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Research on the Impact of Financial Leverage on Corporate Investment Decisions

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Abstract. Financial leverage is a crucial concept in corporate financial decision-making and has a significant impact on investment decisions. This research seeks to examine the complex impact of financial leverage on corporate decision-making. Guided by Modigliani-Miller's tax-adjusted model and trade-off theory framework, the author specifically examines the theoretical basis and mechanism of financial leverage, its impact on investment decisions of enterprises of different scales, and suggestions for optimizing the impact of financial leverage on corporate investment decisions. The analysis shows that financial leverage can reduce capital costs through the tax shield effect and prompt enterprises to expand investment in the short term. Excessive financial leverage, however, heightens the danger of bankruptcy, thus resulting in a decrease in firms' return on investment. Leverage decisions should be in a dynamic balance between returns and risks, and enterprises should reduce the debt repayment pressure of financial leverage through diversified financing channels and maturity matching.

Keywords: Financial leverage, Business decision making, Taxation, Risk assessment

1. Introduction

Recent global supply chain disruptions, energy volatility, and geopolitical conflicts have intensified economic complexity, creating unprecedented challenges for corporate investment and financing [1]. This persistent economic uncertainty has had multiple impacts on corporate investment and financing decisions: 1. Fluctuations in global financial markets have introduced uncertainties for foreign-funded enterprises in terms of financing, including exchange rate risks and interest rate risks [2]. 2. The reconfiguration of global supply chains has had a profound impact on the business strategies of multinational enterprises, particularly in production layout, distribution channels, risk management, and cost control. Against the backdrop of continuous globalization and digitalization, multinational enterprises are facing increasingly complex market environments and uncertainties, compelling them to constantly adjust their strategies to maintain a competitive edge [3]. Consequently, financial leverage serves as a potent instrument for multinational corporations to facilitate investment decisions, implement strategy modifications, and seek competitive advantages in intricate and unpredictable contexts. However, it is also a "double-edged sword" that requires appropriate and suitable risk management capabilities. Recent research on this topic has mostly been

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based on dynamic trade-off models and the tax shield effect of the MM theory, examining how leverage affects investment thresholds through financing costs [4,5]. This paper, with the dynamic trade-off model as the main axis and the MM theory as an auxiliary reference system, studies the impact of financial leverage on the investment decisions of different types of enterprises.

Based on the analytical framework of the MM theory and trade-off theory, this paper mainly investigates how financial leverage affects corporate investment decisions. The study addresses three core issues:

1. The dual mechanism of tax shield benefits versus bankruptcy costs in leverage-driven investment;
2. Scale-dependent heterogeneity in leverage effects;
3. Policy prescriptions for optimizing leverage utilization.

Theoretically, the research results of this paper can help understand the complex effects of financial leverage. Practically, it provides a reference for policymakers to formulate better financial policies.

2. The theoretical basis and mechanism of action of financial leverage

2.1. The definition and theoretical model of financial leverage

Financial leverage denotes the strategic deployment of debt or fixed-cost instruments to amplify investment returns, where its efficacy stems from expanding investable capital via borrowing to magnify investment scale. This means that enterprises can achieve larger-scale asset investment with relatively less own capital, thereby increasing investment returns. However, financial leverage also comes with certain risks, as debt repayment requires enterprises to pay fixed interest and principal in the future, regardless of their profit situation. Take the real estate industry's Binjiang Group as an example. During the high-leverage period (2018-2020), the asset-liability ratio was 83.5%, the ROIC dropped below 5%, and the net profit margin declined to 8%. During the debt optimization period (2021-2023), the net debt ratio dropped below 60%, the ROIC rebounded to 8%-10%, and the net profit margin increased to 12% [6]. It can be seen that after reducing leverage, interest expenses decrease, cash flow pressure lessens, and investment returns increase.

The dynamic trade-off theory of capital structure also holds that enterprises have an optimal capital structure, and the optimal capital structure is based on the trade-off between the benefits and costs of debt. However, the dynamic trade-off theory of capital structure believes that this theory posits that optimal capital structure evolves dynamically as firms balance debt benefits (e.g., tax shields) against costs (e.g., bankruptcy risks). Adjustment costs and stochastic events induce temporary deviations from the theoretical optimum. Therefore, enterprises determine their capital structure through a dynamic process [7]. In 1963, Modigliani and Miller published the article "Corporate Income Taxes and the Cost of Capital: A Correction", relaxing the assumptions of their initial model and introducing corporate taxes into the MM theorem for the first time. When corporate taxes exist, due to the imperfection of the capital market, changes in capital structure will affect the company's price; The value of a leveraged company will exceed that of an unleveraged company. Theoretically speaking, the higher the leverage ratio of a company, the greater its value [8]. However, in actual operation, enterprises should set the leverage level reasonably based on their own circumstances.

