

# Impact of Capital Structure on Profitability: Examining Firm Value and Risk Management in SMEs in Dili, Timor-Leste

Aderito Lino Monteiro, Teresa Freitas Belo, Elinora A.S. de Carvalho, Nunuk Supadmi, Olinda da Cruz Alves, Zenilda Cardoso Canossa Lesu and Pedro Jose de Deus Guterres

Lecturer of the Finance Management Department, Dili Institute of Technology, Timor-Leste

Email: [aderitolinomonteiro1990@gmail.com](mailto:aderitolinomonteiro1990@gmail.com), [teresafreitas.belo@hotmail.com](mailto:teresafreitas.belo@hotmail.com), [elinoracarvalho@gmail.com](mailto:elinoracarvalho@gmail.com), [nunusu-padmi@gmail.com](mailto:nunusu-padmi@gmail.com), [lindacruzalves75@gmail.com](mailto:lindacruzalves75@gmail.com), [zenildacanossa@gmail.com](mailto:zenildacanossa@gmail.com), [pedroguterres000@gmail.com](mailto:pedroguterres000@gmail.com)

## ABSTRACT

Firm value and risk management are employed as the mediating variables in the study, as it examines the impact of capital structure management on the profitability of small and medium enterprises (SMEs) in Dili, Timor-Leste. Among other players, SMEs are very important in the growth of the economy of Timor-Leste but are normally characterized by financial success through the implementation of effective financial management practices, such as those concerning capital structure management. Quantitative method approach to examine the mediation of the relationship between the value of a company and the strategies of risk management. In the process of secondary data analysis, the process of data gathering was followed by the distribution of research questionnaires among the owners and top officers of the SMEs in Dili. The findings clearly indicate that the successful formulation of balanced capital structure strategies will significantly enhance the profits of a company, provided the company is successful at risk management. The paper further emphasizes the need to design specific strategies and capacity building efforts to ensure the sustainability of the SMEs within the dynamic setting of the economy of Timor-Leste.

**Keywords:** capital structure, trade-off theory, firm value, risk management, profitability, DER, SMEs.

## 1. Introduction

With the understanding that SMEs are leading forces of economic growth, job creation, and innovation in many countries, they account for up to 40% of global GDP and over 70% of all employment in developing economies. In Timor-Leste, SMEs represent a crucial pillar of the non-oil sector, accounting for roughly 21% of national GDP and comprising over 23,000 registered businesses operating across diverse industries, including retail, construction, healthcare, and manufacturing (TradeInvest, 2018). Despite their economic importance, SMEs in Timor-Leste continue to encounter persistent structural and financial constraints, particularly limited access to affordable credit, elevated interest rates, and macroeconomic instability associated with fluctuations in oil revenues.

The optimal capital structure, or the right mix of debt and equity financing, is considered one of the leading financial challenges facing these businesses. A suitably balanced capital structure may enhance business value and financial resilience, while an inefficient structure can lead to lower liquidity, profitability, and potential growth. However, there is still a lack of empirical information on the relationship between capital structure choices and SME performance, especially in vulnerable post-conflict countries like Timor-Leste. Conflicting findings from studies conducted in other developing contexts, such as Amoa & Dhliwayo (2023), Bui et al. (2023), Rehan et al. (2023), and Rostami et al. (2025), indicated that the relationship between capital structure, profitability, and firm value could be context-dependent and shaped by unique institutional and market dynamics.

The purpose of conducting research on the impacts of capital structure decisions on the profitability of SMEs in Dili, Timor-Leste, by considering the mediating roles of company value

and risk management, is to address the existing literature research gap. The research project intends to emerge with empirical evidence that could assist in developing more successful financially oriented approaches in making the SMEs of Timor-Leste more sustainable in the long term by applying theoretical constructs such as the pecking order theory and the trade-off theory (Mensah & Arhinful, 2025; Sommer, 2024; Rostami et al. 2025).

The integration of efficient models of finance theory with the practical financially distressed challenges of small and medium-sized enterprises (SMEs) in a post-conflict developing country like Timor-Leste makes the research intriguing. Despite the trade-off theory (Myers, 1977; Ahmad luf, 1984) have been fully researched amongst developed and developing countries. emerging markets, empirical validation in fragile, low income, especially within post-conflict settings, and currently the state of studies mainly deal with countries having a middle income economy characterized by quite mature financial systems, thus over looking environments, such as in Timor-Leste, where institutional capacity, credit infrastructure, and market efficiency are still in their developing phases in emerging markets due nascent stages of development (Czerwonka & Jaworski Martinez et.al.2023).

Moreover, existing literatures rarely include an examination of the mediating factors of firm value and risk management between the combination of capital structure and profitability. More specifically, existing literatures show that financial performance is widely studied in isolation by existing literatures without taking into account its inter-dependencies (Abor 2005; Al-Taani 2013; Puspitawati 2022; Crawford & Jabbour 2024; Nayme & Taybi 2025). This analytical gap constrains a comprehensive understanding of how financial decision-making

contributes to sustainable value creation in high-risk, liquidity-constrained environments.

This study adds to the body of knowledge by filling in these theoretical and empirical gaps and providing context-specific information on the factors that influence and result from capital structure decisions made by SMEs in Timor-Leste. The results are likely to offer key insights for policymakers, financial institutions, as well as SME players, ensuring that initiatives aimed at ensuring improved access to finance, optimal capital structure, as well as improving financial sustainability and development contributions by SMEs are achieved in a post-conflict economy.

## 2. Theoretical Frameworks

### 2.1. Definition SMEs

Accordingly, the definition of SMEs varies internationally, reflecting the different economic structures and policy objectives of various countries. According to Conroy (2006), in Timor-Leste, for example, the enterprises are mainly differentiated based on the small number of employees. In Canada and the United States, medium-sized enterprises are mostly defined as firms with less than 500 employees (Félix & Belo, 2019). In Timor-Leste, SMEs are legally categorized under Decree-Law No. 23/2017, Article 5, based on the number of employees and annual turnover: micro enterprises may employ less than six workers, small enterprises may employ 6–20 workers, and medium enterprises may employ between 21 and 50 workers. The classification bears in mind the country-specific economic conditions and developmental priorities.

