

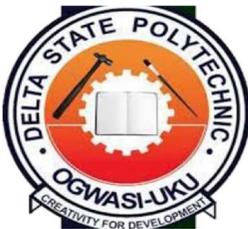


## Full Empirical Research Paper

# Capital Structure and the Performance of Financial Companies In Nigeria

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### ABSTRACT

Capital structure / base is important in the business affairs of any financial company as it is the overall source of finance used by a company in financing its operations and has been considered as one of the most important factors in firm financing policy due to its crucial role in corporate performance. The study sought to examine the capital base in relation to the performance of financial companies in Nigeria from 1980 -2018. The research design adopted was ex-post facto using four models to analyze the impact of capital structure and performance of finance companies. Descriptive statistics and regression were used as tools of analysis. The study reveals that there are statistically significant and non-significant effects of capital structure on performance variables. Finally, the study recommends that finance companies should adopt balanced capital structure strategy that will optimize the performance and corporate value of finance companies.

**Keywords:** Board Size, Board Ownership, Corporate Governance, Performance, Nigeria

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## 1. INTRODUCTION

The capital structure of a firm plays an important role in the survival of the company because it goes a long way in determining its growth, development and sustainability over time. The capital structure is comprised of all the sources of finance utilized by a company in funding its operations ranging from retained earnings to equity and debt finance. Capital structure has been considered as one of the most important factors in firms financing policy due to its crucial role in corporate performance (Gambo, Ahmad & Musa, 2016). According to Akintoye (2016), Capital structure decision is important for any business establishment arising from the need to maximize the wealth of business stakeholders and because of the fact that such decision has a significant impact on the firm's ability to compete in the competitive atmosphere (Gambo, Ahmad & Musa, 2016, Salawu, 2009). The capital structure is a framework which depicts how equity and debt are employed for financing the company's operations to yield optimum returns for the stakeholders to maximise company's returns given a level of risk (Dada & Ghazali, 2016). The performance of management is often measured in terms of profitability which reflects manager's ability to earn optimum returns on assets at their disposal over a period.

According to Owolabi and Obida (2012) performance (Profitability) is the ability of a business to make returns higher than the cost of financing their core operations to ensure the continued survival of the company. This implies that performance (profitability) is the ability of a company to make profit from its operating, investing and financing activities to maximise the values and wealth of the shareholders. Often, listed companies in the Nigerian economy found it difficult to make profit and this affects their performance which may be attributed to inadequate finance. Where the finance is available, the cost of production is often too high. (Akintoye, 2016; Lambe, 2014; Akinyomi & Olagunju, 2013; Salawu, 2009). The problem of capital structure, therefore, arises from determining the quantum of each source of finance that will yield optimum return with minimal risk. (Akintoye, 2016; Dada & Ghazali, 2016; Gambo et al., 2016).

### 1.1 Statement of the Problem

In Nigeria, research on capital structure and performance of companies is often skewed to finance companies in the economy especially banks despite their contributions to the Nigerian economy. In this modern world economy, the power of globalization has come into existence so speedily due to the fact that information and communication technology (ICT) and knowledge have become the most precious assets of the companies. Transformation into modern world of technology has necessitated the urgent need to look and find out intellectual means in a company's financial reports (Salman et al., 2012). Therefore, capital structure has been recognized as the bedrock for the achievement of organizational goals (Pulic, 1998).

An extensive recognition of capital structure as a medium of competitive advantage resulted in the new strategies of monitoring the activities needed in the company to achieve maximum productivity (Salman et al., 2012; Maditinos et al., 2011; Makki and Lodhi, 2008). Hence, old-fashioned accounting and measurement systems seem to be inappropriate and imbalanced in the new world economy where competitive advantage is driven by capital structure. This is because, old fashioned accounting does not reflect the true picture about the company and may mislead investors and other relevant stakeholders to make appropriate choices when making economic decisions (Brooking, 1996).



