

CAPITAL STRUCTURE STRATEGIES- POINTERS FOR FURTHER INVESTIGATION RESEARCH

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Abstract - The capital structure is a puzzle which has been attempted to solve by researchers for the past fifty years and still there is much that needs to be explored. There have been studies which developed the theoretical models, some studies that tested these models empirically. Some studies which identified factors affecting capital structure decision and many other studies related to several aspects of capital structure have occupied the academic literature. Present study is an attempt to do an exhaustive literature review of the universe of capital structure and try figure out the contribution of prominent studies. Further, the paper attempts to identify the scope for further research in this field.

Key words: Capital Structure, Literature Review, Strategy,

Introduction-

Capital Structure is the most pertinent topic discussed by researchers and finance managers around the world economies (both developed as well as developing economies). Its effect came into existence since the Modigliani and Miller's (1958) seminal paper, and then subsequently the choice between debt and equity has been extensively investigated in the finance literature. Capital Structure decisions are among the most essential and vital decisions for all sectors' (agricultural, manufacturing, services) firm, because the firms constantly make investment decisions for their sustenance and growth and it has a direct impact on the value and cost of the firm. Appropriate decision about capital structure of a firm also contributes to the country's economic development. Capital structure represents its mix of capital sources, i.e. its mix of debt financing and equity financing, which is associated with different levels of risk, benefit and control.

Capital structure may vary across time e.g., Korajczyk & Levy (2003) even though concentrate on relatively stable capital structures (Lemmon et al., 2008) which suggests the existence of an optimal level of leverage. Incidentally, the issue of a given capital structure that may increase the shareholder value is one of the most important discussions in the finance field, both theoretically and empirically.

In this context, a large number of researchers had developed the theoretical models to explain the capital structure pattern such as MM Irrelevance Theory (1958), MM Relevance Theory (1963), trade-off theory (1973), agency cost theory (1976), signalling theory (1977), pecking- order theory (1984), market timing theory (2002) and to provide the empirical evidence that the theoretical models have explanatory power when applied to the real world such as Shyam- Sunder & Myers, (1999) is the first study to formally introduce empirical models for the Trade- off and Pecking- Order Theories. Baker & Wurgler (2002) introduced the Market Timing Theory of Capital Structure and tested for equity market timing and its long-run impact on capital structure. Frank & Goyal (2004) empirically validate that the assumptions of the market timing theory is competitively less studies. Miglo (2010) compared to pecking-order and trade-off theory and also analysed the theoretical part of market timing theory which is underdeveloped. Some recent studies like Baker, Greenwood, and Wurgler (2003) and Butler, Grullon, and Weston (2004) have focused on debt market timing instead of equity market timing. Myers (2003) claims that "all the capital structure models are conditional and that there is no universal theory of capital structure and no reason to expect one."

But still the debate is not over yet and constantly searching the optimal answer of certain question i.e. what determines the choice of capital structure and how this choice affects firm performance (Weston and Brigham (1981). Capital structure has been analysed separately in both finance and strategy research. The financial policy of firm is very crucial decision which cannot be solely taken either by finance managers' or by strategy managers'. So, there is a need to integrate the finance and strategy research to solve the capital structure puzzle.

The strategy-capital structure puzzle was first thrown into light in 1976 when Jensen and Meckling explored the relationship between investment and financing decision and the importance of strategic variables has recognized by Harris and Raviv (1991). Barton and Gordon (1987) first link the corporate strategy and diversification to the capital structure decision and argued that a "corporate strategy perspective on managerial choice would yield a more detailed understanding of capital structures and their effects". Along the same lines, Andrews (1971) claimed that "capital structure decisions are made based on managerial perspectives on the value of the firm in terms of internal and external business factors". This is referred to as the "Strategy-Capital structure" relationship. This concept implies that corporate capital structures and strategic behaviour are more accurately understood through a holistic approach that brings together corporate strategic perspectives and extant financial research.