### 2.2. Capital Structure

The proportion of funds coming from debt and equity that a firm relies upon to conduct operations as well as make investments is generally referred to as capital structure. This plays an important part in determining how firms meet long-term financial obligations, manage risks, and generally stay financially stable. The allocation of risk between equity and debt holders of firms can be analyzed more easily through the employment of quantifiable measures such as the Debt to Equity Ratio in capital structure analysis (Bylo & Çankaya, 2019; Brusov & Filatova, 2023; Schoenmaker & Schramade, 2023; Gostkowska & Koralun, 2025). The relevance of balancing the benefits of debt, such as tax advantages, against the potential cost of financial distress is discussed by the theoretical perspectives such as the trade-off theory. While traditional research work, Modigliani and Miller (1958), suggested that capital structure is of less significance in a perfect capital market, more relevant models such as pecking order theory and trade-off theory (Nam & Tuyen, 2024; Pham & Hrdý, 2023) were developed by subsequent research work incorporating such aspects of taxation, bankruptcy cost, agency theory, and information asymmetry.

Firm-specific and contextual factors further influence capital structure decisions. Businesses in emerging economies and SMEs, as in the case of Timor-Leste, usually face financing constraints, regulatory challenges, and increased agency costs. These decisions thus have implications for operational

flexibility, investment capacity, and financial stability. Capital structure management is therefore integral to sustainable growth, mitigation of financial risk, and value creation within firms—particularly in dynamic or uncertain economic environments. A strategic balance between debt and equity allows firms to perform optimally with minimum exposure to financial vulnerabilities.

### 2.3 Firm Value

Profitability also makes a significant contribution to firm value as it indicates the efficiency of the firm in managing and implementing strategies, with increased profitability enticing more investors, thereby increasing market value (Ali et al., 2022; Mihail & Micu, 2021). As increased profitability indicates efficient use of leverage, profitability often becomes a mediator for the relationship between capital structure and firm value. Risk management plays a significant role in maintaining as well as increasing firm value, as risk management helps to stabilize business as well as manage the risk of potential losses, thereby allowing firms to efficiently use debt as a leverage. Risk management can act as a moderating variable, thereby increasing the positive impact of profitability, capital structure, and total value of the firm.

### 2.4 Risk Management

Capital structure risk management involves the continuous identification, assessment, and mitigation of financial risks resulting from financing decisions that the firm makes, with the primary objective of weighing between debt and equity in financing ventures to ensure financial stability and long-term value creation. It, therefore, allows firms to foresee and react to uncertainties regarding leverage, liquidity, and the aggregate financial outcome. Risk management practices minimize risks of credit risk, market risk, operation risk, and liquidity risk (Saiful & Ayu, 2019; Inegbedi-on et al., 2020), which aid in maintaining the optimal capital structure by enhancing profitability and lowering the Weighted Average Cost of Capital (WACC). Prudent debt management helps avoid financial distress situations, and management of operational and liquidity risks helps to ensure a smooth flow of working capital (Bastomi et al., 2017; Géczy et al., 2006).

Additionally, the capital structure-performance connection could be contingent upon risk management practices. This is because risk management practices could enable firms to make optimal use of debt without undermining their profitability through the enhancement of firm value (Barnea et al., 1981; DeAngelo, 2021). This assumption assumes added significance when considering the case of SMEs within developing countries such as Timor Lesthua due to the resultant limited access to formal finance, coupled with the associated risks of economic uncertainty, making risk management practices all the more important (Chow et al., 2018; Bloom, 2009). Theoretically, risk management practices coordinate capital structure with business strategy, firm value, enhances, and sustains profitability.

### 2.5. Profitability

A crucial financial indicator, profitability assesses a business's capacity to turn a profit in relation to its sales, assets, and

equity over a given time frame. Profitability, according to Hanafi (2024), is a gauge of a business's capacity to turn a profit at particular sales, asset, and share capital levels. Kasmir (2013) goes on to say that ratios that measure a company's capacity to generate profits a sign of the management's efficacy are used to determine profitability. In essence, profitability reflects how well a company can turn its sales into net in-come and provides insight into its overall financial health and operational efficiency (Hendayana et.al 2024; Nissim, 2022; Handini & Susilo 2025).

### 2.5.1. Indicators of Profitability

#### a. Net Profit Margin (NPM)

NPM is a basic profitability ratio that shows how much of the revenues are being retained or covered in the form of net profit after subtracting all the expenses. It is an important indicator of financial performance and shows how efficient an entity is at generating profit out of its revenues. It is observed in past research that the higher the NPM ratio of an entity, the better its financial performance and the more favorable its financial position is considered within the market. Therefore, NPM is an important tool that helps in comprehensively judging an entity's efficiency in managing its expenses. creating profits out of the sales (Gunanto and Preda, 2023; Budianto and Dewi, 2023; Gitman, 2012

#### b. Gross Profit Margin (GPM)

GPM is an important profitability ratio indicating how well a firm controls its production cost in relation to its revenue by computing the percentage of revenue remaining after deducting the cost of good sold. Stronger cost management, successful pricing tactics, and greater production-level efficiency all increase a higher GPM. Empirical research indicates that GPM plays a significant role in shaping investor perception and firm value since firms with greater profit-ability ratio are mostly perceived as having a better image in the market. Research also shows that higher GPM is related to improved operational efficiency with resisting the power of cost volatility. Furthermore, Technological advancement contributes to a better GPM as it improves the production process with a cost reduction that in turn strengthens the profitability as a whole (Sudiyatno et.al 2021; Khan et al. 2023; Pérez and Díaz ,2024).c. Operating Profit Margin (OPM)

OPM is a key profitability metric that indicates the proportion of revenue remaining after operating expenses excluding interest and taxes are deducted. OPM, which is determined by dividing operating income by total sales, shows how well a company manages its primary business operations. A higher OPM suggests strong control over operating costs and greater operational effectiveness. Prior research shows that firms with higher OPM tend to demonstrate superior cost management and enhanced operational efficiency, contributing to improved profitability. Additionally, studies reveal that strong OPM performance is associated with higher firm value, as investors view such firms as more stable and capable of generating consistent operating profits. Overall, OPM serves as an important indicator of operational performance and its contribution to a company's

financial health (Olayinka, 2022; Boccardi et al. 2023; Nguyen and Sim, 2023).

## 3. Hypothesis Development

### 3.1. Capital Structure on Profitability

However, there exist conflicting empirical findings related to the relationship between leverage and earnings management. According to several studies (DeFond & Jiambalvo, 1994; Huang & Sun, 2017; Lazzem & Jilani, 2018; Omid, 2012; Zamri et al., 2013; Afza & Rashid, 2014), debt management in firms that have high leverage can manipulate earnings to evade breaking debt covenants or to meet favorable terms for re-negotiation, whereas other studies have found a negative relationship, whereby lender scrutiny limits managerial flexibility. Firm specific factors such as capital structure, size, and profitability are significantly related to investors' perceptions. According to reports by Hamidah & Umdiana (2017), Suffah & Riduwan (2016), Sucuahi & Cambarihan (2016), and Kontesa (2015), profitability measured by return on equity power (ROE) has reliably demonstrated.

