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EFFECTIVENESS OF CAPITAL STRUCTURE ON GROWTH AND STARTUP OF BUSINESS: THEORETICAL AND EMPIRICAL EVIDENCE

Robert Kiprono Koech[1]
[1]*Senior Lecture, Kenya Highlands University, Kericho County, Kenya*

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ABSTRACT

Start-up and growing businesses require adequate financial resources to survive and achieve sustainable growth. Empirical evidence indicates that a significant proportion of business failures result from inadequate financing alongside operational and managerial challenges. This study investigates the effectiveness of capital structure on the growth and start-up of businesses, focusing specifically on the roles of equity capital, debt capital, and retained earnings. A desk review methodology was adopted, synthesizing relevant theoretical and empirical literature. The study draws on the Pecking Order Theory, which emphasizes the superior impact of internal financing on financial performance, favoring equity and retained earnings over debt. The Modigliani–Miller Capital Structure Theory provides a conceptual benchmark, though its relevance is limited to perfect market conditions. Agency Theory highlights the influence of corporate governance and managerial decision-making on capital structure choices, while Trade-off Theory underscores the cost-effectiveness of equity and retained earnings relative to debt. Empirical evidence indicates that equity financing significantly enhances financial performance, and retained earnings support firm growth when effectively reinvested. In contrast, debt financing generally has an insignificant or negative impact on start-up and growing businesses. The study concludes that low-cost, internally generated financing is most effective in promoting sustainable growth and recommends that start-up businesses prioritize equity mobilization through personal savings and family contributions while strategically limiting external borrowing and reinvesting retained earnings.

KEY WORDS: *Capital Structure, Business Start-up and Growth, Pecking Order Theory, Modigliani–Miller Capital Structure Theory, Agency Theory, Trade-off Theory, Empirical Review.*

INTRODUCTION

In the contemporary business environment, start-up and growing enterprises continuously strive to achieve profitability, sustainability, and long-term growth. Financial decisions, particularly those relating to capital structure, are critical in determining whether businesses survive the start-up phase and successfully transition into growth-oriented firms. Capital structure refers to the mix of financing sources used by a firm, commonly comprising equity capital, debt capital, and retained earnings. According to Mbugua (2014), an appropriate capital structure enables firms to withstand financial distress, enhance operational capacity, and improve overall financial performance. Firms that expand their capital base through internally generated profits are better positioned to increase assets, strengthen market presence, and attain competitive advantage.

Capital structure decisions remain among the most strategic choices made by top management, as they directly affect firm risk, cost of capital, and performance outcomes. Amenya (2015) observed that capital structure may include various long-term financing instruments such as ordinary shares, preference shares, convertible loan stocks, debentures, and bank loans. The selection of an optimal capital mix is therefore a central concern of senior management, particularly in balancing growth objectives against financial risk. Mujahid, Zuberi, Rafiq, Sameen, and Shakoor (2014) conceptualized capital structure using debt-related ratios, including total debt-to-capital, short-term debt-to-capital, and long-term debt-to-capital ratios, and established a significant relationship between these ratios and firm performance. Despite the existence of numerous measurement approaches, equity capital, retained earnings, and debt financing remain the most widely applied indicators of capital structure, particularly in start-up and growth-oriented enterprises.

Empirical evidence across different contexts reveals mixed findings on the relationship between capital structure and financial performance. Globally, some studies report a positive relationship, others a negative relationship,

while some find no significant association. For instance, Pratheepkanth (2011) found a negative relationship between capital structure and financial performance among firms in Sri Lanka, attributing this outcome to heavy reliance on debt financing and the associated interest burden. Similarly, Rakesh (2013) reported a negative relationship between capital structure and firm performance among companies listed on the Bombay Stock Exchange, largely due to excessive dependence on debt capital.

In Africa, empirical studies have also produced divergent results. Evidence from Nigeria indicates that capital structure variables, measured through firm risk, age, and sales, exhibited a negative and significant relationship with Tobin's Q and Return on Assets (ROA) (Oziomobo & Zahiruddin, 2016). While firm sales positively influenced performance, firm age and risk factors negatively affected ROA, suggesting that capital structure decisions interact with firm-specific characteristics to shape performance outcomes.

