Capital Structure and Financial Performance in Nigeria

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ABSTRACT

Capital structure has been found to have impact on firm performance. Bank consolidation in Nigeria has increased bank equity capital against debt. This study aims to determine the impact of post-consolidation capital structure on the financial performance of Nigeria quoted banks. The study used profit before tax as a dependent variable and two capital structure variables (equity and debt) as independent variables. The sample for the study consists of ten (10) Nigerian banks quoted on the Nigerian Stock exchange (NSE) and period of eight (8) years from 2005 to 2012. The required data and information for the study were gathered from published annual reports. Ordinary least square regression analysis of secondary data shows that capital structure has a significant positive relationship with the financial performance of Nigeria quoted banks. This suggests that the management of quoted banks in Nigeria consistently use debt and equity capital in financing to improve earnings.

1.0   INTRODUCTION

Capital structure is one of the important decisions by finance managers. Pandey (2010) defined capital structure as the various means of financing a firm, that is, the proportionate relationship between debt and equity. Pandey (2010) further stated that capital structure is a significant managerial decision because it influences the shareholder's return and risk as the market value of the share may be affected by the capital structure decisions. In making capital structure decisions, to Pandey (2010) corporate managers are expected to seek answers to the following questions: how should the investment project be financed; does the way in which the investment projects are financed matter; how does financing affect the shareholders' risk, return and value; does there exist an optimum financing mix in terms of the

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maximum value to the firm's shareholders; can the optimum financing mix be determined in practice for a company; and what factors in practice should a company consider in designing its financing policy?

The pioneer of this debate and studies on capital structure theory is Modigiliani and Miller (1958). Several empirical and theoretical researches (see Jensen and Meckling, 1976; Myers and Majluf, 1984; Brander and Lewis, 1986; Harris and Raviv, 1990) have been carried out in this pioneering effort of Modigiliani and Miller (1958). The general direction of opinion of researchers is that a firm should determine and chose an optimal level of debt and equity combination based on the tradeoff between the cost and benefits of debt. Some companies according to Pandey (2010), do not plan their capital structure but rather evolve from financial decisions taken by the financial managers without a formal policy and planning. Thus, their capital structure is reactive because they are products of past operating decisions rather than planned decisions. A company that do not plan its capital structure may have difficulties in raising funds to finance its operations in the future and may not be able to economize its use of funds. It is the general opinion among researchers that each firm should plan its capital structure in such a way that it will maximize its use of funds and to be able to adapt to changing situations. Therefore, the financial manager should plan an optimum capital structure for the company so as to maximize the market value of the firm.

There have been several studies on the effect of capital structure on firm performance in developed countries. However, empirical studies on capital structure and its implication on firm performance in developing countries, especially in Nigeria, are very scanty. Also, after the bank consolidation exercise in Nigeria, there have not been any serious study on how the emerging capital structure has affected bank performance. Most banks in Nigerian have not been taken the advantage of debt in their capital structure mix as reflected on their financial statements.

This study attempts to fill this gap by investigating the effect of capital structure on bank performance in Nigeria using variables from the banks' post-consolidation published financial statement covering 2005 to 2012.

Empirical studies on the relationship between firms' performance and capital structure have produced mixed results. Abor (2007) reports a positive relation between capital structure and performance over the period 1998-2002 in the Ghanian firms. Masulis (1983), Jordan et al (1998), Simerly and Li (2000), Frank and Goyal (2003), and Deping et al (2011) showed that there is positive correlation between firm performance and capital structure, which reflects the basic theory of capital structure. Chakraborty (2010) employed two performance measures, including ratio of profit before interest, tax and depreciation to total assets and ratio of cash flows to total assets and two leverage measures, including ratio of total borrowing to assets and ratio of liability and equity, and reported a negative relation between these ones.

