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ORIGINAL RESEARCH

Determinants of Firm Value in Frontier Markets: Evidence from a Panel Oprobit Analysis in Sri Lanka

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Abstract

This study explores the firm-level determinants of firm value in the context of a frontier market, using a panel dataset of 222 companies listed on the Colombo Stock Exchange from 2013 to 2024. Employing panel probit and ordered probit models, the analysis examines how capital structure, investment decisions, profitability, firm size, and sector classification influence firm value, measured across three distinct valuation tiers. The results reveal that the debt-to-equity ratio positively impacts firm value, especially during transitions from low to medium categories, supporting the relevance of the Trade-Off Theory. Profitability and firm size are also found to significantly increase the probability of achieving higher firm valuations. However, the price-to-earnings ratio displays negligible predictive power in this context. Sectoral analysis indicates that non-financial firms demonstrate stronger valuation potential than financial firms, likely due to reduced regulatory constraints and greater strategic flexibility. These findings contribute to the limited empirical literature on frontier markets by highlighting key drivers of corporate value and providing comparative insights. The study offers practical implications for policymakers, investors, and corporate managers aiming to enhance firm value through financial structure optimisation, strategic growth initiatives, and regulatory improvements that promote market confidence and transparency.

Keywords Firm value · Capital structure · Profitability · Panel oprobit model · Colombo stock exchange

Extended author information available on the last page of the article

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1 Introduction

Understanding the factors that influence firm value has become a core focus of recent research in corporate finance, especially in frontier markets. Today, the characteristics that determine the drivers of firm value are crucial for the long-term sustainability of companies. Firm value combines internal metrics such as profitability and size with external forces, including sector-specific regulations and market structures (Hidayat et al., 2025; Tubastuvi et al., 2024; Wanigasekara et al., 2024). Over the past few years, institutional investors have emphasised long-term value creation over short-term earnings, further demonstrating the strategic importance of firm value (Aggarwal & Padhan, 2017; La Porta et al., 2000). In 2018, Sri Lanka introduced developments focusing on transparency and liberalisation of the economy, but execution remained weak and inconsistent (US Department of State, 2018). However, by 2023, structural improvements under the International Monetary Fund-supported program and anti-corruption efforts marked progress; nonetheless, unpredictability and weak institutional enforcement affected investor confidence and long-term firm value (US Department of State, 2023). The importance of transparency and governance in capital markets directly links them to firm value, enhancing investor confidence. Sri Lanka's capital market similarly requires deeper investor education and structural reforms to unlock firm value potential sustainably (CFA, 2025; Premathiratne, 2021). Therefore, firm value is a strategic tool for investors, managers, and regulators to evaluate a firm's ability to convert its operational strength into stable economic value (Bon & Hartoko, 2022; Syamsudin et al., 2020). Finally, firm value emerges as a strategic reflection of how well companies align their internal strengths with shifting institutional, market, and investor dynamics.

The Sri Lankan equity market has grown by 22.7% over the past twelve months, with earnings forecast to expand at an impressive 57% annually, reflecting improved investor confidence and highlighting the impact of market valuation trends on firm value dynamics in frontier markets (Simply Wall Street, 2025). The volatility in frontier markets signals businesses to prioritise searching for optimal solutions between funding options and operational and investment levels (Antwi et al., 2012; Ebaid, 2009). Firm value often reacts to macroeconomic events, regulatory policies, or foreign investment dynamics in these markets (Nguyen & Nguyen, 2020). Consequently, it serves as an anticipator of a firm's resilience and adaptability (Salim & Yadav, 2012). In such unpredictable settings, where valuation models can be complex to apply consistently, price-to-book-value (PBV) emerges as a preferred measure due to its simplicity, transparency, and ability to reflect shifts in market sentiment. Market participants estimate the value of companies by comparing PBV with current market prices, revealing whether a firm is overvalued or undervalued (Aggarwal & Padhan, 2017; Cheng & Tzeng, 2011). Moreover, using PBV as a reliable indicator gains empirical backing in long-term financial assessments through its evaluation alongside growth and profitability measurements (Afridi et al., 2022). These insights underscore that firm value in frontier markets is shaped by market-specific constraints and expressed through PBV, which functions as a widely adopted representation of firm value.

Various variables have been used to assess firm value, including capital structure, profitability, investment decisions, firm size, and sector classification. Marketing tools are also proven essential mechanisms firms utilise to stimulate sales and enhance market share (Velnampy & Anojan, 2014). Capital structure is a significant area in corporate finance for stakeholders and is crucial when making informed financial decisions within a firm, particularly for Sri Lanka, a developing country (Kasthury & Anandasayanan, 2019; Perera & Gunadeera, 2015; Tharmila & Arulvel, 2013; Thayaraj & Jayawardhana, 2021; Yogendrarajah & Thanabalasingam, 2011). Investment prospects are vital to a firm's corporate finance and indicate its future growth, essential for forecasting shareholders' wealth (Nazar, 2021b). Profitability is also a key indicator of operational efficiency and internal resource consumption; higher profitability attracts investor confidence, improves wealth, and supports long-term valuation stability (Syamsudin et al., 2020; Velnampy & Pratheepkanth, 2010). Firm size, often represented by market capitalisation (MCAP), is typically linked to its ability to attract investor attention and secure external financing due to its stability and scale advantages (Demsetz & Lehn, 1985; Fama & French, 1992). Finally, sector association, particularly the distinction between financial and non-financial firms, has been shown to moderate how firm characteristics influence firm value, considering differences in regulatory structures, risk exposure, and capital intensity (Chandrasiri et al., 2021; Wanigasekara et al., 2024). In Sri Lanka, the financial sector is least preferred by investors, who are trading close to its 3-year average valuation of 5.7 times earnings, reflecting relatively quiet expectations.

In contrast, the non-financial sector, particularly renewable energy, shows stronger momentum, highlighting how sector-specific dynamics can shape firm value differently in frontier markets (Simply Wall Street, 2025). Sectoral differences play a moderating role in the relationship between firm characteristics and value (Ajanthan, 2013). When examined collectively, these variables yield core firm-level characteristics that shape firm value in frontier markets.

The study aims to systematically examine the influence of capital structure, investment decisions, firm size, profitability, and sector classification on firm value in Sri Lanka using panel probit and oprobit models. This research provides novelty and gravity in four impactful ways, positioning it as a significant contribution to the evolving literature on firm value within frontier markets. First, while existing studies mainly focus on the influence of capital structure, firm size, investment decisions, or profitability in isolation or pairs, this study is among the first to integrate all these variables systematically within the Sri Lankan context using a panel oprobit model, thereby offering a multi-dimensional perspective on how firm characteristics shape classifications of firm value.

Second, unlike prior literature that often treats firm value as a continuous or binary outcome, we introduce a three-tiered ordinal framework (low, medium, and high firm value) to reflect the more refined stages observed in real market evaluations. This methodological shift allows for assertive interpretation and tailored implications for firms across their value range.

Third, although sector-specific studies exist, few have openly compared the behaviour of financial and non-financial firms within a combined modelling framework. Our study addresses this gap by incorporating sector association directly into

the model, uncovering structural differences in how capital and investment decisions shape firm value across financial and non-financial sectors.

Fourth, the study goes beyond theoretical alignment by providing actionable insights for policymakers and corporate decision-makers, demonstrating how debt management, profitability, and firm size can be strategically leveraged to support firms' movement across valuation tiers.

Finally, the study responds to the rising call in the literature for context-sensitive modelling strategies that account for the institutional and informational realities of frontier markets like Sri Lanka rather than relying on generalised frameworks developed in more advanced economies. These contributions offer a grounded and methodologically progressive advancement to corporate finance research in frontier markets.

The succeeding parts of this paper are organised as follows: Sect. 2 reviews relevant literature, Sect. 3 outlines the methodology, Sect. 4 presents results and discusses them, and Sect. 5 concludes with key insights and implications.

2 Literature Review

This segment outlines the core variables examined in this study: capital structure, profitability, firm size, investment decisions, and sectoral classification, as well as their collective influence on firm value. The objective of the literature review is to critically examine past research on these determinants, highlighting both the depth of individual variable exploration and the limited attention given to their dual effects, especially in Sri Lanka. The literature search process followed a structured approach involving four stages: identification, screening, eligibility, and inclusion. Articles were sourced from multiple academic databases, searching for combinations of 'firm value,' 'capital structure,' 'profitability,' 'firm size,' 'investment decisions,' 'sector comparison,' 'Sri Lanka,' and 'panel oprobit.' Fig. 1 illustrates the rising research interest in these related variables from 1999 to 2025, reflecting an increasing academic focus. The stacked bar chart displays the number of publications from 1999 to 2025 for each variable. Publications on capital structure and profitability have remarkably increased after 2010, whereas firm value and size have acquired much focus in recent years, particularly from 2021 to 2024.

Figure 2 displays contributions around the globe. Studies have been conducted for the six key variables in South Asia, especially in countries like Sri Lanka and Indonesia. The pie charts show the distribution of the studies on the variables in different countries.