These patterns can be explained using theoretical models. Although the theory of trade-off advocates the optimal capital structure between tax subsidies and the risk of financial distress becoming a compromise (Brigham & Houston, 2011), the pecking order theory states that successful firms use internal sources for financing, resulting in lower debt (Myers, 1977; Megginson et al., 2019). According to Manoppo & Arie (2016) and Hamid et al. (2015), debt to equity ratios (DER) are important in determining investment confidence and financial position. Empirical findings also indicate the positive influence of higher leverage on the augmentation of the profitability of banks in some situations (Mehzabin et al., 2023), supporting the agency costs of complexity theory. Capital structure is a crucial factor for the stability and profitability of banks in the financial sector. Well-stabilized capital structure results in the better absorption of losses and performance of the financial institution itself (Demirgüç-Kunt & Huizinga, 1999; Adesina et al., 2015; Anafo et al., 2015). These studies show the simultaneous influence of various factors at the sector level for the determination of profitability.H1: Capital structure choices and profitability levels among SMEs in Dili, Timor-Leste, are significantly correlated.

### 3.2. Capital Structure in relation to Firm Value

The link between capital structure and firm value is still not empirically supported. Rahman (2016) points to the importance of liquidity to creditors and links firm value to a firm's debt-paying ability. Capital structure has no significant influence on firm value, according to some research findings (Hamidah et al., 2015; Antwi et al., 2012), but others have documented a positive relationship (Rehman, 2016; Suffah and Riduwan, 2016; Manoppo and Arie, 2016). Firm size has also been highlighted as a major determinant, with larger firms benefiting from wealth transfer and increased investor confidence (Horne and Wachowicz, 2009; Brealey et al., 2011); however, the findings remain inconclusive since Velnampy and Pratheepkanth (2011) report

no direct influence, while Manoppo and Arie (2016) show a positive impact. Theoretical frameworks provide further insight into these empirical patterns. According to the trade-off principle, businesses can balance the benefits of debt financing against related financial risks by optimizing the Debt Equity Ratio (Rahman, 2014; Suffah and Riduwan, 2016; Manoppo and Arie, 2016).

Empirical studies support this proposition, indicating that strategic use of debt can enhance firm value and profitability (Hirdinis, 2019; Rahman, 2014; Bui et al., 2023). Moreover, research highlights the context-dependent interplay between business value is shaped by capital structure, business size, and profitability (Jin and Xu, 2022; Khan et al., 2021; Ayuba et al., 2019; Natsir and Yusbardini, 2020). When taken as a whole, these results highlight how crucial capital structure composition is in affecting investor perceptions, business performance, and overall corporate value.

H2: Among SMEs in Dili, Timor-Leste, there is a substantial correlation between factors impacting capital structure choices and firm value.

### 3.3. Capital Structure on Risk Management

Managers typically seek to adopt a capital structure that optimizes business value for investors (Ross et al., 2016). Nevertheless, during periods of reduced operating profitability, excessive leverage can increase a firm's exposure to financial distress, as failure to meet interest obligations may precipitate bankruptcy (Brigham & Houston, 2011). The inverse relationship between debt and risk is highlighted by the Trade-Off Theory (TOT), proposing that firms with higher default risk should adopt more conservative leverage levels (Wiwattanakantang, 1999; Titman & Wessels, 1988). Empirical evidence presents a nuanced perspective: Jordan et al. (1998) report a positive association between debt and market value in high-growth markets, suggesting that leverage can enhance market valuation while simultaneously elevating bankruptcy risk. In contrast, studies by Ezeoha (2011), Viviani (2008), and Su (2010) find no significant link between debt ratios and business risk, whereas Eldomiaty (2008) and Sheikh & Wang (2011) identify a negative association, indicating that higher-risk businesses typically rely more on internal funding to preserve financial stability (Low & Chen, 2004; Abor & Biekpe, 2009).

Effective risk assessment is essential in informing capital structure decisions. Profit variability and the standard deviation of profitability, especially Return on Assets (ROA), are important metrics, which capture earnings fluctuations and performance volatility (Chung, 1993; Al-Najjar & Taylor, 2008). These indicators function as proxies for business risk, reflecting a firm's potential susceptibility to financial distress. Collectively, these theoretical and empirical findings underscore the importance of risk management in shaping leverage strategies, optimizing capital structures, and ensuring long-term corporate sustainability. The following hypothesis is developed to guide this investigation.

H3: Capital structure significantly influences the risk profile of SMEs in Dili, Timor-Leste.

### 3.4. Firm Value on Profitability

Profitability serves as a key indicator of a company's financial well-being, frequently assessed through Return on Equity (ROE), which indicates how effectively shareholder equity is employed to generate earnings. Elevated ROE not only reflects strong financial performance but also attracts investor interest, potentially enhancing stock prices and overall firm value. Empirical evidence supports this positive association, with Sucuahi & Cambarihan (2016), Hamidah & Umdiana (2017), and Suffah & Riduwan (2016) highlighting profitability's significant contribution to firm valuation. Collectively, these theoretical and empirical conclusions highlight the crucial role of profitability in shaping shareholder wealth and market performance. Effective management of operational and legal risks is critical to sustaining profitability, particularly within the banking sector. Operational risks, arising from internal inefficiencies or external disruptions, can negatively impact financial outcomes, whereas rigorous risk management enhances operational efficiency and profitability (Abu & Al-Ajmi, 2012; Suganya & Kengatharan, 2018). Further, studies by Gadzo et al. (2019) and Marwan & Rohami (2018) demonstrate that unmanaged operational risks can diminish bank profitability, emphasizing the importance of robust internal controls. Legal risks, including fraud and inadequate credit assessment, pose additional threats to financial stability, as noted by the Basel Committee for Bank Supervision and evidenced during the financial crisis (Robertson, 2011). Together, these findings indicate that mitigating operational and legal risks is essential for maintaining profitability and reinforcing firm value.

H4: Firm value and profitability levels are significantly correlated among SMEs in Dili, Timor-Leste.

