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THE MODERATING INFLUENCE OF CORPORATE REPUTATION ON THE COST OF CAPITAL AND FIRM PERFORMANCE RELATIONSHIP: A STUDY OF INDIAN LISTED COMPANIES

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ABSTRACT

The present study aims to investigate the role of Cost of Capital (COC) in influencing firm performance with the moderation of firm reputation in Indian companies. This study analyses a sample of 383 companies from the BSE 500 over the period 2011-12 to 2020-21, using System GMM to explore the relationship between COC and firm performance with moderating role of corporate reputation. The findings revealed a negative and significant relation between COC and firm performance. In addition firm reputation positively moderates the relation between Cost of Capital and firm performance. This suggest that a strong and positive firm reputation can lessen the negative impact of a high cost of capital on performance. This study is a pioneering effort in the Indian corporate sector examining the role of corporate reputation in the relationship between cost of capital and firm performance. The reputation index offers an innovative tool for investors to assess corporate reputation. The research holds considerable value for managers, investors, and regulatory bodies, especially given the distinctive characteristics of Indian capital markets, corporate governance practices, and the prominence of reputation in emerging economies like India.

Keywords: *Cost of capital, Corporate reputation, Return on assets, Moderation, India.*

1. INTRODUCTION

The cost of financing plays a pivotal role in determining a firm's performance. Theoretically, a negative correlation is expected between the cost of capital and firm performance. This is because investment decisions are influenced by the COC. Projects that yield returns exceeding COC are deemed profitable. A positive spread between return and financing cost enables firms to meet debt obligations and potentially maximize return on investment (Tamunotonye & Obutor, 2023). Consequently, firms aim to secure funding at the lowest possible cost. Thus general idea is that every firm efforts to obtain funds at lowest cost to fulfill the desire of shareholder wealth maximization.

Previous literature suggest that relationship between cost of capital and firm performance is influenced by many external variables such financial distress (Sumaryati & Tristiarini , firm size (Onkware et al., 2022), Capital Structure (Kurnaisih et al., 2022) and Corporate governance

(Judijanto et al.,). However, Investors and other stakeholders of organisation rely not only on financial profits but also on valuable intangible assets which is essential for driving superior performance and profitability in long run (Lee & Roh, 2012) . Among these, corporate reputation stands out as a critical yet often overlooked intangible asset. Corporate reputation is increasingly recognized as a key non-financial factor affecting both access to capital and firm performance (Bushman & Smith, 2001; Anginer et al., 2011; Cao et al; Houqe et al., 2023).

Merton (1987) Investor Recognition hypothesis highlights the role of corporate image in improving firm performance via lowering cost. According to this perspective, investors tend to choose those stocks in their portfolio with which they are more familiar. This is because strongly reputed firms, in order to maintain their image tends to disclose more information and transparent in their operations. Better financial reporting and enhanced transparency serves to lower the perceived risk of investors (Cao et al., 2012) which help the firms to obtain funds at lower cost. Even Smith et al (2010) found that firm with positive image in the market are rewarded with lower COC, improved ROA and increased sales. This suggests that firm reputation is a critical variable that can influence firm performance via lowering cost of financing. The lower cost of capital permits the firms to divert their resources to value enhancing projects which results in better financial performance.

Previous researchers focused on independent analysis of COC and Firm performance or largely explored the relationships between COC and reputation, in isolation (e.g., Gomes et al., 2019; Anginer et al., 2011; Cao et al., 2012; Rahman, 2022). Moreover, most of these studies have been concentrated in developing or underdeveloped economies, with limited exploration within the Indian context. Addressing this gap, the current study investigates the moderating role of corporate reputation in the relationship between COC and firm performance, using a sample of BSE 500 firms listed on the Indian stock exchange over a ten-year period (2011–2021). The result of our System GMM indicates that corporate reputation positively and significantly moderates the impact of cost of capital on firm performance. This shows that financial position of highly reputed Indian firms is less impacted by increase in cost of financing.

This paper makes a substantial contribution to the literature on cost of capital, firm performance, and corporate reputation, as it is a pioneering work to explore this relationship within the Indian context. The study implicates to managers that they should prioritize building a strong corporate image, as positive relationships with stakeholders can help firms secure financing at lower costs. Policymakers are also encouraged to develop and enforce robust corporate governance regulations, which can enhance firms' reputations and financial resilience. Additionally, during economic downturns, the government should consider offering interest rate relief to reduce the financing burden on companies.

