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EQUITY FINANCE AND DEBT FINANCE: A COMPARITIVE ANALYSIS OF CORPORATE FINANCING DECISIONS

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ABSTRACT

This paper examines the comparative role of debt finance and equity finance in corporate financing decision and analyzes how firms determine an optimal capital structure. It evaluates major theoretical frameworks, including the Modigliani-Miller theory, Trade-off Theory, Pecking Order Theory, and Market Timing Theory, study further explores the impact of financing choices on profitability, shareholder value, financial risk, and managerial control. Through a comparative analysis of empirical literature and market trends, the paper concludes that no single financing method is universally superior, and firms must adopt a flexible and dynamic balance between debt and equity financing.

BACKGROUND

One of the most basic decisions faced by every organization is 'Corporate financing', despite the organization being at an initial stage seeking seed capital or whether it is a transnational corporation pursuing global expansion. This corporate financing decisions involves choosing the way of raising capital i.e, by way of debt or equity. While equity involves selling a segment of company's ownership in return for capital, debt involves borrowing money for running and expanding the business and paying it back after a specified time with interest. This decision is made after considering various factors such as financial situation of the company, goals of the company etc,[2] Various practitioners, corporate managers, economists and policymakers have delved and written upon these two choices, thereby generating ample of empirical and theoretical literature.

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[2] Imarticus Learning, *Equity vs. Debt Financing: Pros, Cons, and Strategic Applications - Imarticus Blog*, Imarticus Blog - Your complete guide to finance, technology, analytics, management, and more!(Jan. 6, 2025), https://imarticus.org/blog/equity-vs-debt-financing/).

The discussion on capital structure was started long back in 1958 by Merton Miller and Franco Modigliani. As per their propounded theory, choice between equity and debt is irrelevant in a world of perfect capital markets as the firm value remains the same.[3] However, the later theorists propounded more realistic theories such as the Trade-off Theory, Pecking Order Theory and Market Timing Theory. Pertinently, each of these theories offer different explanations for choosing particular financing structures.[4]

Application of different theories becomes much more complicated in practice when it comes to taking corporate financing decisions. Moreover, with the advancement of technology, businesses, education, investing options and global expansion, the financing landscape has grown increasingly complex. Further, the financial crisis that post-2008 witnessed, brought with it stringent regulations on companies, which made companies more cautious of taking on too much debt.[5] At the same time, long periods of low interest rates was witnessed making it easier for corporates to borrow at cheaper rates. However, the COVID-19 pandemic once again disrupted the financing patterns, as many companies started taking up "emergency" debt facilities and some even resorted to equity dilution. As of 2025, interest rates has risen consequently making borrowing expensive and thereby, has been forcing firms to rethink over the debt versus equity choice.

What makes the financing choice more difficult are the factors such as emerging markets in India and other developing economies, limited access to institutional equity, underdeveloped capital markets and governance challenges.[6] Therefore, understanding how the debt and equity finance operate across different market environments is therefore critical for policymakers, practitioners, and scholars.

[3]Bank for International Settlements (2023). "Annual Economic Report 2023." *BIS, Basel.* Available at: https://www.bis.org/publ/arpdf/ar2023e.htm
Modigliani, F., & Miller, M. H. (1958). "The Cost of Capi
[4]Myers, S. C. (2001). "Capital Structure." *Journal of Economic Perspectives, 15(2), 81–102.* Available at: https://pubs.aeaweb.org/doi/10.1257/jep.15.2.81
[5]Bank for International Settlements (2023). "Annual Economic Report 2023." *BIS, Basel.* Available at: https://www.bis.org/publ/arpdf/ar2023e.htm
[6] Booth, L., Aivazian, V., Demirguc-Kunt, A., & Maksimovic, V. (2001). "Capital Structures in Developing Countries." *Journal of Finance, 56(1), 87–130.* Available at: https://onlinelibrary.wiley.com/doi/10.1111/0022-1082.00320

RESEARCH OBJECTIVES

(i) To analyze the theoretical frameworks concerning choice debt finance and equity finance and assessing their applicability to real world corporate financing decisions in the modern context both developed and budding markets.