### 3.5. Risk Management on Profitability

Risk management practices are essential for safeguarding organizational assets and mitigating potential losses; however, evidence indicates that these practices can sometimes negatively affect profitability across various sectors. For example, higher levels of risk management disclosure in annual reports have been associated with lower measures of profitability, including Return on Equity (ROE), Return on Investment (ROI), and Earnings Per Share (EPS) (Yu, 2019). Similarly, the implementation of risk identification and control mechanisms has been linked to reduced profitability in non-life insurance companies (Owusu & Owusu, 2023), while increased monitoring of non-performing loans in the banking sector has corresponded with decreased financial performance (Kinyua, 2020). These findings suggest that although risk management aims to protect organizational value, the associated costs and operational constraints may sometimes offset its benefits.

Risk management's impact on profitability varies greatly depending on the circumstances. According to studies, the effect varies depending on the type of risk, industry, and management approaches. In banks, certain risk management measures may reduce profitability depending on operational exposures (Alshatti et al., 2024). In Islamic banking, operational risk practices have been associated with lower ROA and ROE (Darlam, 2023), while industries such as mining have shown that greater

exposure to corporate and operational risks can reduce profitability (Karima et al., 2023). Overall, these findings show the intricate and diverse nature of the relationship between risk management and financial performance, emphasizing the necessity for organizations to carefully balance risk mitigation benefits with potential impacts on profitability, tailoring strategies to their specific industry and operational context.

H5: The profitability of SMEs is negatively impacted by risk management in Dili, Timor-Leste.

### 3.6. Capital Structure's Impact on Profitability via Firm Value

A company's solvency, generally measured by the ratio of total assets to total debt, is a significant indicator of financial stability, with higher leverage potentially signaling increased insolvency risk. Empirical evidence of the influence of leverage on business value, however, remains mixed. Farooq and Masood (2016) document a significant negative relationship, whereas according to Markonah et al. (2020), leverage, measured by the Debt-to-Equity Ratio (DER), has a favorable effect on company value, whereas the Debt-to-Assets Ratio (DAR) has a negative impact. These data demonstrate that the link between leverage and business value is complicated and dependent on the chosen measurement approach, highlighting the need for careful consideration of capital structure decisions in corporate financial management.

Profitability, reflecting a firm's capacity to generate earnings, consistently demonstrates a positive effect on firm value. High profitability signals sound financial health, bolsters investor confidence, and can drive increases in stock prices. The substantial and favorable impact of profitability on firm valuation is supported by empirical research by Cambarihan and Sucuahi (2016) and Tui, Nurnajamuddin, Sufri, and Nirwana (2017). Together, these theoretical and empirical insights suggest that profitability is still a solid indicator of company value, even though the effect of leverage on it may differ depending on measurement and context. This highlights the significance of matching capital structure strategies with profitability goals.

H6: In Dili, Timor-Leste, firm value acts as an intervening variable that mediates the impact of capital structure on the profitability of SMEs.

### 3.7. Capital Structure on Profitability through Risk Management

The trade-off idea states that taking on more debt can enhance profitability if effectively utilized (Myers, 1977); however, the theory does not fully explain the observed inverse relationship between profitability and debt ratios. Empirical evidence demonstrates a favorable impact of capital structure on profitability, as reported by Antwi et al. (2012), Hamidah et al. (2015), and Yapa Abeywardhana (2016). These findings suggest that strategic management of debt can improve firm performance, although the strength and direction of this relationship are contingent upon firm-specific characteristics and prevailing market conditions.

In the banking sector, profitability is particularly sensitive to capital structure, given banks' reliance on third-party funds for lending and credit operations. Credit risk, arising from borrower defaults, directly impacts profitability, while market and operational risks further influence financial outcomes. Consequently, effective risk management is essential to safeguarding profitability and ensuring sustainable returns. With these factors in mind, the following hypothesis will direct this study's reexamination of the connection between capital structure and profitability:

H7: Risk acts as an intervening variable in the positive relationship between capital structure and the profitability of small and medium-sized businesses (SMEs) in Dili, Timor-Leste.

### 3.8. The model of research

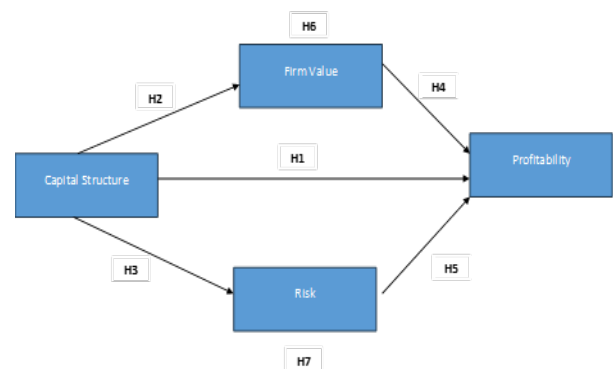


Figure 1. The Model of Research

## 4. Research Methods

This study looks at how capital structure choices affect small and medium-sized businesses' (SMEs) profitability in Dili, Timor-Leste, with firm value and risk management assessed as mediating variables. A quantitative, explanatory design was employed to analyze causal relationships using numerical data and structural modelling techniques suited to latent-variable research and hypothesis testing. The study targeted 23,605 registered SMEs in Dili (TradeInvest, 2018), the country's primary economic hub, and determined a minimum sample of 394 SMEs utilizing Slovin's formula with a 5% error margin. A method of stratified random sampling was used to reflect the distribution of Sole Proprietorships (75.03%), Limited Liability Companies (24.58%), and Joint Stock Companies (0.39%). Data were gathered using a standardized survey that was modified from established literature, translated and back-translated between English and Tetum, and refined following a pilot test conducted in August 2024. The final survey was administered between September and October 2024, with all subjects provided informed consent, and ethics approval was obtained.

Utilizing data analysis SMART-PLS 4.0 was chosen for Partial Least Squares Structural Equation Modeling (PLS-SEM) due to its capacity to manage complicated models with mediating factors, non-normal data, and both reflective and formative

constructs (Hair et al., 2014; Saldanha et al., 2018). Cronbach's Alpha, Composite Reliability, factor loadings, Average Variance Extracted (Hair et al., 2017), and discriminant validity tests based on the Fornell–Larcker criterion and Heterotrait–Monotrait ratio (Henseler et al., 2015) were used to evaluate reliability and validity. Bootstrapping was used to test the hypotheses and produce path coefficients, t-statistics, and p-values, allowing the assessment of both direct and indirect relationships. Descriptive statistics and demographic characteristics are presented in concise tables, and a summary matrix is provided to indicate which hypotheses were supported, with all significance values reported using the  $p < 0.05$  threshold.

## 5. Results

### 5.1. Respondents' Characteristics

Owners of small and medium-sized businesses made up the 285 respondents who took part in this study. Their characteristics were analyzed based on gender, age, and education level.

