Capital Structure and the Performance of Quoted Companies in Nigeria

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Abstract:
The research work was designed to evaluate capital structure and the performance of quoted companies in Nigeria. The focus was to identify the relationship that exists between capital structure and performance indices such as the net profit margin, return on assets and return on equity. The theoretical component of the study attempted to evaluate the major contending theories of capital structure with the purpose of finding the best empirical explanation for corporate financing choice of a cross section of 94 Nigerian quoted companies. The result showed that Capital mix has a significant relationship with the earnings per share of quoted firms in Nigeria. Debt equity ratio has a significant positive impact on the return on assets of quoted companies in Nigeria and debt asset ratio has a significant inverse relationship with the return on assets of quoted companies in Nigeria. Also debt equity ratio has a significant inverse impact on the return on equity of quoted companies in Nigeria and debt asset ratio has a significant positive impact on return on equity of quoted companies in Nigeria. Quoted companies in Nigeria should invest their profits when there are good investment opportunities and pay cash dividend as soon as enough income is generated.
Keyword: *Earnings per share, Return on equity, return on assets, Debt stock, Debt/asset ratio*

INTRODUCTION

The overall objective of any firm in a contemporary business environment is for the owners' wealth to be maximized. In other words, the business must obtain and effectively appropriate the available funds efficiently for the smooth operation of the business. The effective raising and management of funds is central to the firm's finance function. It covers therefore every concerned functions geared towards obtaining and effectively managing every financial resource in order to achieve the goals of the business firm (Akinsulire, 2014). Financing decision is one of the three core decision areas in financial management which involves the identification of the appropriate sources of funds that would be used to finance projects.

According to Pandy (2010), the decision regarding capital structure should be viewed from the point of its effect on the firm's value. He noted that under favorable economic conditions, the earning per share of a firm should increase with financial leverage. However, the increase in leverage is expected to increase also shareholders' financial risk but it is uncertain if this will result to increased value of the firm or not. Over the decades, the associations between the firm's value and decisions on capital structure have been investigated extensively. According to Desai (2007), two effects are associated with capital structure; first, firms that belong to the same category are likely to have higher leverage and cost of capital. Lastly, the value of the firm may be affected by capital structure, with firms with more leverage being riskier and valued lower than firms that are less leveraged. If capital structure is considered not irrelevant, then the association between investment and financing is considered.

In a bit to distinguish between the impacts of various capital structure determinants, the assumption holds that, investment decision is constant. The factors that affect capital structure determinants of a firm can be viewed in four different forms: the asymmetric information approach, the agency approach, and approach to stakeholders' claims upon the firm's resources and product/input market competition and corporate dispute control (Pandy, 2010). Nonetheless, a firm contemplating to raise funds through the issue of debt must ensure that the earnings to be generated with such funds must at least be equal to the cost of debt. If the earnings that are generated falls below the cost of such funds, it will reduce the earnings due to shareholders because holders of debt instruments have prior claims to income before the equity holders. This reduction in earnings of the shareholders will lead to a drop in the market value of the equity stocks (Adesola 2011).

What should be the optimum capital structure as well as the factors that influence firms in making their capital structure decision has been a source of major debate among finance scholars for years now. Series of theories have been developed on the subject. Nevertheless, no singular consensus has been reached. Several attempts have been made to discover which of the theories best reflects the financing decision of firms. For instance, Frank and Goyal (2003) reflect such investigations in Europe, USA and Asian data respectively. In Nigeria, attempts have being made to research in this field as seen in the works of Odedokun (1995), Eboh (2004), Adesola(2011), Akintoye (2008), Onadopo & Kokoto (2010) and many others.

Ultimately shareholders want to maximize their expected utility. To realize the desired results, quoted firms in Nigeria and even in other countries need to plan for an optimum capital structure. This is because it is the optimum capital structure that maximizes the value of the firm. However, despite the efforts made by financial managers to maximize owners' expected value in terms of their financing decisions, there remains a problem on how best these expected utilities can be attained optimally. The determination of an optimum capital structure is a formidable task. This is the case because, while

theories may provide guidelines on the best way to go about optimum capital structure determination, factors such as the nature of business, market and economic conditions, industries' specifics, shareholders' preference, etc. play a very key role.

