rahayu & Darim, 2020). However, other studies show that a high level of debt can result in increased agency costs and bankruptcy costs, which will ultimately be detrimental to firm value. This diversity of results confirms the importance of companies to carefully consider external and internal factors in determining the optimal capital structure, which is in line with business strategy and minimizes financial risk in order to improve financial performance (Rimeš, 2024). Important issues in this regard include a firm's strategic direction to optimize its capital structure in order to achieve a balance between growth, risk, and returns for shareholders (Reid & Myddelton, 2020).

Thus, although the financial literature has examined the relationship between capital structure and financial performance, the research results still show a lack of uniformity (Darman & Hilumalo, 2023). Some studies find a positive relationship between debt and financial performance, emphasizing the benefits of debt as a means of leverage to increase profitability. (Aguome, 2021) However, other studies show that too much debt can increase financial costs and bankruptcy risk, which ultimately harms the company's financial performance. This suggests the need for a deeper understanding of how companies can optimize their capital structure to improve financial performance (Suwandhayani & Fitdiarini, 2020).

It is in this context that this study finds its relevance. By looking at the existing gaps in the literature and variations in corporate practice, this study aims to discuss how the optimization of capital structure can improve corporate financial performance. Looking at various theories and previous research results, a literature review will be conducted to formulate the best recommendations for companies in designing their capital structure, which is not only able to improve overall financial performance, but also manage the risks associated with choosing different financing strategies. Thus, this research is expected to provide insights and tangible contributions to strategic decision-making in corporate financial management.

Research Methods

The study in this research uses a literature review. The literature study research method is a research approach conducted by collecting and analyzing existing data, such as books, journal articles, magazines, and other sources of information relevant to the research topic (Kim et al., 2024). In conducting a literature study, the researcher adopts a keyword search strategy to find suitable materials, and then evaluates,

synthesizes, and interprets the collected literature to build a comprehensive understanding of the research object (Nesset et al., 2024; Gökçearslan et al., 2024).

Essentially, literature review allows researchers to identify existing research gaps, formulate new theories or add insights to existing knowledge (Teixeira & Carvalho, 2024). This method is also often conducted as an initial step in empirical research to help determine the direction and focus of the research. This literature study method requires the ability to read critically, sort and compare one literature with another (Dong et al., 2024).

Results and Discussion

Financial Theory and Capital Structure

The phrase "capital structure" describes how a business chooses its long-term funding sources, which can include both equity (common stock and preferred stock) and debt (which might take the form of bonds or loans). (Santosa et al., 2020). The way a business balances debt and equity to fund its operations and investments in order to maximize firm value and reduce total cost of capital is the essence of capital structure. (Haditya, 2022). Companies have different optimum capital structures depending on a variety of circumstances, including market conditions, tax laws, operational risk, and shareholder preferences. A company's financial performance and capacity to handle competition and market unpredictability are directly impacted by its ability to manage its capital structure. (Reza et al., 2023).

Capital structure theory has evolved over time and produced several main theories that explain the motivations and consequences of corporate funding decisions (Wibowo & Surjandari, 2023). One of the most famous theories is the Trade-Off Theory, which proposes a balance between the advantages and disadvantages of using debt. According to this theory, companies try to balance the tax benefits of debt interest (which lowers the after-tax cost of capital) with the higher bankruptcy and financial costs associated with greater levels of leverage (Mustakin et al., 2021). The Trade-Off Theory emphasizes on finding the optimal capital structure that maximizes firm value by minimizing the total cost of capital. It recognizes the tax benefits of debt as well as the direct and indirect costs of bankruptcy as important factors in determining capital structure (Akhmadi et al., 2021).

On the other hand, Pecking Order Theory offers a somewhat different view on how firms fund their activities. This theory argues that firms have an ordered preference in financing new investments: they prefer to use internal funds first, then debt, and finally equity, if internal funds are insufficient (Irdiana, 2021). The main reason for this preference is the information imbalance between management and investors; management tends to avoid issuing new shares because it could signal that the shares are overvalued (Chowiyah & Nurasik, 2023). In contrast, by using internal funds or debt, companies can avoid the negative signals generated by issuing new equity. According

to Pecking Order Theory, a firm's capital structure is more a result of financing preferences than an attempt to achieve an optimal capital structure (Hertina, 2024).

In addition to Trade-Off and Pecking Order Theory, there are also other theories such as Windows of Opportunity Theory and Market Timing Theory that explain corporate funding behavior. Windows of Opportunity Theory argues that firms tend to issue shares when the stock market is bullish and share prices are valued high, taking advantage of these conditions to optimize capital at a lower cost (Ria, 2023). Meanwhile, Market Timing Theory argues that the company's capital structure decisions are mainly influenced by management's efforts in capturing favorable market conditions, assessing that the timing of issuing shares or debt can affect the cost of capital (Sianipar, 2023).

The conclusion that can be drawn from the capital structure theories is that there is no single theory that can universally explain a firm's decision regarding its capital structure. The reality of a firm is often much more complex and influenced by a variety of factors, ranging from market conditions, interest rates, industry prospects, to managerial preferences and behavior. As a consequence, firms may apply a combination of different approaches in determining their capital structure, with the main objective always being to maximize firm value for shareholders. On the other hand, it is also important for companies to be mindful of the risks associated with excessive leverage and to always maintain a healthy balance between debt and equity. The most effective approach often involves dynamic adjustments in the funding strategy to suit market conditions and the company's overall business strategy.