#### 5.1.1. Gender, Age & Education Level

The SME sector in Dili exhibits a nearly balanced gender distribution among owners and managers, with 51% male and 49% female representation, reflecting notable progress in gender equity within business leadership in Timor-Leste. This gender balance likely fosters diverse approaches to financial decision-making, as men tend to pursue growth-oriented strategies with higher risk tolerance, while women often prioritize stability and sustainability. Such a mix can enhance resilience in the SME ecosystem by promoting innovation while mitigating risks. Despite these gains, systemic challenges persist, including unequal access to financing and decision-making power for women. Addressing these barriers through gender-sensitive financing, financial literacy programs, and tailored risk management support could enable both male and female entrepreneurs to optimize profitability and enhance firm value.

Age and educational background further shape decision-making in Dili's SMEs. Younger entrepreneurs dominate the sector, with 41% aged 26–35 and 24% aged 17–25, often favoring innovative, growth-oriented strategies that may involve higher debt utilization, thereby increasing potential profitability and financial risk. The 36–45 age group (21%) balances growth with stability, while older groups (46–55: 12%, over 55: 2%) tend toward risk-averse, equity-based financing approaches. In terms of education, 49% hold a Bachelor's degree, 46% completed Senior High School, 4% possess a Master's degree, and 1% only Junior High School, indicating that while most leaders are capable of basic financial management, advanced financial literacy remains limited. These demographics suggest a high overall risk appetite among SMEs, highlighting the importance of financial education and mentorship to combine growth ambitions with sustainable risk management, ultimately enhancing firm value and long-term profitability.

Table 1. Gender, Age & Education Level

Characteristic	Category	Frequency (n)	Percentage (%)
Gender	Male	145	51%
	Female	140	49%
Age	15-25	68	24%
	26-35	117	41%
	36-45	60	21%
	46-55	34	12%
	>55	6	2%
Education	Junior High School	3	1%
	Senior High School	131	46%
	Bachelor's Degree	139	49%
	Master's Degree	12	4%

#### 5.1.2. Sectors Types

The SME landscape in Dili is dominated by Retail Stores and Mini Markets (23%), emphasizing their critical role in shaping capital structure and profitability, followed by Restaurants, Cafes, and Bars (17%), highlighting the food and hospitality sector's importance. Construction and Building Materials (11%) reflect growth in infrastructure, while Automotive and Workshops and Technology and ICT Services (10% each) illustrate a blend of traditional and modern business activities. Smaller sectors like Health and Beauty (8%), Fashion and Accessories (3%), and Manufacturing and Industrial (7%) represent niche and production-focused markets with unique financing and risk management needs. Supporting sectors, including Transportation, Agencies, Consulting, and Suppliers (2–5%), play complementary roles. Retail and restaurant businesses often rely on short-term financing, while capital-intensive sectors like construction and technology require long-term funding for growth. Effective risk management is critical for larger, competitive sectors, while smaller sectors face challenges in accessing favorable financing, which can limit their firm value and profitability.

## 5.2. Descriptive Statistical Analysis

### 5.2.1. Structure of Capital

The capital structure's descriptive statistical analysis preferences among SMEs in Dili, Timor-Leste, reveals notable patterns in their financing behavior. Average scores varied from 3.41 to 3.88, with an overall mean of 3.61, based on Likert-scale responses ranging from 1 (strongly disagree) to 5 (strongly agree). This suggests that SME owners and financial managers have a generally favorable opinion of capital structure management. Debt financing emerged as the preferred strategy, valued for supporting business expansion, asset acquisition, and continuity, while respondents remained aware of its related concerns, like financial hardship and insolvency. This reflects elements of the pecking order theory, which prioritizes internal funding, and is consistent with trade-off theory, which weighs the tax benefits of debt against possible financial hardship, and debt is employed

only when necessary. Many SMEs reported favorable access to credit in Dili, citing acceptable interest rates and lending terms, further encouraging the use of debt as a financing mechanism.

SMEs in Dili also demonstrate caution in their financial decision-making, actively assessing debt levels in response to changing market conditions. This behavior corresponds combining the agency cost theory and the static trade-off theory, as firms aim to minimize managerial discretion risks. Most SMEs preferred debt over equity to avoid ownership dilution and maintain control, consistent with Myers' pecking order theory, though some opted for equity during economic uncertainty to preserve financial flexibility. Overall, the findings suggest a deliberate, theory-informed capital structure strategy among SMEs in Dili, while highlighting the underdeveloped equity markets in Timor-Leste, where debt remains the dominant external financing source. These results corroborate prior observations regarding structural barriers to equity financing in emerging economies (Ai, Frank, & Sanati, 2020; Frank & Goyal, 2024; OECD, 2022; World Bank, 2024).

### 5.2.2. Firm Value

The descriptive analysis of firm value perceptions among SMEs in Dili shows a typically optimistic perspective, with an average score of 3.78 on a 5-point Likert scale and individual indicator scores ranging from 3.14 to 3.95. Key value drivers identified include sales growth, operational efficiency, asset utilization, and return on investment (ROI). Sales growth was particularly emphasized, reflecting the resource-based view (RBV) that positions growth as a strategic capability enhancing long-term competitiveness (Xie et al., 2022). However, concerns regarding the sustainability of growth, influenced by inconsistent strategies or external shocks, align with dynamic capabilities theory, which stresses adaptive resource management in changing markets (Teece, 2007).

Asset efficiency, measured through Return on Assets (ROA), was recognized as critical, consistent with efficiency theory linking operational performance to profitability and firm value (Altman, Hotchkiss & Wang, 2019). ROI and ROE were valued as indicators of effective investment strategy and shareholder value creation (Damodaran, 2007; Maenuddina et al., 2020). Some respondents expressed doubts about sustaining growth and investor appeal, reflecting stakeholder theory, which highlights the role of external trust in perceived firm value (Xie et al., 2022; Teece, 2007). Overall, SME stakeholders maintain positive perceptions of firm value, contingent on aligning performance with stakeholder expectations.

### 5.2.3. Management of Risk

With an average score of 3.38 on a 5-point Likert scale, the descriptive study of risk management perceptions among SMEs in Dili shows a somewhat optimistic outlook. Respondents valued cash flow management, contingency planning, and standardized procedures as key practices. Cash flow monitoring aligns with cash flow theory, emphasizing liquidity oversight to mitigate short-term financial risk (Gomes et al., 2022). Contingency planning reflects the Enterprise Risk Management (ERM) framework, promoting proactive measures for organizational resilience (Black & Glaser-Segura, 2020). Despite these positive

perceptions, concerns were raised regarding the transparency of internal reporting and the depth of contingency plans, suggesting room for improvement.