The paper is structured as follows: Section 1 presents an introduction to the study. Section 2 reviews

the existing literature and develops hypotheses of the study. Section 3 describes the sample, data sources, and variable measurement. Section 4 explains the research methodology. Section 5 discusses the results, while Section 6 provides discussions. Section 7 addresses the study's implications and offers concluding insights.

2. LITERATURE REVIEW AND HYPOTHESES FORMULATION

i. Relationship between Cost of capital and Firm performance

Many researchers claims that escalation in cost of capital leads to decline in firm performance. The inverse relationship is supported by theoretical framework by and Pecking Order theory by (Myers, 1984) . First, Modigliani and Miller's (1963) theory suggests that firms can improve performance by strategically using debt in their capital structure. By optimizing leverage, firms gain tax advantages that reduce the effective cost of debt. This lowered debt cost helps counterbalance the rising cost of equity associated with increased financial risk, ultimately decreasing the firm's overall cost of capital. As a result, lower cost of debt financing costs can enhance firm value and profitability. Thus suggesting an inverse relationship between the cost of capital and firm performance.

Second, Pecking Order Theory (POT) advocates that in order to lower their cost of capital firms always use retained earning first due to zero cost. The debt financing comes with cost of regular interest payments and equity financing leads to risk of ownership dilution and problem of information asymmetry. This suggests that if firms choose to increase debt beyond certain level, the increase in interest burden and risk of bankruptcy will impede the firm ability to invest in value enhancing projects, which adversely effects firm performance. On the other hand, usage of more equity financing sends signals to investors that firm is not having sufficient internal funds and face liquidity problems. This increase the risk perception of investors, who then demand high returns, which negatively influence firm performance. argued that only profitable firms use their own funds i.e. retained earnings for financing their projects. Thus when then firms do not have internally generated funds they rely on equity or more debt financing, which comes with cost of interest payments, bankruptcy risk and dilution of ownership, which negatively influences firm value and profitability. found that a negative relationship between the cost of capital and market performance in Bangladesh. also found that a rise in the overall cost of capital led to decreased profitability. explored the relation between COC and firm performance in telecommunication sector of India and reported a significant and negative relation between COC and firm performance. Shadab & Sattar (2015), Gomes et al. (2019) and F. Hussain et al (2021) also suggested negative and significant impact of COC on firm performance. Rahman (2022) found similar results in in case of Food and allied industry of Bangladesh.

Contrarily some researchers argue that increase in cost of capital positively influence firm value.

Judijanto et al. (2023) suggest that when firms are willing to finance their projects with higher cost of capital, it signals that mangers have identified valuable growth opportunities that require substantial investment. These investments are expected to generate higher returns in future which result in increase firm value in long run. It also provides signal to investors that firms are able to provide adequate return in the form of dividend to its shareholders, which positively influences share prices and firm valuation in the market (Sumaryati & Tristiarini 2018) . In similar vein Mohamd & Saad (2012), Pouraghajan et al (2012). Tsai & Chen (2015), Giwa, (2019) found significant and positive association between COC and financial performance. Omwanza (2018) found that increase in cost of debt resulted in improved financial performance of commercial banks listed in Nairobi Stock Exchange.

Another group of researchers contended that the cost of capital does not affect firm value and profitability. Even the theoretical framework supports these assertions. Modigliani & Miller (1958) , theory of capital structure explains this insignificant relationship between cost of financing and firm performance. The theory posits that under the assumptions of perfect market conditions, alteration in the proportions of debt and equity in the capital structure does not affect firm value. This occurs because when firms increase their leverage, as a less expensive source of finance, it raises the financial risk for equity holders, which, in turn, results in a rise in the cost of equity. The increase in the cost of equity is offset by a lower cost of debt, keeping the overall cost of capital constant. Therefore, the Modigliani and Miller (1958) theory of irrelevance argues that firm value depends on the operating income of the firm rather than the cost of capital. Empirical studies conducted Tamimi and Obeidat (2013) Ibrahim and Ibrahim (2015) and Omwusiribe et al. (2023) and found insignificant impact of COC on firm performance.