Combinations of equity and debt in firms' capital structures have been identified by scholars (Tian and Zeitun, (2007), Champion, (1999), Gosh et al, (2000), Hadlock and James, (2002), Abor, (2005), San and Heng, (2011), and Chakraborty (2010) to affect current and future financial operations of the firm. Debt, a tax deductible expense, seems cheap when minimal as the after-tax cost is lower than equity improving earnings per share and dividend per share. Increasing levels of debt in a firm's capital structure increases it's after-tax cost, negatively affecting corporate financial performance. Bank consolidation increased banks equity capital against debt in the short run with increasing level of debt after Central Bank of Nigeria's bailouts soon after the consolidated exercise. How has this variability in bank capital structure affected post-consolidation banks' performance? Therefore, this study aims to determine the relationship between capital structure variables and corporate performances of quoted banks in Nigeria. Data for this study, equity, debt and profit before tax, will be from the published financial statements of the sampled banks and the least square regression analysis will be used for data analysis. The study concludes that bank management in Nigeria should consistently use debt in the capital structure so as to enhance bank financial performance.

The rest of the paper is divided into Section 2.0 review of the literature; section 3.0-data and methodology; section 4.0 data analysis and discussion of findings; and section 5.0 conclusions and recommendation.

2.0   LITERATURE REVIEW AND THEORETICAL FRAMEWORK

Modern studies on capital structure theory dated back to more than fifty decades ago when Modigliani and Miller (1958), from now on MM, published their seminar work. They proved that, under certain assumptions (existence of perfect market and the absence of taxes and transaction costs), costs of capital does not affect capital structure. That is; debt in a firm's capital structure does not affect the firm's value. This theory is normally referred to as irrelevant theory.

Later, Modigliani and Miller (1963) modified the irrelevant theory by presenting proof that cost of capital affect capital structure and thus the value of the firm when the assumptions that there are no taxes or transaction cost were removed. They then opined that borrowing give a tax advantage, where the tax deducted from the interest results in tax shields, which in turn reduces the cost of borrowing and maximizes the firm performance (Miller, 1977). This requires the firm to make a trade- off between the cost of debt and the benefits of using debt.

Several studies shed light on the specific characteristics of firms and industries that determine leverage ratios. These studies agree that leverage increases with fixed assets, non-debt tax shields, growth opportunities, and firm size and decreases with volatility, advertising expenditures, research and development expenditures, bankruptcy probability, profitability and uniqueness of the product.

Bauer (2004), using the data available studied the effect of the following on capital structure; size, profitability, tangibility, growth opportunities, tax, non-debt tax shields, volatility, and industry classification. He concluded that leverage is positively correlated with size while leverage is negatively correlated with profitability. There was also a negative relation between tangibility and leverage. The relationship between leverage and P/B ratio (Proxy for growth opportunities) is negative which means that firms with higher future growth opportunities should use more of equity financing. It was discovered that leverage is positively correlated with tax and it is negatively correlated with non-debt tax shields. No relationship was found between leverage and volatility.

A firm's capital structure may evolve as a result of deliberate plan by the firm's managers while at other times it is as a result of the combination of situation in which the firm had to deal with in the past. Some firms are not able to access banks loan (Kamsvag, 2001)[25] while some have enough retained earnings to undertake their investment opportunities without resulting to debt financing (Anderson, et al, 2006). Some firms, in principle, do not want to undertake any debt (Anderson and Williamson, 2001).
However, there are several other factors that have been suggested by scholars as determinants of firm's capital structure. Peterson and Rajan (1994) argued that business size, age and cash flow are relevant factors. Olowe (2011) opined that "in other to maximize shareholders' wealth, the practical factors a financial manager should consider in the choice of capital structure include: business risk, nature of the firm's assets, growth rates of the firm, stability of sales, profitability, taxes, control, management attitudes, lender and rating agency attitudes, conditions in the stock market, perceived undervaluation of equity shares in the Stock market, and reserve borrowing capacity".

In addition to the concerns about EPS, value and cash flow, Pandey (2010) noted that in practice capital structure decision involve considerations of assets, growth opportunities, debt and non-debt tax shields, financial flexibility and operating strategy, loan covenants, financial slack, sustainability and feasibility, control, marketability and timing, issue costs and capacity of raising funds.

Huang and Song (2002), posited that theoretical and empirical studies have shown that profitability, tangibility, tax, size, non-debt tax shields, growth opportunities volatility, and so on affect capital structure. They went further to say "on the relationship between these factors and companies' capital

structure, Harris and Ravis (1990), summarizing a good number of empirical studies, from US firms suggest that 'leverage increases with fixed assets, non-debt tax shields, investment opportunities and firm size and decreases with volatility, advertising expenditure, the probability of bankruptcy, profitability and uniqueness of the product'. However, Wald (1999) observed that leverage decreases rather than increases with non-tax shields.