2.1 Capital Structure

The effect of capital structure on firm value has evolved through foundational theories to diverse empirical evidence across frontier markets; it represents one of the critical aspects in showing the importance of firm capacity to meet its stakeholders and avoid the adverse effects of excessive debt (Ali, 2024; Leon, 2013). In Bangladesh's manufacturing sector, it was found that a high debt-equity (DE) ratio significantly weakens

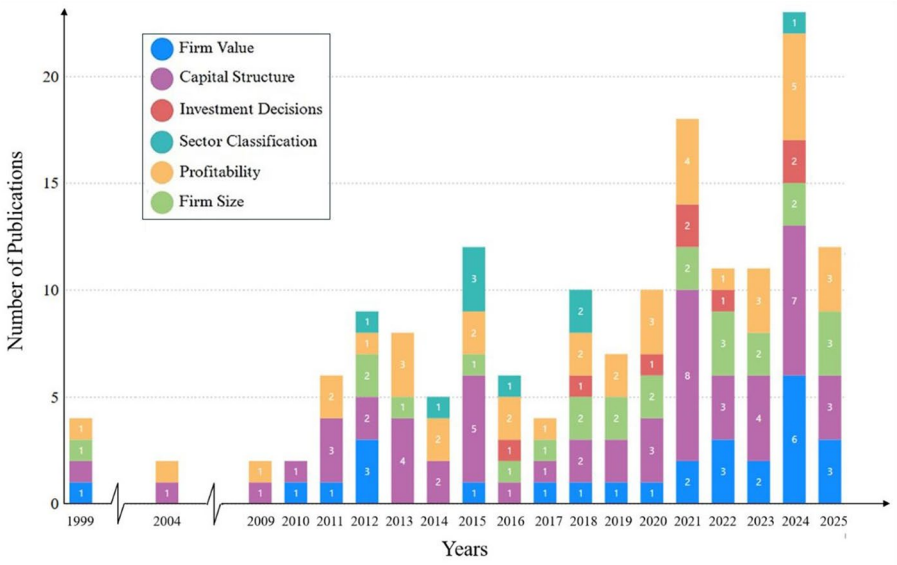

Fig. 1 Number of publications by year for each of the variables. Source: Authors' compilation from the literature survey

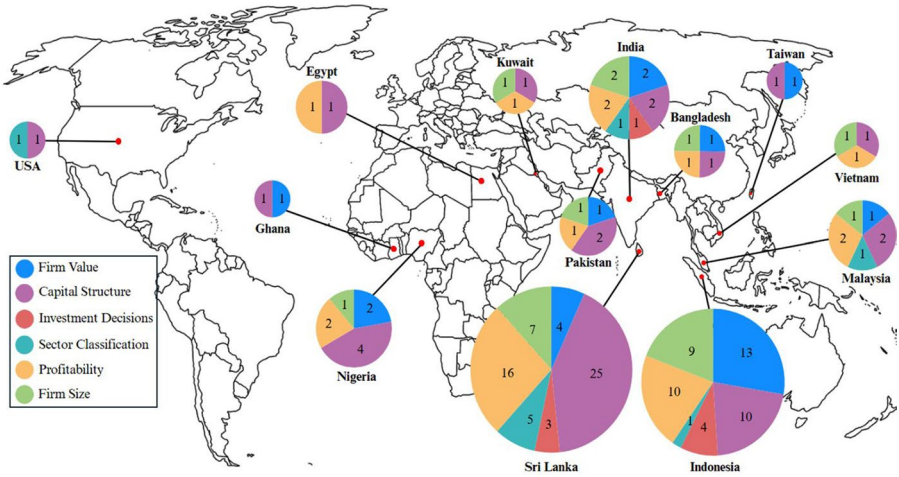

Fig. 2 Number of publications by research country context for each variable. Source: Authors' compilations from the literature survey

firm value (Biplob, 2025). Similarly, a negative impact from high capital structure on firm value has been reported, and some note a mediator role (Handini & Susilo, 2025; Hidayat et al., 2025; Mazumdar & Mara, 2024). However, studies from other regions propose a different outcome: finding a positive impact on firm value in countries such as Nigeria, Vietnam, and Ghana (Akanji & Kehinde, 2024; Antwi et al.,

2012; Nguyen & Nguyen, 2020). Similar effects have been observed in Indian and Indonesian non-financial firms (Sharma & Nathani, 2018; Syamsudin et al., 2020). In Nigeria, it was observed that short-term debt improves firm value (Ronic & Amadi, 2021). However, in Kuwait, long-term debt was reduced (Gharaibeh & Sarea, 2015). However, some findings indicate that leverage had no significant effect on firm value (Ramadhani & Wahjudi, 2024). These global findings show that although the impact of debt on firm value is widely studied, the outcomes are mixed and often depend on the economic structures and industry dynamics of specific countries.

Capital structure is one of the critical areas in finance, particularly in Sri Lanka (Amjath & Sufeera, 2021; Sithy Safeena, 2014). Some studies identify an indirect positive relationship between leverage and firm value (Premkanth et al., 2015). However, the manufacturing sector in Sri Lanka implies that moderate debt use increases shareholder wealth (Priya et al., 2015). Despite these findings, some studies highlight a preference for internal financing, consistent with the Pecking Order Theory (Pratheepan & Banda, 2016; Yogendrarajah & Thusyanthi, 2013). However, more recent research in Sri Lanka provides weak evidence for the Pecking Order and Trade-Off models (Kalainathan & Kengatharan, 2022).

Furthermore, improving capital structure has been confirmed to maximise firm value (Sivathaasan & Rathika, 2013). Although these findings differ, recent literature leans towards a positive relationship between moderate leverage and firm value, particularly when strategically managed, which enables firms to make informed financing decisions that align with their strategic objectives, optimise their capital structure, and boost their market valuation. Although extensive literature exists on capital structure and firm value in global and Sri Lankan contexts, the impact of capital structure across different firm value categories is rarely explored. This shows a critical research gap in the Sri Lankan context.

2.2 Investment Decisions

Investment decisions are a critical determinant of firm value, yet the literature remains limited, and existing literature reveals mixed evidence. Investment decisions are the most influential factor affecting firm value in Indonesia's food and beverage sector (Zaldi et al., 2024). Similarly, in the LQ45 index non-financial sector, these decisions significantly positively affect firm value (Syamsudin et al., 2020). However, other studies find that the price-to-earnings (PE) ratio has no statistically significant effect on firm value in Indonesia (Bon & Hartoko, 2022; Tubastuvi et al., 2024). Earlier theoretical work has likewise questioned the analytical power of investment decision metrics like the PE ratio, suggesting that these measures may reflect investor confidence more than actual firm value (Cheng & Tzeng, 2011; Fama & French, 1992). These global findings show that although investment decisions are often considered essential drivers of firm value, their quantifiable impact is frequently debated, and the validity remains unpredictable across firms.

In the Sri Lankan context, similar evidence has been found. Strategic alignment between investment scale and financial structure is considered essential (Nazar, 2021a). Supporting this, studies have shown that firms employing complex evaluation methods tend to have higher firm value, indicating a value-aware approach (Prem-

kanth et al., 2015; Swarnapali & Rajapakse, 2016). Evidence shows that investment decisions may not directly impact firm value but influence it through strategic capital allocation. This is due to investment decisions often involving long-term projects, and their impact on firm value is mediated by how effectively the capital is allocated, the level of risk, and market expectations. This implies that PE should be interpreted cautiously, especially in frontier markets where its reliability as a standalone valuation metric may be limited. However, despite these contributions, prevailing research rarely identifies how investment decisions influence firm value across diverse valuation categories, such as low, medium, or high value firms, which leaves a notable gap.

2.3 Profitability

Profitability has consistently emerged as a key determinant of firm value across global financial literature, primarily due to its ability to reflect a firm's efficiency in transforming resources into returns. International studies reveal strong positive relationships between profitability, measured as Return on Assets (ROA), and firm value. This relationship has been observed across Nigerian and Indonesian firms, particularly within Indonesia's food and beverage sector (Ayange et al., 2021; Hidayat et al., 2025; Ramadhani & Wahjudi, 2024; Syamsudin et al., 2020). This pattern is also found in Taiwan, confirming that ROA significantly influences firm value in Asia (Cheng & Tzeng, 2011). Also, profitability is crucial in improving firm value (Saputri & Bahri, 2021). However, some study results show that profitability does not significantly impact the firm value in Indonesia's food and beverage sector (Handini & Susilo, 2025). These findings confirm the demand for profitability as a fundamental driver of firm value, especially in global markets. Despite this global consistency, profitability's impact is not always direct, particularly in markets where valuation metrics are sensitive to investor confidence and external macroeconomic shifts.

Within the Sri Lankan context, researchers have observed a similar pattern. For instance, a significant relationship between profitability and firm value has been identified in Sri Lankan firms (Tharsika & Pratheepkanth, 2023). Early empirical evidence also supports the positive relationship between firm value (Premkanth et al., 2015; Velnampy & Pratheepkanth, 2010). ROA is commonly applied in both global and local studies due to its ability to capture efficiency and a firm's capacity to generate returns from its assets. These findings suggest that profitability, irrespective of the measure applied, is a dependable and vital driver of firm value across global and Sri Lankan firms. However, there remains limited literature that directly investigates how profitability influences firm value in Sri Lanka, especially when considering different categories of firm value, which shows a critical gap in both the Sri Lankan and global context.

