



CAPITAL STRUCTURE DECISIONS AND THEIR IMPACT ON FINANCIAL STABILITY OF AN ORGANIZATION

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ABSTRACT

Capital structure plays a very crucial role in defining the financial stability of a firm. Capital structure is the specific mix of debt and equity that a company uses to finance its operations and growth. Proper selection of the debt and equity mix is very important for the company. Financial stability relates to continual profitability and increases in revenue alongside expenses that don't see big changes. When your company is financially stable, it's in a better position to weather difficult economic times as well as take advantage of growth opportunities. This means that a good capital structure decision by a company's management leads to fairly good financial stability and health. This research paper is focused on finding out how different capital structure decisions of different companies lead to differences in their overall financial stability.

Keywords:

Cost of capital, cost of equity, cost of debt, corporate finance, optimal capital structure, liquidity, profitability, interest rates.

1. INTRODUCTION

When analysts refer to capital structure, they usually mean the company's debt-to-equity (D/E) ratio, which reveals the level of risk in its borrowing strategy. Typically, a more aggressive capital structure, characterized by high debt levels, presents greater risk to investors. However, this risk can also be a significant driver of the company's growth. Both debt and equity appear on the balance sheet, along with company assets, which are acquired through these forms of financing. The capital structure of a company includes a combination of long-term debt, short-term debt, common stock, and preferred stock. When assessing a company's capital structure, analysts consider the ratio of short-term debt to long-term debt.

Companies that rely more on debt than equity for financing their assets and operations exhibit a high leverage ratio and an aggressive capital structure. Conversely, companies that fund their assets with more equity than debt have a low leverage ratio and a conservative capital structure. However, a higher leverage ratio and aggressive capital structure may result in faster growth, while a conservative capital structure might lead to slower growth.

Higher debt results into higher interest that is to be paid by the company on timely intervals even if the company is suffering from losses. But it has its own benefits; this is that such payment of interest leads to exemptions in tax to be paid for the assessment year.

On the other hand, raising funds through equity leads to loss of control of the company but has the benefit that there is no timely payment of interest or dividend required, whenever the company generates profits, it distributes the dividend to the shareholders.

So, selecting the proper ratio of debt-equity ratio becomes important for the management of the organization. In business terms, financial stability means generating sufficient revenue from operations to cover regular expenses and having confidence in the long-term financial health of your company. Achieving financial stability is crucial because it allows you to consistently meet business expenses, manage market fluctuations, and seize opportunities for growth. A financially stable business avoids excessive reliance on debt, uses its assets effectively, and maintains a strong profit margin. It typically has an emergency fund to cushion against economic challenges, reducing the risk of closure due to financial strain. Additionally, a stable business benefits from a solid base of repeat customers, which provides consistent revenue and lowers customer acquisition costs.

Financial stability is crucial for lenders, business partners, and investors. When seeking a small business loan, lenders typically require evidence of financial stability, such as a statement demonstrating adequate cash flow and manageable debt levels. Similarly, investors and business partners look for proof of financial stability to assess whether collaborating with or investing in your business is a sound decision.

The capital structure significantly influences a company's capacity to handle financial risks, sustain profitability, and adapt to economic changes. By carefully balancing debt and equity financing, a thoughtfully designed capital structure not only leverages the advantages of each type of financing but also mitigates their respective risks. This balance is essential for maintaining overall financial stability and optimizing the cost-benefit ratio of financing options.

2. OBJECTIVE

1. How capital structure affects the financial stability of companies.
2. Finding an optimal capital structure for optimal financial stability.
3. Finding the differences in capital structure decisions of different companies.

3. RESEARCH PROBLEM

Determining how capital structure decisions influence the financial stability of organizations across different industries and market conditions.

4. REVIEW OF LITERATURE

Capital structure decisions are crucial in shaping the financial stability of firms. The literature on this topic explores how the mix of debt and equity financing influences a company's risk profile, cost of capital, and overall financial health. Research has delved into the trade-offs between debt and equity, highlighting how these choices affect both short-term performance and long-term stability. By examining various theoretical frameworks and empirical studies, this review aims to synthesize the key findings on how capital structure decisions impact financial stability, providing insights into optimal financing strategies and their implications for organizational resilience.

Chandrika Prasad Das and Rabindra Kumar Swain¹ The study was based on descriptive and analytical research design to find out that which debt-equity ratio of the company is having significant impact on profitability of Tire companies in India. The study concludes that there is a significant relationship between capital structure and profitability and capital structure has significant impact on financial performance of sample companies.

Muhammad Usman² Finding out whether there is a positive relationship between capital structure and financial performance Making a decision on what the composition of their capital structure will be, companies should look critically and make comparison between the cost of obtaining a particular source of capital and the benefit that can be derived from it instead of making capital structure decisions on baseless generalizations.