It is in the light of the above concerns, the central aim of the study is to examine the association between capital structure and the performance of quoted companies in Nigeria. Other specific objectives of the study are to:

i. Ascertain the relationship that exists between capital mix and the quoted companies' earnings per shares in Nigeria.
ii. Investigate the effect of debt asset ratio and debt/equity ratio on the quoted companies' return of assets in Nigeria.
iii. Examine the impact of debt asset ratio and debt/equity ratio on the quoted companies' return of equity in Nigeria.

LITERATURE REVIEW

Theoretical framework

The pecking order theory is the theoretical underpinning on which this study is rooted. This became necessary due to the fact that available literature has shown no evidence of the application and the testing of the theory among studies in Nigeria. This theory was first developed by Donaldson in 1961 but got adapted in 1984 by Myers and Majluf with some adjustments. The theory holds that firms' financing follows the laws of least effort or resistance (from internal financing to equity), hence, equity financing is regarded as the "last resort" to the firm. Hitherto, internal funds are first exhausted, then debt is considered and equity is finally issued.

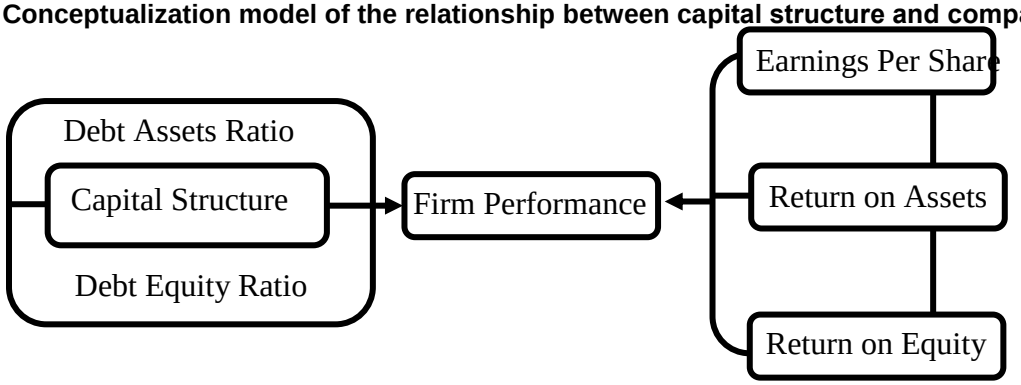
Further insight into the pecking order theory argued that, firms adhere to financial hierarchy sources; and would prefer internal financing options to external, and would also prefer debt financing over equity when considering external financing. The perception of the theory is that a firm's manager is exposed to certain critical information regarding the firm more than the investors. This disparity in information availability is known as asymmetric information. In a normal circumstance, to pay creditors their principal and fixed interest amount implies that the firm' expectation of cash flow's is steady.

Conceptual framework

The capital structure of a company reveals the various finance sources a company is employing to finance its activities. It mirrors the firm's approach in financing its activities comprising of equity capital, preference share capital, debt capital and retained funds. If these sources of finance are appropriately maintained in their right proportions, the firm's weighted average cost of capital will be constant (Akinsulire, 2014). Furthermore, when the gear is low, it means that the proportion of debt to the entire capital is low. From the foregoing, it becomes obvious that the higher the gear, the more speculative the venture and hence the higher the risk exposure and vice-versa.

FIG 1.0

Conceptualization model of the relationship between capital structure and companies' performance



Source: Adopted from Kajanathan and Nimalthasan, (2013).

Corporate environment in Nigeria: An overview

With the abundance resources in Nigeria, the Nigerian economy should thrive better if the necessary economic infrastructure are put in place for economic and business activities to succeed. Unfortunately, in the Nigerian scenario, the critical economic amenities needed to drive the economy successfully are absent conspicuously. For instance, the roads are bad, poor electricity supply, unabated insecurity and unstable government policies. This situation clearly portrays the unfriendly business environment which directly or indirectly inhibits the performance of quoted companies in Nigeria. However, business growth has remained precarious in most of these states and local government areas. Obiwuru, Oluwalaiye and Okwu (2011) pinpointed the factors that inhibit business as:

i. **Technological factors**
ii. **Ecological factors**
iii. **Legal factors**
iv. **Political factors**

v. **Economic factors**
vi. **Social factors**

Review of empirical works

Several authors across the world have adopted different methodologies in an attempt to examine the association between firms capital structure and their performance. Most of these works would be reviewed as they will guide the researcher in his investigation into the research problem.