2.4 Firm Size

Firm size has long been associated with firm value in financial literature, mainly due to its influence on operational efficiency, market visibility, governance strength, and investor confidence. In empirical research, MCAP and total assets commonly serve as proxies for measuring firm size. For instance, in Indonesian banking companies,

firm size has been found to significantly and positively affect firm value (Boenyamin & Santioso, 2023). However, studies have reported no significant impact of firm size on firm value (Handini & Susilo, 2025; Ramadhani & Wahjudi, 2024)in Indonesia's food and beverage sector. In that sector, firm size instead showed a significantly positive effect on corporate reputation (Daromes et al., 2022). Similarly, in Pakistan, large-cap firms have been shown to experience greater investor trust and earnings stability, as reflected in higher PBV (Afridi et al., 2022). However, the relationship between firm size and firm value varies across sectors; the global literature suggests that larger firms commonly profit from more substantial investor confidence, better governance instruments, and greater market credibility, which often enhance firm value.

However, there is an apparent absence of literature in the Sri Lankan context that directly examines the relationship between firm size and firm value. This represents a significant empirical gap, particularly in the study of frontier markets, where firm size may signal not only operational scale but also a firm's stability and investor confidence.

2.5 Non-Financial and Financial Sectors

Sectoral classification plays a vital role in understanding the firm value, as regulatory constraints and flexibility differ significantly between financial and non-financial firms. Empirical evidence suggests that the influence of financial indicators on firm value can vary by sector. For instance, sector classification has been found to moderate the impact of financial metrics on firm value in Indonesian companies (Bon & Hartoko, 2022; Tubastuvi et al., 2024). In Vietnam, more substantial capital structure effects have been observed in non-financial firms, whereas financial firms remain more constrained by regulations (Nguyen & Nguyen, 2020). A similar pattern appears in Malaysia, where firm value is driven more by profitability and size in non-financial firms (Salim & Yadav, 2012). Additionally, some studies note that capital structure has a limited impact on firm value in the financial sector due to regulatory rigidity (Ebaid, 2009). These global findings support the notion that sectoral context meaningfully changes how financial variables impact firm value, making it crucial to distinguish between financial and non-financial firms.

In the Sri Lankan context, similar patterns are observed. For instance, the impact of financial variables on firm value has been shown to differ across Sri Lankan industries (Wanigasekara et al., 2024). In the banking sector, high debt and profitability have been linked to reductions in firm value (Chandrasiri et al., 2021; Sivalingam & Kengatharan, 2018). Similarly, the effects of limited capital structure on financial firms have been attributed to regulatory constraints (Samarakoon, 1999). Theoretical perspectives also contain mixed results. One study underscores the importance of the Pecking Order Theory for Sri Lankan financial firms while noting limited support for trade-off and agency cost theories; however, another observes that these firms generally prefer internal financing, which is consistent with Pecking Order assumptions (Abeysekara, 2020; Kengatharan, 2023). Therefore, sectoral differences are vital for firm value because they shape investor expectations and impact the financial firms where regulatory, structural, and growth dynamics vary across sectors. These find-

ings stress the need to treat financial and non-financial firms separately when understanding firm value. However, there remains a noticeable gap in the literature on discovering how these sector dynamics impact different firm value categories.

2.6 Theoretical Framework

This study builds its theoretical foundation by tracing the evolution of finance theories, from classical models to contemporary frameworks, to explain how firm-level decisions on capital structure, investment choices, profitability, and firm size impact firm value. This section reviews the development of Modigliani and Miller's Irrelevance Theory, Trade-Off Theory, Agency Theory, Pecking Order Theory, Signalling Theory, Fama-French Framework, and Contingency and Institutional theories over time.

The Capital Structure Irrelevance Theory, developed in 1958, serves as the classical starting point. It argues that capital structure decisions do not affect firm value (Modigliani & Miller, 1958)in a world of perfect markets. More realistic frameworks later challenged this proposition, laying the foundation for more practical theories.

Trade-Off theory was introduced as a response to the Irrelevance Theory, which provided a balance between tax shields and bankruptcy costs while acknowledging real-world frictions(Kraus & Litzenberger, 1973). It proposes that firms aim to balance the tax benefits of debt with the potential costs of financial distress, offering a broader perspective on how capital structure influences value.

Agency Theory connects firm value with managerial behaviour, capital utilisation, and agency costs (Jensen & Meckling, 1976). It emphasises how conflicts between owners and managers can impact the efficient use of capital and, ultimately, firm valuation.

The Pecking Order Theory, developed in the mid-1980s, highlights firms' preference for internal financing, making profitability a key determinant of firm value (Myers & Majluf, 1984). This establishes profitability as a critical determinant of firm value, especially in limited disclosure markets.

Signalling Theory suggests that decisions like issuing debt or maintaining a high PE ratio communicate confidence or caution to the market (Fama & French, 1992). It has also been argued that characteristics like firm size and profitability are efficiently priced by the market, with larger firms often receiving valuation premiums.

Finally, Contingency Theory and Institutional Theory emphasise the role of external context, such as sectoral differences, institutional structures, and regulatory environments, in shaping financial decisions and their outcomes (DiMaggio & Powell, 1983). These frameworks recognise that value creation is not uniform but varies across organisational and environmental settings.

These theoretical perspectives emphasise value creation's multidimensional and contextual nature, which is visually captured in Fig. 3. This framework demonstrates how capital structure, profitability, investment decisions, sectoral classification, and firm size, shaped by the foundational theories, relate to determining firm value. It represents a mixture of traditional and modern finance, contributing a comprehensive visualisation to examine firm value in varying regulatory and market environments.

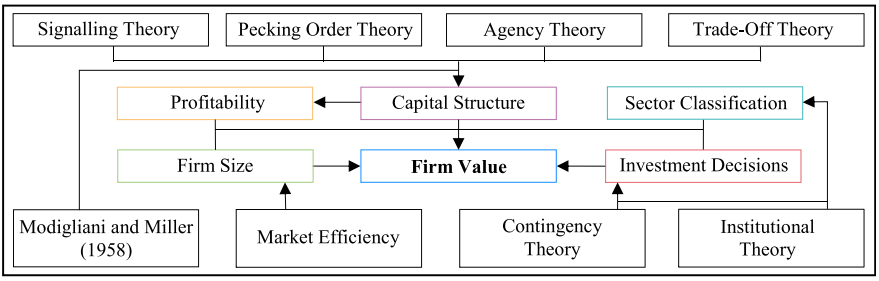

Fig. 3 Theoretical framework of the study. Source: Authors' compilation using the literature

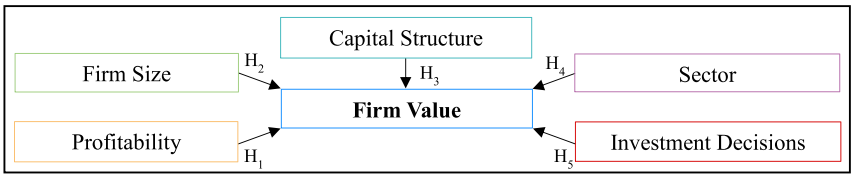

Fig. 4 Conceptual framework of the study. Source: Authors' compilation using the literature

The conceptual framework was established to bridge the existing gap in literature knowledge, as illustrated in Fig. 4. This model was developed with a combination of five main hypotheses. These predictive variables have been identified as critical factors that influence firm values in frontier markets.

The study estimates the likelihood of capital structure, investment decisions, firm size, profitability, and sector classification on firm value through empirical testing using panel probit models. The research derives the first four hypotheses primarily from the existing empirical literature, which collectively aims to analyse their combined impact on firm value (Syamsudin et al., 2020; Tubastuvi et al., 2024). Prior journal-based studies, such as the effect of capital structure, investment decisions, firm size, and profitability, were explained to support these relationships (Chen et al., 2002; Demsetz & Lehn, 1985; Fama & French, 1992; Myers & Majluf, 1984). The final hypothesis of this research introduces a novel standpoint by investigating the distinctive behaviour of firm value when considering financial and non-financial sectors. This contrasts with earlier research that focuses on financial firms (Chen et al., 2002; Demsetz & Lehn, 1985; Fama & French, 1992; Krishnamurthy & Vissing-Jorgensen, 2015). The final hypothesis of this research introduces a novel standpoint by investigating the distinctive behaviour of firm value when considering financial and non-financial sectors. This contrasts with earlier research that focuses on financial firms (Krishnamurthy & Vissing-Jorgensen, 2015; Pandey, 2004). The following five main hypotheses have been developed per the research framework.

H_1: $\beta_1 \neq 0$.
There is a significant impact between profitability and the probability of firm value.
H_{1a}: There is a significant impact between profitability and the probability of observing a high firm value.

H_{1b}: There is a significant impact between profitability and the probability of observing a medium firm value.

H_{1c}: There is a significant impact between profitability and the probability of observing a low firm value.

H_2: $\boldsymbol{\beta_2 \neq 0}$.

There is a significant impact between firm size and the probability of firm value.

H_{2a}: There is a significant impact between firm size and the probability of observing a high firm value.

H_{2b}: There is a significant impact between firm size and the probability of observing a medium firm value.

H_{2c}: There is a significant impact between firm size and the probability of observing a low firm value.

H_3: $\boldsymbol{\beta_3 \neq 0}$.

There is a significant impact between capital structure and the probability of firm value.

H_{3a}: There is a significant impact between capital structure and the probability of observing a high firm value.

H_{3b}: There is a significant impact between capital structure and the probability of observing a medium firm value.