However in real world, capital markets are imperfect. Corporate taxes and issues of information asymmetry impact the costs of debt and equity, which, in turn, influence firm performance.

Based on the prevailing theoretical arguments and empirical findings, the following hypothesis is formulated.

H1: There is a negative relationship between the cost of capital and firm performance.

ii. Role of Corporate Reputation as Moderator

Corporate reputation plays a significant role in shaping and enhancing organisation value. (Lee & Roh, 2012). Firms use their organisation image to obtain financial and non-financial benefits (Shah, 2020). One of the main economic rewards of strong reputation is lower cost of capital and superior firm performance. Theoretically, Resource Based View (RBV) uncovers the importance of firm reputation in enhancing firm performance and lowering cost of capital. According to this perspective, every organisation has some intangible resources that are based on VRIO framework, i.e. vital, rare,

inimitable and organised to capture value.

Such resources help to achieve competitive superiority in the market which rivals can never buy or imitate. Corporate reputation is considered as one of those vital resources (Lee & Roh, 2012). Strong reputation help the firms to attract customers, workers and suppliers who trusts company operations and activities due to its past behaviour of good governance, ethical behaviour and quality of products and services (Bravo, 2016). The increase in customer base helps the firms to generate more revenue, resulting in better firm performance. Empirical studies conducted by previous researchers also suggest positive impact of corporate reputation on firm performance. Roberts & Dowling (2002) used sample of 300 US firms and Lee & Roh, (2012) examined 230 high technology and low technology firms of USA. The findings of both the studies revealed a significant and negative relation between firm reputation and performance. Muthoni & Kinuya (2020) developed a questionnaire to examine the impact of reputation on firm performance in Kenya and found that strong reputation of firms positively impacts the financial performance of firms.

Rose & Thomsen, (2004) argue that highly reputed firms benefit from lower transaction cost. Transaction cost is the cost incurred during negotiations and contracts. Reputed firms enjoy more trust among lenders which enables the firm to save these expenses. Furthermore, reputed firms are perceived as more financially stable and less likely to default (Anginer et al., 2011), as a result cost incurred by creditors on checking solvency and creditworthiness is reduced. This further enables the firm to obtain funds at lower cost. The previous researchers also suggested that good reputation aids in obtaining funds from market at lower rates. Cao et al. (2014) studied 9276 US companies and found that firm with good image in the market enjoyed lower cost of equity financing. Angi explored the impact of corporate reputation on cost of debt using Fortune Most Admired companies list and analysed sample of 35 firms listed in German stock exchange. Both the studies found that firm reputation significantly lower cost of equity financing. Houqe et al. (2023) also reported a negative and significant impact of corporate reputation on cost of equity and debt capital in case of global sample of 20 countries. Smith et al (2010) analysed sample of 542 firms of US from 2002 -2004 and found that reputable firms enjoy lower cost of capital as investors perceive reputed firms as less risky due to certainty of cash flows which result in lesser stock price volatility. Moreover, the findings also indicate that reputed firms enjoy superior financial performance driven by efficient utilisation of resources and economies of scale.

Thus from the previous studies it can be inferred that corporate reputation influences cost of capital as well as corporate performance and can be considered as moderating variable in the relationship between cost of capital and firm performance.

Thus, based on the preceding theoretical and empirical arguments, following hypothesis is framed and

tested.

H2: Corporate reputation moderates the relationship between cost of capital and firm performance.

3. DATABASE AND RESEARCH METHODOLOGY

3.1 Sample, time period and data source

The initial sample comprised of 500 companies listed on the Bombay Stock Exchange. To ensure consistency in the dataset, companies with a financial year not ending on 31st March and firms with incomplete data were excluded from the sample. After applying the necessary filters, the final sample includes 383 companies analysed over a 10-year period, from 2011-12 to 2020-21. Data was collected from secondary sources, including Annual Reports, statistical database like Ace Equity and Prowess.