Charles Yegon, Joseph Cheruiyot, Dr. J. Sang, Dr. P.K. Cheruiyot³ Capital structure decisions are likely to be the product of multifarious group processes. It is difficult if not impossible to mull over all relevant factors with bounded rationality, at least in the current scenario. The determination of a company's capital structure constitutes a difficult decision, one that involves several and antagonistic factors, such as risk and profitability.

Niway Ayalew Admassu⁴ The study attempts to seek the extent of debt usage and differentiate which debt level give effects to the firms' financial performance. The study result revealed a significantly negative relationship between capital structure ratios (short term debt, long term debt, and total debt ratios) financial performance measured by Return on Assets and Return on Equity.

5. RESEARCH METHODOLOGY

Data collection: the data collected for various primary and secondary data, Secondary data collecting through companies' websites and publications, various books and journals.

6. DATA ANALYSIS

Capital Structure of companies (Tesla and Mercedes) for the recent 5 years.

S.No.	Year
1	2018-19
2	2019-20
3	2020-21
4	2021-22
5	2022-23

COMBINED BALANCE SHEET OF TESLA AND MERCEDES YEAR 2018-19

(For the year ending 31st March, 2019)

	Tesla	Mercedes
Debt (Total Liabilities)	\$26199	\$72233
Equity	\$7467	\$39732
Debt-to-Equity Ratio	3.51x	1.82x
Debt as % of total Assets	76.4%	72.1%
Equity as % of total Assets	21.8%	39.6%

Table 6.1

Tesla shows signs of higher financial risk with a high debt- to-equity ratio, lower equity, and tighter liquidity. It relies heavily on debt, and although its current ratio is positive, it could face challenges during financial stress.

Mercedes has a more stable and balanced capital structure, with strong equity, better liquidity ratios, and a manageable debt load. It demonstrates better financial stability and operational flexibility.

COMBINED BALANCE SHEET OF TESLA AND MERCEDES YEAR 2019-20*(For the year ending 31st March, 2020)*

	Tesla	Mercedes
Debt (Total Liabilities)	\$25930.38	\$55240.89
Equity	\$41969.68	\$24690.25
Debt-to-Equity Ratio	1.05x	1.32x
Debt as % of total Assets	51.2%	56.8%
Equity as % of total Assets	48.8%	43.2%

Table 6.2

Tesla: the financial position of Tesla has improved markedly, showcasing a commitment to reducing debt and increasing equity. However, its accumulated deficit and reliance on liabilities still pose risks, particularly if market conditions worsen. The presence of redeemable non-controlling interests indicates additional complexity in its financial landscape, necessitating careful management of investor expectations.

Mercedes: the relatively high level of debt signifies a potential risk, especially in the face of economic downturns or rising interest rates. Nevertheless, Mercedes consistent equity and capital reserves suggest resilience. The company appears to be managing its obligations effectively, but vigilance is necessary to ensure continued financial health.

COMBINED BALANCE SHEET OF TESLA AND MERCEDES YEAR 2020-21*(For the year ending 31st March, 2021)*

	Tesla	Mercedes
Debt (Total Liabilities)	\$30548	\$62353
Equity	\$30189	\$77609
Debt-to-Equity Ratio	1.01x	0.80x
Debt as % of total Assets	49.19%	50.06%
Equity as % of total Assets	48.61%	62.34%

Table 6.3

Tesla: the higher leverage implies increased financial risk for the company. The nearly equal debt and equity levels may pose challenges during economic downturns or rising interest rates, as obligations to creditors could strain cash flows. While leveraging can lead to higher returns in favourable conditions, it also exposes the company to greater volatility and risk of financial distress.

Mercedes: the solid equity position contributes to a greater financial stability, enabling Mercedes to withstand economic fluctuations better. Its relatively low debt levels suggest that it is less exposed to interest rate risk and has greater flexibility in pursuing strategic investments.

COMBINED BALANCE SHEET OF TESLA AND MERCEDES YEAR 2021-22

(For the year ending 31st March, 2022)

	Tesla	Mercedes
Debt (Total Liabilities)	\$36440	\$119700
Equity	\$44704	\$92600
Debt-to-Equity Ratio	0.82x	1.29x
Debt as % of total Assets	44.25%	42.95%
Equity as % of total Assets	54.31%	33.23%

Table 6.4

Tesla: the combination of a strong equity position and a lower debt burden contributes to Tesla's robust financial stability. This enables the company to pursue aggressive growth strategies, including expansion in new markets and investment in R&D, while maintaining a lower risk profile.

Mercedes: the companies' substantial equity and manageable debt levels signal a stable financial position, allowing for continued investment in innovation, manufacturing capabilities, and market expansion. However, the relatively high proportion of debt also indicated the potential for increased financial obligations, which must be monitored closely.