In the Kenyan context, Ruri (2017) examined small and medium-sized enterprises and found that both equity capital and debt capital had a positive and significant influence on financial performance, while retained earnings had no statistically significant effect. The study further noted that although debt financing enhances capital availability, it exposes firms to higher financial risk, making equity capital a relatively more sustainable financing option for SMEs. Similarly, Masavi, Kiweu, and Kinyili (2017), using debt ratio and debt–equity ratio as proxies for capital structure, found that debt–equity ratio significantly affected the financial performance of agricultural firms listed on the Nairobi Securities Exchange.

Theoretically, capital structure is underpinned by several competing perspectives, including the Pecking Order Theory, Trade-off Theory, Agency Theory, and the Modigliani–Miller (MM) Capital Structure Theory. The Pecking Order Theory emphasizes the preference for internal financing, particularly retained earnings, over external financing due to lower information asymmetry and financing costs. Trade-off Theory similarly acknowledges the cost advantages of internal financing while balancing the tax benefits and bankruptcy costs of debt. Agency Theory highlights the role of managerial decision-making and governance in capital structure choices, though it offers limited explanation of performance outcomes. The MM theory, while foundational, assumes perfect market conditions that rarely exist in practice, particularly for start-ups and growing firms.

Equity financing remains a dominant source of capital for growing businesses, particularly during the early stages of operation. Ruri (2017) confirmed that equity capital significantly influences firm performance among SMEs in Embu County. Conversely, debt financing, whether short-term or long-term, has been shown to exert varying effects on performance depending on its scale and cost. Studies in Sri Lanka and India indicate that excessive reliance on debt financing adversely affects firm performance due to high interest obligations and increased financial risk (Pratheepkanth, 2011; Rakesh, 2013). Retained earnings, which represent internally generated funds, are widely regarded as the most preferred financing source due to their low cost and minimal risk. Amenya (2015) found that retained earnings, measured through dividend ratios, positively influenced financial performance, although contrasting evidence from Ruri (2017) suggests insignificance in certain SME contexts.

Statement of the Problem

Financial performance is critical to the survival, growth, and sustainability of start-up businesses. Evidence suggests that approximately three out of five businesses fail during the start-up stage, primarily due to financial constraints and inappropriate financing decisions. In an attempt to remain afloat, start-up and growing firms adopt different capital structures involving equity capital, debt financing, and retained earnings, each of which presents distinct advantages and risks. Poor capital structure choices often expose firms to excessive financial risk, leading to stagnation or bankruptcy, while others successfully leverage optimal financing combinations to achieve sustained growth.

Despite the existence of established capital structure models such as the Modigliani–Miller framework, which emphasizes tax advantages of debt financing, these models provide limited insight into performance outcomes for start-up and growing businesses operating in imperfect markets. Empirical studies have produced inconsistent findings, with some reporting negative relationships between capital structure and financial performance (Pratheepkanth, 2011; Rakesh, 2013), while others report positive effects (Ruri, 2017). These inconsistencies highlight a contextual and methodological gap in understanding how different components of capital structure influence the growth and start-up of businesses. Consequently, there is a need for empirical evidence that specifically examines the effectiveness of equity capital, debt capital, and retained earnings in supporting business start-up and growth.

Objective of the Study

The general objective of this study is to examine the effect of capital structure on the growth and start-up of businesses. The specific objectives of the study are to:

i. Examine the effect of equity capital on the growth and start-up of businesses.
ii. Establish the effect of debt capital on the growth and start-up of businesses.
iii. Investigate the effect of retained earnings on the growth and start-up of businesses.

THEORETICAL REVIEW

This study is anchored on four major theories of capital structure: the Pecking Order Theory, Modigliani–Miller Capital Structure Theory, Agency Theory, and Trade-off Theory. Collectively, these theories provide a conceptual foundation for understanding firms' financing choices and explain how different components of capital structure—equity capital, debt capital, and retained earnings—influence business start-up and growth. The theories further illuminate the economic, behavioral, and governance considerations that shape capital structure decisions, particularly in imperfect market conditions commonly faced by start-up and growing firms.