Rationale of the Study-

The central idea of this study is to provide a synoptic literature review on capital structure strategies. This study aims to give a bird's eye view on the major work carried out over a time on capital structure theories, its determinants, corporate strategy and capital structure relation. More specifically, it intends to find the answer of some queries such as - Whether the firms should go for debt or equity finance at the time of requirement, how much debt and equity the company should take? Is there any relationship between corporate strategies and capital structure? Can diversification strategies be the determinants of capital structure? Furthermore this study explores research gaps in the related area and recommends potential directions for future capital structure strategies research.

This paper is organized as follow: Section II presents historical perspective of capital structure and gives the synoptic view of literature on various theories developed by eminent researchers and determinants of capital structure and linkages of capital structure and corporate strategy. Section IV provides research findings and research gaps identified in the existing literature. Section V presents the conclusion and suggests areas of future research.

2. Capital Structure: A Historical perspective-

In the late 1950s, there have been the footprints of works of Lintner (1956), Hirshleifer (1958)

and Modigliani and Miller (1958) on firms' capital structure choice. After the seminal paper of Modigliani and Miller (1958) compel researchers to rethink in the direction of firms' financing behaviour and the value of the firm. Therefore, large number of theoretical models of capital structure of a firm has been developed such as absence of taxes in irrelevancy theory gives rise to the trade-off model, information asymmetry in the market gives rise to the concept of pecking order, signalling effect, market behaviour and behavioural aspects of capital structure. In table 2.1 summarizes all the major views of renowned researchers on capital structure.

Year	Researcher	Proposed Theory	Researcher's Contribution
1958	Modigliani & Miller	Modigliani & Miller (MM) Theory (without taxes) (Irrelevance Theory)	Created a milestone in financial literature. According to this theory, no impact of capital structure on firm's value.
1961	Gordan Donaldson	Pecking Order Theory	Pointed out that the firms follow a particular sequence of financing.
1963	Modigliani & Miller	Modigliani & Miller (MM) Theory (Relevance Theory)	Considered the effect on tax shield on interest payments
1973	Kraus & Litzenberger	Static Trade-off Theory (Tax Based Theory)	The theory is considered trade-off between cost of financial distress and interest tax shield of debt. And firms gradually move towards the targeted debt.
1976	Jensen & Meckling	Agency Costs Theory	Effect of manager- shareholder conflict and debt holder-share holder conflict on financing decisions.
1977	Ross S.A.	Signalling Theory/ Asymmetric Information	Perceived debt issuance as an indicator of good performance of a firm as opposed to equity issuance.
1984	Myers and Majluf	Modified Pecking Order Theory	Extend the work of Gordan Donaldson and present the information asymmetry concept. Firms' prefers internal funds then debt and finally issue equity.
1989	Fischer et. Al	Dynamic Trade-Off Theory	Introduced the transaction cost in the capital structure and argued that variation in debt ratio can also occur due to a small transaction cost.
1991	Harris & Raviv	Debt as a Disciplining Device	Reviewed the capital structure theories and introduced the control driven theory as well as the strategic variables.
2002	Baker & Wurgler	Market Timing Theory	Issue equity when market is overvalued and issue the debt when market is undervalued.
2012	Uckar	Behavioural Financing	Suggested the new concept of behaviour element in capital structure

Lots of empirical studies have been done by researchers focusing upon the determinants of capital structure in two different economies i.e. in the developed economy and in the emerging economy. Because the institutional structures of companies in the developed countries are different from the developing countries. Majority of empirical studies done in developed countries such as USA, UK, Canada, France, Italy, Japan, Portugal and Swiss etc. such as Titman and Wessels (1988) uses data from U.S.; Harris and Raviv (1991); Rajan and Zingales (1995) across G-7 countries; Nuri (2000) and Bevan and Danbolt (2000) analysed data from UK firms; Antoniou et al, (2002) for European countries; Goddard et al. (2005) analysed a set of data from service and manufacturing sector firms for the study of Belgium, France, Italy and UK; Nunes et al. (2009) works on Portuguese Service Industries Firm; Serrasqueiro (2011) uses data from Portuguese Service and Manufacturing small and medium enterprises (SMEs).