3.2 Measurement of variables

3.2.1 Measurement of Firm performance: The study used Return on Assets (ROA) as a main dependent variable to capture firm performance. It represents how efficiently companies utilise its assets to generate profits. A higher ROA indicates more resourceful use of assets, while a lower ROA can indicate underutilisation of assets. It is an accounting based measure of firm performance and is measured with the help of following formula:

$$\text{Return on Assets} = \frac{\textbf{Profit after tax}}{\textbf{Total Assets}}$$

Pouraghajan et al. (2012); Ibrahim & Ibrahim (2015); Gomes et al. (2019); Akintoye et al. (2019) also used ROA for measuring firm performance in their studies

3.2.2 Measurement of Corporate Reputation: Previous researchers used America's most admired companies list (Cao et al. 2014), Fortune's reputation index (Lee & Roh, 2012), Firm age, number of awards received, PE ratio and market capitalisation (Kaur & Singh, 2018) and many others measures of measuring reputation. The present study considers reputation rankings published in the "India's Most Valuable Companies" list by Business Today magazine. The BT500 ranking evaluates companies based on four key financial indicators i.e. market capitalization, total assets, total income, and profit after tax. These metrics collectively provide a holistic view of a company's financial health and operational efficiency. By aggregating and normalizing these parameters, the list offers a balanced perspective on a company's standing in the market. We derive each company's reputation ranking by calculating a combined rank through the cumulative sum of these four measures. Each of these parameters is individually ranked and then normalized using the following formula.

Rank - Median

Quartile Deviation

3.2.3 Measurement of Cost of Capital

WACC provides a comprehensive rate of return for discounting the future cash flows than the cost of individual sources of finance i.e. cost of debt and cost of equity. Sharma (2012); Nicodemus & Wamugo (2017); Hussain et al.(2021); Kurniasih et al. (2022) also advocated the use of WACC as cost of capital measure while examining relationhsip with firm performance. In line with prior studies, the current research also employs WACC as proxy using Modigliani & Miller (1958) formula. It is calculated as per the following formula.

$$\text{ko} = ke * \frac{E}{v} + \text{kd} * \frac{\text{D}}{\text{v}} * (1 - taxrate)$$

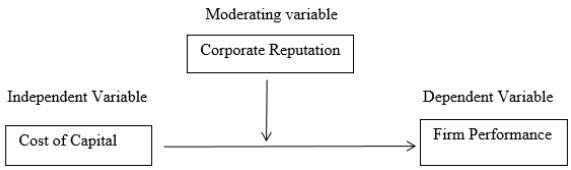
Where ko= Overall cost of capital, ke = Cost of equity, E = Market value of total equity, Kd = Cost of debt, D = Market value of total debt, V = Total value of company combined of debt and equity financing.

3.2.4 Measurement of control variables: The study incorporates number of control variables that could influence the impact of cost of capital on firm performance. The specific control variables include, Beta, a measure of firm systematic risk. Financial leverage to control for financial risk and is measured through the ratio of total debt to total equity. Firm size is measured as the natural logarithm of market capitalization. Firm growth is computed through the market-to-book ratio. Firm age is estimated as the number of years since the incorporation of a firm. Liquidity (LR) is measured through the current ratio, Asset tangibility is measured as ratio of tangible assets over fixed assets and corporate governance mechanism measured through average of individual governance variables.

4. RESEARCH DESIGN

The preliminary analysis of the panel data set, encompassing 383 cross-sectional units observed over a decade (from 2011-12 to 2020-21), reveals inconsistencies in estimates due to endogeneity within the dataset. To mitigate this issue and achieve more reliable and robust estimates, the study utilizes a two-step System Generalized Method of Moments (GMM) approach. The empirical framework is illustrated below in Figure 1. In this figure Cost of capital represents the main independent variable, Firm performance represents main dependent variable and corporate reputation represents moderating variable.

Figure 1: Empirical model for testing the moderating role of corporate reputation in the relationship between cost of capital and firm performance.



For the purpose of analysis two regression equations have been developed. Model 1 estimates the impact of cost of capital on firm performance. Model 2 illustrates the moderation impact of corporate reputation in the relationship between cost of capital and firm performance with help of interaction variable. In addition, firm size, leverage, liquidity, Firm risk, Firm age, firm growth, Asset tangibility and corporate governance have been added as control variables in the models.

