



# DEBT OR RETAINED EARNINGS: WHICHEVER IS OPTIMUM FOR THE GROWTH OF THE FIRM

SHIVANI GAUTAM<sup>1</sup>, DR. ASHOK PUROHIT<sup>2</sup>

<sup>1</sup>Institute of Business Management and Commerce, Mangalayatan University, Beswan, Aligarh

<sup>2</sup>Institute of Business Management and Commerce, Mangalayatan University, Beswan, Aligarh

## Abstract

*This research paper explores the crucial question of determining the optimal capital structure for firm growth, considering the choices between debt and retained earnings. The aim is to assess how the utilization of debt and retained earnings influences the financial performance of selected Indian companies. The objectives are twofold: to analyze the capital structure choices of the companies and to evaluate the impact on performance metrics such as ROE, ROA, and EPS. The research methodology involves a comprehensive literature review, data analysis of six Indian companies, and data interpretation based on relevant theories and studies. The findings highlight industry-specific nuances and underscore the significance of empirical evidence and prudent financial analysis for capital structure decisions. The research contributes to the understanding of the relationship between capital structure and firm growth in the context of emerging markets like India. The future scope involves further industry-specific analyses and dynamic studies to guide companies towards optimized capital structure decisions for long-term success.*

**Keywords:** ROE, ROA, EPS, Firm, Retained earnings, Debt, Financial growth

## INTRODUCTION

Capital structure decisions are of utmost significance in the strategic decision-making process of companies with a direct impact on the firm's performance. A firm's capital structure, encompassing debt and retained earnings, is pivotal in determining its capacity to sustain growth, capitalise on investment prospects, and augment shareholder value. In pursuing growth objectives and enhanced profitability, firms face the critical strategic choice of effectively managing the trade-off between debt financing and utilising internally generated funds in the form of retained earnings (Carol and Parry (2017)). The decision of whether to rely on external debt or retain earnings for expansion has attracted substantial scholarly attention, leading to the formulation of diverse theoretical frameworks aimed at elucidating this fundamental aspect within the domain of corporate finance.

**Debt** refers to the financial obligation incurred by a company when it borrows funds from external sources. Debt financing allows companies to access additional capital to fund their operations, investments, and expansion plans without diluting ownership or control, as it does not involve issuing new shares. On the contrary, **retained earnings** represent the portion of a company's net profit or earnings retained and reinvested in the business rather than distributed as dividends to shareholders. It is the cumulative sum of past profits that have not been paid to shareholders as dividends. Retained earnings serve as an internal source of financing for the firm's growth initiatives, such as research and development, acquisitions, capital expenditures, and debt reduction.

The optimal choice between debt and retained earnings significantly influences a firm's growth prospects, warranting a meticulous evaluation of its implications. Financial leverage, hinged on the strategic use of debt financing to magnify returns for equity shareholders, plays a central role in this decision-making process (DeAngelo & DeAngelo, 2018). When a company embraces debt to finance its operations, it enhances financial leverage, leading to potentially higher returns on equity, particularly during periods of growth and profitability. The fixed cost of debt, represented by interest payments, can be outweighed by the returns generated from investments, creating a surplus that amplifies shareholder returns.

On the contrary, utilising retained earnings for investment exerts an opposing effect on financial leverage (Gilson, 2021). By eschewing external debt, the firm reduces its leverage level, as it circumvents the fixed costs associated with interest payments. Consequently, this diminishes financial risk, albeit at the potential



cost of curtailed returns compared to leveraging through debt. The dynamic interplay between debt, retained earnings, and financial leverage extends profound implications for the overall growth trajectory of the firm. Striking a prudent balance between these financing sources is vital to optimise financial leverage and align risk considerations with the firm's growth objectives and risk tolerance. Moderate financial leverage may bolster returns for equity shareholders, stimulating growth and capitalising on investment opportunities. However, excessive reliance on debt can expose the company to heightened financial risk, potentially leading to distress in adverse economic conditions, thereby impeding growth prospects.

Hence, a comprehensive understanding of the trade-offs associated with debt and retained earnings is indispensable in guiding the firm towards a capital structure that fosters sustainable growth. Effective financial decision-making, informed by a judicious evaluation of the interrelation between debt, retained earnings, and financial leverage, is paramount for enhancing long-term growth prospects and ensuring the firm's resilience in an ever-evolving economic landscape. Hence, this research examines the relationship between capital structure decisions, specifically the utilisation of debt and retained earnings, and its impact on the performance and growth of select Indian companies. The study seeks valuable insights into how different financing strategies influence company performance metrics and long-term growth prospects. The company has the following research objectives:

1. To analyse the capital structure choices of selected Indian companies.
2. To evaluate the effect of the chosen capital structure strategies on the financial performance of the companies

The research will adopt a mixed-method approach. Initially, data will be collected from financial statements, annual reports, and reputable financial databases to assess the utilisation of retained earnings and debt for each company. Quantitative analysis, including descriptive statistics and regression techniques, will be applied to examine the relationships between capital structure decisions and performance indicators. Additionally, qualitative insights will be obtained through interviews with finance experts and industry practitioners to better understand the companies' rationale behind their financing strategies. Furthermore, Future studies could expand the sample size to encompass a broader range of industries, enabling a more comprehensive analysis of sector-specific factors influencing financing choices and performance outcomes.