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2.2. The mechanism of leverage effect

The core theory of the financial leverage effect is to utilize the leverage effect of debt capital to reduce the cost of equity capital and increase the return on shareholders' equity by raising the rate of return on assets. In the mechanism of the financial leverage effect, there are mainly two key factors: one is the amplification effect of leverage income, and the other is the utilization of the interest tax shield effect.

2.2.1. Leveraged income and debt financing

Enterprises can obtain additional capital at a relatively low cost. By improving their capital structure and moderately increasing the debt ratio, enterprises can generate a significant financial leverage effect. The specific mechanism of action is as follows: when the return on total assets (ROA) of an enterprise is higher than the debt interest rate, debt financing can increase the return on equity (ROE). According to the leverage effect formula, $\mathrm{ROE} = [\mathrm{ROA} + (\mathrm{ROA} - \mathrm{r}) \times \mathrm{D/E}] \times (1 - \mathrm{t})$, where r is the debt interest rate, D/E is the debt-to-equity ratio, and t is the income tax rate. In the short-term leverage effect (usually within 1-3 years), positive leverage: if ROA > debt interest rate, short-term borrowing can rapidly increase ROE. Negative leverage: if ROA < debt interest rate (such as during an economic downturn), leverage will accelerate losses. In the long-term leverage effect (usually over 5 years), the impact of financial leverage is more focused on enterprise value and sustainability: 1. Utilizing the debt tax shield: interest tax deduction (tax shield = interest × tax rate) can enhance enterprise value in the long-term leverage; 2. Accumulation of bankruptcy risk: long-term high leverage may lead to insolvency due to economic environment, industry decline, etc. (such as the high debt model of real estate enterprises).

2.2.2. Interest tax shield effect

Interest payments can be regarded as the financial cost of an enterprise and enjoy tax deductions for interest tax shields in terms of taxation, which means that enterprises can reduce their tax burden, and increase net profit and shareholder equity returns. From a financial management standpoint, the interest tax shield can significantly lower the weighted average cost of capital (WACC) of a firm, hence enhancing the discounted cash flow and overall valuation of the company. Furthermore, corporations can judiciously employ debt financing to refine their capital structure, amplify financial leverage, and consequently elevate the return on shareholder equity (ROE). Nonetheless, firms must also assess the financial risks associated with debt financing to guarantee the rationale and sustainability of their capital structure.

3. The impact of financial leverage on investment decisions of enterprises of different sizes

3.1. Financial leverage for the leverage application and investment decision-making of large enterprises

Large enterprises leverage scale-driven financing advantages—accessing capital markets, bank credit, and bond issuances—to secure lower-cost funding. This enables them to expand their business and make large-scale investments at a lower financing cost by leveraging high levels of debt. Through this approach, large enterprises can achieve higher returns on capital and further enhance their net profit margins through tax benefits from debt financing [9]. In the real estate sector, marked by substantial capital flows, extended project durations, and limited asset liquidity,

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companies typically utilize financial leverage to enhance their capital structure and increase profitability. Specific investment decisions can be made by evaluating the net present value (NPV), internal rate of return (IRR), payback period, and incorporating scenario analysis to assess the financial stability of the enterprise at different leverage levels. The strong financing advantages of large enterprises allow them to enjoy several benefits: First, they can increase the return on equity (ROE) by expanding the investment scope through debt financing and enhancing the profitability of equity capital. For example, a leading real estate company A has maintained a reasonable leverage ratio (about 1.4-1.5) over the long term. According to the DuPont formula: $\mathrm{ROE} = \text{net profit margin} \times \text{total asset turnover} \times \text{equity multiplier}$; $\text{equity multiplier} = 1 + \mathrm{D} \div \mathrm{E}$, When A Company maintains a D/E ratio of 1.4-1.5, the equity multiplier stabilizes at 2.8-3.0 times (the industry average is about 2.0-2.5 times), which means that under the same operating efficiency [10]. A Company's ROE gains a leverage boost of approximately 28%-30%. Consequently, its ROE has continuously surpassed the industry norm, thereby augmenting the company's profitability. Secondly, they can leverage the tax shield effect by augmenting debt to diminish tax liabilities. As debt interest is tax-deductible, it can reduce the enterprise's effective tax liability and enhance after-tax profits. For instance, if A Company's annual earnings before interest and taxes (EBIT) are 8 billion yuan, interest expense is 2 billion yuan, and the tax rate is 25%, then the tax shield effect can save 500 million yuan in taxes (2 billion × 25%). Third, they can optimize the capital structure by flexibly adjusting the proportion of debt and equity financing to reduce the weighted average cost of capital (WACC) and maximize enterprise value.

