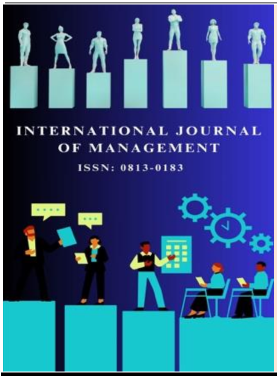

International Journal of Management

Original Research

Capital Structure Decisions in Emerging Markets

[1]Tamara Jensen,[2]Cory Beck
[1]Associate Professor, Department of Commerce, Alpine Institute of Technology, Switzerland
[2]Research Associate, Department of Corporate Governance, Kingdom College of Economics, UK

Received: April 12, 2023 Revised: April 13, 2023 Accepted: April 16, 2023 Published: April 26, 2023

Abstract
Capital structure decisions in emerging markets are complex and influenced by a unique blend of firm-specific, macroeconomic, and institutional factors. This article examines the interaction of foundational finance theories—such as the Trade-Off, Pecking Order, and Agency theories—with country-specific challenges including limited capital access, higher cost of capital, volatile economic conditions, and underdeveloped financial markets. Empirical evidence highlights that firms in emerging markets tend to rely more heavily on short-term debt and retained earnings due to constrained equity markets and regulatory uncertainties. Critical determinants such as firm size, profitability, asset tangibility, banking sector development, inflation, legal protections, and stock market depth are analyzed for their effects on leverage and financing choices. The article addresses challenges unique to these markets, including refinancing risks, currency mismatches, ownership concentration, and governance issues. Strategic best practices emphasize market development, corporate governance reforms, diversification of funding sources, hedging financial risks, and leveraging fintech innovations. Looking forward, ESG integration and expanding South-South capital flows are projected to reshape capital structures. Ultimately, the article underscores the imperative for emerging market firms to adopt agile, well-governed, and diversified financing strategies to foster sustainable growth and resilience amid evolving global financial dynamics.

Keywords: Capital structure | Emerging markets | Leverage determinants | Financial constraints | Corporate governance

INTRODUCTION

Capital structure—the mix of debt and equity used by companies to finance growth and operations—is a central strategic decision for firms worldwide. In emerging markets, however, these choices are shaped by unique challenges: limited access to capital, volatile economic conditions, institutional weaknesses, and rapidly evolving financial systems. This article analyzes the enduring and emerging influences on capital structure in emerging economies, reviewing empirical evidence, contextual determinants, and strategic best practices for 2025 and beyond.

FOUNDATIONS AND RELEVANCE

Key Theories

- **Trade-Off Theory:** Firms balance the tax benefits of debt against costs of potential financial distress.
- **Pecking Order Theory:** Firms use internal financing first, then debt, and issue equity as a last resort.
- **Agency Theory:** Ownership concentration and regulation affect the costs and benefits of external financing.

In emerging markets, these theories interact with unique country-specific factors, creating distinct corporate finance patterns compared to developed economies[1][2].

CAPITAL STRUCTURE IN EMERGING MARKETS: CURRENT LANDSCAPE

Characteristics

- **Higher Cost of Capital:** Firms face capital costs 540 basis points higher than in the US, with average cost of equity around 15-16%[3].
- **Greater Reliance on Debt:** Institutional constraints, underdeveloped markets, and tax incentives often push firms toward debt as equity markets remain less accessible[1][3].
- **Short-Term Debt Dominance:** Limited long-term bond markets and lender preferences for shorter tenors increase refinancing risks[4][3].
- **Reliance on Internal Funds:** Where external capital is scarce or costly, firms lean heavily on retained earnings[1][3].

Quantitative Overview

Factor	Emerging Markets	Developed Markets
Cost of Equity Capital	15.6%[3]	10.2%[3]
Preferred Funding	Debt-heavy[1][2][3]	More balanced
Debt Maturity	Short-term focus	Long-term flexibility
Access to Capital Markets	Limited[4][3]	Developed

DETERMINANTS OF CAPITAL STRUCTURE IN EMERGING MARKETS

Firm-Specific Factors

- **Profitability:** Profitable firms prefer low leverage, funding growth with retained earnings, in line with the pecking order theory[1][2].
- **Firm Size:** Larger firms have better access to external funding and negotiate lower costs. Smaller firms face higher capital constraints and risk premiums[1][5][4].
- **Asset Tangibility:** Firms with fixed assets are more likely to use debt, leveraging collateral to secure loans[1][2][5].
- **Growth Prospects:** High-growth firms often have limited collateral and rely more on equity, but may face restricted access to equity markets[5].

Macroeconomic and Institutional Variables

- **Banking System & Credit GDP Ratio:** An underdeveloped banking sector limits long-term lending and raises overall costs[5][6].
- **Inflation and Interest Rates:** Higher inflation encourages short-term borrowing and, paradoxically, can favor more debt over equity[3][6].
- **Legal and Regulatory Environment:** Weak investor protection, poor contract enforcement, low transparency, and lack of strong bankruptcy laws constrain companies' ability to access and manage diverse forms of capital[1][3].
- **Stock Market Development:** More robust exchanges support higher equity ratios, but many emerging markets lack this maturity[2][4].
- **Economic Volatility:** Periodic crises (e.g., Asian Financial Crisis) and currency risks make firms cautious about leverage and currency mismatches[2][4].