## LITERATURE REVIEW

### 1. Theoretical Framework

The Modigliani and Miller (MM) theorem, proposed by Franco Modigliani and Merton Miller in 1958, forms the foundation of modern capital structure theory. The theorem is based on several assumptions, including perfect capital markets, no taxes, no transaction costs, no bankruptcy costs, and homogeneous expectations among investors. Under these assumptions, the MM theorem states that the capital structure decision of a firm is irrelevant and does not impact its overall value. In other words, in a perfect world without any market frictions, the value of a firm is determined solely by its underlying assets and the future cash flows it generates, regardless of how it is financed.

However, in real-world situations, various imperfections exist, leading to deviations from the MM theorem. One such theory that emerged to explain these real-world scenarios is the trade-off theory (Gogineni & Puthenpurackal, 2018). The trade-off theory suggests that firms face a balancing act between the tax advantages of using debt and the costs of financial distress associated with higher debt levels. On one hand, debt financing offers tax shields in the form of interest expense deductions, reducing the overall tax burden for the firm. On the other hand, increasing debt levels raise the risk of financial distress, such as bankruptcy costs and agency problems between debt holders and equity shareholders. As a result, firms seek an optimal capital structure that maximizes the tax benefits of debt while managing the associated financial distress costs.

Another theory that emerged as a response to real-world market imperfections is the pecking order theory. The pecking order theory suggests that firms have a preference for financing their investments using internal funds, such as retained earnings, followed by debt issuance, and as a last resort, issuing new equity (Raymar,



2021). The theory is based on the idea that information asymmetry between managers and investors leads to adverse selection problems when issuing new equity. Therefore, firms prefer to use internal funds whenever possible, as it signals positive information to investors. Debt issuance is considered less information-sensitive compared to equity issuance, making it a preferred option when internal funds are insufficient. The pecking order theory implies that firms' growth strategies are influenced by the availability of internal funds and their willingness to take on debt.

In conclusion, while the Modigliani and Miller theorem suggests capital structure irrelevance under certain assumptions, real-world market imperfections have given rise to theories like the trade-off theory and the pecking order theory. These theories offer insights into how firms manage their capital structure decisions in the face of taxes, financial distress costs, and information asymmetry, influencing their growth strategies and long-term financial performance.

## **2. Empirical Studies**

Empirical studies examining the relationship between capital structure and firm growth have yielded diverse findings, leading to a nuanced understanding of this complex phenomenon.

### **Positive Correlation between Debt Utilization and Firm Growth**

Research conducted (Raymar, 2021) analyzed a sample of U.S. manufacturing firms. The study found a positive correlation between debt utilization and firm growth. The authors argued that debt can act as a source of external financing, enabling companies to undertake profitable investment opportunities that they might not have been able to pursue solely with internal funds (retained earnings). Debt financing allows firms to leverage their equity base and generate higher returns for shareholders, particularly during periods of economic expansion and favourable market conditions. This positive relationship is often observed in companies with strong cash flow generation capacity and a prudent risk management approach.

### **Mixed Findings - Debt's Impact on Firm Growth**

In contrast, a study conducted by DeAngelo and DeAngelo (2018) explored the capital structure decisions of a large sample of firms across various industries. The results of this study presented mixed findings regarding debt's impact on firm growth. While some firms experienced positive growth outcomes with higher debt utilization, others faced challenges due to excessive leverage. The study highlighted the existence of an optimal level of debt, beyond which the increase in financial risk could hinder long-term growth prospects. Firms that faced financial distress due to high debt burdens experienced difficulties in accessing new capital, leading to constrained growth opportunities and potential negative effects on shareholder value.

## **3. Industry-Specific Analysis**

Industries vary in their risk profiles. For instance, technology startups may have high growth potential but also face higher uncertainty and volatility, while established utility companies may have stable cash flows but limited growth prospects. These differences in risk levels can influence the optimal capital structure for each industry. Companies in riskier industries may prefer a more conservative capital structure with lower debt to mitigate potential financial distress, whereas firms in less volatile industries may be more comfortable leveraging debt for growth. Industries differ in their growth opportunities and investment needs. Capital-intensive industries like infrastructure and manufacturing may require substantial investments in fixed assets, which could be financed through a mix of debt and equity. On the other hand, knowledge-based industries like software and technology may have lower capital requirements and rely more on retained earnings or equity financing. Understanding these varying growth dynamics can help identify the most suitable capital structure for each industry.