Pecking Order Theory

The Pecking Order Theory was developed by Myers (1984) and posits that firms follow a hierarchical order of financing preferences. According to the theory, firms prioritize internal financing sources, particularly retained earnings, due to their low cost and absence of contractual obligations. When internal funds are insufficient, firms resort to debt financing, while equity financing is considered a last option because of higher issuance costs and information asymmetry between insiders and external investors. The theory assumes that managers possess superior information about firm value and prospects, which makes external financing relatively costly.

Pecking Order Theory emphasizes that internal financing minimizes financing costs and reduces agency and information asymmetry problems. For start-up and growing businesses, which often face limited access to capital markets and high external financing costs, reliance on retained earnings and internally generated funds becomes particularly attractive. This perspective aligns with the study's focus on examining the effectiveness of retained earnings and equity capital in supporting business growth and sustainability.

However, Pecking Order Theory contrasts with the Trade-off Theory in that it does not advocate for an optimal debt-equity ratio. Instead, it argues that financing decisions are driven by the availability of internal funds rather than target leverage levels (Shyam-Sunder & Myers, 1999). While the theory provides strong justification for the preference of internal financing, it has been criticized for failing to explicitly link capital structure choices to firm performance outcomes. Additionally, it does not adequately explain financing behavior in firms with limited retained earnings, such as start-ups at early stages. Despite these limitations, the theory is relevant to this study as it explains the preference for low-cost capital structures in growing and start-up businesses.

Modigliani–Miller Capital Structure Theory

The Modigliani–Miller (MM) Capital Structure Theory was proposed by Modigliani and Miller (1958) and is based on the assumption of a perfect capital market. The theory asserts that, under conditions of no taxes, no transaction costs, no bankruptcy costs, and no information asymmetry, a firm's value is independent of its capital structure. According to this proposition, financing decisions do not affect firm performance or market value, as investors can replicate any desired leverage position on their own.

Despite its foundational contribution to capital structure theory, the MM theory has been widely criticized for relying on assumptions that are unrealistic in practical business environments. Real-world firms operate in imperfect markets characterized by taxes, transaction costs, financial distress, agency conflicts, and information asymmetry (Sheikh & Wang, 2010). These factors significantly influence financing decisions, particularly for start-up and growing businesses that face higher risk and limited access to capital.

As a result, the MM theory offers limited explanatory power regarding the effectiveness of capital structure on business growth and performance. Nonetheless, it provides a benchmark against which alternative theories, such as the Trade-off and Pecking Order theories, were developed. In this study, the MM theory is acknowledged for its theoretical contribution but is considered insufficient in explaining capital structure behavior and performance outcomes in start-up and growth-oriented firms.

Agency Theory

Agency Theory was developed by Ross and Mitnick in 1972 and focuses on conflicts of interest arising from the separation of ownership and control in firms. The theory explains the relationship between principals (owners or shareholders) and agents (managers) and highlights how divergent objectives between the two parties influence corporate decision-making. Agency problems arise when managers pursue personal interests at the expense of shareholders, leading to inefficiencies in resource allocation and financial decisions (Mitnick, 1975).

Capital structure decisions are central to agency theory because different financing options create varying incentive and control mechanisms. Equity financing increases managerial discretion but may dilute ownership and shareholder control. Debt financing, on the other hand, imposes fixed repayment obligations and external monitoring, which can discipline managerial behavior but also increase financial risk. Retained earnings often generate agency conflicts, as shareholders may prefer dividend payouts while managers favor reinvestment to expand firm size and influence (Kiptoo, 2018).

Although Agency Theory provides valuable insights into governance and decision-making dynamics affecting capital structure, it does not directly establish a clear relationship between capital structure and financial performance. Instead, it explains how conflicts of interest shape financing choices among equity, debt, and retained earnings. This theory is therefore relevant to the study in understanding managerial behavior and governance issues influencing capital structure decisions in start-up and growing businesses.

