

Analyzing the Relationship Between Capital Structure, Financial Leverage, and Business Risk

Dr. Vikram Nair¹ and Dr. Pooja Agarwal²

¹ Department of Psychology, BBA University, Lucknow, India

² Department of Psychology, BBA University, Lucknow, India

ABSTRACT

The choice between debt and equity is among the most consequential decisions a firm makes. It shapes the returns earned by shareholders, the volatility of those returns, the cost of capital and the probability of financial distress. This article analyses the relationship between capital structure, financial leverage and business risk. It reviews the principal theories of capital structure: Modigliani–Miller irrelevance and its tax-adjusted extension, trade-off theory, agency theory, pecking order theory and market timing. It then explains how operating and financial leverage combine to determine the total risk borne by shareholders. Using a worked example, the article shows how a firm financed with 70 percent debt earns a return on equity of 18.67 percent when operating profit is high but suffers a negative return when operating profit is low. Its degree of financial leverage is 1.875, against 1.00 for an unlevered firm. When combined with operating leverage of 1.33, a 10 percent fall in sales reduces the levered firm's net profit by 25 percent. A stylised model of the cost of capital illustrates how moderate leverage can minimise the weighted average cost of capital, while excessive leverage raises it. The article reviews empirical evidence on the determinants of capital structure. It then examines the Indian experience, where heavy corporate borrowing in the late 2000s contributed to a sharp deterioration in bank asset quality. Gross non-performing assets reached 10.2 percent of bank advances by September 2017. The article concludes that capital structure should be matched to business risk, and offers guidance for managers, lenders and policymakers.

Keywords: capital structure, financial leverage, operating leverage, business risk, trade-off theory, pecking order theory, cost of capital, financial distress, India

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1. INTRODUCTION

Every firm must decide how to finance its assets. It can use equity, provided by owners who share in profits and losses, or debt, provided by lenders who are entitled to fixed payments of interest and principal regardless of the firm's performance. The mix of these sources is the firm's capital structure. It is one of the most debated subjects in corporate finance, and also one of the most practically important.

Debt offers attractive benefits. Interest is deductible for tax purposes, so debt reduces the firm's tax burden. Debt allows owners to expand the business without diluting their ownership. And when the firm earns a return on its assets above the cost of borrowing, debt magnifies the return to shareholders. These benefits come with costs. Fixed interest obligations must be met in good times and bad. When revenues fall, a highly indebted firm can quickly find itself unable to pay, leading to financial distress, loss of value and possibly bankruptcy.

The extent to which a firm can safely use debt depends on its business risk: the uncertainty in its operating profits arising from demand, prices, costs and competition. A firm with stable, predictable cash flows

can carry more debt than one whose earnings fluctuate widely. Capital structure decisions are therefore inseparable from an understanding of business risk.

The Indian experience of the past decade illustrates these relationships vividly. During the investment boom of the mid-2000s, many Indian companies, particularly in infrastructure, power, steel and telecommunications, financed ambitious expansion with heavy borrowing. When growth slowed, projects were delayed and commodity prices fell, many of these firms struggled to service their debt. The result was a sharp rise in non-performing assets in the banking system. It eventually led to the enactment of the Insolvency and Bankruptcy Code in 2016.

This article analyses the relationship between capital structure, financial leverage and business risk. Section 2 presents the conceptual framework. Section 3 reviews theories of capital structure. Section 4 explains operating, financial and combined leverage, with a worked example. Section 5 examines the relationship between leverage and the cost of capital. Section 6 reviews empirical evidence on determinants of capital structure. Section 7 discusses