(ii) To study impact of using debt and equity respectively on a company's financial risk, long-term shareholder value and performance of the firm, based on empirical studies from different countries and industries.

(iii) To identify the main determinants influencing a company's choice between equity and debt finance, and to find workable strategies for managing an optimal capital structure management.

RESEARCH QUESTIONS

(i) Whether the different theoretical frameworks concerning capital structuring are sufficiently applicable in practice in explaining the observed financing behaviors of different corporations across developed and developing economies?

(ii) Whether debt and equity financing have assessable effects on firm profitability, shareholder wealth, credit risk, and and whether these effects vary across industries and market conditions?

(iii) Whether different factors such as profitability, firm size, asset tangibility, macroeconomic conditions and growth opportunities determine the preference of firms for equity versus debt finance?

RESEARCH METHODOLOGY

The research for the paper primarily involves secondary sources including research papers of various reputed journals, working papers, articles, journal articles, websites, financial reports and textbooks on corporate finance. A detailed search has also been conducted using various academic databases such as Google Scholar, SSRN, JSTOR etc. It is to be noted that the the primary focus of the paper is on the studies published between 2000 and 2025. Analysis through the chosen literature is being done using a "comparative" approach for assessing the relation between corporate financing choices of a firm and its effect on the firms' performance. In furtherance of the same, the key factors that have been examined include tax shield benefits, cost of capital, financial distress costs, information asymmetry, market timing and agency costs. Further, firms across multiple industries have been studies

for the present paper in both developed as well as developing markets. However, as the reliance is solely on secondary data, the analysis may be constrained as far as recent macroeconomic developments and firm-specific nuances are concerned.

LITERATURE REVIEW

The basic foundations of the equity veruss debt finance was laid by Modigliani and Miller,[7] who gave the "irrelevance theorem". This theorem when viewed from the lens of perfect capital markets, the choice among debt and equity finance does not affect value of the firm. Interestingly, all the subsequent theories have departed from this benchmark. Thereafter, in 1973, Kraus and Litzenberger[8] introduced the world to the the Trade-off Theory. This theory was further advanced as per which companies balance the tax shield of debt against financial distress costs to arrive at an optimal leverage ratio. However, Myers and Majluf's[9] in 1984, gave a different view by way of their Pecking Order Theory. Pertinently, as per this theory, firms give primary preference to using their own internal money. Accordingly, if they prefer to take debt and avail the option of equity only as the last resort. This pattern has been empirically recognized by Frank and Goyal.[10] Thereafter, Market Timing Theory by Baker and Wurgler[11] in 2000s indicated that there may be not be any one "best" capital structure. To elaborate, it provided that capital structure of a company is shaped by past decisions of managers to issue equity when price is high and using debt or option of buy back of shares when the price is low, ultimately suggesting "no single optimal target ratio" exists.

It is to be further noted that there is ample literature on the comparative evidence and characteristics of debt finance and equity finance. Equity finance which includes preference shares, ordinary shares and venture capital placement gives significant boost to the balance sheet of firms while also freeing

[7] Brealey, R. A., Myers, S. C., & Allen, F. (2023). "Principles of Corporate Finance (14th ed.)." *McGraw-Hill Education.* Available at: https://www.mheducation.com/highered/product/principles-corporate-finance-brealey-myers/M9781265078829.html

[8] Kraus, A., & Litzenberger, R. H. (1973). "A State-Preference Model of Optimal Financial Leverage." *Journal of Finance, 28(4), 911–922.* Available at: https://onlinelibrary.wiley.com/doi/10.1111/j.1540-6261.1973.tb01415.x

[9] Myers, S. C., & Majluf, N. S. (1984). "Corporate Financing and Investment Decisions when Firms Have Information that Investors Do Not Have." *Journal of Financial Economics, 13(2), 187–221.* Available at: https://www.sciencedirect.com/science/article/pii/0304405X84900230