To the contrary, there are some empirical studies which focus on the emerging markets a few studies that considered emerging markets i.e. (Brazil, Mexico, China, India, South Korea, Jordan, Malaysia, Pakistan, Thailand, Turkey and Zimbabwe etc.). Few examples Booth et al., (2001) had done a pioneering study on the capital structures decision of 10 emerging markets for 10 years.

Works done by Kakani & Reddy (1998) and Rao & Jijo (2002) both empirically analyzed the implications of liberalization of Indian economy on the determinants of the capital structure of Indian firms and found that during the pre liberalization Indian firms had more debt rather than equity in their capital structure. Bhaduri (2002), study concluded that the optimal capital structure choice is influenced by factors such as growth of earnings, cash flow of the firm, size of the firm, and product and industry characteristics. Bhole & Mahakud (2004) found that high debt used in public limited companies rather than private limited companies and also concluded that the pecking order of funds in India broadly has been borrowings, trade dues, external equity and reserves and surplus. Chen (2004) claims that there is a new pattern has seem in the capital choice decision among the Chinese firms i.e. retained profit, equity, and long-term debt, called as “new Pecking order.” Huang & Song (2006) focused on limited range of ownership structures, although they do consider industry effects.

From the rigorous literature, we extract a long list of factors (i.e. determinants of capital structure) claimed to have some influence on corporate leverage and this capital structure determinants can be nested in at least three levels: firstly firm- specific, secondly industry- specific and finally country- specific level. The list of determinants of capital structure and the implications of capital structure theories and empirical evidences on the relationship of capital structure determinants is shown in the table-2.2:

2.1. Linkages of Corporate Strategies and Capital Structure:

Early financial theorists suggested that financing decisions may be ‘irrelevant’ for firm strategy (Modigliani–Miller, 1958), but recent research indicates that such choices may differentially affect

Table 2.2 Summary of the implications of capital structure theories and empirical evidences on the relationship of capital structure determinants with gearing

S. No.	DETERMINANTS	PREDICTED SIGN BY THE THEORIES	SAMPLE EMPIRICAL EVIDENCE
A. FIRM SPECIFIC DETERMINANTS			
1.	Size	- (Pecking order)	Titman and Wessels (1988); Chakraborty (2010)
		+ (Trade-off, Signalling)	Marsh (1982); Rajan and Zingales (1995)
2.	Profitability	- (Pecking order)	Titman and Wessels (1988); Shyam-Sunder and Myers (1999); Booth et al., (2001)
		+ (Trade-off, Signalling)	Bowen et al. (1982); Dammon and Senbet (1988);
3.	Tangibility	+ (Trade-off)	Long and Malitz (1985); Rajan and Zingales (1995); Titman and Wessels (1988); Chakraborty (2010)
		+ (Pecking order)	Chung (1993); Walsh and Ryan (1997)
4.	Growth opportunities	- (Trade-off)	Long and Malitz (1985)
		± (Signalling Pecking order)	Titman and Wessels (1988); Chen (2004); Chakraborty (2010)
5.	Non-Debt Tax shields effect shields	+ (Trade-off)	Bradley et al. (1984); Chakraborty (2010)
6.	Age	+ NA	Abor and Biekpe (2009)
		-NA	Michaelas et al. (1999); Viviani (2008)
7.	Uniqueness	- (Trade- off)	Titman and Wessels (1988); Chakraborty (2010)
8.	Cost of Financial Distress/ Bankruptcy Cost	- (Trade- off)	Bradley et al. (1984); Walsh and Ryan (1997)
9.	Liquidity	+ N.A	Bradley et al. (1984); Kaurand Rao (2009)
		- (Pecking order)	Pathak (2010); Sheikh and Wang (2011)
10.	Asset Structure	+ (Trade-off)	Long and Malitz (1985)
		+ (Pecking order)	Chung (1993); Walsh and Ryan (1997)
11.	Business risk	- (Trade- off)	Al-Ajmi et al. (2009); Chen et al. (2009); Pathak (2010)
		+ N.A.	Nguyen and Ramachandran (2006); Kaur and Rao (2009)
12.	Tax	+ N.A.	Booth et al., (2001); Cheng and Shiu (2006)
B. INDUSTRY SPECIFIC DETERMINANTS			
13.	Capex	NA	Taggart (1986)
14.	Industry Leverage	NA	Abor (2007); Frank and Goyal (2009)
15.	Creditors	NA	Fan et al. (2012); Serrasqueiro (2011)
C. COUNTRY SPECIFIC DETERMINANTS			
16.	Economic Development	+ (Trade-off)	Booth et al., (2001); Frank and Goyal (2009)
		- (Pecking order)	Cheng and Shiu (2006); Bayrakdaroğlu et al. (2013)
17.	Inflation	+ (Trade-off)	Booth et al., (2001); Frank and Goyal (2009)
		- (Pecking order)	Cheng and Shiu (2006); Bayrakdaroğlu et al. (2013)
18.	Corporate Tax		Bayrakdaroğlu et al. (2013)