Due to the knowledge-based economy, all companies around the world depend heavily on capital structure to achieve the concept of going concern and increase their productivity (Ahangar, 2011). Broring and Cloutier (2008) analyse value-creation in the functional foods and nutraceutical industry in Canada. Similarly, the study of Nezakati et al. (2011) examines the Market Value Coverage in Fast Food Products Industries. In Nigeria, Ademola and Kemisola (2014) studied the effect of working capital management on market value of quoted food products and beverages manufacturing companies. However, the study related to capital structure on performance of finance companies is limited. Therefore, this study attempt to fill the aforementioned lacunas which aims at examining the impact of capital structure on performance of finance companies in Nigeria.

From the above, it is apparent that the exact effect of capital structure and performance of finance companies is yet to be established and it is calling for further investigation within the Nigerian context. These constitute the gaps to be filled by this study. The primary objective of this study is to investigate the impact of capital structure on the performance of finance companies in Nigeria, while the specific objectives are to examine strategies aimed at achieving profitability.

## **2. LITERATURE REVIEW AND HYPOTHESES DEVELOPMENT**

Numerous definitions exist on capital structure. Nirajini and Priya (2013) define capital structure as the way in which an organisation has financed a combination of long-term capital (ordinary shares and reserves, preference shares, debentures, bank loans, convertible loan stock and so on) and short-term liabilities such as a bank overdraft and trade creditors. Also, Lambe (2014), Akinyomi and Olagunju (2013), Salawu (2009); Brealey and Myers (2003) opined that capital structure is the mix of different securities utilized by a company in financing its profitable ventures. What is common to the above definition is that capital structure reflects each component of finance from equity to debt that a company uses in financing its operations. There are numerous measures adopted by a company in achieving its financial performance and arising from this; there is lack of consensus as to the measure or variable which should be used in measuring the performance of the firm.

Different measures that can be used in measuring performance and which have been used by different authors on capital structure and performance include the return on asset, return on equity, and earnings per share. The measures are used to determine the contributions of the managers towards the growth and sustainability of the company. Performance is usually measured regarding profitability. Profitability according to Owolabi and Obida (2012) is the ability of a company to make profits from all its operations (operating, investing and financing activities). For a company to make a profit, it must be able to generate revenue more than the direct and indirect costs incurred in generating the revenue. The wealth maximisation of shareholders is the ability of a company to witness growth and stable dividend payment or capital gain arising from appreciation in the market value of the company's shares. The shareholder's wealth is very important as it determines the investment decisions of the shareholders and as such proper attention should be paid to it by management (Olowe, 2018).



## 2.1 Empirical Review

Empirical review entails and appraisal of other authors studies on a subject matter with the aim of identifying gaps and filling them appropriately. Literature is replete with capital structure and performance but has often produced conflicting findings. This section groups the literature into studies done in developed and developing countries as well as in Nigeria Empirical Evidence from Developed Countries A study by Jaworska and Nehrebecka (2015) was achieved by using correlation analysis to conclude that debt has a negative relationship with profitability. Also, a study by Iavorskyi (2013) revealed that negative relationship exists between leverage and performance in Ukraine. Fosberg and Ghosh (2006) utilised regression analysis to establish the relationship, carried out separately on America Stock Exchange (AMEX) companies and New York Stock Exchange (NYSE) companies. Results concluded that there is little or no relationship between profitability and the amount of debt in the AMEX firms' capital structure. Nonetheless, the strong negative relationship was proved to exist in the case of NYSE firms.

In Nigeria, the study of Gambo et al. (2016) was limited to debt finance by using descriptive, correlation and regression analysis and discovered that there is a statistically significant effect between long and short-term liability on Return on Assets (ROA) and Return on Equity (ROE). Similarly, a study by Odi, (2014) which employed quantitative research design and regression analysis and ordinary least square in carrying out this study. The results of the study revealed that capital structure of firms in Nigeria has a long run relationship with the growth and development of Nigerian economy.