The effect of capital structure decision on the performance of firms in Egypt according to Ibrahim (2009) estimated the association between the level of leverage and the performance of firms using multiple regression technique from 1997 to 2005. The study adopted gross profit margin, return on assets and return on equity as accounting measures for financial performance. The findings from his study revealed a weak-to-no effect of capital structure decision on the performance of firms.

According to Kajanathan and Nimalthasan (2013) who investigated the association between capital structure and the performance of firms in the quoted manufacturing firms in Sri Lankan from 2008 to 2012 used net profit, return on assets, return on equity and gross profit as a firms' performance measures. The proxies adapted to measure capital structure in their study were debt assets ratio and debt equity ratio. The results from correlation and regression analysis showed that, return on assets, gross profit, return on equity and net profits were insignificantly correlated with debt equity ratio. On the other hand, gross profit margin and return on equity were statistically significant as the correlated with debt assets ratio.

Mustafa and Osama (2012) in their study of the impact of capital structure on the Jordanian firms' performance in the Amman stock market employed the ordinary least squares (OLS) technique in examining about 76 firms for the periods of 2001 to 2006. The findings revealed the presence of negative statistical relationship between capital structure and firm performance.

Muhammad, Zaighum and Muhammad (2012) examine the effect of capital structure on the financial performance of about 100 consecutive firms of Pakistan in Karachi stock exchange from 2006 and 2009. The exponential generalized regression was used in estimating relevant equation on the relationship between capital structure and the financial performance of firms. The findings emanating their study revealed that, the choice of capital structure is a critical factor in determining a firm's financial performance.

Mykhialo (2013) examined the relationship between capital structure and firm performance. Using the sample of 165 Ukrainian firms over 2001-2010 and applying the multiple regression techniques, found that the relationship existing between the leverage and firm performance was actually negative. Ahmed (2015) investigated the impact of capital structure on about 17 nonfinancial firms' performance listed in the Bahrain Bourse from 2009 to 2013. Using the OLS multiple regression technique, key macroeconomic variables (inflation rate, gross domestic product growth) on the financial performance variables (return on asset, return on equity, earnings per share, and dividend yield)). The results indicated that capital structure had a positive and significant effect on the firms' performance proxied return on equity.

Ogebe, Ogebe and Alewi (2013) investigated capital structure effect on the performance of firms in Nigeria from 2000 to 2006 employing major macroeconomic measures on the performance of firms. The study employed capital structure traditional theory in order to determine the significance of macroeconomic measures and leverage on the performance of firms. The study was a comparative analysis of firms grouped into lowly and highly geared firms using the static panel analysis. The findings from the study revealed that the study conformed to the capital structure traditional theory showing a significant but negative relationship between leverage and the performance of firms.

Ishaya and Abduljelee (2014) investigated capital structure and the profitability of listed companies in Nigeria using the agency cost theory. About 70 selected companies were chosen from the Nigerian stock exchange from 2000 to 2009 using the random effects, fixed effects and Hausman chi-square techniques. The result showed that debt capital was negatively related to profitability, but equity showed a direct relationship with profitability.

Muritala (2012) examined capital structure optimum level through a firm can enhance its financial performance. The Pesaran and Shine unit root analysis showed that the five years annual data were non-stationary at five per cent significance level. Further findings revealed that there exist a negative association between capital structure and firms' operational performance while the panel data result revealed a positive relationship between asset tangibility, size, asset turnover, age of firm and the performance of firm. Finally, a significant but negative relationship was seen between asset tangibility and the performance of the firm (ROA).

Li-Ju and Shun (2014) used pecking order theory in exploring capital structure important factors. The model of their was specified using the hierarchical regression on debt decision determinants of about 305 quoted electronic firms in Taiwan stock exchange in 2009. The findings showed that capital structure determinants were growth rate and profitability.