H_{3c}: There is a significant impact between capital structure and the probability of observing a low firm value.

H_4: $\boldsymbol{\beta_4 \neq 0}$.

There is a significant impact between the non-financial sector and the probability of firm value.

H_{4a}: There is a significant impact between the non-financial sector and the probability of observing a high firm value.

H_{4b}: There is a significant impact between the non-financial sector and the probability of observing a medium firm value.

H_{4c}: There is a significant impact between the non-financial sector and the probability of observing a low firm value.

H_5: $\boldsymbol{\beta_5 \neq 0}$.

There is a significant impact between investment decisions and the probability of firm value.

H_{5a}: There is a significant impact between investment decisions and the probability of observing a high firm value.

H_{5b}: There is a significant impact between investment decisions and the probability of observing a medium firm value.

H_{5c}: There is a significant impact between investment decisions and the probability of observing a low firm value.

To empirically test the above hypotheses, the study employs a structured quantitative methodology aiming to capture the impact on firm value within CSE listed firms.

3 Methodology

3.1 Data

This study utilises secondary panel data from the interim financial statements of 222 companies listed on the CSE, covering the period from the fourth quarter of 4 (Q4 2013) to the third quarter of 2024 (Q3 2024). The target population comprised 280 firms listed on the CSE as of January 16, 2025. The financial statements used in this study were obtained from the official CSE website. The data collected were channelled and analysed using STATA 17. A purposive sampling method was employed to refine the dataset, ensuring that only firms with sufficient data were included in the analysis. Two key exclusion criteria were applied: firms with missing financial data for the entire period, and those that consistently had missing values throughout the observation period were excluded. After implementing these selection criteria, the final sample comprised 222 companies, representing approximately 79% of the total listed firms on the CSE.

Table 1 summarises the operational definitions and computation formulas of all variables used in the analysis. These definitions ensure consistency in measurement and enhance the replicability of the study's results. To maintain accuracy and consis-

Table 1 Definitions and equations of all the independent and dependent variables

Variable	Definition	Equation
Firm Value PBV	The ratio of the stock price to the book value per share.	$PBV\ ratio = \frac{\text{LP}}{\text{Book Value Per Share}}$ Where LP = Last Price
Capital Structure DE ratio	Total debt divided by total shareholders' equity.	$Total\ Debt - to - Total\ Equity = \frac{\text{STD+LTD}}{\text{Shareholders}'\ \text{Equity}} \times 100$ Where STD = Short Term Debt LTD = Long Term Debt
Investment Decisions PE ratio	Ratio of the price of stock and the company's Earnings Per Share (EPS).	Where T12 = Trailing 12 months
Firm Size Ln MCAP	Total value of a company's outstanding shares of stock.	*MCAP = IQ*LP* Where IQ = Issued Quantity (Shares outstanding)
Sector	1 if non-financial and 0 otherwise	
Profitability ROA	Indicator of how profitable a company is relative to its total assets, in percentage. ROA gives an idea as to how efficient management is at using its assets to generate earnings.	Industrials, Banks, Financials, Utilities $ROA = \frac{T12\ NI}{Average\ TA} \times 100$ Where NI = Net Income TA = Total Assets Insurance $ROA = \frac{T12\ NI + T12\ Policyholders'\ Surplus}{Average\ TA} \times 100$

Source: Authors' compilation using data from CSE (2025)

tency in financial analysis, the study relies on book values for computing key financial ratios, minimising discrepancies that could arise from data inconsistencies.

3.2 Method

As this study proposes to estimate the likelihood of a firm having high or low value based on capital structure, investment decisions, firm size, profitability, and sector, the panel probit model would be appropriate. The Probit model is an estimation technique for equations with dummy dependent variables that avoids the unboundedness problem of the linear probability model by using a variant of the cumulative normal distribution (Gankandage & Jayathilaka, 2025; Jayathilaka & Keembiyahetti, 2009). The panel probit model extends the standard probit model to unobserved heterogeneity across individuals, which is a statistical technique employed to analyse binary outcome variables within panel data structures, where observations are collected from multiple individuals over several periods (Widyangga et al., 2024). General specification of the panel probit model is given by,

$$Y_{it}^{*} = X_{it}\beta + u_i + v_{it},\ i = 1,2,\ \ldots\ ,\ N;\ t = 1,2,\ \ldots\ ,\ T \tag{1}$$

Where Y_{it}^{*} is the latent response variable of ith individual at t^{th} time, $X_{it} = (1\ X_{1it}\ X_{2it}\ \ldots\ X_{pit})$ is the vector of predictor variables at i^{th} unit of cross-section and t^{th} unit of time, $\beta = (\beta_0, \beta_1, \ldots, \beta_p)'$ is the parameter vector, u_i is the random effect of the ith unit of cross-section which is assumed to be identically independent distributed (iid). $N(0, \sigma_u^2)$, and v_{it} is the random error of the ith unit of cross-section and t^{th} unit of time which is assumed to be distributed $N(0,1)$, which is independent of u_i.

The observed binary response variable Y_{it} is derived as 1 if Y_{it}^{*} >0 and 0 otherwise. Based on Eq. (1), the success probability of the response variable is obtained Y_{it}^{*} is as follows,

$$P(Y_{it} = 1 | u_i, X_{it}) = \Phi\ (X_{it}\beta + u_i) \tag{2}$$

where Φ(.) represents the cumulative distribution function of the standard normal distribution.

The dependent variable is a panel dummy variable, taking the value of 1 if the firm has a high and 0 otherwise as follows:

Group 1 (PBV= 0): Low=Value of PBV less than or equal to 0.7330 (Median).

Group 2 (PBV= 1): High=Value of PBV greater than 0.7330 (Median).

Thus, the model to be estimated is,

$$(PBV = 0,1) = \Phi\,(\beta_0 + \beta_1 ROA + \beta_2 Ln\,MCAP + \beta_3 DE + \beta_4 Sector + \beta_5 PE + u_i) \tag{3}$$

where,

β_0 is the intercept term.

ROA denotes return on assets, representing profitability.

$Ln\ MCAP$ is the natural logarithm of MCAP, representing firm size.

DE is the debt-to-equity ratio, capturing the capital structure.

$Sector$ is a dummy variable, taking 1 for non-financial firms and 0 for financial firms.

PE ratio represents the price-to-earnings, indicating investment decisions.

While the initial analysis employs a binary framework to classify firms as high or low value, such a classification may overlook the varying degrees of PBV within the dataset. To address this limitation, the study extends the analysis using a panel oprobit model, which is appropriate for dependent variables that are ordinal in nature with more than two categories (Jayathilaka et al., 2015; Jayathilaka & Udara, 2024; Weerasena & Jayathilaka, 2023). The panel oprobit model generalises the standard probit model to the case of more than two outcomes of an ordinal dependent variable.

The selection of the panel oprobit model is further supported by several key advantages. Firstly, it is an appropriate method to analyse ordinal data with or without equal spacing between categories, allowing more accurate classification of PBV data (Jayathilaka & Udara, 2024). Following it, the interpretable coefficients show how each independent variable affects the likelihood of the dependent variable moving from one category to another, enabling a better understanding of the influence of the predictors on the data (Jayathilaka & Udara, 2024; Kalansuriya & Jayathilaka, 2025). Subsequently, the model provides several goodness-of-fit measures, allowing for an unambiguous assessment of the fitting of the data (Jayathilaka & Udara, 2024). Finally, the model controls unobserved heterogeneity that varies across units but remains time invariant, enhancing the parameter estimates' consistency and efficiency (Baltagi, 2021).

Accordingly, PBV is divided into three categories as follows:

Group 1 ($PBV = 1$): Low = Value of PBV less than or equal to 1.

Group 2 ($PBV = 2$): Medium = Value of PBV greater than 1 and less than or equal to 5.

Group 3 ($PBV = 3$): High = Value of PBV greater than 5.

The attached Appendix 1 provides a categorised frequency distribution derived from designating the PBV of firms for both the panel probit and panel oprobit models, offering deeper insights into category prevalence.

The general form of the panel oprobit model is specified as,

$$Y_{it}^{*} = X_{it}\beta + u_i + v_{it}\; i = 1,2, \ldots, N;\; t = 1,2, \ldots, T \tag{4}$$

where all variables are as defined in Eq. (1). The observed ordinal outcome Y_{it} is determined based on the following threshold structure:

$$Y_{it} = \begin{cases} 1, & if\ Y_{it}^{*} < \tau_1 \\ 2, & if\ \tau\, 1 < Y_{it}^{*} \leq \tau_2 \\ 3, & if\ Y_{it}^{*} > \tau_2 \end{cases} \tag{5}$$

where τ_1 and τ_2 are threshold parameters to be estimated, determining the cut-off points between the levels of Y_{it}. Accordingly, the probability of each outcome is expressed as,

$$P\left(Y_{it}=1|u_i,X_{it}\right)=\Phi\ \left(\tau_1-X_{it}\beta\ -u_i\right) \tag{6}$$

$$P\left(Y_{it}=2|u_i,X_{it}\right)=\Phi\ \left(\tau_2-X_{it}\beta\ -u_i\right)-\Phi\ \left(\tau_1-X_{it}\beta\ -u_i\right) \tag{7}$$

$$P\left(Y_{it}=3|u_i,X_{it}\right)=1-\Phi\ \left(\tau_2-X_{it}\beta\ -u_i\right) \tag{8}$$

The following panel oprobit model has been developed by detailing the general equation:

$$(PBV=1{,}2{,}3)=\Phi\left(\beta_{\,0}+\beta_{\,1}ROA+\beta_{\,2}Ln\,MCAP+\beta_{\,3}DE+\beta_{\,4}Sector+\ \beta_{\,5}PE+u_i\right. \tag{9}$$

The marginal effects of the explanatory variables, obtained from the estimates of the panel oprobit model, measure the impact of changes in each variable on the likelihood of a firm falling into each specific category of PBV. Both the above selected models were subjected to a forward stepwise method to derive the final model. The overall structure of the study's methodology is illustrated in Fig. 5, which outlines the sequential flow from data collection and categorisation to model estimation and result interpretation which indicates the flow of overall research through each phase and step.