[10] Frank, M. Z., & Goyal, V. K. (2003). "Testing the Pecking Order Theory of Capital Structure." *Journal of Financial Economics, 67(2), 217–248.* Available at: https://www.sciencedirect.com/science/article/pii/S0304405X02002726

[11] Baker, M., & Wurgler, J. (2002). "Market Timing and Capital Structure." *Journal of Finance, 57(1), 1–32.* Available at: https://onlinelibrary.wiley.com/doi/10.1111/1540-6261.00414

it from "fixed obligations". Venture capital provides considerable guidance and networking opportunities, which is especially beneficial for early-stage firms.[12] The drawbacks of the same, as has been documented by Ljungqvist and Wilhelm[13], include are underpricing costs and dilution of ownership . When it comes to debt finance, the ownership is preserved and firms benefit from the "tax deductibility" of interest. Michael Jensen and William Meckling[14] also explain that debt has a positive impact on manager, making them more disciplined as the company earning are to be used to repay the debt eventually. This idea is further supported by Jensen's[15] Free Cash Flow Hypothesis. However, excessive debt can be very risky and must therefore be avoided, as demonstrated by Brunnermeier[16] in the context of the 2008 financial crisis.

Studies from other countries by Raghuram Rajan and Luigi Zingales[17] and by John Graham and Campbell Harvey[18] show that factors such as credit ratings, financial flexibility and financial system of the country globally influence the choice between debt finance and equity finance. In India, earlier studies by Javed Hamid and Ajit Singh[19] and I.M. Pandey[20] found that companies preferred debt over equity finance as owners did not want to dilute their ownership. Moreover, equity market was not fully developed at that time. With time, the country witnessed expansion of capital markets, shifting the choice towards equity finance. As of 2026, the equity finance is being chosen specially by firms operating in consumer and technology sectors.

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[12] Gompers, P., & Lerner, J. (2001). "The Venture Capital Revolution." *Journal of Economic Perspectives, 15(2), 145–168.* Available at: https://pubs.aeaweb.org/doi/10.1257/jep.15.2.145

[13] Ljungqvist, A., & Wilhelm, W. J. (2003). "IPO Pricing in the Dot-Com Bubble." *Journal of Finance, 58(2), 723–752.* Available at: https://onlinelibrary.wiley.com/doi/10.1111/j.1540-6261.2003.tb01453.x

[14] Jensen, M. C., & Meckling, W. H. (1976). "Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure." *Journal of Financial Economics, 3(4), 305–360.* Available at: https://www.sciencedirect.com/science/article/pii/0304405X7690026X

[15] Jensen, M. C. (1986). "Agency Costs of Free Cash Flow, Corporate Finance, and Takeovers." *American Economic Review, 76(2), 323–329.* Available at: https://www.jstor.org/stable/1818789

[16] *Brunnermeier*, M. K. (2009). "Deciphering the Liquidity and Credit Crunch 2007–2008." *Journal of Economic Perspectives, 23(1), 77–100.* Available at: https://pubs.aeaweb.org/doi/10.1257/jep.23.1.77

[17] Rajan, R. G., & Zingales, L. (1995). "What Do We Know about Capital Structure? Some Evidence from International Data." *Journal of Finance, 50(5), 1421–1460.* Available at: https://onlinelibrary.wiley.com/doi/10.1111/j.1540-6261.1995.tb05184.x

[18] Graham, J. R., & Harvey, C. R. (2001). "The Theory and Practice of Corporate Finance: Evidence from the Field." *Journal of Financial Economics, 60(2–3), 187–243.* Available at: https://www.sciencedirect.com/science/article/pii/S0304405X01000496

[19] Singh, A., & Hamid, J. (1992). "Corporate Financial Structures in Developing Countries." *IFC Technical Paper No. 1, World Bank.* Available at: https://documents.worldbank.org/en/publication/documents-reports/documentdetail/906981468739170488