Yusuf, Onafalujo, Idowu and Soyebo (2014) investigated the association between capital structure and the conglomerate's profitability of financial services and consumer goods quoted firms in Nigeria stock exchange from 2000 to 2011. The association between capital structure and performance proxies was analyzed using regression and correlation estimates. The findings revealed that debt asset ratio and debt equity ratio and return on assets was insignificant except for Nestle and 7uup, also between debt asset ratio and return on equity. However, the association between all the firms' debt to equity and return on equity was significant justifying the fact that, highly geared firm are more profitable.

Akinyomi (2013) investigated capital structure effect on the performance of firms in Nigeria by employing the correlation analysis to analyze the firms' annual sample from 2007 to 2011. He found out that, the age of the firm, debt to equity, debt to capital, short term debt to total debt were positively and significantly related to return on asset and return on equity, whereas, the relationship between long term to capital and return on asset and return on equity were significant but negative. From the literature reviewed, aggregated shareholders' fund has always been employed as a single variable, this poses a gap. Hence, this study filled this gap by disaggregating the shareholders' fund. Also, Earnings per share; being the major measure of owners' wealth was employed and evaluated in order to reveal the association between capital structure and the performance of quoted firms in Nigeria.

Research methodology

The exploratory and ex-post facto research design were used in this study. The data employed in the estimation of the model were obtained from secondary sources; mainly from the publication of the quoted companies' annual reports and the fact-books of the Nigerian stock exchange. The study population was made up of the one hundred and eighty seven (187) quoted firms on the Nigerian stock exchange. The study further adopted the systematic sampling design to select the number of quoted companies required for this study. To this end, the list of all the 187 quoted companies in Nigeria was arranged alphabetically. Applying the technique, a total of 94 quoted firms were selected. Thus:

K = $\frac{N}{n}$

Where;

K = the sampling interval

N = the population size which

n = the quoted companies to be included in the sample

K = $\frac{187}{100}$=1.87 ; Appr. 2

This therefore implies that every 2nd firm on our list of firms in the population was selected to form our sampling size.

The panel data analysis was done using the multiple regression techniques to investigate the relationships that existed among the variables of interest. In line with pecking order theory of capital structure and the objectives of this study, the following econometric models were specified to show the association between capital structure and quoted companies' performance in Nigeria. Three performance indicators tests were specified as follows:

Equation I. Functionally, **EPS= f(REAR, DEST, EQST,)**

Putting the model in a structured form, we obtained

EPS $= \beta_o + \beta_1$**REAR**$+\beta$**2DEST**$+ +\beta$**3EQST**$+\mu$

Where;

EPS = Dependent variable= Earnings per share of quoted companies in Nigeria

β_0 = Regression constant

$\beta_1, \beta_2, \beta_3$ = Unknown parameters

REAR = Retained Earnings of quoted companies in Nigeria

DEST = Debt stocks of quoted companies in Nigeria

EQST = Equity stocks of quoted companies in Nigeria

U = Stochastic error term

Equation II. Functionally, **ROA= f(DER, DAR)**

Putting the model in a structured form, we obtained

ROA $= \beta_o + \beta_1$**DER**$+\beta$**2DAR**$+\mu$

Where;

ROA = Dependent variable= Return on assets of quoted companies in Nigeria

β_0 = Regression constant

$\beta_1, \beta_2,$ = Unknown parameters

DER = Debt Equity Ratio of quoted companies in Nigeria

DAR = Debt Assets Ratio of quoted companies in Nigeria

U = Stochastic error term

Equation III. Functionally, **ROE= f(DER, DAR)**

Putting the model in a structured form, we obtained

ROE $= \beta_o + \beta_1$**DER**$+\beta$**2DAR**$+\mu$

Where;

ROE = Dependent variable= Return on equity of quoted companies in Nigeria

β_0 = Regression constant

$\beta_1, \beta_2,$ = Unknown parameters

DER = Debt Equity Ratio of quoted companies in Nigeria

DAR = Debt Assets Ratio of quoted companies in Nigeria

U = Stochastic error term

Data presentation and analysis

Data showing annual earnings per share, return on equity, debt stock, return on assets, retained earnings, equity stock debt/equity ratio and debt/asset ratio of selected quoted companies in Nigeria (Refer to Appendix for data presentation).

The tables in the appendix showed the trend performance of the selected variables captured in this study. Here, a company by company trend analysis was done for the selected quoted firms in Nigeria. The analysis was carried out to trace their behaviours during the period of evaluation (2011 to 2014). The study applied the multiple regression technique to evaluate the three econometric equations formulated to examine capital structure and quoted companies' performance in Nigeria. The result of the panel least squares for the three equations are as presented below.