Documented procedures and employee training were also positively evaluated, supporting standardization theory by enhancing compliance and reducing human error. However, inconsistencies in policy dissemination and enforcement were noted (Rosenthal et al., 2021). Integration of risk management with business strategy through process reviews aligns with Supply Chain Risk Management (SCRM) theory, emphasizing the embedding of risk considerations into core planning (Christopher & Peck, 2004). Overall, while foundational elements are appreciated, gaps in execution, communication, and strategic alignment limit effectiveness, highlighting the need for improved transparency, consistent enforcement, and practical integration.

### 5.2.4. Profitability

The analysis of profitability, presented in Table 7, shows generally positive perceptions, with an average Likert score of 3.86. Respondents highlighted the net profit margin (NPM) and operating profit margin (OPM) as key indicators, though some inconsistencies suggest areas for improved communication. NPM assesses profitability after all expenses, reflecting cost management, pricing strategies, and overall business effectiveness, aligning with profitability theory that emphasizes maximizing net profits for long-term sustainability and shareholder value. However, 166 respondents expressed reservations about relying on NPM as a primary measure, likely due to unclear application in decision-making. Smith (2021) notes that without effective communication, stakeholders may undervalue such metrics. Trends in Gross Profit Margin (GPM) support pricing and cost management decisions, compatible with the resource-based view (RBV), as Freeman, Dmytriiev, and Phillips (2021) stress linking metrics to tangible performance objectives. OPM is recognized as an essential measure of operational efficiency and profitability, consistent with value chain theory. Monitoring OPM enables identification of inefficiencies, supporting proactive financial management (Chen et al., 2024). Addressing declines in OPM reflects contingency theory, emphasizing strategy adaptation. Clear communication of OPM remains critical, as Lee and Raschke (2023) note, to maintain stakeholder confidence and alignment with organizational goals.

### 5.3. Validity and Reliability

The Composite Reliability and Cronbach's Alpha values exceeding 0.70 in this study's validity and reliability analysis show that the research satisfies the required reliability requirements (Hair et al., 2017). The Composite Reliability and Cronbach's Alpha values for each variable in the study surpass the threshold, confirming that the reliability of the research is acceptable. Moreover, the Composite Reliability values are higher than the Cronbach's Alpha, which further demonstrates that all research variables satisfy the required reliability criteria for analysis of structural equation modeling (SEM) with SmartPLS. These results guarantee the measurement model's reliability and consistency, offering a strong basis for the structural analysis (Nurhalizah et al., 2024).

In terms of validity, all indicators for both exogenous and endogenous variables have loading values more than 0.70, indicating good convergent validity, which confirms the high validity of these indicators (Hair et al., 2017). Convergent validity is essential to ensure that the indicators appropriately reflect the underlying constructs. Additionally, discriminant validity analysis, which ensures that constructs are distinct from each other,

was conducted using methods like the Fornell-Larcker Validity Test and HTMT, which are included in SmartPLS's criteria for evaluating measurement models (Nurhalizah et al., 2024). These results indicate that the constructs in the model are valid, distinct, and adequately measured, ensuring the robustness of the research model.

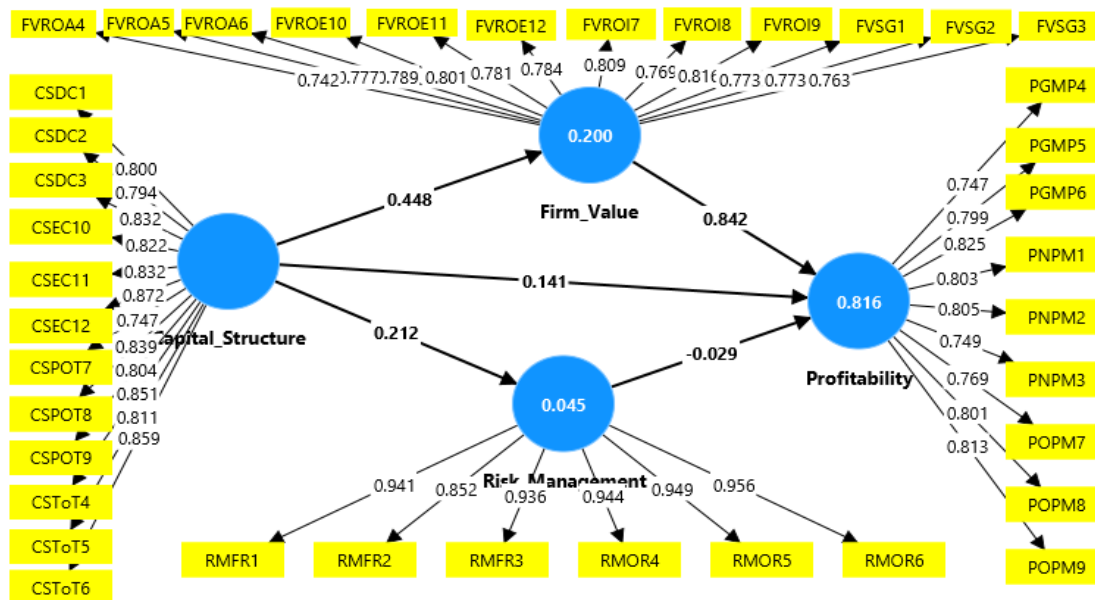


Figure 2. Algorithm SMART-PLS 4.0's outer loading for convergent validity

5.4. R-Values for Testing Inner Models

The purpose of the inner model analysis is to investigate the connections between the variables. The R-squared (R<sup>2</sup>) value is the parameter used in this investigation. R-squared is a key metric for evaluating the model's predictive power as well as a measure of how strongly the variables are related to one another. The following categories apply to the R-squared values: According to Hair et al. (2014), values above 0.75 indicate a strong relationship, values between 0.50 and 0.75 show a moderate link, and values below 0.25 reveal a weak relationship.

Table 2. Results of the R<sup>2</sup> Values

	R-square	R-square adjusted
Firm Value	0.200	0.197
Profitability	0.816	0.814
Risk Management	0.045	0.042

A strong correlation between capital structure and profitability is demonstrated by the R<sup>2</sup> value of 0.816, which shows that the independent variables account for 81.6% of the variation in profitability while factors not included in the model account for 18.4%.

5.5. Test of Hypothesis

SMART-PLS 4.0 is used in four of the study's hypotheses to assess the direct relationship between variables. The parameters used to assess them are path coefficients (T and P values). Hair et al. (2014) and Hair et al. (2017) state that if the T value is higher than 1.96 and the P value is less than 0.05, two variables have a substantial influence.