Model 1: Impact of Cost of Capital on Firm Performance.

$$FP_{it} = \alpha 0_{it} + \alpha 1 FP_{it-1} + \beta 1 COC_{it} + \beta 2\ Corporate\ reputation_{it} + \beta 3\ Firm\ size_{it} + \beta 4\ Leverage_{it} + \beta 5\ Liquidity_{it} + \beta 6\ Firm\ risk_{it} + \beta 7\ Firm\ age_{it} + \beta 8 Firm\ growth_{it} + \beta 9\ Asset\ tangibility_{it} + \beta 10\ Corporate\ governance_{it} + u1_{it} \quad (1)$$

Model 2: Impact of Cost of Capital on Firm Performance with moderating role of corporate reputation

$$FP_{it} = \alpha 0_{it} + \alpha 1 FP_{it-1} + \beta 1 COC_{it} + \beta 2\ Corporate\ reputation_{it} + \beta 3\ Firm\ size_{it} + \beta 4\ Leverage_{it} + \beta 5\ Liquidity_{it} + \beta 6\ Firm\ risk_{it} + \beta 7\ Firm\ age_{it} + \beta 8 Firm\ growth_{it} + \beta 9\ Asset\ tangibility_{it} + \beta 10\ Corporate\ governance_{it} + \beta 11\ COC \times Corporate\ reputation + u2_{it} \quad (2)$$

5. Results

5.1 Descriptive statistics

Table 1: Descriptive statistics

Variable	Mean	Std. Dev.	Min	Max
Firm performance	18.1	27.5	-106.	229.
Cost of capital	0.07	0.06	0.00	0.37
Corporate reputation	7.41	0.59	4.43	8.24
Firm size	8.84	1.54	3.49	14.0
Leverage	0.73	2.24	0.00	70.1
Liquidity	1.72	1.19	0.37	5.14
Firm risk	41.5	4.24	0.61	52.9
Firm age	43.7	26.7	2.00	215.
Growth	4.39	1.70	-1.20	10.5
Asset tangibility	0.02	0.20	0.01	0.73
Corporate governance mechanism	1.81	4.65	-9.57	22.6

Source: Author's own calculations

The descriptive statistics in Table 1 show that the average firm performance, measured by Return on Assets (ROA), is 18.1 with a standard deviation of 27.5, suggesting that the sample firms are producing a moderate return on their assets with significant variation. The average Cost of Capital for firms is 7%, indicating that Indian firms generally have access to relatively low-cost financing. Corporate reputation shows a mean value of 7.41, reflecting a strong overall reputation. The average firm size is 8.84, with a standard deviation of 1.54, suggesting that the sample includes moderately large firms with significant variation in size. A higher degree of financial risk is indicated by the average leverage ratio of 0.73, while an average liquidity ratio of 1.724 suggests that the sample firms generally maintain sufficient liquid assets to meet short-term obligations. Average firm risk is 41.55, with a standard deviation of 4.244, highlighting some variability in risk levels among firms. The mean age of the sampled companies is 43.79 years, indicating well-established firms. The sample also includes high-growth companies, as indicated by an average growth rate of 4.39. The low asset tangibility value of 0.02 reflects that firms hold relatively few tangible assets compared to total assets. Finally, the average corporate governance mechanism score of 1.817 suggests a robust overall governance structure across the sample.

5.2 Correlation analysis

The results of Bivariate Correlation analysis have been presented in Table 2. Our findings reveal all the variables are having correlation value less than 0.8, which indicates that there is no multi-collinearity in the data set.

Table 2: Pearson correlation matrix

Variables	FP 1	COC 2	REP 3	FS 4	LEV 5	LQ 6	FR 7	AGE 8	GRWT 9	AT 10	CGM 11
FP	1.00										
COC	-0.010	1.000									
REP	0.140	0.073	1.000								
FS	0.071	0.029	0.382	1.000							
LEV	-0.091	-0.102	-0.069	-0.000	1.000						
LQ	0.019	0.022	-0.006	-0.051	-0.022	1.000					
FR	0.105	0.028	0.034	-0.004	-0.025	-0.062	1.000				
AGE	-0.007	0.059	0.101	0.040	0.032	-0.015	0.002	1.000			
GRWT	0.084	0.058	0.428	0.103	-0.061	-0.035	-0.004	0.036	1.000		
AT	-0.010	0.008	0.011	0.003	-0.006	0.002	0.020	0.020	-0.010	1.000	
CGM	-0.010	0.017	-0.174	-0.038	0.023	0.017	-0.094	0.023	-0.072	-0.008	1.000