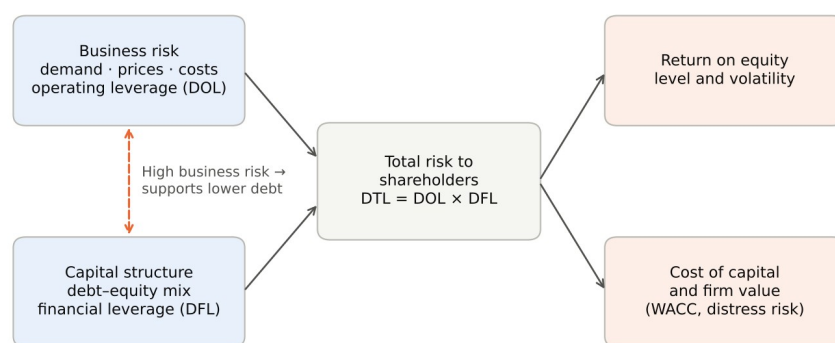
the Indian context. Section 8 offers implications, and Section 9 concludes.

2. CONCEPTUAL FRAMEWORK

Figure 1 summarises the framework used in this article. Business risk arises from the firm's operations: variability in demand and prices, the structure of its costs and the competitive environment. Operating leverage, the extent to which costs are fixed rather than variable, amplifies

business risk. Capital structure determines the firm's financial leverage, the extent to which it uses fixed-cost debt financing. Operating and financial leverage combine to determine the total risk borne by shareholders, which affects both the level and the volatility of returns on equity. Leverage also affects the cost of capital and the value of the firm through the balance between tax benefits and the costs of financial distress. A key implication is that firms with high business risk should generally use less debt.

Figure 1. Conceptual framework: business risk, leverage and value



3. THEORIES OF CAPITAL STRUCTURE

3.1 Modigliani–Miller irrelevance

Modigliani and Miller (1958) showed that, in a world without taxes, transaction costs, bankruptcy costs or information asymmetries, the value of a firm is independent of its capital structure. Investors can create any desired level of leverage on their own account, so the firm's financing choice cannot create value. This irrelevance proposition is important not because its assumptions hold in practice, but because it identifies the conditions under which capital structure matters: taxes, distress costs, agency costs and information problems.

Modigliani and Miller's second proposition states that the cost of equity rises linearly with leverage, because shareholders bear increasing financial risk. As cheaper debt replaces equity, the rising cost of equity exactly offsets the benefit, leaving the weighted average cost of capital unchanged.

3.2 The tax advantage of debt

Modigliani and Miller (1963) corrected their analysis to include corporate taxes. Because interest is tax-deductible, debt creates a tax shield whose present value adds to the value of the firm. Taken alone, this implies that firms should be financed almost entirely by debt. Miller (1977) argued that personal taxes on interest income may offset part of the corporate tax advantage, but the general conclusion that taxes favour debt has remained influential.

3.3 Trade-off theory

The trade-off theory holds that firms balance the tax benefits of debt against the costs of financial distress (Kraus & Litzenberger, 1973). Distress costs include direct costs of bankruptcy, such as legal and administrative expenses. They also include indirect costs, such as lost customers, suppliers' reluctance to extend credit, departure of key employees and forgone investment opportunities. As leverage rises, the probability and expected cost of distress increase. An optimal capital structure exists where the marginal tax benefit of additional debt equals the marginal expected cost of distress. The theory predicts that firms with stable earnings, tangible assets and high taxable profits will use more debt. Firms with volatile earnings and intangible assets will use less.

3.4 Agency theory

Jensen and Meckling (1976) identified agency costs arising from conflicts between managers, shareholders and creditors. Debt can reduce the agency costs of equity by committing managers to pay out cash, limiting wasteful investment. Jensen (1986) argued that this disciplining effect is particularly valuable in firms with large free cash flows and few profitable investment opportunities. Debt also creates agency costs of its own. Myers (1977) showed that highly indebted firms may underinvest in valuable projects because the benefits would accrue largely to creditors, a problem known as

debt overhang. Shareholders of distressed firms may also be tempted to take excessive risks.