SOURCE: - Baker, H. Kent and Gerald S. Martin, Capital Structure and Corporate Financing Decisions: Theory, Evidence and Practices, John Wiley & Sons, 2011 ISBN: 978-0-470-5695

firm value largely because of market imperfections (Myers and Majluf, 1984). Several prior studies have attempted to verify which theory (i.e., trade-off theory or pecking-order theory or agency cost theory or market timing theory) better explains financing behaviour. Others investigated capital structure decisions at the level of corporate strategic position. Maurizio et.al (2007) presented the studied on the integration between finance and strategy research and examining how financial decisions are related to corporate strategy by using the literature on finance and strategy which indicates that how the strategic actions of key players affect value of firm and the allocation of value between claimholders. However, few studies examined the role of diversification strategy in the choice of capital structure (Taylor and Lowe, 1995; Markides and Williamson, 1996; Kochhar and Hitt, 1998; Alonso, 2003). As La Rocca et al. (2009) claimed that “examining the relationship between capital structure and diversification could expand our understanding of financing behaviour.”

Early linkages of strategy to capital structure:

The notion that there might be some relationship between a firm’s ‘strategic’ decisions and its capital structure first came to light with Jensen and Meckling’s (1976) seminal paper on agency costs. Barton and Gordon (1976) suggested the usefulness of the corporate strategy perspective in understanding capital structure. Titman’s (1984) analysis of the effect of capital structure on a firm’s liquidation decision revealed that a firm’s capital structure might be a source of strategic value. Harris and Raviv (1991) also suggested that the effect of strategic variables on capital structure is a relatively unexplored area.

Modern strategic perspectives on capital structure:

Ansoff (1957) had initiated the term diversification in the corporate strategy to illustrate the firm’s growth i.e. ‘entering new market with a new product’. Following this line of research, Wrigley (1970) and Rumelt (1974) had developed the concept of classification of diversification strategies. The detail of Wrigley/Rumelt classifications of diversification strategies has shown in box 2.1.1 and table 2.1.1.

Box 2.1.1

The Wrigley/Rumelt classifications of diversification strategies are based upon these two dimensions which are measured by:

1. The specialization ratio- the firm's sales within its major activity as a proportion of its total sales, and
2. The related ratio- the proportion of the firm's total sales which are related to one another.