Source: Author's own calculations

In the above table 2, FP = Firm performance, COC = weighted average cost of capital, REP =Corporate reputation, FS= Firm size, LEV = Leverage, LQ= Liquidity, FR = Firm risk, AGE = Age of the firm, GRWT = Firm growth, AT= Asset tangibility, CGM = Corporate governance mechanism

5.3 Results of System GMM

Many previous researchers provide evidence of impact of cost of capital on firm performance (Hussain & Chakraborty,2010; Hussain et al .,2012; Sharma 2012; Shadab & Sattar 2015; Gomes et al., 2019; Hussain et al.,2021; Ibrahim et al.,2021; and Rahman, 2022). On other hand researchers also studied the impact of firm performance on cost of capital (Setiany & Suhardjanto, 2021).This advocates the presence of causal relation between cost and capital and firm performance. This indicates the issue of Endogneity in the panel data set. According to Woolridge (2010) , endogeniety arises when there is a correlation between an independent variable and the error term, due to a causal connection between the dependent and independent variables. To address this issue, the study applied the System GMM model, as proposed by Arellano and Bond (1991), using two- to four-period lags of the explanatory and control variables as instruments. For the System GMM application, two vital conditions must be met: the Sargan-Hansen test for over-identifying restrictions and the Arellano-Bond test for serial (or autocorrelation), both of which assess the robustness of the GMM model. Both the conditions have been met. The results of these diagnostic tests are presented in the following Table 3.

Table 3: Impact of cost of capital on firm performance without Moderator (Model 1) and with Moderator (Model 2)

	Model 1 (without moderator)				Model 2 (without moderator)			
Variables	***Coefficient***	***z***	***P- value***	***Significance***	***Coefficient***	***z***	***P- value***	***Significance***
Constant	-15.23	-1.450	0.148		-12.07	-1.170	0.241	
Lag of Firm performance	0.119	1.710	0.088	*	0.122	-2.750	0.075	*
Cost of capital	-19.15	-2.940	0.003	***	-13.70	-2.750	0.006	***
Corporate reputation	0.001	1.930	0.053	**	0.001	2.000	0.046	**
Firm size	0.319	0.410	0.684		0.193	0.250	0.805	
Leverage	-0.612	-1.770	0.077	*	-0.599	-1.940	0.053	**
Liquidity	2.349	2.030	0.042	**	1.303	2.290	0.022	**
Risk	0.498	2.660	0.008	***	0.466	2.430	0.015	**
Firm age	-0.020	-0.850	0.395		-0.028	-1.270	0.203	
Firm growth	0.002	1.800	0.072	**	0.002	1.850	0.064	*
Asset Tangibility	-0.017	-0.990	0.324		-0.014	-1.120	0.264	
CG mechanism	0.392	2.180	0.029	**	0.416	2.540	0.011	***

Cost of capital Corporate reputation	–	–			**0.004**	1.950	0.051	**
Number of Moment conditions	**362**				**347**			
Number of Cross-sectional units	**383**				**383**			
Sargan Hansen Test	Prob > chi2 = 0.2342				Prob > chi2 =0.2118			
First-order autocorrelation (AR 1)	**z = -2.0990, Prob > |z| = 0.0358**				**z = -1.7724, Prob > |z| = 0.0283**			
Second-order autocorrelation (AR 2)	**z = -1.7724 , Prob > |z| = 0.0963**				**z = -1.6762, Prob > |z| = 0.0762**			