3.5 Pecking order theory

Myers (1984) and Myers and Majluf (1984) proposed that information asymmetry between managers and investors leads firms to follow a financing hierarchy. Firms prefer internal funds first, then debt and finally equity. Because managers know more than investors about the firm's value, an equity issue may be interpreted as a signal that shares are overvalued, causing the share price to fall. To avoid this cost, firms rely on retained earnings and issue equity only as a last resort. The theory predicts that more

profitable firms will use less debt, because they can finance investment internally.

3.6 Market timing

Baker and Wurgler (2002) argued that capital structure reflects the cumulative outcome of past attempts to time the equity market. Firms issue equity when their market valuations are high relative to book values and repurchase shares when valuations are low. Under this view, there is no optimal capital structure; current leverage reflects the history of market conditions.

Table 1 summarises these theories and their predictions.

Table 1

Theories of capital structure and their predictions

Theory	Key idea	Prediction about leverage
MM irrelevance (1958)	In perfect markets, financing does not affect value	Capital structure is irrelevant
MM with taxes (1963)	Interest tax shields add value	Firms should use substantial debt
Trade-off theory	Tax benefits balanced against distress costs	Optimal moderate leverage; lower for risky firms
Agency theory	Debt disciplines managers but creates creditor conflicts	Debt valuable when free cash flow is high
Pecking order theory	Information asymmetry makes external finance costly	Profitable firms use less debt
Market timing	Firms issue equity when valuations are high	Leverage reflects past market conditions

4. OPERATING, FINANCIAL AND COMBINED LEVERAGE

4.1 Definitions

Leverage refers to the use of fixed costs to magnify the effect of changes in sales on profits. Two types are distinguished.

Operating leverage arises from fixed operating costs, such as rent, salaries of permanent staff and depreciation. A firm with high fixed costs experiences large proportionate changes in operating profit, or earnings before interest and tax (EBIT), when sales change. The degree of operating leverage (DOL) is measured as:

DOL = Contribution ÷ EBIT = % change in EBIT ÷ % change in sales

Financial leverage arises from fixed financing costs, principally interest on debt. A firm with high interest obligations experiences large proportionate changes in profit after tax and earnings per share when EBIT

changes. The degree of financial leverage (DFL) is measured as:

DFL = EBIT ÷ (EBIT – Interest) = % change in EPS ÷ % change in EBIT

The two combine multiplicatively to give the **degree of total (or combined) leverage**:

DTL = DOL × DFL = % change in EPS ÷ % change in sales

Business risk is associated with operating leverage and the underlying variability of sales, while financial risk is associated with financial leverage. Total risk to shareholders reflects both. Mandelker and Rhee (1984) found that the degrees of operating and financial leverage together help explain the systematic risk (beta) of common stocks. Hamada (1972) showed how the beta of a firm's equity rises with financial leverage, providing a link between capital structure and the cost of equity.

Table 2 summarises the main leverage and risk measures.

Table 2

Measures of leverage and risk

Measure	Formula	Interpretation
Debt–equity ratio	Total debt ÷ Shareholders' equity	Extent of reliance on borrowed funds
Debt ratio	Total debt ÷ Total capital	Share of capital provided by lenders
Interest coverage ratio	EBIT ÷ Interest expense	Ability to meet interest payments from operating profit
Degree of operating leverage	Contribution ÷ EBIT	Sensitivity of EBIT to sales
Degree of financial leverage	EBIT ÷ (EBIT – Interest)	Sensitivity of EPS to EBIT
Degree of total leverage	DOL × DFL	Sensitivity of EPS to sales
Levered beta (Hamada)	$\beta_L = \beta_U \times [1 + (1 - t) \times D/E]$	Equity risk rises with leverage

4.2 A worked example

Consider three firms, A, B and C, identical in every respect except their capital structure. Each has total assets of ₹1,000 crore. Firm A is financed entirely by equity.

Firm B is financed by 40 percent debt (₹400 crore), and Firm C by 70 percent debt (₹700 crore). The interest rate is 10 percent and the tax rate is 30 percent. Table 3 shows their results when EBIT is ₹150 crore, equivalent to a 15 percent return on assets.