Result of Regression Analysis of Earnings Per Share, Retained Earnings, Debt Stock and Equity Stock

Dependent Variable: EPS
Method: Panel Least Squares
Date: 08/01/17 Time: 11:30
Sample: 1 93
Periods included: 82
Cross-sections included: 1
Total panel (balanced) observations: 82

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	0.051304	0.055578	0.923091	0.3588
DEST	-3.212310	1.934110	-1.660067	0.1009
REAR	2.865409	2.301009	1.243743	0.2173
EQST	4.930511	3.632311	1.358562	0.1782

R-squared	0.752130	Mean dependent var	0.050207
Adjusted R-squared	0.715673	S.D. dependent var	0.478492
S.E. of regression	0.474728	Akaike info criterion	1.395400
Sum squared resid	17.57858	Schwarz criterion	1.512801
Log likelihood	-53.21138	Hannan-Quinn criter.	1.442534
F-statistic	9.429921	Durbin-Watson stat	2.365051
Prob(F-statistic)	0.000415		

Source: Researcher's computation using E-view7 (2017).

The above result is a product of panel data of quoted companies in Nigeria. From the result, the independent variables with the exception of debt stock (retained earnings, debt stock and equity stock) are in conformity with the a priori criteria. Retained earnings showed a positive sign in the model meaning that a unit increase in retained earnings resulted in a 2.865 unit increase in earnings per share and vice and versa. Debt stock showed a negative sign in the model implying that a unit increase in debt stock led to a 3.21 unit increase in earnings Per Share. Also, equity stock showed a positive sign in the model implying that a unit increase in equity stock led to a 4.93 unit increase in earnings per share.

Further examination of the t-statistics values of the result showed that all the independent variables were statistically insignificant at 1 per cent and 5 per cent; however at 10 per cent level all the parameters became significant. The R2 and adjusted R2 of 0.7521 and 0.7157 respectively revealed that the model has a goodness of fit. The overall significance of the model was assessed using the F-statistics, hence, the high F-vale (9.4299) showed that the data fitted well into the model.

Result of Regression Analysis of Return on Asset, Debt/Equity Ratio and Debt/Asset Ration

Dependent Variable: ROA
Method: Panel Least Squares
Date: 07/07/16 Time: 16:53
Sample: 1 93
Periods included: 82
Cross-sections included: 1
Total panel (balanced) observations: 82

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	0.075616	0.028330	2.669059	0.0092
DAR	-0.100192	0.046313	-2.163367	0.0335
DER	0.001115	0.001614	3.690743	0.0918

R-squared	0.856060	Mean dependent var	0.024366
Adjusted R-squared	0.832163	S.D. dependent var	0.131322
S.E. of regression	0.129193	Akaike info criterion	-1.219121
Sum squared resid	1.318573	Schwarz criterion	-1.131070
Log likelihood	52.98396	Hannan-Quinn criter.	-1.183770
F-statistic	22.34589	Durbin-Watson stat	2.072837
Prob(F-statistic)	0.000400		

Source: Researcher's computation using E-View7 (2016).

The empirical result showed that the constant term had a positive sign in the model. This implies that holding all other variables constant, the return on assets increased by "0.0756 units. The result also showed that debt equity ratio was positive. This implies that a unit increase in debt equity ratio resulted in a 0.00112 unit increase in return on assets of quoted companies in Nigeria. The result further revealed an inverse relationship between debt assets ratio and return on assets. This implies that an increase in debt assets ratio resulted to a decrease in the return on assets of quoted companies in Nigeria. In other words, a unit increase in debt assets ratio resulted in a 0.100019 unit decrease in the return on assets of quoted companies in Nigeria.The individual statistical significance of the respective independent variables was also examined using the t-statistics. Both debt equity ratio and debt assets ratio were statistically significant 1 percent, 5 percent and 10 percent level. The goodness of fit of the model as indicated by the R^2 and R^2 -adjusted values of 0.85606 and 0.83216 respectively showed that the model fits the data well. Specifically, the R^2 -adjusted value of 0.83216 showed that about 83.22 per cent of the total variations in the return on asset of quoted companies in Nigeria are jointly explained by the variations in debt equity ratio and debt assets ratio. The overall significance of the model was also tested using the ANOVA or F-statistics. Here, the high significance of the F-statistics value of 22.346 confirmed that the model fitted the data well".