Note: *, **, *** represent 10 %, 5% and 1% level of significance

Source: Author's own calculations

The results presented in Table 3 indicate that the coefficient of lagged firm performance in Model 1 and Model 2 is 0.119 and 0.122, respectively. These coefficients are less than 1 and statistically significant at the 10% level, confirming the presence of a dynamic panel effect. For the application of GMM, the number of moment conditions should be less than the number of cross-sectional units. Results of Table 3 indicates that the number of moment conditions in Model 1 is 362, and in Model 2, it is 347 both of which are less than the number of cross-sectional units (383), satisfying this requirement. Furthermore, the coefficient of cost of capital shows a negative and statistically significant relationship with firm performance at the 1% level in both models. This suggests that an increase in the cost of capital leads to a decline in firm performance. Corporate reputation exhibits a positive and statistically significant association with firm performance at the 5% significance level. Additionally, the interaction term between cost of capital and corporate reputation in Model 2 is positive and statistically significant at the 5% level. This implies that corporate reputation mitigates the negative impact of the cost of capital on firm performance. Among the control variables, leverage, liquidity, risk, firm growth, and corporate governance mechanisms show a positive and significant association with firm performance. However, firm size, firm age, and asset tangibility exhibit statistically insignificant relationships with firm performance.

6. Discussion

The findings of the model 1 suggest that cost of capital is negatively and significantly associated with firm performance, thus accepting H1. This demonstrates that for Indian firms, increase in cost of capital leads to corresponding lower financial performance and decrease in cost of capital leads to higher firm performance. Our findings support the validity of Prominent Hypothesis of Modigliani and Miller approach (1963), which propagates that with the optimum use of debt in the capital structure, firms can achieve higher firm value and profitability. The observed impact can be traced

from the World Bank data on lending rates in India. According to World Bank statistics, during the period of this study (2012 to 2021) the average lending rates in India decline from 10.6% in 2012 to 8.7% in 2021. The declining figures reflect the efforts made by Indian government to improve credit demand in country and boost economic growth. The fall in interest rate on loans must have encouraged firms to use debt funds due to lower cost of debt capital and consequently improved the profitability of firms that depend on loans to finance their projects. Furthermore, according to Care Ratings Ltd. the average interest coverage ratio for NBFCs in India increased from 3.38 times to 4.95 times in financial year 2020-21 (Mint, 2021). The increase in interest coverage ratio signifies that firms are earnings sufficient more profits to pay off their debt obligation. This suggests that Indian firms have used more debt due to lower cost and enjoy higher operating profits. Additionally, according to survey conducted by EY India (professional service organization), on cost of capital in India 2021, the average cost of equity is 14% which is 100 basis point lower than rate reported in same survey conducted in 2017. In addition, the survey conducted in 2024, highlight that firms with lower cost of equity enjoy higher return on equity and more stable cash flows than firms with higher cost of equity. This further confirms the inverse relationship between cost of capital and firm performance. The results of our Model 1 are in agreement with those of Hussain & Chakraborty (2010); Hussain et al (2012); Sharma (2012); Shadab & Sattar (2015); Gomes et al (2019); F. Hussain et al (2021) Ibrahim et al (2021) and Rahman (2022), who also reported negative association between cost of capital and firm performance.

Table 3 (Model 2) discusses the moderation effect of corporate reputation in association between COC and firm performance. Results suggest that interaction term of cost of capital and corporate reputation is negative and statistically significant at 1% level of significance. This demonstrates that in case of Indian firms, corporate reputation strengthens negative impact of cost of financing on firm performance. Strong reputation as a cushion for the firm against the adverse effects of rising cost of capital. Thus accepting H2. The observed impact can be traced from Reserve Bank of India (RBI) interest rate hike in 2018, when RBI increased the repo rate by 25 basis points to reach 6% to 6.25%. This resulted in increase in cost of debt financing for many Indian firms. However, despite the increase in interest rate on borrowings, many reputed firms such as Reliance industries, Indian Oil Corporation, ONGC, State Bank of India, Tata Motors, Bharat Petroleum, Hindustan Petroleum Corporation (as ranked by Economic Times list of most reputed companies), were less effected by interest rate hikes as they have other financing options. Even during tough times, these companies attained superior financial performance. There has been increase in revenue and profit after tax of Reliance industries by 43.36 % and 9.74%, respectively, Indian Oil Corporation by 24.99% and ONGC by 29.97% and 37.95% (Economic times, 2018). This suggests that financial position of highly reputed firms is less impacted by increase in cost of financing. Our results are in agreement

with model are in agreement with those of Smith et al (2010) who claimed that firm reputation plays a significant role in lowering cost of financing and improving firm performance.