Table 3

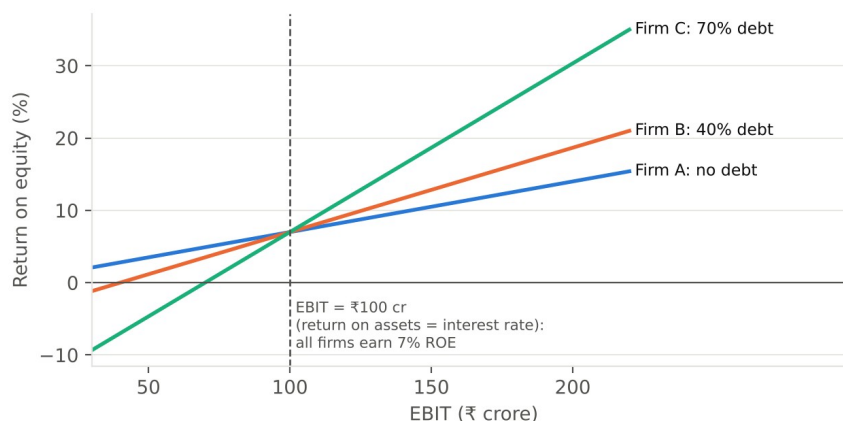
Effect of capital structure on returns: worked example at EBIT of ₹150 crore

Item (₹ crore unless stated)	Firm A (0% debt)	Firm B (40% debt)	Firm C (70% debt)
Debt	0	400	700
Equity	1,000	600	300
EBIT	150	150	150
Interest at 10%	0	40	70
Earnings before tax	150	110	80
Tax at 30%	45	33	24
Profit after tax	105	77	56
Return on equity (%)	10.50	12.83	18.67
Interest coverage (times)	—	3.75	2.14
Degree of financial leverage	1.00	1.36	1.875

When the return on assets (15 percent) exceeds the interest rate (10 percent), debt magnifies the return to shareholders. Firm C's return on equity is almost 80 percent higher than Firm A's. But the picture reverses when operating performance deteriorates. Figure 2 shows return on equity for each firm across a range of EBIT levels. At EBIT of ₹100 crore, when the return on assets equals the interest rate, all three firms earn the same 7

percent return on equity. Below this point, leverage works against shareholders. At EBIT of ₹50 crore, Firm A still earns 3.5 percent. Firm B earns only 1.17 percent, and Firm C suffers a loss equivalent to -4.67 percent of equity. The steeper lines for the levered firms show that leverage increases not only expected returns but also their volatility, which is the essence of financial risk.

Figure 2. Financial leverage magnifies returns and risk



Illustrative example: total assets ₹1,000 crore, interest 10%, tax 30%. Authors' calculation.

4.3 Combining operating and financial leverage

Suppose each firm has sales of ₹500 crore, variable costs of 60 percent of sales (₹300 crore) and fixed operating costs of ₹50 crore. Contribution is ₹200 crore and EBIT is ₹150 crore, so the degree of operating leverage is $200 \div 150 = 1.33$. For Firm C, the degree of total leverage is $1.33 \times 1.875 = 2.5$.

The implications are significant. If sales fall by 10 percent to ₹450 crore, contribution falls to ₹180 crore and EBIT to ₹130 crore, a decline of 13.3 percent. Firm C's earnings before tax fall from ₹80 crore to ₹60 crore,

and its profit after tax from ₹56 crore to ₹42 crore, a decline of 25 percent. A modest fall in sales thus produces a large fall in shareholders' earnings. A firm with higher operating leverage, for example a capital-intensive manufacturer with large fixed costs, would experience an even larger effect. This is why firms with high business risk or high operating leverage should be cautious in adding financial leverage.