Trade-off Theory of Capital Structure

The Trade-off Theory, advanced by Myers (1984), proposes that firms determine their capital structure by balancing the benefits and costs of debt financing. The theory emphasizes the tax advantages of debt, particularly interest tax shields, against the costs of financial distress, bankruptcy, and agency conflicts. Unlike the MM theory, the Trade-off Theory incorporates market imperfections and recognizes that firms can optimize their capital structure by minimizing the overall cost of capital and maximizing firm value.

According to Danso and Adomako (2014), the Trade-off Theory explains why firms with higher taxable income may prefer debt financing to exploit tax benefits, while firms with higher financial distress costs maintain lower leverage levels. Sheikh and Wang (2010) further argue that firms target an optimal capital structure that reflects prevailing market conditions, risk levels, and cost considerations.

For start-up and growing businesses, the Trade-off Theory is particularly useful in guiding financing decisions based on risk exposure and cost efficiency. Start-ups typically face high bankruptcy risk and limited cash flows, making excessive reliance on debt financing undesirable. Consequently, equity capital and retained earnings emerge as more viable financing options due to their lower financial distress costs. This study draws on the Trade-off Theory to explain how businesses can strategically combine equity, debt, and retained earnings to support sustainable growth while minimizing financial risk.

EMPIRICAL REVIEW

Empirical studies related to capital structure and its components—equity capital, debt capital, and retained earnings—and their influence on business start-up and growth. The reviewed literature provides evidence from global, regional, and local contexts, highlighting mixed findings and contextual variations that justify the current study.

Capital Structure and Growth of Start-up Businesses

Capital structure varies across organizations depending on firm size, ownership structure, industry characteristics, and access to financing. Empirical studies demonstrate that firms adopt different combinations of equity, debt, and retained earnings, each of which influences growth and performance outcomes differently.

In Sri Lanka, Pratheepkanth (2011) examined the relationship between capital structure and financial performance and found that although most firms relied heavily on debt financing, debt had a negative effect on performance due to high interest obligations. Similarly, Rakesh (2013), studying firms listed on the Bombay Stock Exchange in India, established that excessive dependence on debt capital significantly and negatively affected financial performance. The findings suggested that firm growth was constrained by the high cost of borrowing, particularly in developing economies.

In Nigeria, Akinyomi and Olagunju (2013) investigated the effect of capital structure on firm performance among listed firms on the Nigerian Stock Exchange using a descriptive research design. The study revealed that leverage negatively influenced firm size and tax obligations, but positively affected profitability, asset tangibility, and firm growth. These mixed findings indicate that capital structure effects may differ depending on firm characteristics and performance measures.

Using panel data, Dada and Ghazali (2016) examined the impact of capital structure on firm performance in Nigeria, measuring performance using Return on Assets (ROA) and Tobin's Q. The study found that sales turnover and tangible assets positively influenced firm value, while leverage exhibited inconsistent effects across performance indicators. These results suggest that capital structure interacts with operational factors in influencing business growth.

In Kenya, Mwaura (2014) examined the relationship between capital structure and financial performance of investment firms listed on the Nairobi Securities Exchange. The study found that total debt had a significant negative effect on financial performance, while internally generated funds positively influenced firm outcomes. The study recommended that firms should prioritize internal financing and limit debt levels to avoid financial distress. Similarly, Amenya (2010) found a strong relationship between capital structure and financial performance, where dividend payout ratio had a positive effect while leverage had a negative relationship with Return on Equity (ROE).

Although these studies provide valuable insights, most focus on established firms and listed companies, leaving limited empirical evidence on start-up and growing businesses, thereby creating a contextual gap that this study seeks to address.

Equity Capital and Growth of Start-up Businesses

Equity capital represents ownership financing and is commonly used by start-up and growing businesses due to its flexibility and absence of fixed repayment obligations. Empirical studies indicate that equity financing plays a critical role in enhancing firm growth and performance, particularly among small and medium-sized enterprises (SMEs).