[20] Pandey, I. M. (2004). "Capital Structure, Profitability and Market Structure: Evidence from Malaysia." *Asia Pacific Journal of Economics & Business, 8(2), 78–91.* Available at: https://ssrn.com/abstract=1533718

DISCUSSION/ ANALYSIS

6.1 APPLICATION OF DIFFERENT THEORIES TO PRACTICAL FINANCING DECISIONING

An analysis of different theoretical framework revolving around corporate financing reveals that there is no single theory that provides a complete "explanation". In light of this, Myers[21] rightly acknowledged that different theories work for different firms under certain conditions. For instance, the Trade-off Theory is suitable for large firms which pay tax and developed markets that strikes to balance the "tax shield of debt" against distress costs. On the other hand, the Pecking Order Theory works better for the firms or companies in emerging economies, including the firms in India. It would work well for the Indian companies as herein, there is generally less desire to dilute one's ownership concentration, consequently driving preference towards internal funds and debt.[22] In the midst of this, the Market Timing Theory can be seen being followed mostly in developed economies getting involved in active equity trading and shares are issued during the periods of "high valuations". Pertinent to note in light of this discussion is that the existing and consistent differences in companies across the world as far as Structuring is concerned, cannot be explained by variables at the firm level alone. This indicates the high influence of various related or remotely related factors such as tax or fiscal aspects, legal systems, governing regulations and rules and Market development. Therefore, the theories revolving around decision of corporate financing apply differently under different conditions and they must be thereby adapted accordingly.

6.2 EFFECTS OF CORPORATE FINANCE ON PROFITABILITY, SHAREHOLDER WEALTH AND CREDIT RISK

It is important to know that debt finance provides two very clear advantages. First is deduction of tax on interest which consequently lowers the overall cost of capital of companies or firms. Second advantage is that the requirement of making regular payments to clear debt instils "financial discipline" in the management. This is also demonstrated in Free Cash Flow Hypothesis given by Jensen and

[21] Supra note 8.

[22] Singh, A., & Hamid, J. (1992). "Corporate Financial Structures in Developing Countries." *IFC Technical Paper No. 1, World Bank.* Available at: https://documents.worldbank.org/en/publication/documents-reports/documentdetail/906981468739170488

Meckling[23]. However, too much debt is also financially risky. Analysis of the 2008 crisis[24] shows that high credit firms may face the stress of acute liquidity, if debt repayment obligations could not be met due to decline in revenue. On the other hand, equity finance involves no pressure for repayment and also provides strategic flexibility to firms. However, the same is also not without disadvantages such as dilution of ownership and chances of overvaluation to the market, which consequently causes short term fall in price of share upon its insurance. Ultimately, 'equity dilution' is found to be the most concerning aspect or deterrent when it comes to choosing the option of equity finance.

Further, it is also important to know that the mentioned effects can also vary from sector to sector. For instance, industries with high capital and stable revenues choose higher credit, while pharmaceutical and technology firms, where the value rests on uncertain future revenues and intangible assets, typically rely more heavily on equity. Thus, it is confirmed from the empirical records that neither the debt finance nor the equity finance increases performance of any form uniformly and that the outcome or the performance ultimately depends on a number of factors such as industry, prevailing economic conditions and quantum of financing.

6.3 KEY DETERMINANTS AND STRATEGIES FOR OPTIMAL CAPITAL STRUCTURE

It is to be noted that at the level of firm, four key determinants have been consistently highlighted in the existing literature: tangibility, profitability, firm size and opportunities for growth. The choice of structure of the financial system play a significant role in shaping financial patters at the country level, as has been discussed by Rajan and Zingales[25]. On the other hand, weak investor protection lead to underdeveloped equity markets and concentrated ownership, ultimately pushing firms towards incurring debt by default. Further, the macroeconomic conditions including the rate of interest, and fiscal policies plays a major role choosing the appropriate mode of corporate finance.