From the empirical result, the a priori expectation about the size of Debt equity ratio conforms to finance theory. The parameter showed a positive sign in the model implying that debt equity ratio has a direct impact on return on equity of quoted companies in Nigeria. Stated differently, a unit increase in debt equity ratio resulted in about "0.0566 unit increase in the return on equity of quoted companies in Nigeria. The a priori expectation about the size of Debt assets ratio does not conform to finance theory.

The parameter entered the model with a negative sign implying that debt equity ratio impacted directly on quoted companies return on equity in Nigeria. Put in another way, a unit increase in debt equity ratio resulted in about "0.0566 unit increase in the return on equity of quoted companies in Nigeria. The a priori expectation about the size of Debt assets ratio does not conform to finance theory. The parameter entered the model with a negative sign implying that debt assets ratio has an inverse impact on return on equity of quoted companies in Nigeria.

Result of Regression Analysis of Return on Equity, Debt/Equity Ratio and Debt/Asset Ratio

Dependent Variable: ROE
Method: Panel Least Squares
Date: 07/07/16 Time: 16:52
Sample: 1 93
Periods included: 82
Cross-sections included: 1
Total panel (balanced) observations: 82

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	0.047941	0.124076	0.386383	0.7003
DAR	-0.242479	0.202832	-1.195466	0.2355
DER	0.056606	0.007068	8.009179	0.0000

R-squared	0.952069	Mean dependent var	0.100207
Adjusted R-squared	0.938197	S.D. dependent var	0.754888
S.E. of regression	0.565815	Akaike info criterion	1.734800
Sum squared resid	25.29159	Schwarz criterion	1.822851
Log likelihood	-68.12682	Hannan-Quinn criter.	1.770151
F-statistic	32.58931	Durbin-Watson stat	1.981837
Prob(F-statistic)	0.000000		

Source: Researcher's computation using E-View7 (2016).

Stated differently, a unit increase in debt asset ratio resulted in about 0.24248 unit decreases in the return on equity of quoted companies in Nigeria. The individual statistical significance of the respective independent variables was also tested using the t-statistics. Debt equity ratio was statistically significant at 1 percent, 5 percent and 10 percent level; debt asset ratio was only significant at 10 percent level. The goodness of fit of the model as indicated by the R2 and R2 - adjusted values of 0.95207 and 0.938197 respectively showed that the model fits the data well. Particularly, the R2 - adjusted value of 0.938197 showed that about 93.82 percent of the total variations in the return on equity of quoted companies in Nigeria are jointly explained by the variations in debt equity ratio and debt assets ratio. The overall significance of the model was also tested using the ANOVA or F-statistics. Here, the high significance of the F-statistics value of 32.589" revealed the fitness of the data into the model.

Conclusion

The study was undertaken to examine capital structure and the performance of quoted companies in Nigeria. So many theories of capital structure have been developed over the years. These theories have directly and indirectly affected the ways firms in Nigeria raise their capital. From the results obtained, it was revealed that capital structure of Nigerian quoted firms hass a significant measure of their performance. There existed a positive and significant relationship between debt equity ratio and return on asset while debt-asset ratio had a significant negative relationship with the return on assets of quoted companies in Nigeria.

On the flip side, the relationship that existed between debt equity ratio and return on equity of quoted companies in Nigeria was positive but insignificant and debt asset ratio related significantly and negatively with return in equity of Nigerian quoted companies. Based on the findings, it was concluded that capita structure of Nigerian quoted firms is a significant measure of their performance and should be effectively and efficiently managed at all time.

Recommendations

In view of the findings from this study, it was recommended that:

i. Quoted firms in Nigeria should invest their profits when there are viable investment opportunities and pay cash dividend as soon as enough income is generated.
ii. Quoted companies in Nigeria should desist from the use of excessive debt during the period of harsh and unfavorable economic conditions but more of equity and internal financing options should be used in order to achieve a positive return on their assets.
iii. Debt funds should only be used to finance assets that generate high returns so as to defray the cost of such debts and boost profitability.

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