Capital structure has a major impact on SME profitability in Dili, according to the direct effect test results in the table above, with a positive and statistically significant path coefficient of 5.256, surpassing the 1.96 threshold and a significance level below 0.05, thereby supporting H1. This demonstrates that debt financing enables faster growth by allowing profits to remain with owners for reinvestment, though high debt-to-equity ratios may pose risks by limiting access to additional funding. These results align with prior studies highlighting the nuanced relationship between debt, profitability, and risk management (Mehzabin et al., 2023; Yapa Abeywardhana, 2016; Antwi et al., 2012; Ahmad et al., 2015). Managerial characteristics, including age, gender, and education, as well as sector-specific financing needs, further influence financial strategies: younger managers are more growth-oriented and risk-tolerant, while older managers prefer stability; nearly equal gender representation supports diverse decision-making; and a substantial proportion of leaders hold at least a Bachelor's degree, reflecting

moderate financial literacy. Additionally, sectoral differences—retail and food services favoring short-term financing versus capital-intensive sectors like construction and technology requiring long-term funding highlight the importance of tailored

financial literacy programs, gender-sensitive financing models, and sector-specific support to optimize SME profitability and sustainable growth in Dili.

Table 3. T and P Values for the Direct Effect Hypothesis Test

	First sample (O)	Sample mean (M)	Standard deviation (STDEV)	T statistics ((O/STD EV))	P values	Obs.
CS -> P	0.141	0.141	0.027	5.256	0.000	Supported
CS -> FV	0.448	0.449	0.063	7.121	0.000	Supported
CS -> RM	0.212	0.215	0.059	3.610	0.000	Supported
FV -> P	0.842	0.842	0.023	36.525	0.000	Supported
RM -> P	-0.029	-0.029	0.027	1.065	0.287	Not Supported

The findings support H2, showing that capital structure positively and significantly influences firm value among SMEs in Dili, with a statistical value of 7.121 exceeding the 1.96 threshold and a significance level below 0.05. Strategic use of debt enables SMEs to reduce their Weighted Average Cost of Capital (WACC), facilitating reinvestment, business expansion, and long-term value creation, consistent with Modigliani and Miller's theory that having debt has more advantages than disadvantages when capital structure is optimized. Managerial characteristics, including age, education, and gender distribution, influence risk tolerance and financial decision-making, while sector-specific financing needs shape the choice between both immediate and long-term debt. These observations emphasize the significance of tailored financial literacy programs, gender-sensitive financing approaches, and sector-specific solutions to enhance firm value. The results align with prior research emphasizing balanced debt financing and effective capital structure management for sustainable SME growth (Hirdinis, 2019; Fajriani et.al 2023; Driffield & Temouri, 2018; Kusumajaya, 2011).

The findings support H3, demonstrating that capital structure significantly enhances risk management among SMEs in Dili, with a statistical value of 3.610 exceeding the 1.96 threshold and a significance level below 0.05. Optimizing the balance between debt and equity enables SMEs to mitigate financial risks while fostering growth and resilience, aligning with prior research emphasizing capital structure's role in reducing risk and ensuring business continuity (Baranoff et al., 2007; Jordan et al., 1998; Wiwattanakantang, 1999). While debt financing facilitates rapid expansion and reinvestment, excessive leverage can constrain access to additional capital. Sectoral financing needs and managerial risk tolerance further shape financial strategies, highlighting the importance of tailored interventions such as advanced financial literacy programs, gender-sensitive financing models, and sector-specific support to strengthen profitability, resilience, and sustainable growth in Dili's SME sector.

The results support Hypothesis 4 (H4), indicating that firm value significantly enhances the profitability of SMEs in Dili, as evidenced by a statistical value of 36.525, exceeding the 1.96 as the crucial threshold, with a significance level of less than 0.05. Higher firm value facilitates improved access to financing,

strengthens market positioning, enhances operational efficiency, and informs strategic decision-making, creating a virtuous cycle whereby increased profitability further reinforces firm value and drives sustainable growth. For SMEs that rely on debt financing, a strong firm value enables more favorable borrowing conditions and supports reinvestment for business expansion, despite challenges associated with high-interest obligations. Sector-specific financing requirements, particularly in retail and food service industries, underscore the importance of tailored economical solutions. These results align with prior research highlighting the critical relationship between firm value and profitability for long-term business success (Sucuahi & Cambarahan, 2016; Hamidah & Umdiana, 2017; Suffah & Riduwan, 2016; Tiska, 2015) and emphasize the need for financial literacy programs, gender-sensitive financing models, and sector-specific support mechanisms to optimize SME growth.

The findings for H5 indicate that risk management has a negative but statistically insignificant effect on profitability among SMEs in Dili, with a statistical value of 1.065 (below the 1.96 threshold) and a significance level exceeding 0.287. Although risk management is critical for minimizing potential losses and ensuring regulatory compliance, an excessive focus on risk avoidance may constrain innovation, limit market expansion, and restrict new product development. This focus can divert resources away from growth-oriented initiatives without yielding substantial improvements in profitability. Despite the potential risks, SMEs that rely on debt financing continue to pursue expansion, reflecting a tension between cautious financial management and growth objectives. These results are consistent with prior studies highlighting the trade-offs between risk mitigation and profitability (Suganya & Kengatharan, 2018; Gadzo, Kportorgbi, & Gatsi, 2019) and emphasize the need for targeted interventions that balance effective risk management with strategies supporting sustainable growth and financial performance.

The results strongly support Hypothesis 6 (H6), indicating that capital structure has a beneficial impact on profitability with a t-value of 7.320 and a p-value of 0.05 show that firm value acts as a mediator in SMEs in Dili. Optimizing capital structure enhances profitability by leveraging firm value, which facilitates the translation of structural advantages into financial gains. Sales growth further amplifies this effect by reflecting effective

business strategies, achieving economies of scale, and signaling future profitability. These findings align with prior

Table 4. Mediation Effects (Particular Indirect Effects)

	Original sample (O)	Sample mean (M)	Standard deviation (STDEV)	T statistics ( O/STDEV)	P values	Obs.
CS-> FV-> P	0.377	0.377	0.051	7.320	0.000	Supported
CS-> RM-> P	-0.006	-0.006	0,007	0.933	0.351	Not Supported

studies demonstrating firm value's function as a mediator between capital structure and profitability (Tui et al., 2017; Cambarian & Sucuahi, 2016). SMEs frequently use debt funding to support their quick expansion and reinvestment, despite challenges such as high-interest obligations and limited future capital access, while sector-specific dynamics influence financing needs. The results underscore the importance of tailored financial literacy programs, gender-sensitive financing models, and sector-specific support to optimize profitability and growth, and suggest that further research should investigate the long-term sustainability of SMEs and how institutional support affects business development.