A cumulative reading of the above discussed findings give a clear strategic principle i.e., the "optimal" capital structure cannot be a fixed target but has to be a dynamic balance. In this regard, Psillaki and

[23] Supra note 13 and 14.
[24] *Brunnermeier*, M. K. (2009). "Deciphering the Liquidity and Credit Crunch 2007–2008." *Journal of Economic Perspectives, 23(1), 77–100.* Available at: https://pubs.aeaweb.org/doi/10.1257/jep.23.1.77
[25] Supra note 16.

Margaritis[26] seek to confirm that "moderate leverage" leads to improved operational efficiency while too much of debt undermines the same. This further highlights the need to stay within a balanced range of borrowing as far as debt is concerned. It has been reinforced by survey conducted by Harvey and Graham[27] that in practice, CFOs prioritise maintaining a good credit rating maintenance and financial flexibility over any "theoretical" target concerning leverage. This suggests that a prudent risk management system is one of the most significant and influential determinant affecting the decisions concerning capital structure across the world. Therefore, most resilient firms are those which consider "capital structure" as a continuing, dynamic and adaptable strategy, rather than working based on a "fixed" debt-equity ratio.

RECOMMENDATIONS

One of the foremost recommendations is that a dynamic and flexible approach must be adopted towards choosing the capital structure. In other words, firms must not stick to a fixed debt-equity but should rather focus on adjusting the same based on certain important and emergent factors such as market conditions, business risks and tax changes. Thus, even though debt provides tax advantages, it must be used carefully so that excessive risk can be avoided. Equity should always be issued strategically especially when share prices are high in order to limit the dilution of ownership. Investor confidence can only be maintained through strong corporate governance, transparency and independent oversight. There is a need to reduce tax bias towards debt as noted by the International Monetary Fund and Organisation for Economic Co-operation and Development. This will strengthen financial and legal systems and lead to improved access to equity, particularly in emerging markets. Institutional investors must actively provide guidance to firms towards prudent debt use, promotion of ESG aligned instruments of finance and articulating long term strategies.

CONCLUSION

Through this paper, debt finance and equity finance have been comprehensively analyzed. The analysis went as back as 1958 to trace the capital structure theory propounded at that time and then analyzed other theories from irrelevance theorem through to contemporary dynamic models. Key finding from

[26] Margaritis, D., & Psillaki, M. (2010). "Capital Structure, Equity Ownership and Firm Performance." *Journal of Banking & Finance, 34(3), 621–632.* Available at: https://www.sciencedirect.com/science/article/pii/S0378426609002660

the comprehensive analysis is that no mode of corporate finance, out of debt and equity, is universally superior. Rather, there must be an ideal balance between debt and equity, which depends upon a multifaceted matrix of industry-specific, firm-specific and macroeconomic factors. On one hand, equity finance provides benefits of flexibility, exempt firms from repayment, and suits specifically the high-uncertainty and high-growth environments. On the other hand, there is debt finance which offers great option of deducting tax on interest while calculating income, prevents dilution of or preserves ownership and control of firms and can discipline management to generate funds through increase profit. Thus, a strong corporate financial strategy lies in choosing the right balance of debt and equity at the right time.

Further, review of the empirical evidence confirms that firms in both developing and developed markets follow a systematic pattern when choosing between debt and equity finance. Though their choice is "generally" in consonance with financial theories but factors in local context such as laws and market conditions significantly affect their choice. Moreover, factors such as increasing interest rates, mandatory tax compliances and governing laws and ESG considerations are considerably affecting the decision of firms. These emerging factors are making the topic important for to study both the managers and researchers. Ultimately, one of the most successful firms are not those which treat capital structure as "fixed decision" but are those which see it a flexible strategy which they are willing to adjust as per the firm's need and capacity. Thereby, in the present age of ever expanding global economy, firms that can manage to strike a balance between the option of debt and equity for corporate structuring wisely and are open to adaptability will have a strong "competitive advantage".