5. LEVERAGE AND THE COST OF CAPITAL

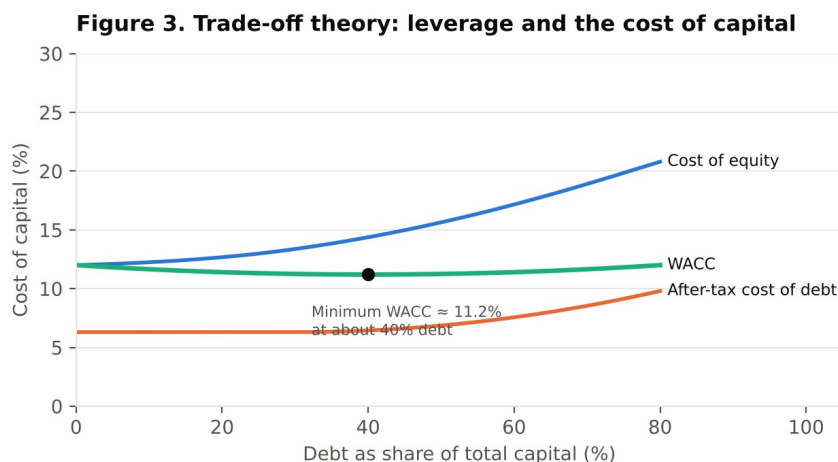
The weighted average cost of capital (WACC) is the average return required by all providers of capital, weighted by their shares in the capital structure:

$$WACC = (E \div V) \times K_e + (D \div V) \times K_d \times (1 - t)$$

where E is equity, D is debt, V is total capital, K_e is the cost of equity, K_d is the cost of debt and t is the tax rate.

Because debt is cheaper than equity and interest is tax-deductible, replacing equity with debt initially lowers the

WACC. But as leverage increases, both shareholders and lenders demand higher returns to compensate for greater risk. The cost of equity rises as financial risk increases, and the cost of debt rises once lenders perceive a meaningful probability of default. Figure 3 presents a stylised illustration of this trade-off. The WACC falls gently at first, reaches a minimum at moderate leverage, around 40 percent debt in this illustration, and then rises as distress costs dominate. The minimum WACC corresponds to the maximum value of the firm under trade-off theory.



Stylised illustration: cost of debt 9% rising with distress risk; tax 30%; WACC minimised at moderate leverage.

The location of the optimal point depends on business risk. For a firm with stable cash flows, the cost of debt rises slowly with leverage and the optimum lies at a higher debt ratio. For a firm with volatile cash flows, distress risk rises quickly and the optimum lies at a lower debt ratio. Graham and Harvey (2001) found that chief financial officers regard financial flexibility and credit ratings as among the most important considerations in setting debt policy. They also attach considerable weight to earnings volatility. These findings are consistent with the view that managers adjust leverage to business risk.

6. EMPIRICAL EVIDENCE ON THE DETERMINANTS OF CAPITAL STRUCTURE

A large empirical literature has examined the factors associated with corporate leverage. Titman and Wessels (1988) studied the attributes of firms that explain their debt ratios. Rajan and Zingales (1995) found that the same factors were associated with leverage across the major industrialised countries. Frank and Goyal (2009) identified the factors most reliably related to leverage in United States data. Booth et al. (2001) extended the analysis to developing countries. They found that similar variables explained leverage, but that country-specific institutional factors also mattered greatly. Table 4 summarises the main determinants.