The findings for Hypothesis H7 show that capital structure does not considerably influence profitability through risk management in SMEs in Dili, as evidenced by the t-statistic of 0.933 and a p-score greater than 0.05, implying that risk management does not mediate this relationship. While essential for long-term sustainability, risk management can impose high implementation costs and foster risk-averse decision-making, potentially reducing profitability by limiting investment opportunities, innovation, and focus on operational efficiency or product development. These findings are consistent with earlier studies highlighting the potential drawbacks of excessive risk management (Gadzo, Kportorgbi, & Gatsi, 2019; Suganya & Kengatharan, 2018; Kengatharan, 2018). SMEs in Dili continue to rely on debt financing to support growth despite associated risks, including high-interest obligations and constrained future capital access, emphasizing the need for balanced strategies. Targeted financial literacy programs, gender-sensitive financing models, and sector-specific support are crucial for optimizing profitability and fostering sustainable SME growth in the region.

## 6. Discussion

The findings demonstrate that capital structure decisions significantly shape profitability outcomes among SMEs in Dili, Timor-Leste, and these patterns can be interpreted through established theoretical perspectives. SMEs' strong reliance on debt financing (average score 4.11) reflects behavior aligned with the trade-off argument, which proposes that corporations balance the tax benefits of debt with the potential risks of financial trouble. When borrowing costs remain below expected returns, debt becomes a mechanism for profit enhancement, as supported by Habibniya et al. (2022) and Singh and Bagga (2019). The favorable and considerable impact of capital structure on business value (average score 4.07) further aligns with

pecking order theory and agency cost theory, given that SMEs often prefer debt over external equity to maintain ownership control and reduce agency conflicts, consistent with findings by Hirdinis (2019) and Mehzabin et al. (2023). Profitability also reinforces firm value, as demonstrated by Sucuahi and Cambarian (2016) and Hamidah and Umdiana (2017), because effective cost management, pricing strategies, and resource allocation strengthen stakeholder confidence and market presence.

The study also finds a positive correlation between capital structure and risk management (risk management score 4.10), which is compatible with Enterprise Risk Management (ERM) concepts. Companies that implement comprehensive financial oversight, such as cash flow monitoring and contingency planning, are better positioned to mitigate liquidity risks and improve access to external financing, echoing the conclusions of Baha et al. (2023) and Tahir (2020). However, the negative and statistically insignificant association between risk management and profitability indicates that overly conservative or compliance-driven practices may diminish innovation capacity, increase operating costs, and reduce flexibility—findings consistent with Gadzo et al. (2019). Mediation analysis further reveals that firm value, rather than risk management, serves as the primary conduit through which capital structure enhances profitability, highlighting the greater short-term financial influence of market confidence and valuation effects compared to internal control mechanisms.

Collectively, these findings reinforce the contextual relevance of the theories of agency cost, pecking order, and trade-off in explaining SME financial behavior within a developing economy, while illustrating the limitations of the theorem Modigliani–Miller in environments characterized by credit constraints, taxation effects, and institutional inefficiencies. The study also yields important policy and practical implications for Timor-Leste. Policymakers should expand SME access to affordable credit, strengthen financial education initiatives, and promote diversified financing instruments to support more effective capital structure decisions. At the firm level, SMEs must balance their use of debt with risk management frameworks that safeguard financial stability without impeding innovation or competitiveness. Such combined efforts will enhance SME sustainability and contribute to broader economic development across Timor-Leste.

## 7. Conclusion and Recommendation

This inquiry concludes capital structure, which is a critical determinant of the financial performance also strategic positioning of SMEs in Dili, Timor-Leste. By demonstrating that firms achieve higher profitability when they balance internal financing with prudent debt utilization, the research reinforces the applicability using the notions of trade-off and pecking order in the context of developing economies. Moreover, the findings highlight firm value as a key mechanism through which capital structure decisions translate into enhanced profitability, whereas conventional risk management practices-if excessively conservative-may constrain innovation and limit the ability of SMEs to convert financial discipline into tangible performance gains. This distinction provides a valuable conceptual contribution by differentiating the roles of value creation and risk control in SME financial management.

The study also offers significant practical and policy implications. Enhancing financial literacy, improving access to structured credit, and promoting gender-sensitive and sector-specific financing initiatives can empower SMEs to make informed and growth-oriented decisions. For practitioners, adopting risk management strategies that foster strategic flexibility, rather than strictly enforcing compliance, can support innovation and opportunity-seeking while maintaining financial stability. Finally, the research identifies several avenues for future inquiry, including the long-term impact of capital structure decisions in emerging markets, the influence of digital financial tools and regulatory reforms, and comparative or longitudinal studies to further elucidate how SMEs can optimally align financing strategies with evolving economic and institutional contexts.

## 8. Recommendation

According to the results, a number of practical recommendations include proposed to be improve a financial management out of SMEs in the Dili, focusing on capital structure, profitability, and risk management.

First, SMEs should strive to balance debt financing with effective risk management. While leveraging debt is crucial for business growth, it is important to adopt flexible risk management strategies that encourage innovation and opportunity-seeking without undermining financial stability. Proactive risk mitigation-rather than avoidance can enable SMEs to capitalize on profitable ventures while managing potential downsides.

Second, tailored financial literacy programs should be developed to meet the diverse needs of SME owners and managers. These programs ought to consider factors such as age, sector, and educational background, and cover a broad range of financing options including debt, equity, and grants, as well as practical risk management techniques. Offering accessible training and resources will empower SMEs to make informed financial decisions.

Third, promoting gender-sensitive financing models is essential to ensure equitable capital access for all entrepreneurs. Policymakers and financial institutions should support initiatives such as microfinance schemes, mentorship programs, and networking opportunities designed specifically for women,

helping to reduce barriers and foster greater gender equity in the SME sector.

Fourth, sector-specific financial support mechanisms should be established help deal with the particular difficulties SMEs encounter different industries, like retail and food services. Customized training, funding programs, and advisory services tailored to each sector's characteristics can enhance profitability and sustainable growth.

Finally, SMEs are encouraged to cultivate a balanced approach to risk management by integrating it seamlessly into their strategic decision-making. Fostering a culture of calculated risk-taking will allow businesses to remain competitive and seize growth opportunities while maintaining financial health.

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