4 Results and Discussions

4.1 Results

This section summarises and encloses the results of the empirical study, examining the multifaceted role of determinants of firm value, based on five formulated hypotheses. The study begins with preliminary insights through a comparison of descriptive statistics for financial and non-financial firms, as represented in Table 2.

The comparison carried out in terms of the sectoral division reveals that, generally, non-financial firms have higher mean values in PBV, PE, and ROA, suggesting comparatively attractive market valuation and profitability. However, financial firms report a higher mean for DE and Ln MCAP, attributed to greater leverage and firm size. When assessing the coefficient of variation (CV), the financial sector shows lower variability across most variables, implying steady performance. In contrast, non-financial firms demonstrate high variability in CV, suggesting wider fluctuations, likely due to their operational multiplicity and exposure to sector-specific alarms.

Figure 6 depicts the combination of violin and box plots for all the dependent and independent variables considered in the study. Figure 6(a) shows the distribution of the Ln MCAP, which forms a multimodal structure, suggesting that firms exhibit distinct size groups. Figure 6(b) corresponds to the PBV, displaying a peak with a wider lower spread, indicating that while most firms have lower PBV, some have significantly higher values. About Fig. 6(c), the DE illustrates a highly skewed distribution. Lower DE values have a high density, suggesting that most firms have relatively low DE. Figure 6(d) displays the ROA distribution, which is relatively balanced, implying that most firms have similar profitability levels, while some carry

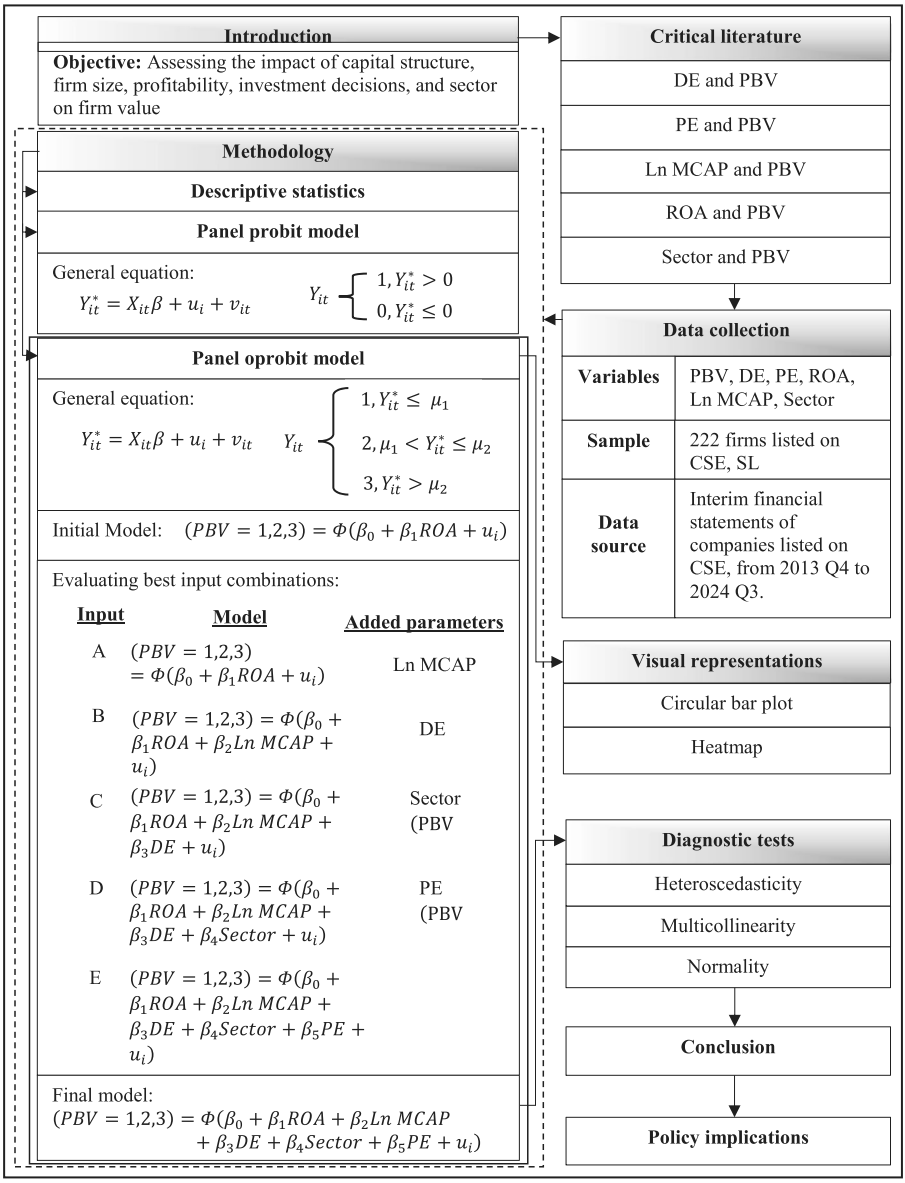

Fig. 5 Overview of the workflow of the study. Source: Authors' compilation based on literature and methodology

extreme values. Finally, Fig. 6(e) shows PE, which is symmetrically distributed with a broader spread, indicating variation in PE. The violin and box plots provide insight into the dispersion and distributional characteristics of the financial variables analysed in the study.

To assess the strength and direction of linear relationships among the study variables, Fig. 7 presents the correlation matrix. The matrix is colour-coded, with shades

Table 2 Descriptive statistics of variables for financial and non-financial firms

Variable	Mean	SD	CV	Min	Max	Obs
Financial Firms						
PBV	0.8246	0.5437	0.6593	0.0264	4.1618	2,156
PE	8.4988	19.6343	2.3102	−261.1111	336.6713	
DE	112.5783	123.036	1.0929	0.0000	782.3201	
Ln MCAP	9.7084	0.6491	0.0669	8.1249	11.4693	
ROA	2.2236	3.4402	1.5471	−17.5084	24.6436	
Non-Financial Firms						
PBV	1.2606	2.2735	1.8035	−16.851	35.3169	7,612
PE	10.4335	18.2032	1.7447	−131.4815	268.165	
DE	58.7188	129.1357	2.1992	−1,935.3888	3,414.71	
Ln MCAP	9.4489	0.6874	0.0727	7.4858	11.4294	
ROA	4.7156	8.3580	1.7724	−47.4177	68.1648	

Source: Authors' calculations based on data

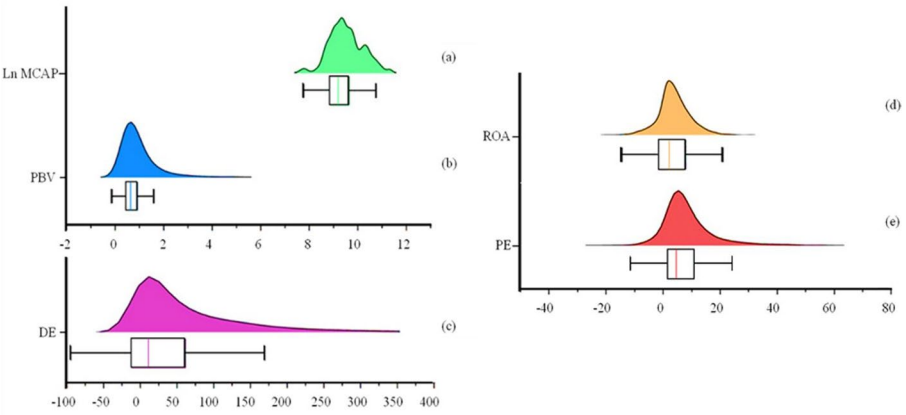

Fig. 6 Violin plots of the variables. Source: Authors' compilation based on data

of blue and red indicating the strength and direction of the correlations. Dark blue and red represent stronger correlations, while lighter shades indicate weaker correlations. The circles within the matrix reflect the strength of the correlation, with the colour intensity representing the degree of correlation. The significant correlations are highlighted with a black border. Figure 7 shows a significant but weak positive correlation between PBV and PE, DE, and ROA. This suggests that a higher PBV may result from stronger profitability, greater leverage, or growth expectations. Investors may perceive firms with higher ROA or moderate DE as having sufficient earnings potential to support both valuation and debt commitments, reinforcing market confidence.