Rumelt (1974) refines the Wrigley classification by introducing different dimensions of relatedness:

1. Constrained diversification- where the firm's activities are related to one another, is distinguished from linked diversification, where each activity is related to at least one other activity, but not to all other activities;
2. Vertically integrated firms are classified into a separate dominant-vertical category.

Table 2.1.1. The Wrigley and Rumelt classifications of diversification strategies	
Wrigley classification	
Single business	specialization ratio (SR) >95%
Dominant business	95% > SR >70%
Related business	SR <70%, related ratio (RR) >70%
Unrelated business	SR <70%, RR <70%.
Rumelt classification	
Single business	SR >95%
Dominant vertical	vertically- related sales >70
Dominant constrained	95% < SR <70%, majority of other businesses related to one another through a core asset or skill
Dominant-linked	95% < SR <70%, majority of other businesses related to at least one other business within the firm
Dominant-unrelated	95% < SR <70%, majority of other businesses unrelated
Related-constrained	SR < 70%, 70% + of businesses related to one another
Related-linked	SR <70%, RR >70%, majority businesses related to at least one other business within the firm
Unrelated business	SR <70%, RR <70%.

Companies diversify their operation either across different national markets (international market diversification) or across multiple lines of business (product diversification) or both to increase the economy of scale and economies of scope, thus increasing their efficiency, learning, and innovation respectively (Kochhar and Hitt, 1998).

An ample of literature predicts that international diversification is associated with lower debt ratio while the product diversification is associated with higher debt ratio (Lang and Stulz 1994; Berger and Ofek 1995; Kim and Mathur 2008). Singh et al. (2003) alluded that “these asymmetric impacts might be concluded that the two types of diversification complement one another in generating debt usage, although individually they may be negatively related to firm leverage.”

Effect of diversification on capital structure:

Basically, three traditional theories has elucidated the relationship between diversification and capital-structure choices i.e. coinsurance effect, transaction cost hypothesis and agency cost. **Coinsurance effect** posits that diversifying firms can reduce the risk which is associated to operating in a single business and this reduced risk helps firms to increase the debt capacity (Lewellen (1971); Kim and McConnell (1977)).

Transaction cost hypothesis deals with the governance of contractual relations in transactions between two parties (Williamson, 1988). A firm's financial decision between debt and equity is highly related to its asset characteristics (Markides and Williamson (1996)). Thus, the transaction cost hypothesis considers debt a rule-based governance structure and equity a discretionary governance device. In turn, it supports the use of debt to finance non-specific assets and the use of equity to finance specific ones.

Consequently, highly specific assets, which are associated with related diversification, should be financed by equity because they are limited in terms of liquidation in the event of a bankruptcy. General assets, which are associated with unrelated diversification, should be financed by debt because they are easily liquidated in case of bankruptcy and are valuable as collateral. Thus, in this case related diversification would decrease debt leverage while unrelated diversification would increase debt leverage.

Agency theory (Jensen and Meckling, 1976) also contributes to the theoretical stream supporting the relationship between capital structure and diversification (Kochhar, 1997; Kochhar and Hitt, 1998). As mentioned earlier, Jensen (1986) argued that debt could constrain managerial behaviour by reducing the free-cash flow under managerial discretion. This supports the positive role of debt in reducing management detrimental diversification strategies, especially unrelated diversification. Consequently, shareholders promote the use of debt as a way to limit managers' unrelated diversification decisions. Along the same lines, Li and Li (1996) mentioned that low leverage under a diversification strategy could lead to over-investment. Thus, diversified firms need to maintain higher levels of debt leverage than non-diversified firms to avoid over-investment (Riahi-Belkaoui and Bannister, 1994).

Previous empirical evidence regarding the effect of diversification on capital-structure determinants is quite limited. Rumelt (1974), for 249 US firms, observed that firms employing a strategy of unrelated diversification have the highest debt level. Barton and Gordon (1988), for 279 US firms, and Lowe et al. (1994), for 176 Australian firms obtained similar results. Kochhar and Hitt (1998), focusing on 187 US firms, showed that equity financing is preferred for related diversification, while unrelated diversification is associated with debt financing. In contrast, Alonso (2003) analyses 480 Spanish manufacturing firms during the period from 1991 to 1994 but did not find a significant relation between leverage and diversification.