Table 4

Determinants of capital structure: summary of empirical evidence

Determinant	Typical relationship with leverage	Theoretical explanation
Profitability	Negative	Pecking order: profitable firms finance internally
Asset tangibility	Positive	Tangible assets serve as collateral and reduce distress costs
Firm size	Positive	Larger firms are more diversified and less likely to fail
Growth opportunities (market-to-book)	Negative	Agency costs and debt overhang; market timing
Earnings volatility (business risk)	Negative	Trade-off: higher distress risk
Industry median leverage	Positive	Industry characteristics and benchmarking
Non-debt tax shields	Negative	Depreciation reduces the value of interest tax shields
Expected inflation	Positive	Real value of debt falls with inflation

The negative relationship between earnings volatility and leverage is the most direct link between business risk and capital structure. Firms facing greater uncertainty in operating profits use less debt, consistent with trade-off theory. The negative relationship between profitability and leverage, however, is more consistent with pecking order theory than with trade-off theory, which would predict that profitable firms use more debt to shield income from tax. Most researchers conclude that no single theory explains capital structure fully. Firms appear to balance tax benefits, distress costs, information problems and flexibility in ways that vary with their circumstances.

Altman's (1968) Z-score model, which combines measures of working capital, retained earnings, profitability, market value of equity relative to debt and asset turnover, remains widely used to assess the probability of financial distress. It illustrates how leverage interacts with profitability and liquidity in determining a firm's vulnerability.

7. THE INDIAN CONTEXT

7.1 The corporate debt build-up

India experienced a corporate investment boom between roughly 2004 and 2011. Rapid economic growth, optimistic demand expectations and the government's emphasis on infrastructure encouraged large investments in power, roads, ports, steel, cement and telecommunications. Much of this investment was

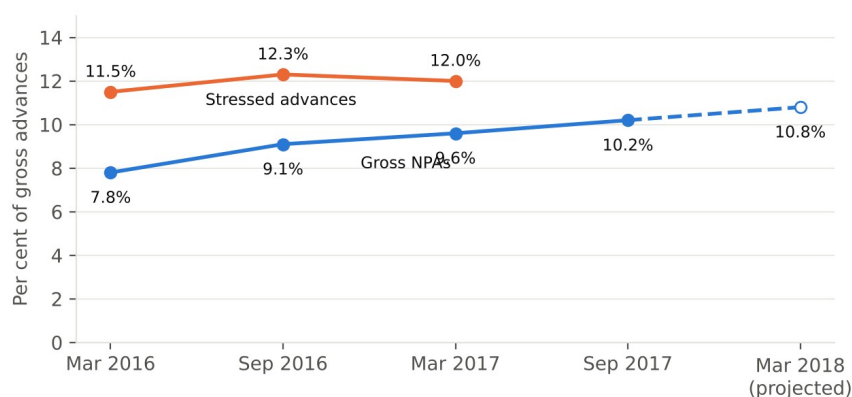
financed by bank borrowing, often from public sector banks, and many projects were highly leveraged.

The risks of this strategy became apparent when growth slowed after 2011. Projects faced delays in land acquisition, environmental clearances and fuel supply. Global commodity prices fell, reducing revenues in sectors such as steel and mining, while high interest rates raised financing costs. Firms with high operating leverage, typical of capital-intensive industries, and high financial leverage found themselves unable to service their debt. The combined effect of operating and financial leverage, illustrated in Section 4, played out on a national scale.

7.2 Deterioration in bank asset quality

The consequences were visible in the balance sheets of Indian banks. As Figure 4 shows, the gross non-performing assets (GNPA) ratio of scheduled commercial banks was reported at 7.8 percent in March 2016. It rose to 9.6 percent in March 2017 and 10.2 percent in September 2017, according to successive Financial Stability Reports of the Reserve Bank of India (Business Standard, 2016; Reserve Bank of India, 2017). Stressed advances, which include restructured loans, were reported at 11.5 percent in March 2016 and 12.0 percent in March 2017. The RBI's baseline stress test projected that the GNPA ratio could rise to 10.8 percent by March 2018 (Business Standard, 2017). The capital adequacy ratio of banks stood at 13.9 percent in September 2017.

Figure 4. Asset quality of Indian banks



Source: RBI Financial Stability Reports (Dec 2016, Jun 2017, Dec 2017), as reported. Mar 2018 is RBI's baseline projection.