4.2 Panel Probit Model

The hypotheses are empirically tested using a panel probit model, the results of which are detailed in Table 3. More insights into the model, are represented in Appendix 2

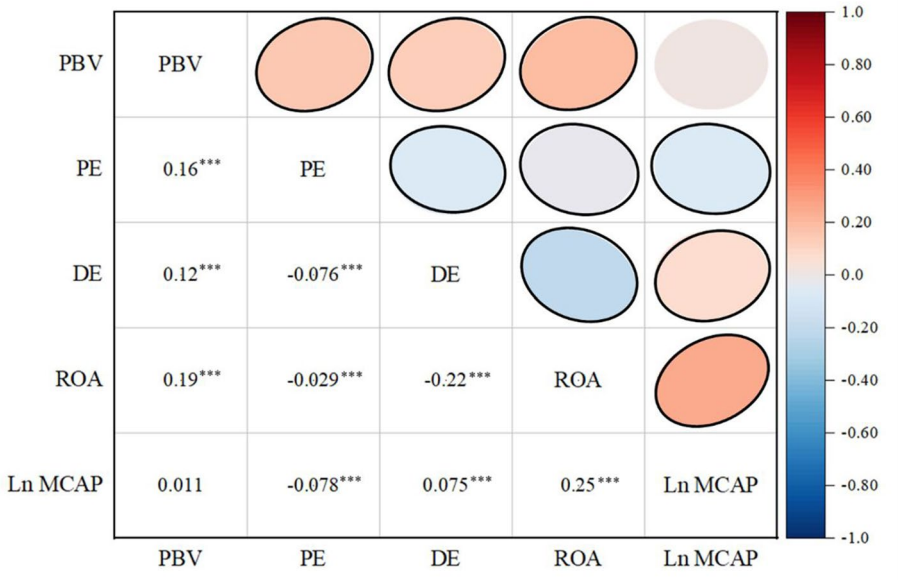

Fig. 7 Correlation matrix of the variables. Note: *** represents the 1% significance level. Source: Authors' illustration based on data.

Table 3 Panel probit model estimated results with marginal effects

Variable	Estimate	Robust SE	Marginal effect
Constant	−17.7512***	2.2749	
DE	0.0012**	0.0006	0.0177**
PE	0.0051	0.0036	0.0732
Ln MCAP	1.7777***	0.3819	25.6617***
ROA	0.0394***	0.0076	0.5687***
Sector	0.8825**	0.3819	12.6864**
Area under ROC	0.5861		
Wald chi^2	101.5300		
Log-pseudo likelihood	−3,804.3044		
No of obs	9,768		

*** and ** represent 1% and 5% significance level respectively

Source: Authors' compilation based on analysis results

where the forward stepwise panel probit results examined the determinants of firm value.

Hypothesis 1 states that profitability has a significant impact on firm value. Coefficients indicate that when ROA increases, firm value also increases at a considerable level. A 1% increase in ROA increases the probability of the firm having high value roughly by 0.57% points, keeping all other variables constant. This study aligns with the empirical studies which show that profitability is a crucial element in determining firm value (Cheng & Tzeng, 2011; Hidayat et al., 2025; Sunday & John, 2024). Companies with higher profitability are likely to generate cash flows, which inspires investor confidence and enhances firm value. This relationship between profitability

and firm value is particularly evident in capital-intensive companies, where efficient asset utilisation (reflected in high ROA) is critical to maintain competitive benefit.

Hypothesis 2 suggests a significant impact of firm size and firm value. The coefficients indicate that when Ln MCAP increases, firm value also increases significantly. The probability of a firm having a high value increases by approximately 25.66% points when the Ln MCAP changes by a 1% rise, assuming all other factors are held constant. This implies that equities are traded more frequently and in larger amounts on the capital market in large companies, attracting more investors. The significant and positive influence indicates that firm size can predict and explain the increase in profitability (Afridi et al., 2022; Hirdinis, 2019). Larger companies often have better access to financial markets, allowing them to secure funding under more favourable conditions (Nuraina, 2012).

Hypothesis 3 suggests a significant impact of capital structure on firm value. Coefficients indicate that when DE increases, the corresponding firm with a higher value will experience a considerable increase. A 1% increase in DE raises the probability of achieving a higher firm value by 0.02% points, holding all other variables constant. These results align with empirical studies, highlighting the significant role of DE on financial performance and investor confidence (Akanji & Kehinde, 2024; Nguyen & Nguyen, 2020; Sharma & Nathani, 2018; Syamsudin et al., 2020). As discussed earlier, the Trade-Off Theory provides theoretical evidence for this relationship, indicating that firms reach an optimal capital structure when the marginal benefit of debt (tax shield) equals its marginal cost (financial distress) (Kraus & Litzenberger, 1973). Businesses can leverage growth prospects, maximise their cost of capital, and enhance market value with a well-designed capital structure. These findings underscore the strategic importance of capital structure in driving long-term firm value and ensuring financial stability.

According to hypothesis 4, the non-financial sector has a significant impact on the probability of firm value. Coefficients indicate that when a company is in the non-financial sector, its corresponding firm value will increase significantly. Suppose a firm belongs to the non-financial sector. In that case, the probability of having a high firm value increases by approximately 12.69% points compared to firms in the financial industry when all other variables are constant. Empirical evidence conveys how the impact of economic variables on firm value differs across industrial sectors (Tubastuvi et al., 2024; Wanigasekara et al., 2024). According to the Pecking Order Theory, non-financial firms depend more on internal financing (such as RE) than external financing (debt or equity issuance). This allows them to avoid the costs of external capital, contributing to a more stable capital structure and enhancing firm value over time. Non-financial companies are also more likely to reinvest profits due to their greater reliance on RE, which promotes long-run growth and increases firm value. Capital structure theory proposes that firms in the financial sector operate under different conditions of leverage and risk compared to non-financial firms, due to the regulatory frameworks they must adhere to. Severe capital requirements often affect financial firms, potentially limiting their ability to seize growth opportunities and influencing their overall market valuation effectively. In contrast, non-financial companies tend to maintain a more flexible capital structure, allowing them to capi-

talise on growth opportunities with fewer regulatory restrictions, which can enhance their business valuations (Modigliani & Miller, 1958).

Hypothesis 5 examines the significant effect of firm value on investment decisions. Coefficients indicate that when PE increases, the corresponding firm having a high value will reciprocate the change. However, in this analysis, PE was found to be statistically insignificant. This suggests that PE does not have a significant likelihood of having higher firm value. The results align with empirical studies, which concluded that investment decisions do not significantly impact firm value (Bon & Hartoko, 2022; Tubastuvi et al., 2024). Typically, allocating funds among different assets involves the ability of the investment to generate future profits. These decisions become crucial for a company's long-term sustainability, often receiving little attention from investors. As a result, the influence of investment decisions on firm value is minimal, as they have a limited impact on investors' overall assessments of a company's worth.

Receiver operating characteristic (ROC) curve analysis is a standard method for assessing the sensitivity and specificity of diagnostic procedures. Our study presents the ROC curve and classification table in Appendices 3 and 4, respectively. These are derived from the final panel probit model using the selected variables, with an area under the curve (AUC) of 0.5861.

4.3 Panel Oprobit Model

The following section discusses the marginal effects of all five hypotheses on firm value categories based on the panel oprobit model. These results are visually summarised in Fig. 8, which presents the marginal effect of each variable across low, medium, and high firm value categories. This figure illustrates the impact of independent variables on firm value, derived from the marginal effects of the panel oprobit model. Each segment represents an independent variable, while the colour-coded bars indicate their effects on firm value categories. The results in Fig. 8 are further supported by the heatmap in Fig. 9, which highlights the intensity of each effect. The heatmap is colour-coded, with shades of red and green indicating the impact among factors affecting firm value. Dark red indicates a lower impact, while darker green signifies a higher impact.

The panel oprobit model assessed the impact of capital structure, investment decisions, firm size, profitability, and sector classification on the likelihood of a firm being categorised into one of three value groups: low, medium, or high based on its PBV. The cut-off values used for classification were $PBV \leq 1$ (low), $1 < PBV \leq 5$ (medium), and $PBV > 5$ (high). To gain deeper insights into the marginal effects, Appendix 5 and Appendix 6 present the final model results and the stepwise panel oprobit analysis, which examines the determinants of firm value. The results are discussed about the five hypotheses.