COMBINED BALANCE SHEET OF TESLA AND MERCEDES YEAR 2022-23

(For the year ending 31st March, 2023)

	Tesla	Mercedes
Debt (Total Liabilities)	\$43009	\$139954
Equity	\$63387	\$99507
Debt-to-Equity Ratio	0.68x	1.41x
Debt as % of total Assets	40.4%	49.6%
Equity as % of total Assets	59.5%	35.3%

Table 6.5

Tesla: with 40.4% of total assets financed by debt, Tesla's level of debt is substantial but lower than that of Mercedes. The higher equity proportion at 59.5% showcases a solid financial foundation, providing resilience against economic fluctuations. The stronger equity position suggests that Tesla is better equipped to manage its financial obligations and navigate market uncertainties.

Mercedes: with 49.6% of total assets financed through debt, nearly half of the company's assets are encumbered financial obligation, which could strain cash flows, especially if interest rates rise or market conditions deteriorate. The relatively low equity as a percentage of total assets at 35.3% further emphasizes the company's reliance on debt, indicating a less stable capital structure compared to Tesla.

7. FINDINGS OF THE STUDY

1. Evolution of capital structure:

Tesla transformed its financial position, reducing its debt to equity ratio from 3.51x in 2019 to 0.68x in 2023, reflecting a shift toward greater equity and reduced reliance on debt. In contrast, Mercedes maintained a stable but higher debt to equity ratio, peaking at 1.82x in 2019 and stabilizing at 1.41x in 2023, indicating persistent reliance on debt.

2. Financial health and risk assessment:

Tesla's increasing equity (from 21.8% to 59.5% of total assets) showcases improved resilience against market fluctuations, while Mercedes' declining equity (from 39.6% to 35.3%) highlights its vulnerabilities in cash flow management amid high debt levels.

3. Strategic implications:

Tesla's focus on equity growth positions it favourably for innovation and expansion, whereas Mercedes must enhance its debt management strategies to maintain operational flexibility and navigate potential market volatility.

4. Long term financial sustainability:

Tesla is better positioned for long-term sustainability due to its reduced debt and solid equity foundation. Mercedes needs to reassess its capital structure to ensure viability and maintain competitiveness as economic conditions evolve.

5. Market position and competitive landscape:

Tesla's equity-focused model allows for quicker adaptation to market shifts, enhancing its competitive edge. In contrast, Mercedes' reliance on debt may hinder its agility in seizing new opportunities.

8. SUGGESTIONS

For Tesla:

1. **Diversify Funding Sources:** Explore alternative financing options, such as green bonds or strategic partnerships, to support expansion without increasing debt.
2. **Invest in R&D:** Allocate more resources to research and development to foster innovation and maintain leadership in electric vehicle technology.
3. **Strengthen Supply Chain Resilience:** Develop local supply chains to reduce dependency on global suppliers, mitigating risks related to market fluctuations.
4. **Enhance Marketing Strategies:** Increase brand visibility and customer engagement through targeted marketing campaigns to further boost sales.
5. **Expand Product Offerings:** Introduce new vehicle models or services (like energy storage or solar products) to diversify revenue streams.

For Mercedes:

6. **Debt Restructuring:** Consider refinancing existing debt to lower interest rates and extend maturities, easing cash flow pressures.
7. **Improve Cost Efficiency:** Implement cost-cutting measures across operations to enhance profitability and improve cash flow management.
8. **Strengthen Equity Financing:** Explore equity issuance options to bolster the equity base, reducing the debt-to-equity ratio over time.
9. **Focus on EV Transition:** Accelerate investment in electric vehicle development to align with market trends and regulatory requirements, enhancing future growth prospects.
10. **Enhance Risk Management:** Develop robust risk assessment frameworks to better navigate market volatility and protect financial stability.

9. CONCLUSION

Ultimately, the findings of this study emphasize the necessity for companies to tailor their capital structure decisions to their unique strategic objectives, operational contexts, and prevailing market conditions. Each organization must conduct a thorough assessment of its risk appetite and growth ambitions, recognizing that the ideal capital mix can vary significantly based on these factors.

For instance, a high-growth company like Tesla may benefit from a more aggressive capital structure that leverages debt to fund innovation and rapid expansion. However, this approach requires robust risk management practices to mitigate potential downsides, particularly in volatile markets. On the other hand, a well-established company like Mercedes may find that a conservative capital structure offers greater financial stability, allowing it to navigate economic fluctuations with confidence and maintain steady profitability.

This research provides valuable insights for managers tasked with making informed decisions about capital structure. By understanding the implications of different financing strategies, managers can better align their choices with the long-term vision of the company. Investors also benefit from this analysis, as they can gain a clearer picture of how a firm's capital structure may influence its risk profile and overall performance.

In conclusion, a well-considered capital structure not only enhances financial performance but also serves as a protective buffer against economic uncertainties. Firms that strategically balance debt and equity can position themselves for sustainable success, leveraging the advantages of each financing source while mitigating inherent risks. This study contributes to the broader discourse on corporate finance, highlighting the importance of informed capital structure strategies in achieving organizational resilience and growth.

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