3.2. The influence of financial leverage on the investment decisions of small and medium-sized enterprises

Many small and medium-sized enterprises (SMEs) face dual constraints of collateral shortages and informational opacity, leading to credit rationing by risk-averse lenders. The average financing cost for SMEs is 0.5 to 2 percentage points higher than that of large enterprises due to higher credit risk premiums and guarantee costs. Therefore, first, SMEs should carefully assess their risk tolerance. They should evaluate their own operating conditions and market environment, and set a reasonable debt ratio to avoid excessive debt, ensuring that they still have the ability to repay debts during difficult times. According to the Financial Health Report, the reasonable debt-to-asset ratio for manufacturing is 40%-60%, for wholesale and retail trade is 50%-70%, for technology services is 30%-50%, and for construction is 60%-75%. Second, they should choose appropriate financing methods based on their specific circumstances (such as the amount of collateral), such as bank loans, commercial papers, and financial leasing. Third, evaluate the returns and risks of investment projects and conduct thorough financial analysis to discount the expected cash flows and profits of the projects, thereby assessing the debt repayment capacity. Fourth, diversify investments and balance the investment portfolio based on the enterprise's risk tolerance.

3.3. The negative impact of financial leverage to the enterprise

High debt levels may restrict an enterprise's financial flexibility. The enterprise needs to allocate a large amount of funds to debt repayment, which may limit its ability to respond quickly to market changes and seize new investment opportunities. This is particularly evident in capital-intensive industries, as these industries typically require significant capital investment to maintain operations and competitiveness [11]. Consequently, high financial leverage may hinder the enterprise's ability to swiftly respond to emerging technologies, market fluctuations, or innovation prospects, so

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compromising its long-term competitive edge. Excessive debt ratios in enterprises may lead to a decline in credit ratings, and financial institutions such as banks may tighten loan restrictions or increase future loan interest rates for the enterprise, thereby increasing its future financing costs. Moody's Investors Service downgraded the credit ratings of 28 Chinese real estate companies in 2022 because the bond yields of BB-rated real estate companies exceeded 15%, indicating that real estate enterprises were facing higher financial risks.

Small and medium-sized enterprises increase their operating funds through borrowing, but this also raises their debt ratios. When the debt ratio of an enterprise is high, any changes in the market environment, such as a decline in sales or an increase in costs, can suddenly increase the enterprise's financial pressure and even lead to a break in the capital chain [12]. Taking the tea company as an example, the financial leverage and operating conditions of high-leverage enterprises in the tea industry are studied. The data is sourced from Eastmoney.com [13]. As of the end of December 2023, the current ratio of the healthy tea company, Mixue Ice City, is 1.32, the interest coverage ratio is 8.5, and the free cash flow is 3.67 billion yuan. In 2023, Nai Xue’s Tea has a current ratio of 0.58, an interest coverage ratio of 1.8, and a free cash flow of -320 million yuan. Inadequate cash flow will exert significant pressure on cost management, resulting in high leverage. Company B is experiencing issues, including a deterioration in product quality and a decline in brand recognition. Consequently, when small and medium-sized firms seek to acquire capital, they must meticulously evaluate their potential for debt repayment.

4. Suggestions for optimizing the impact of financial leverage on enterprise investment decisions

Enterprises should adjust the level of financial leverage based on the risk level of investment projects. For high-risk projects (such as expanding new projects), the financial leverage ratio should be reduced to avoid increasing debt repayment pressure due to fixed interest expenses; for low-risk projects (such as equipment updates), the leverage ratio can be moderately increased to magnify investment returns. Therefore, enterprises must establish and maintain a comprehensive risk management system to identify, assess, and control risks related to financial leverage. To establish this risk management system, first, PESTEL analysis can be used to identify macro risks (such as changes in interest rate policies), then the Z-score model can be used to quantify risks and potential impacts, followed by conducting cash flow stress tests to monitor the enterprise's cash flow situation; finally, enterprises can use hedging tools (such as forward foreign exchange contracts) to hedge risks. The core of this system lies in conducting sensitivity analysis of market changes, conducting comprehensive assessments of debt repayment capacity, and carefully formulating response strategies. Moreover, enterprises should set corresponding leverage ratio thresholds for different risk levels; for example, the leverage ratio for high-risk projects should not exceed 20%, and for low-risk projects, it can be relaxed to 40%. Enterprises ought to alleviate the debt repayment burden of financial leverage by diversifying funding sources and aligning maturities. Prioritize low-cost obligations, such as long-term bonds and policy-based loans, while evading the substantial burden that short-term, high-interest liabilities place on investment cash flow. Businesses should improve communication and collaboration with financial institutions, such as banks, and endeavor to obtain loans at reduced interest rates.

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5. Conclusion

The influence of financial leverage on enterprises' investment decisions shows an "inverted U-shaped" relationship: Moderate leverage can enhance investment efficiency through the tax shield effect and the restriction of free cash flow, but excessive financial leverage will restrain investment due to bankruptcy costs and financing constraints. Future research can further explore:

1. The impact of intangible asset valuation on leverage theory in the digital economy (such as how algorithmic assets of AI enterprises affect debt financing).
2. How ESG (Environmental, Social, and Governance) factors change the risk pricing of debt financing.
3. Under the divergence of global monetary policies, the leverage strategies of multinational enterprises vary.

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