Determinant	Influence on Capital Structure (in Emerging Markets)
Profitability	Lower leverage; preference for internal funding[1][2]
Firm Size	Higher leverage for larger firms; lower cost of capital[1][5][4]
Asset Tangibility	More leverage (collateral backs loans)[1][2][5]
Banking Sector	Limited development = shorter maturities, high cost[5][4][3]
Inflation/Interest	Promote short-term debt, deter long-term planning[6]
Legal Environment	Weakness increases financial constraints[3]
Stock Market Depth	Shallow markets = lower equity use, higher leverage[2][3]

EMPIRICAL EVIDENCE: RECENT TRENDS AND CASE EXAMPLES

Empirical Studies (2025)

Longitudinal research across seven emerging markets (2010–2018) finds that:

- **Firm size, profitability, and asset tangibility** remain primary drivers of capital structure.
- **Macroeconomic variables**—including inflation, FDI inflows, and GDP growth—also shape leverage, but effects vary by country and region.
- **Shareholder rights, creditor protection,** and regulatory frameworks are particularly influential during and after financial crises[1][2][5].

In an 18-country study, higher asset tangibility and firm size correlate with increased leverage, whereas profitability and growth opportunities yield lower leverage[2]. The effect of these variables is amplified during macroeconomic shocks, revealing substantial volatility in capital structure decisions.

Factor	Association with Leverage (Emerging Markets)[2][5]
Profitability	Negative
Firm Size	Positive
Tangibles	Positive
Growth	Negative
Inflation	Positive (short-term debt favoring)
Stock Market Size	Negative

Illustration: Capital Structure Mix

Region	Avg. Debt Ratio (2025)	Avg. Equity Ratio (2025)
Latin America	53%	47%
Asia-Pacific	48%	52%
Africa/MENA	55%	45%

Challenges Unique to Emerging Markets

- **Structural Market Limitations:** Absence of robust local bond markets pushes firms toward expensive, short-term bank loans[4][3].
- **Volatile Capital Flows:** Sudden stops or reversals, especially during global financial shocks, force rapid deleveraging or asset sales[3].
- **Regulatory Uncertainty:** Inconsistent policy signals and uneven enforcement raise risk premiums for both debt and equity[7][4].
- **Currency Mismatches:** Heavy reliance on foreign-currency debt without matching revenues exposes firms to exchange rate risk during currency devaluation episodes[3].
- **Ownership and Corporate Governance Issues:** High ownership concentration and related-party transactions complicate monitoring and increase agency costs[3][8].

Graph: Key Challenges for Capital Structure Decisions in Emerging Markets (2025)

Challenge	Percentage of Firms Impacted (%)
Regulatory/Legal Uncertainty	45
Limited Long-Term Funding Options	60
High Cost of Capital	55
Volatile Macroeconomic Environment	48
Corporate Governance Constraints	38

STRATEGIC APPROACHES & BEST PRACTICES

Strengthening Capital Markets

- **Policy Initiatives:** Enforcing consistent, transparent regulations and investor protections boosts market confidence and access to multiple funding sources[7][4].
- **Developing Local Bond Markets:** Broadening investor bases and lengthening debt maturities create more favorable funding options[7][4].
- **Fostering Corporate Governance:** Reforms to protect minority investor rights and improve transparency reduce reliance on costly debt[3].

Firm-Level Actions

- **Diversification of Funding:** Combining local and foreign currency, and short- and long-term funding, helps mitigate risks.
- **Hedging and Currency Management:** Utilizing derivatives or natural hedges (export revenues in borrowed currency) counters exchange rate risk.
- **Building Internal Resilience:** Maintaining healthy liquidity and robust internal controls improves access to both debt and equity[1].

Future Directions (2025 and Beyond)

- **Integration of ESG:** Environmental, Social, and Governance factors are becoming central to capital raising, with international investors prioritizing sustainable operations.
- **Digital Financial Platforms:** Fintech solutions are expanding access to financing for SMEs, reducing costs, and increasing transparency.
- **South-South Integration:** As trade and financial flows increase between emerging markets, cross-border listings are expected to account for an increasing share of future IPOs and capital raises[9][10].

CONCLUSION

Capital structure decisions in emerging markets reflect a complex interplay between firm-specific, macroeconomic, and institutional variables. While many challenges remain—limited access to domestic capital markets, regulatory uncertainty, and macroeconomic volatility—reforms in governance, capital market development, and regulatory frameworks are improving conditions for firms to diversify and optimize their funding structures. The next decade will test the resilience and adaptability of emerging-market corporates as new financial instruments, digital platforms, and evolving investor preferences reshape the capital-raising landscape.