Moreover, Study by Gambo et al. (2016) which utilized descriptive statistics, correlation and regression as analytical technique reveals that there is statistically significant effect between long and short-term liability on Return on Assets (ROA) and Return on Equity (ROE). Also, David and Olorunfemi (2010) used panel data analysis to analyse capital structure and corporate performance in Nigeria petroleum industry. They found that a positive relationship exists between earning per share and leverage ratio on the one hand and positive relationship between dividend per share and leverage ratio on the other hand.

Olokoyo (2013) examined the impact of leverage on firm's performance in Nigeria using fixed-effect estimation, random-effect estimation and a pooled regression model. The author found that all the leverage measures have a positive and highly significant relationship with the market performance measure (Tobin's Q). However, a study by Nwude, Itiri, Agbadua and Udeh (2016) revealed from the regression estimations showed that debt structure has a negative and significant impact on the performance of Nigerian quoted firms within the period under review. The findings by Oladeji, Tolulope, Ikpefan and Olokoye (2015) also conclude that a negative relationship exists between leverage and firm performance. With the above reviews, it is evident that the area of interest to this study has not been considered by scholars in this field hence the aim of this study to examine the effect of capital structure on the financial performance of firms in Nigerian manufacturing sector.



### 3. METHODOLOGY

The paper adopted the ex-post facto research design. Data were mainly from secondary sources. The secondary sources were obtained from various publications of the central bank of Nigeria. Other sources include journal articles and the internet in building the literature and empirical reviews of the study. In order to measure the relationships, the multiple regression analysis technique was adopted in the multiple regression analysis of the secondary data from 1980 - 2018. The use of multiple regression models is appropriate because the relations in view are multivariate. The aim of this multiple regression is to examine the nature of the relationship between a given dependent variable and independent variable in a regression function (Nworuh, 2001). The growth of financial institutions is assumed to be determined by several variables, the dependent variable, Capital base and the independent variables: Return on assets, Equity of company, Total dept and Market price per share, denoted by X.

With the assumption stated above, the multiple regressions can be represented as thus

$$Y = F(X) \text{ ----- 1}$$

Where

Y is the dependent variable and X are the independent variables.

This can also be represented in a non-stochastic form as:

$$CB = F(\text{ROA}, \text{EQC}, \text{TDC}, \text{MPS}) \text{ ----- 2}$$

Where;

CB = Capital Base

ROAt = Return on Assets per period of time

EQCt = Equity of Company per period of time

TDCt = Total Debt of Company per period of time

MPSt = Market Price per Share per period of time

Ut = Error Term per period of time

#### Model Specification

From the above functional form, we derive the stochastic equation as,

$$CB = \beta_0 + \beta_1 \text{ROAt} + \beta_2 \text{EQCt} + \beta_3 \text{TDCt} + \beta_4 \text{MPSt} + \text{Ut} \text{ ----- -3}$$

Econometrically, this equation can be stated in a log linear form as,

$$\text{LRGDP} = \alpha_0 + \alpha_1 \text{LAO} + \alpha_2 \text{LMO} + \alpha_3 \text{LSMO} + \alpha_4 \text{LSO} + \text{Ut} \text{ --- 4}$$

Where;

U= stochastic error term

$\alpha_0, \alpha_1, \alpha_2, \alpha_3, \alpha_4$  = Parameter estimates

LAO = Log of Agrictural output

LMO = Log of Manufacturing Output

LPOR = Poverty Reduction

LSO = Log of Service Output



## 4. RESULTS AND DISCUSSIONS

### 4.1 Unit Root Test

**Table 1: Unit Root test by performing Augmented Dickey Fuller (ADF)**

Variables	ADF	1%	5%	Order of Integration	Significant
D(LogCB)	-3.229346	-3.639407	-2.951125	1	1%
D(LogEPS)	-5.721801	-3.639407	-2.951125	1	1%
D(LogEQC)	-5.091045	-3.639407	-2.951125	1	1%
D(LogDC)	-5.059929	-3.653730	-2.957110	2	1%
D(LogMPS)	-8.420482	-3.646342	-2.954021	2	1%
D(ECT)					

Source: E-view Computation Result

From Table 1, the log of Capital Base, log of Return on Assets, log Equity of company, were stationary at first difference while log of Total Debt and Market Price per Share are stationary at second difference. This shows that the model is integrated at order I (1) and I (2).