Company Financial Performance

Financial performance is an assessment of the operating results and financial condition of a company during a certain period, which is usually evaluated through analysis of financial statements such as balance sheets, income statements, and cash flow statements (Fathihani, 2020). This evaluation includes various aspects such as profitability, liquidity, solvency, and efficiency, as well as the company's ability to generate profits, manage its assets, meet short-term and long-term liabilities, and operate its business efficiently. Solid financial performance is often indicated by steady revenue growth, healthy profit margins, controlled debt-to-equity ratios, and positive cash flow, all of which are important factors for stakeholders in making investment and credit decisions (Hertina, 2024).

Financial performance measurement methods offer tools to analyze management effectiveness in managing the company's assets and equity to generate profits (Kibtiyah & Maryanti, 2022). Return on Equity (ROE) and Return on Assets (ROA) are two popular methods. ROE measures how effectively management generates profit from each unit of equity invested by shareholders, offering a perspective on the return on invested capital (Farhatulmaula & Suparmin, 2024). Meanwhile, ROA provides an

overview of how efficiently the company uses its assets to generate profits, indicating the company's ability to manage its assets in relation to the revenue generated. Both methods provide insight into operational efficiency and investment utilization (Lubis et al., 2022).

In addition to ROE and ROA, Earnings Per Share (EPS) is also an important method in assessing financial performance. EPS measures the amount of earnings available for each common share, providing an overview of the company's profitability on a per-share level, which is very useful for investors in assessing the potential return on their investment (Melananda & Sari, 2024). In addition, other methods such as Debt to Equity Ratio (D/E) are used to assess a company's capital structure and financial risk, by measuring the proportion of debt a company uses relative to equity. These ratios, when reviewed together, assist stakeholders in evaluating the overall financial health and risk of the company more comprehensively (Rohmah et al., 2024).

Other frequently used measurement methods include Current Ratio and Quick Ratio, both of which help in assessing the liquidity of the company. The Current Ratio measures a company's ability to meet its short-term obligations with its current assets, providing an indication of the Company's liquidity strength (Sholeha, 2023). Since inventory might not be instantly convertible into cash, the Quick Ratio—also called the Acid-Test Ratio—offers a more cautious measurement by omitting it from current assets. These metrics shed light on the company's capacity to pay short-term obligations, which is important information for assessing the financial health of the organization as a whole. (Goso, 2022).

From an operational efficiency point of view, Gross Margin, Operating Margin, and Net Margin provide an in-depth view of the company's ability to manage costs and generate profits at various levels of operation (Kurniawati & Yatna, 2020). Gross Margin reflects the profit margin earned from sales after deducting the cost of goods sold, while Operating Margin and Net Margin measure the efficiency of managing costs and earnings after being affected by operating expenses and taxes, respectively (Faissal & Triyono, 2023). In conclusion, the use of these various financial performance measurement methods allows stakeholders to conduct a comprehensive evaluation of the company, not only from the aspects of profitability and liquidity, but also from the perspectives of solvency, risk, and operational efficiency. This is a crucial part of financial analysis for informed decision-making in management, investment, and lending.

Relationship between Capital Structure and Financial Performance

Capital structure refers to the balance between equity capital (shares) and debt capital (loans) used by a company to finance its operations and growth (Hussein, 2020). The relationship between capital structure and financial performance is a key element in financial management, as it affects the risk and cost of capital, which has a direct impact on the profitability and stability of the company. Capital structure theories, such

as Pecking Order Theory and Trade-Off Theory, try to explain how firms decide on the composition between debt and equity. In this context, an optimal capital structure is seen as an appropriate balance between risk and return, where the firm can minimize its cost of capital and maximize firm value and share price (Thamara et al., 2023). A capital structure that is heavier on debt can strengthen financial performance through the leverage effect, provided that the company can generate income from the loan that exceeds the cost of the debt (Abdul et al., 2024).

In practice, companies that use debt as part of their capital structure can utilize the leverage effect to increase returns on equity, as long as the cost of debt is lower than the return on the investment funded by the debt. This suggests a positive relationship between a capital structure consisting of a significant debt component and financial performance, provided that company management can be effective in utilizing borrowed funds (Utami, 2023). However, excessive use of debt also increases the risk of bankruptcy and the cost of financial distress, which can weaken financial performance. Thus, despite the potential positive effect of capital structure on financial performance, companies must carefully weigh the benefits of leverage with the risks arising from excessive debt obligations (Rosyadi & Hariasih, 2021). The alignment between the company's growth strategy and its capital structure is key in creating added value for shareholders and maximizing the company's financial performance (Purwanti, 2020).

Conclusion

Capital structure optimization is an important strategy for companies to improve their financial performance. An optimal capital structure is the combination of debt and equity that a company uses to finance its business operations and expansion. This strategy focuses on adjusting the proportion between debt and equity to minimize the overall cost of capital and maximize firm value. With an optimal capital structure, a firm can achieve an appropriate level of leverage, which not only lowers the cost of capital, but also increases the financial flexibility and investment capability of the firm, thus indirectly contributing to improved financial performance.

Research into capital structure optimization highlights the importance of financial ratio analysis to determine the most profitable combination of debt and equity. Factors such as business risk, dividend policy, market changes, and shareholder preferences should be considered in determining the ideal capital structure. Proper implementation of the capital structure can reduce the cost of finance, increase the return on investment, and ultimately, increase the value of the firm. Therefore, optimizing the capital structure should be made a priority by the company's management to support growth and financial stability in the long run.

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