Njagi, Maina, and Kariuki (2017) examined capital structure decisions among SMEs and found that although equity and debt jointly constitute capital structure, most SMEs prefer internal financing from personal savings, family contributions, and retained earnings. The study further revealed that equity financing had a positive and significant effect on SME performance in Embu County, Kenya.

Ruri (2017) similarly found that equity capital significantly influenced financial performance among SMEs in Kenya. The study observed that equity capital constituted the largest proportion of financing for most SMEs, enabling business owners to retain control, enhance decision-making autonomy, and reinvest profits for growth. These findings support the argument that equity financing is particularly suitable for start-up and growth-oriented firms.

Masavi, Kiweu, and Kinyili (2017), using debt–equity ratio as a proxy for capital structure, found that equity-related financing significantly affected the financial performance of agricultural firms listed on the Nairobi Securities Exchange. Although the study focused on listed firms, the findings underscore the relevance of equity capital in influencing firm performance.

Despite the positive evidence, limited empirical studies isolate the effect of equity capital on start-up and early-stage business growth, highlighting a methodological gap that this study seeks to fill.

Debt Capital and Growth of Start-up Businesses

Debt capital involves borrowing funds from external sources with fixed repayment obligations and interest costs. While debt financing increases access to capital, it also exposes firms to financial risk, particularly during the early stages of business growth.

In Sri Lanka, Pratheepkanth (2011) found that most firms relied on debt financing, resulting in a mixed capital structure dominated by debt and equity. However, the study concluded that debt financing negatively affected financial performance due to high interest expenses. Similarly, Rakesh (2013) reported that debt financing had a

significant negative effect on firm performance among Indian firms, as it constituted the largest portion of capital structure.

In Kenya, several studies have documented the adverse effects of debt financing on firm performance. Mwaura (2014) found that both long-term debt and total debt negatively influenced profitability and Return on Equity among investment firms. The study recommended that firms limit debt usage and instead rely on retained earnings to finance growth and asset acquisition.

Despite its negative implications, debt financing remains a common source of capital due to limited access to equity financing. This contradiction underscores the need to examine the effectiveness of debt capital specifically within the context of start-up and growing businesses.

Retained Earnings and Growth of Start-up Businesses

Retained earnings represent internally generated funds reinvested into the business and are considered the most preferred source of financing under the Pecking Order Theory. Retained earnings are cost-effective and reduce reliance on external financing but may also create agency conflicts due to dividend preferences.

Nikoo (2015) examined the impact of capital structure on firm performance among companies listed on the Tehran Stock Exchange and found a positive relationship between capital structure components and Return on Assets, Return on Equity, and Earnings per Share. The findings suggest that internal financing contributes positively to firm performance.

Amenya (2015) found that dividend payout ratio, which reflects the proportion of earnings retained versus distributed, had a positive effect on financial performance. This implies that firms that effectively manage retained earnings enhance their growth and profitability.

Conversely, Ruri (2017) found that retained earnings had no significant effect on the financial performance of SMEs in Embu County. The study attributed this outcome to the preference of equity holders for dividend payouts, which limited reinvestment opportunities. These mixed findings highlight the need for further empirical examination of retained earnings in start-up and growing businesses.

Empirical Research Gap

The reviewed empirical literature reveals inconsistent findings on the relationship between capital structure components and business growth. Most studies focus on large or listed firms, with limited emphasis on start-up and early-stage businesses. Furthermore, existing studies often examine capital structure as a composite variable without isolating the specific effects of equity capital, debt capital, and retained earnings on business start-up and growth. This study addresses these gaps by empirically examining the effectiveness of individual capital structure components on the growth and start-up of businesses.