Hypothesis 1 investigates the significant impact of profitability on the probability of firm value. The ROA variable was important and had the most substantial marginal effects among all predictors. A 1% increase in ROA reduces the probability of low firm value by 0.42% points. It increases the likelihood of being in medium and high value groups by 0.32 and 0.098% points, respectively. This provides strong empiri-

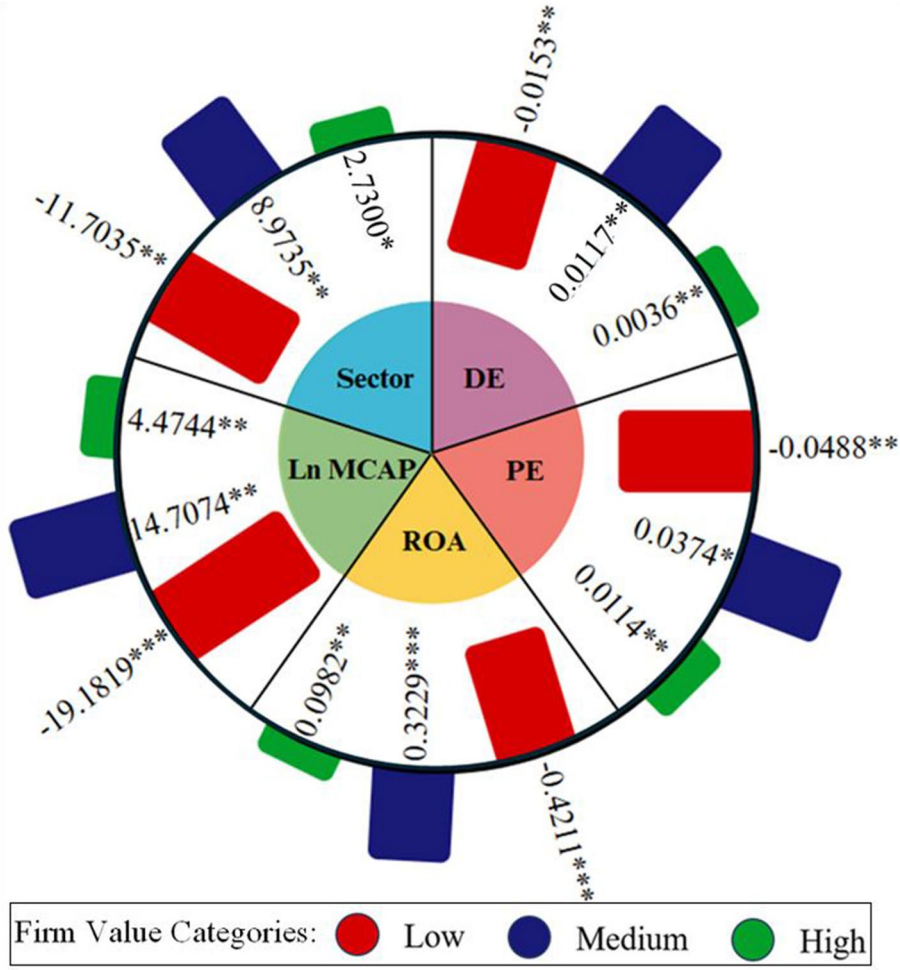

Fig. 8 Marginal effects of the final panel oprobit model. Note: *, **, and *** represent 10%, 5% and 1% significance levels respectively. Source: Authors' illustrations are based on the analysis results

cal support for hypothesis 1. Profitability has a transparent and robust influence on firm value, particularly in preventing firms from being undervalued. The results are consistent with past findings and reflect that investors greatly emphasise internal operational efficiency (Cheng & Tzeng, 2011; Syamsudin et al., 2020). Notably, the negative association with low firm value is much stronger than the positive association with high firm value, indicating that profitability is critical in shielding firms from being perceived as financially unstable.

As hypothesis 2 suggests, firm size significantly impacts the probability of firm value. The Ln MCAP was statistically substantial and demonstrated significant marginal effects. A 1% increase in Ln MCAP reduces the likelihood of low firm value by 19.18% points, increases the probability of medium firm value by 14.71% points, and increases the possibility of high firm value by 4.47% points. These results strongly

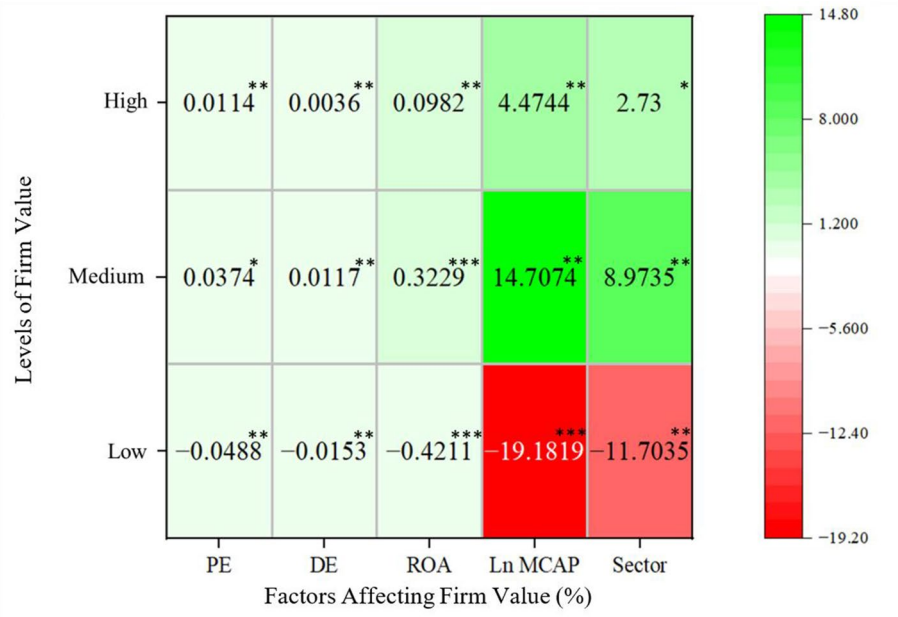

Fig. 9 Heat map for the marginal effects of panel oprobit model. Note: *, **, and *** represent 10%, 5% and 1% significance levels, respectively. Source: Authors' illustrations are based on the analysis results

support hypothesis 2 and emphasise the central role of firm size in determining firm value. Larger firms are perceived as more stable, more diversified, and better governed, and these perceptions translate into higher probabilities of being in the higher valued categories. This aligns well with international literature and confirms that size provides significant visibility and trust in the capital markets, particularly in frontier markets like Sri Lanka (Afridi et al., 2022; Hirdinis, 2019).

Hypothesis 3 states that capital structure has a significant impact on the probability of firm value. The coefficient for the DE is positive and statistically significant. A 1% increase in DE reduces the likelihood of a firm being in the low firm value category by approximately 0.02% points, while increasing the possibility of being in the medium and high firm value categories by 0.01 and 0.004% points, respectively. These results support hypothesis 3, indicating that a higher DE ratio, when managed prudently, can improve the firm's perceived value. This aligns with the Trade-Off Theory, which proposes that moderate levels of debt provide tax advantages and are viewed positively by investors. However, the effect is more substantial for transitioning from low to medium firm value, with only a modest increase in probability for the high firm value group. This suggests that while debt contributes to value creation, excessive reliance may dampen the marginal benefit as firms approach higher valuation tiers.

Hypothesis 4 states a significant relationship between the non-financial sector and the probability of firm value. The sector dummy variable (1 = non-financial, 0 = financial) is positive and statistically significant. The model shows that firms in the non-

financial sector are 11.70% points less likely to be classified as having low firm value, 8.97% points more likely to fall into the medium value group, and 2.73% points more likely to be in the high firm value group. These results support hypothesis 4, confirming that non-financial firms are likelier to achieve higher valuation than financial firms. This aligns with the Pecking Order Theory, which suggests non-financial firms rely more on internal financing and have greater flexibility in capital structure decisions. On the other hand, financial firms face regulatory restrictions (e.g., Basel III), which may constrain their ability to adjust financial strategies quickly, thus dampening their valuation potential (Ebaid, 2009; Nguyen & Nguyen, 2020).

Hypothesis 5 above examines whether investment decisions significantly impact the probability of firm value. The PE is also statistically significant, although its effect is relatively modest. A one-unit increase in PE decreases the likelihood of being in the low firm value group by 0.05% points while increasing the probabilities of medium and high firm value by 0.04 and 0.01% points, respectively. These findings lend partial support to Hypothesis 5. Although the effects are minor, they demonstrate that firms with higher PE are less likely to be undervalued and more likely to be considered as having moderate or high value. However, in contrast to classical expectations, the small magnitude suggests that investment signals may be vacillating or distorted in the frontier market of Sri Lanka. Market inefficiencies, investor short-termism, or limited financial disclosures may explain this muted relationship, although the direction is as hypothesised.

4.4 Categorisation Thresholds ($\widehat{\gamma}_1$ and $\widehat{\gamma}_2$)

The model's cut-points or thresholds used to categorise firm value were $\widehat{\gamma}_1 = 15.22$ and $\widehat{\gamma}_2 = 18.62$. This means,

- firm value ($Y^* \leq 15.22$) corresponds to low firm value,
- $15.22 < Y^* \leq 18.62$ Corresponds To Medium Firm Value, and
- $Y^* > 18.62$ corresponds to high firm value.

These thresholds enable the model to categorise the firm's value based on its characteristics probabilistically. The cut-off system ensures ordinal categorisation, a key strength of the panel probit approach, and permits richer interpretation than linear regression models, that assume continuous changes in firm value.