6. Implications and Conclusion

The current study explores the impact of cost of capital on firm performance with moderating role of corporate reputation. Our findings indicate that cost of capital is negatively associated with firm performance, implying that escalation in cost of financing deteriorates the firm performance. Additionally, corporate reputation positively moderates the relationship between cost of capital and firm performance. The impact of increase in cost of capital on firm performance is less pronounced for firms that enjoy superior corporate image among investors.

Our study strongly advocates the applicability of Modigliani and Miller (1963), modified theory of capital structure and Resource Based View (RBV) approach in Indian corporate setting. M&M (1963) theory is based on the concept that in the presence of corporate taxes, firms get tax deduction from interest payments which lowers the cost of debt and overall cost of financing and consequently improves firm performance. In India, companies are eligible to claim a deduction of interest paid on loan and borrowing under section 36(1) ((III) of Income tax act 1961, without any monetary limit. The current corporate tax rate in India is 25%. This aids Indian firms to claim full deduction of interest paid which lowers the cost of debt financing. On the other hand, cost of equity for Indian firms is high compared to developed nation due market uncertainties, inflation, and information asymmetry. These market imperfections make the equity financing expensive as investors demand higher return for increased risk. However, in order to improve monetary conditions, RBI periodically reduces repo rate which brings down the cost of debt and encouraged the firms to use more leverage in capital structure, which eventually lowers the overall cost of capital. In this context, reputation emerges as a critical intangible asset. Firms with strong reputations are perceived as lower risk by lenders, enabling them to secure debt on more favorable terms even in rising-rate environments. This aligns with RBV, which positions reputation as a sustainable, firm-specific resource that lowers financing costs and strengthens strategic capitalization. Thus, theory is enriched by highlighting how reputation not only buffers firms against adverse economic cycles but actively shapes optimal capital structure decisions in India, offering a novel theoretical bridge between tax-based leverage benefits and intangible-capital advantages in dynamic emerging markets.

Beyond theoretical implications, our study offers practical recommendation for many parties. Managers should engage in reputation building activities to gain advantage of lower cost of financing and attain superior performance. In India, CSR related activities add value to the company image. Moreover, firms adhering ESG practices also gain recognition from investors. Therefore, managers should focus on these areas to build strong image in market. Since, positives relation with stakeholders

help the managers to obtain funds at lower rates, efforts should be made to win their confidence through enhancing transparency of operations and adequate disclosure to create goodwill in the eyes of investors. Additionally, managers should carefully design their capital structure to obtain benefit from low cost of debt while avoiding overreliance on leverage, which can lead to debt trap. Investors while designing their investment portfolio should consider reputed firms since they represent lower risk and generate higher return. A thorough evaluation of the past reputation of firm is vital to estimate its growth prospects. Additionally, non-institutional and retail investors should show active participation in company meetings to gain awareness about investment strategy, reputation building activities and impact on their decisions on their returns. Moreover, investors should be cautious of the unstable operations, instability in Industry and macro-economic conditions of India, while making investment decisions as these factors escalate cost of financing and impact firm profits. Third, policymakers should frame corporate governance related laws and regulation and ensure its adherence as it helps the companies to build higher corporate image. During the times of economic downturns government should offer relaxation in interest rate to reduce the cost burden of companies. Moreover, reputation related index or performance benchmark should be developed to develop competitive spirits among firms and help investors to identify top performing companies. Through these initiatives, government can support the corporate sector in securing capital at affordable rates which fosters economic development of the country.

Our study suffers from some shortcomings also. Cost of capital and firm performance is influenced by many macro-economic variables or country specific variables such as GDP, inflation, economic growth, political stability. Due to unavailability of data for certain firms, study did not include these variables in the study. Due to lack of specific reputation measurement benchmark in India, the study considers the best alternative measures of measuring reputation based on market capitalisation and profit after tax and total income. Despite the limitations, the present research takes a first step toward comprehending the connection cost of capital and firm performance in the Indian context, with corporate reputation as a mediator. Budding researchers can investigate the influence of other moderating or mediating variables such as firm size, corporate governance variables and corporate disclosure in the association between cost of capital and firm performance. It would also be interesting to study the impact of other digital and financial reforms introduced by Indian government and governance reforms brought by SEBI and MOCA. Additionally, upcoming research can be done using multi-country sample to analyse the variation in findings due to different lending norms and government policies across nations.

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