Table 1: Summary of Empirical Studies and Research Gaps

Researcher	Focus of the Study	Key Findings	Identified Research Gaps
Mwaura (2014)	Examined the relationship between capital structure and financial performance of firms listed on the Nairobi Securities Exchange (NSE), Kenya	Long-term debt had a negative influence on profitability, while total debt negatively affected Return on Equity (ROE)	Focused primarily on debt financing and listed firms; did not examine the effects of equity capital and retained earnings, nor address start-up and growing businesses
Akinyomi & Olagunju (2013)	Determinants of capital structure among firms listed on the Nigerian Stock Exchange	Tax, asset tangibility, and profitability positively influenced leverage	Concentrated on leverage determinants rather than the effectiveness of individual capital structure components on business growth; limited to Nigeria
Pratheepkanth (2011)	Relationship between capital structure and financial performance of firms listed on the Colombo Stock Exchange, Sri Lanka	Capital structure had a negative influence on financial performance; most firms relied heavily on debt financing	Context limited to Sri Lanka and listed firms; did not isolate the effects of equity and retained earnings on start-up and growth

Rakesh (2013)	Influence of capital structure on financial performance of selected firms listed on the Bombay Stock Exchange, India	Capital structure negatively affected firm performance; firms were highly dependent on debt financing	Study focused on large listed firms in India; findings may not generalize to start-up and growing businesses
Amenya (2015)	Relationship between capital structure and financial performance of firms listed on the Nairobi Securities Exchange, Kenya	Leverage negatively affected financial performance, while dividend payout ratio positively influenced ROE	Examined leverage and dividend payout only; did not comprehensively assess equity capital, debt capital, and retained earnings jointly
Ruri (2017)	Capital structure and financial performance of SMEs in Embu County, Kenya	Equity and debt capital significantly influenced financial performance; retained earnings had no significant effect	Limited to SMEs in one county; did not specifically focus on start-up and early growth stages
Nikoo (2015)	Impact of capital structure on banking performance at the Tehran Stock Exchange	Capital structure significantly influenced ROA, ROE, and Earnings per Share	Focused on banking sector and listed firms; sectoral and contextual limitations
Njagi, Maina & Kariuki (2017)	Effect of equity financing on financial performance of SMEs in Embu Town, Kenya	Equity financing had a positive and significant effect on SME performance	Focused solely on equity financing; did not examine debt capital and retained earnings as complementary financing options

METHODOLOGY

The study adopts a qualitative desk-based research design based on a systematic synthesis of existing theoretical and empirical literature on capital structure and business growth. A comprehensive review of peer-reviewed journal articles, scholarly books, and credible institutional reports was conducted to examine the effectiveness of equity capital, debt capital, and retained earnings on start-up and growing businesses. The literature was sourced from recognized academic databases and analyzed thematically to identify dominant patterns, consistencies, and contradictions in prior findings. This methodological approach enables the integration of diverse empirical evidence and theoretical perspectives, thereby providing a robust basis for drawing informed conclusions and recommendations regarding optimal capital structure choices for business start-up and growth.

FINDINGS AND DISCUSSION

Based on the synthesis of the reviewed theoretical and empirical literature, this study finds that capital structure decisions significantly influence the growth and start-up of businesses, particularly in developing economies where capital markets are imperfect. This finding contradicts the Modigliani–Miller (1958) proposition that capital structure is irrelevant to firm value under perfect market conditions. Instead, the reviewed evidence demonstrates that financing choices matter, especially for start-up and growing firms that face information asymmetry, financing constraints, and high business risk. The findings largely support the Pecking Order Theory (Myers, 1984) and the Trade-off Theory (Myers, 1984), which emphasize cost minimization, risk management, and financing hierarchy.

Equity Capital and Growth of Start-up Businesses

The reviewed empirical studies consistently show that equity capital positively influences the growth and performance of start-up and growing businesses. For instance, Njagi, Maina, and Kariuki (2017) found that equity financing had a significant positive effect on the financial performance of SMEs in Embu County, Kenya. Similarly, Ruri (2017) reported that equity capital constituted the dominant source of financing among SMEs and significantly enhanced their financial performance. These findings suggest that equity capital enables firms to grow without the burden of fixed repayment obligations, thereby reducing financial distress risk. From the researcher's perspective, this evidence aligns with the Trade-off Theory, which posits that firms with high risk exposure prefer equity to avoid bankruptcy costs (Myers, 1984). Additionally, Agency Theory supports this finding by explaining that equity financing allows owners to retain control and align managerial decisions with long-term growth objectives (Ross & Mitnick, 1972). Therefore, this study finds equity capital to be an effective financing option for business start-up and growth.