Although many of these articles used the deterministic Rumelt categories to study the capital structure-diversification relation (Barton and Gordon, 1988; Lowe et al., 1994), others used directly total diversification measures (Alonso, 2003; Low and Chen, 2004), while just Kochhar and Hitt (1998) use the related-unrelated diversification measures.

Most of the research is based on developed countries, however some focuses on developing countries as well. In Indian context, comparatively few studies have been done on diversification strategies of Indian firms. Such as, Khanna and Palepu (2000) studied the diversification strategies of business groups and compared the performance of group affiliates with the performance of unaffiliated firms. Kakani (2000), extends Khanna and Palepu's (1999, 2000) research on emerging economies by examining groups' characteristics and their performance in the context of major policy changes. Ajay and Madhumathi (2012) studied the relation between two dimensions of corporate scope, geographic diversification, and product diversification and their impact on corporate leverage. Although, these above studies reveals that domestic firms have higher debt in their capital structure as compared to multinational corporations. International and product diversified firms have lower levels of leverage than focused firms in their capital structure.

Other studies (Balakrishnan and Fox, 1993; and Williamson, 1988) have focused on competitive strategies, paying particular attention to the role of specialised, firm-specific assets. Recent empirical work has extended the range of strategies linked to leverage and implicated a strategy of innovativeness as a determinant of leverage. Jordan, Lowe, and Taylor (1998) investigated the relationship between capital structure and strategy using 'a variant of Porter's (1980) generic strategy typology' and found that 'a strategy based on innovation was associated with the lowest level of debt, while firms pursuing a cost-leadership strategy had the highest levels of debt'.

3. Research Findings and Gap-

Existing work done on the capital structure and financing strategies, it was evident that a lot of work has been done for developed nations as compared to developing nations and how the capital structure choices vary across the developing nations remains an open empirical question. Many of the empirical studies have tried to analyse financing behaviour and financing strategies i.e. capital structure of firm, considering for this purpose all sectors, or only manufacturing companies, the study on service industry in particular being somewhat neglected.

Service sector has the special importance in the sphere of Indian economy. The share of service sector in India's GDP at factor cost (at current prices) increased from 33.3% (1950-1951) to 53% (2017-18), has made rapid strides in the past decade and a half to emerge as a bright spot in the world economy, becoming one of the fastest growing large economies in the world. Service industries investments in machinery and equipment are relatively small. If service firms lease their facilities, the total capital invested is working capital (Gill et al., 2008). Moreover, the benefits of diversification derived from scale economies could also differ between manufacturing and service industries due to differences in investments. This suggests that the association between capital structure and strategic choice might produce different outcomes within service industries.

4. Conclusion-

Over the fifty years, there is a still an elusive about the capital structure puzzle, notwithstanding many researchers has developed the theoretical as well as empirical models to explain the capital structure pattern. In his seminal paper on agency costs, Jensen and Meckling's (1976) highlights new insight to this debate considering financial decisions from a strategic viewpoint i.e. relationship between capital structure and corporate strategy. Following this line of research, lots of researchers tried to integrate the finance and strategy research to investigating how financial decisions are related to corporate strategy by using the literature

on finance and strategy which indicates that how the strategic actions of key players affect value of firm and the allocation of value between claimholders. Therefore, there is a need to examine whether diversification strategy has a real influence on firm capital structure.

Corporate strategies and their effectiveness constitute a crucial research problem in international trade, finance, and strategic management areas. Nevertheless, in India, there exists a huge gap in empirical research on the impact of corporate diversification strategy on financial policy in Indian service sector. So, future research is the modest attempt at filling this gap.

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