This experience is often described as a “twin balance sheet” problem: over-leveraged corporations unable to repay, and weakened banks unable to lend. The over-leverage of a relatively small number of large corporate borrowers contributed disproportionately to the stress, demonstrating how capital structure choices at the firm level can create systemic risk.

7.3 Policy responses

The government and regulators responded with several measures. The Insolvency and Bankruptcy Code 2016

created a time-bound process for resolving corporate insolvency, strengthening creditors' rights and shifting control of distressed firms from promoters to creditors during resolution. The RBI's Asset Quality Review of 2015–16 required banks to recognise stressed loans more accurately. In October 2017, the government announced a large recapitalisation programme for public sector banks. These measures are likely to change how Indian firms and lenders think about leverage. The prospect of losing control under the insolvency process raises the cost of excessive borrowing for promoters.

7.4 Implications for Indian firms

The Indian experience reinforces the central lesson of capital structure theory: leverage must be matched to business risk. Firms in cyclical, capital-intensive industries with long project gestation periods face high business risk and high operating leverage, and should use debt cautiously. Lenders, too, must assess borrowers' business risk realistically rather than relying on optimistic projections or the reputation of promoters.

8. IMPLICATIONS FOR MANAGERS, LENDERS AND POLICYMAKERS

For managers:

1. **Match leverage to business risk.** Firms with volatile revenues, high fixed costs or long project gestation should maintain lower debt ratios and stronger interest coverage.
2. **Measure total leverage.** Assess the combined effect of operating and financial leverage on earnings, using DOL, DFL and DTL, rather than considering debt in isolation.
3. **Stress-test the capital structure.** Model the effect of falls in sales, rises in interest rates and project delays on the ability to service debt.
4. **Preserve financial flexibility.** Maintain unused borrowing capacity and liquidity to withstand shocks and take advantage of opportunities.
5. **Align debt maturity with asset life.** Avoid financing long-term projects with short-term borrowing that must be frequently refinanced.

For lenders:

6. **Assess business risk rigorously.** Evaluate demand, cost and execution risks independently rather than relying on promoter assurances.
7. **Monitor leverage and coverage.** Use covenants and early-warning indicators, such as falling interest coverage, to detect stress before default.

For policymakers and regulators:

8. **Strengthen insolvency resolution.** Effective implementation of the Insolvency and Bankruptcy Code encourages prudent borrowing and timely resolution of distress.
9. **Develop corporate bond markets.** Deeper bond markets would diversify sources of debt finance and reduce concentration of risk in banks.
10. **Monitor systemic leverage.** Track leverage across large corporate groups and sectors to identify risks before they threaten the financial system.

9. CONCLUSION

Capital structure, financial leverage and business risk are closely interconnected. Debt offers tax advantages, allows owners to expand without dilution and magnifies returns when the firm earns more on its assets than it pays on

borrowing. But debt also magnifies losses when operating performance falls, increases the volatility of shareholders' returns and raises the probability of financial distress. The worked example in this article showed that a firm financed with 70 percent debt earns a much higher return on equity than an unlevered firm when conditions are good, but suffers losses when they are poor. Combined with operating leverage, a modest fall in sales can produce a disproportionate fall in earnings.

Theories of capital structure offer complementary insights. Modigliani and Miller identified the conditions under which financing matters, and trade-off theory explains why moderate leverage may be optimal. Agency theory highlights debt's disciplining role and its costs, while pecking order and market timing theories explain why observed financing patterns often depart from a static optimum. Empirical evidence consistently shows that firms with higher business risk use less debt.

India's recent experience, in which heavy borrowing by capital-intensive firms contributed to a sharp rise in non-performing assets, underlines the costs of ignoring the link between leverage and business risk. The reforms introduced since 2016, including the Insolvency and Bankruptcy Code, are likely to encourage more prudent capital structure decisions. For managers and lenders alike, the central lesson is clear. The right amount of debt depends not on how much can be borrowed, but on how much risk the business can bear.

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