### 4.2 Co-Integration Test

Co-integration helps to identify the degree to which two variables are sensitive to the same average price over a specific period of time. Co-integration is the existence of long run relationship between two or more variables.

Hypothesized No. of CE (s)	Eigen value	Trace Statistics	0.05 Critical value	Prob.**
None *	0.6 00852	81.28607	69.81889	0.0046
At most 1	0.497532	50.05970	47.85613	0.0306
At most 2	0.411713	26.66009	29.79707	0.1102
At most 3	0.176510	8.621716	15.49471	0.4015
At most 4	0.057648	2.018800	3.841466	0.1554

Source: Eview Computation Result

The trace statistic is greater than the critical in "None" and at most. This shows the absence of co integration at 5% level of significance. Trace test indicates only 1 co integrating equations at 5% level which is at None. Thus, there is long run relationship between LCB, LROA, LEQC, LTDC and LMPS



### 4.3 Error Correction Modelling

**Table 3: Result of Error Correction Model**

Variables	Coefficient	Standard error	T-statistics	Prob
D ROA	0.146186	0.044368	3.294850	0.0026
D EQC	0.132667	0.029827	4.447849	0.0001
D TDC	0.011664	0.023836	0.489345	0.6283
D MPS	0.562053	0.89856	6.255040	0.0000
E C T (-1)	-0.751217	0.136227	-5.512419	0.0000

**Source:** Eview software result

R-squared 0.862954

Adjusted R – square 0.839326

Durbin – Watson Stat 1.631129

From Table 3, ECM is negative and falls between 0 and 1.

E C M = -0.751217ie 75% of disequilibrium can be corrected within a year.

R<sup>2</sup> is the co-efficient of determination of fit among the variables.

It explains the variation in the dependent variable that has been explained by the independent variables. From the model, Adjusted R<sup>2</sup> is 83%.

It explained that 83% of changes in Capital Base, which is accounted for by Return on Assets, Equity of Company, Total Debt, Market Price Per Share.

From the regression result, the co efficient of ROA, EQC, TDC, and MPS are 0.146186, 0.132667, 0.011664 and 0.562033 which conforms to our apriori expectation.

## 5. DISCUSSION OF FINDINGS

The study examines the significant of Capital structure and performance of financial companies in Nigeria. In achieving the objective of the study, OLS methods involving Error corrector Term was adopted in testing the time series properties, the evidence from estimated performance model suggests that all the variables examined are stationary at 1<sup>st</sup> and 2<sup>nd</sup> difference using Augmented Dickey fuller (ADF). Johansen co-integration test reveals that the variables are co-integrated which conforms the existence of long run equilibrium relationship between the variables. The study reveals that Capital Base of the financial companies determines their performance.



## 6. CONCLUSION

From this study, it has been established that capital structure/base is vital to the performance of finance companies in Nigeria. Entities are more interested in the cost associated with their various sources of finance used by a company in financing its operations and has been considered as one of the most important factors in firm financing policy due to its crucial role in corporate performance. It is with that that the study examined the effect of capital structure /base on the financial performance of finance companies in Nigerian financial sector.

## 7. RECOMMENDATIONS

What follows are recommendations based on findings from the research

1. Caution should be exercised in concluding differences in company structure and other factors that are not captured by this study may affect the position of each company.
2. External factors like the quality of Human Resources, environmental factors, organisational structure and operational procedures which affect the profitability of the firm should be giving more preference.



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