5 Discussions

The section analyses the industry-wide variations in firm value, showing the average predicted probabilities estimated from 2020 to 2024. Figure 9 visually represents these probabilities across different industries, considering financial and non-financial sectors. The inner colour ring represents the classification of industries into financial and non-financial categories, while the outer colour ring indicates the number of companies within each industry. Bars within each segment display the average predicted probability values for 2020 to 2024. The diagram visually compares how these

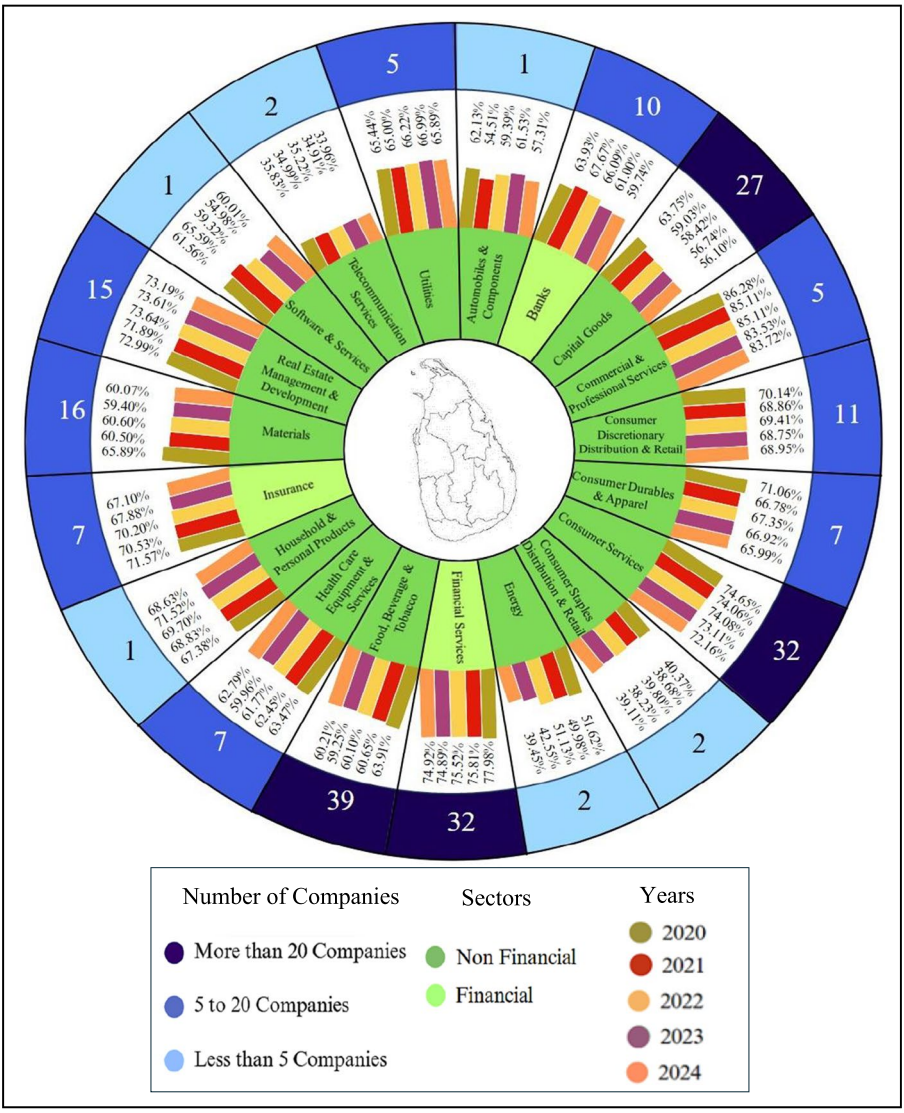

Fig. 10 Average predicted probabilities by industry (2020–2024). Source: Authors' illustrations are based on the analysis results

predicted probabilities for firm value vary across industries over the five years, highlighting performance patterns, consistency, and variation between financial and non-financial sectors. Using predicted probabilities allows a more refined understanding of how industry impacts firm value over time. By analysing these averages, patterns of stability, decline, and industry trends are identified in the Sri Lankan market.

According to Fig. 10, one of the main findings is that the percentage values of the financial industries (banks, insurance, and financial services) are consistently higher than those of the non-financial sectors. The financial services industry holds

one of the highest percentages, starting at 77.98% in 2020 and dropping marginally to 74.92% in 2024. This implies that financial services remain significant economic contributors despite slight variations.

Real estate management and development, along with commercial and professional services, are two non-financial sectors that also exhibit strong performance. Throughout the years, commercial and professional services have consistently maintained remarkably high values—in 2020, they were at 86.28%, dropping to 83.72% in 2024, which demonstrates strong stability and resilience. Similarly, real estate management and development is roughly 73%, indicating that the real estate industry is expected to grow. The industries reporting the lowest percentage values are energy and telecommunications services. Telecommunications have consistently performed poorly, starting at 35.83% in 2020 and falling to 33.96% in 2024. The sharper drops in energy, from 51.62% in 2020 to 39.45% in 2024, may be due to changes in fuel prices, economic policies, or other external disturbances.

Most industries see a minor drop in values between 2020 and 2024. This downward trend may signal industry-specific challenges, shifting market conditions, or economic slowdowns. Consumer services and real estate management and development, for example, have remained steady, suggesting that they might be more resilient to economic changes.

6 Conclusion and Policy Implications

6.1 Conclusion

The study investigates how capital structure, investment decisions, firm size, profitability, and sectoral division affect firm value, using data from firms listed on the CSE in Sri Lanka from Q4 2013 to Q3 2024. The research employed panel probit and oprobit models to categorise firms into low, medium, or high value categories. Key findings show that DE positively impacts firm value, confirming Trade-Off Theory, with debt providing greater benefits when firms move from low to medium value categories than from medium to high. The PE represents a statistically significant but modest effect on firm value, suggesting investors' scepticism about earnings transparency in Sri Lankan markets. Firm size proves essential for firm value, with larger companies typically achieving higher valuations due to perceived reliability and stability. ROA demonstrates the strongest association with firm value, as profitable firms receive better market assessments based on operational stability and growth prospects. The study also found notable differences between sectors, with non-financial firms more likely to achieve medium and high valuations than financial firms, which face regulatory constraints on capital structure flexibility. The research methodology represents an advancement over traditional models by focusing on valuation categories rather than continuous measures, improving practical application for strategic planning.

6.2 Policy Implications

The results of this study provide insightful recommendations for strengthening the financial system in Sri Lanka. Since the impact of firm value is influenced by factors such as capital structure, investment decisions, profitability, firm size, and sector, practical actions can help improve firm performance, enhance investor confidence, and support effective regulation. The implications below are categorised according to the key stakeholder groups: regulators, listed firms, and investors.

6.2.1 Policy Implications for Regulators

- Encourage financial institutions to apply risk-based lending frameworks. These approaches allow a less regulated sector to access debt aligned with its growth potential while avoiding excessive leverage that could threaten stability risks.
- Require more transparent corporate disclosures regarding investment decisions and performance outcomes. Consistent and detailed reporting will lessen information gaps, enabling more accurate valuation and regulatory oversight.
- Adjust regulations according to sector realities. Financial firms operate under strict regulations due to concerns about systemic risk, while non-financial firms often enjoy more flexibility in their capital structures and reinvestment strategies. Regulations should reflect these differences to ensure that policy enhances, rather than restricts, value creation.
- Introduce tax incentives or grant programmes for firms that reinvest their revenues in innovation, operational upgrades, and workforce development. This supports long-term competitiveness and financial resilience across sectors.

6.2.2 Policy Implications for Listed Firms

- Aim for balanced capital structures that optimise the benefits of debt without introducing excessive financial risk. Debt should be utilised strategically to support growth, particularly during the transition from low to medium firm value levels.
- Firms should prioritise efficiency and reinvestment over manipulating short-term earnings to enhance sustainable growth.
- Enhance the transparency of financial strategies, particularly concerning capital allocation. Communicating investment goals and expected returns builds investor trust and attracts long-term funding.
- Develop scaling strategies, particularly for smaller firms seeking to enhance market visibility and attract investors. Expanding the firm's size through market expansion or asset growth can positively influence its valuation.

6.2.3 Policy Implications for Investors

- Investors should not rely solely on indicators such as PE ratios, which may have limited predictive power in the Sri Lankan context. Instead, they should focus on a comprehensive assessment of fundamentals, including profitability, firm size, and capital structure.
- Incorporate sector-specific insights when assessing risk and return. Non-financial firms may offer greater flexibility and valuation upside, while financial firms provide more stable but regulated investment profiles.
- Investors should prioritise firms that consistently demonstrate reinvestment discipline, have clear strategic objectives, and exhibit strong internal performance, all aligning with long-term value creation.

6.3 Limitations of the Study and Future Research

While this study provides meaningful insights into firm value in Sri Lanka, several limitations should be acknowledged. First, the study relies on secondary data obtained from quarterly reports, which may be subject to variations in disclosure quality and reporting standards. Although careful screening procedures were applied, differences in accounting practices could affect the accuracy of the financial data used in the analysis.

Even though the quarterly reports provide timely and consistent data, they do not disclose detailed information on capital expenditures, research and development investments, or other strategic decisions regarding investments. Future research could include alternative measures of investment, such as annual capital expenditure intensity or R&D spending, to capture firms' investment decisions better. Additionally, future studies might explore machine learning modelling techniques to enhance predictive performance.

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Author contributions R.J. conceptualised the study. S.H., U.K., S.K., S.H., and R.J. contributed to the design and conduct of the study. S.H. and U.K. curated the data. S.H., U.K., S.K., and R.J. conducted the data analysis and interpreted the results. S.H., U.K., and S.K. drafted the initial manuscript. R.J. supervised the study, and S.P. co-supervised it. All authors critically reviewed, revised, and approved the final manuscript.

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Data Availability Data cannot be shared publicly because of confidentiality agreement. Data are available from the Colombo Stock Exchange, 04−01, West Block World Trade Centre, Echelon Square, Colombo 01, Sri Lanka for researchers who meet the criteria for access to confidential data.

Declarations

Competing interests The authors declare that they have no competing interests.

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