## **RESEARCH GAP**

The literature review reveals several research gaps, including the need for industry-specific analysis, a focus on emerging markets like India, and the consideration of economic cycles. Additionally, conflicting findings in empirical studies underscore the need for further investigation into the relationship between capital structure decisions and firm growth. By addressing these gaps, the objectives of this research aim to provide



valuable insights into determining the optimal capital structure that fosters sustainable growth and enhances shareholder value for firms in the specific context of emerging markets like India.

**DATA ANALYSIS & DATA INTERPRETATION**

For the research purpose, a comparison of capital structure decisions and their impact on performance for six diverse Indian companies has been done. The data has been fetched from their annual reports, company’s bulletin and news source articles. The analysis reveals distinct patterns in the utilization of retained earnings and debt, which have influenced their financial performance indicators such as Return on Equity (ROE), Return on Assets (ROA), and Earnings per Share (EPS). The result of the analysis has been as follows (NSE, 2022):

Company Name	Industry	Utilization of Retained Earnings	Utilization of Debt	Impact on Performance (e.g., ROE, ROA, EPS)
Reliance Industries	Conglomerate	High - Reinvested in New Ventures & Expansions	Moderate - Utilized Debt for Large Acquisitions	Positive - ROE Improved due to Diversified Business Portfolio
Tata Consultancy Services	IT Services	Moderate - Used for R&D and Expansion of Service Offerings	Low - Minimal Debt Usage	Positive - Steady Growth in ROA and EPS
Infosys Limited	IT Services	High - Allocated for Research & Innovation	Low-Avoided Heavy Debt	Positive - Increased Market Share and Higher Profit Margins
HDFC Bank	Banking	Moderate - Retained for Capital Adequacy	Low - Conservative Debt Usage	Steady - Stable ROE and Strong Asset Quality
Adani Group	Diversified	Moderate - Reinvested in Infrastructure and Renewable Projects	High - Leveraged for Large Projects	Mixed - Improved ROE but High Debt Raises Risk
Bharti Airtel	Telecommunications	Low-Paid Dividends to Shareholders	Moderate - Raised Debt for Network Expansion	Mixed - Growth in Subscribers, but Interest Costs Impact EPS

**Table 1: The utilisation of debt -retained earnings by Indian companies for business growth and its impact (Analysis done by writer)**

Reliance Industries' utilization of retained earnings for new ventures and moderate use of debt align with the trade-off theory. The company strikes a balance between debt tax benefits and potential financial distress costs, leading to improved ROE. Additionally, their diversified business portfolio positively impacts their financial performance, showcasing the effectiveness of this capital structure strategy. Tata Consultancy Services (TCS) adheres to the pecking order theory, prioritizing retained earnings for R&D and service expansion. With minimal debt usage, TCS achieves steady growth in both ROA and EPS, demonstrating the advantage of relying on internal funds for growth.



Infosys Limited's capital structure exemplifies the pecking order theory as well, with its focus on research and innovation using retained earnings. By avoiding heavy debt, Infosys attains increased market share and higher profit margins, emphasizing the significance of internal financing in sustaining growth. HDFC Bank's conservative debt approach, in line with the trade-off theory, ensures a stable financial position and strong asset quality. The moderate utilization of retained earnings for capital adequacy reinforces the importance of a balanced capital structure for consistent ROE.

Adani Group's mixed performance showcases the need for an optimal capital structure, as supported by the trade-off theory. While reinvesting retained earnings improved ROE, the high debt usage for large projects raises financial risk. Prudent management is essential to balance growth opportunities and financial stability effectively. Bharti Airtel's performance aligns with the relationship between financial risk and performance highlighted in the trade-off theory. The company's moderate debt usage for network expansion leads to growth in subscribers. However, the impact of interest costs on EPS emphasizes the need for careful management of financial leverage.

Overall, the data analysis substantiates the relevance of capital structure theories in shaping firm performance. Companies that strategically balance retained earnings and debt following trade-off and pecking order theories demonstrate positive impacts on financial metrics. Understanding the interplay between capital structure decisions and performance is vital for firms to optimize growth strategies and enhance shareholder value.

### CONCLUSION

In conclusion, businesses should continuously reassess their capital structure decisions based on empirical data, industry trends, and market conditions in the dynamic and ever-changing business environment. A well-informed capital structure decision can position companies for long-term success, enabling them to seize growth opportunities while safeguarding against potential financial risks. By striking the right balance between debt and retained earnings, firms can foster sustainable growth, create value for stakeholders, and navigate the challenges and opportunities that lie ahead. Ultimately, the optimum capital structure will vary across industries and firms, underscoring the need for prudent financial analysis and adaptability in pursuing growth and success.

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