Debt Capital and Growth of Start-up Businesses

The empirical evidence reviewed indicates that debt capital generally has a negative or insignificant effect on the growth and performance of start-up and growing businesses. Pratheepkanth (2011) found that heavy reliance on debt financing among Sri Lankan firms negatively affected financial performance due to high interest costs. Similarly, Rakesh (2013) reported a significant negative relationship between debt capital and financial performance among firms listed on the Bombay Stock Exchange in India. In Kenya, Mwaura (2014) established that both long-term debt and total debt had a negative effect on profitability and Return on Equity among firms listed on the Nairobi Securities Exchange. These findings are further supported by Amenya (2015), who found that leverage negatively affected financial performance, while dividend payout ratios had a positive influence. From the researcher's standpoint, these results support the Trade-off Theory, which argues that the costs of debt, such as financial distress and bankruptcy risk, often outweigh its benefits for firms with unstable cash flows (Myers, 1984). Although Agency Theory suggests that debt can discipline managers through external monitoring (Ross & Mitnick, 1972), the reviewed evidence suggests that for start-ups, debt repayment pressure constrains growth. Consequently, this study finds debt capital to be less effective in supporting business start-up and growth.

Retained Earnings and Growth of Start-up Businesses

The findings further reveal that retained earnings are a highly effective source of financing for business growth, particularly for firms that have reached profitability. Nikoo (2015) found that internal financing positively influenced Return on Assets, Return on Equity, and Earnings per Share among firms listed on the Tehran Stock Exchange. Similarly, Amenya (2015) reported that dividend payout ratio, which reflects the proportion of earnings retained for reinvestment, had a positive effect on firm performance. These findings support the Pecking Order Theory, which prioritizes retained earnings as the preferred source of financing due to their low cost and absence of information asymmetry (Myers, 1984). However, Ruri (2017) found that retained earnings had no significant effect on the financial performance of SMEs in Embu County, attributing this outcome to owners' preference for dividend payouts rather than reinvestment. From the researcher's perspective, these mixed findings suggest that while retained earnings are effective in promoting growth, their impact depends on governance structures and reinvestment policies. This observation is consistent with Agency Theory, which highlights conflicts between owners and managers regarding profit distribution and reinvestment decisions (Mitnick, 1975).

This study finds that capital structure significantly affects the growth and start-up of businesses, with equity capital and retained earnings emerging as more effective financing options than debt capital. The findings challenge the Modigliani–Miller theory while reinforcing the relevance of the Pecking Order Theory and Trade-off Theory in explaining financing behavior in real-world contexts. From the researcher's viewpoint, the evidence underscores the importance of prioritizing low-cost and low-risk financing sources to enhance sustainable business growth, particularly during the start-up and early growth stages.

CONCLUSION

This study concludes that capital structure decisions play a critical role in the growth and start-up of businesses, particularly in environments characterized by imperfect capital markets and limited financing access. Equity capital and retained earnings are identified as the most effective sources of financing, as they reduce financial risk, minimize cost, and provide owners with control over managerial decisions.

Conversely, debt capital generally exhibits a negative or insignificant effect on start-up and growing businesses due to repayment obligations and the risk of financial distress. These findings underscore the practical relevance of the Pecking Order and Trade-off theories in guiding financing decisions, highlighting that the choice and combination of internal and external financing significantly influence business performance and sustainability.

Recommendations

The study recommended that start-up and growing businesses prioritize internal financing, particularly retained earnings, and equity capital, to support sustainable growth while minimizing financial risk. Firms should carefully limit the use of debt financing to avoid excessive interest obligations and potential financial distress, especially during early stages of operation. Additionally, business owners and managers should implement effective governance and reinvestment policies to maximize the benefits of retained earnings and equity financing. Policymakers and financial institutions should also develop supportive frameworks that enhance access to low-cost equity and internal financing options for small and growing enterprises, thereby promoting business growth and long-term sustainability.

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