Researchers have identified a number of factors as determinants of firm financial performance.

Abbas et al. (2013) carried a study on determinants of firm's financial performance, using the textile sector of Pakistan for their study, and found that firm's performance is significantly affected by short – term leverage, size, risk, tax and non – debt tax shield.

Safarova (2010), in his study on factors that determine firm performance of New Zealand listed companies discovered that size is the most important factor determining firm performance, followed by growth and leverage, while other factors such as tangibility, corporate governance, cash on hand and risk appeared to be marginally related to firm operating performance. Mirza and Javed (2013) carried out a study on the determinants of financial performance of firms on Pakistan stock market and concluded that firms having well-governed ownership structure, capital structure, and proper risk management tend to have a better financial performance.

Valentin (2012), based on his study of determinants of corporate financial performance, is of the opinion that a company's financial performance is directly influenced by its market position. He also identified risk and growth as important factors influencing a firm's financial performance. The size of the company can also have a positive effect on financial performance because the larger firms can use this advantage to get some financial benefits in business relations. (Marthur and Kenyon, 1997).

According to Kyereboah – Coleman (2007), the basic motive behind any investment, made by the corporate sector, is to earn profit. It is the major goals of a business organization to maximize shareholders' wealth and generate enough profits to continue the business and to grow further in the future. Mirza and Jared, (2013). However, the performance of the firm is affected by multiple external and internal factors. While the internal factors are specific to each firm, the eternal factors can be the same for all or most of the firms. The external factors include market preferences and perceptions, country rules and regulations, and the economy of the country (Mirza and Jared, 2013).

Corporate financial performance is directly influenced by its market position (Ross et al., 1996); risk (Fruhan, 1979); economic growth, (Varaiya et al. 1987); size of the company (Mathur and Kenyon, 1997); capital structure (Kakani et al.,2011) and total assets (Beaver et al, 1970). Safarova (2010) study the factors that determine firm performance in New Zealand listed companies, eight factors were examined, namely intangibles, corporate governance, cash on hand, leverage, firm-specific risk, growth and tangibility in relation to their influence on a firm's performance. He found that size is the most important determinant of firm performance, and other factors have marginal relationships. He however opined that this is due to various reasons surrounding the New Zealand financial market during the sample period, 1996 – 2007.

Mirza and Javed (2013) studied the determinants of financial performance of firms listed on Pakistani Stock Market and found that firms having proper corporate governance structures and monitoring will be more profitable for shareholders. Their conclusion is that firms having well-governed ownership structure, capital structure, and proper risk management tend to have a better financial performance.

In view of the nature of financial institutions, researchers have classified determinants of bank performance into two – bank-specific (internal) and macroeconomic (external) factors (Al–Tamimi and Hasan, 2010; and Aburimem 2005). Internal factors are the characteristics of individual banks which affects performance. These are factors that are influenced by the internal bank management and board decisions. The external factors are the characteristics of the economy of the country where the bank operates, which are beyond the control of the bank and affect bank performance.

Several studies, with mixed results, have been carried out on effects of capital structure on corporate performance.

Fosu (2013), studied 257 South African listed firms using panel data to investigate the relationship between capital structure and firm performance, paying particular attention to the degree of industry competition, found that financial leverage has a significant positive effect on firm performance.

He (2013), in his study, titled "Comparison of impact from capital structure to corporate performance between Chinese and European listed firms" using data from more than 1200 listed companies in Germany and Sweden and more than 100 listed companies in China covering the period 2003- 2012, found that capital structure has a significant negative effect on firm performance in China, whereas, significant positive effect in 2 European countries before financial crisis happened in 2008.

Thamila and Arulvel (2013) studied the relationship between capital structure and financial performance of listed companies traded in Colombo stock exchange using secondary data, 2007 – 2011 financial statements of the respective companies. In all 30 companies were selected for analysis and Net Profit Ratio, Return on capital employed and Return on Equity were used as indicators of financial performance. The researcher discovered a negative relationship between capital structure and firm's performance.

Saeed et al. (2013), using multiple regression models, studied the impact of capital structure on performance of Pakistani banks. They utilized data of banks listed on Karachi Stock exchange for the period 2007 to 2011. Performance was measured by return on assets, return on equity and earnings per shares and determinants of capital structure include long – term debt to capital ratio, short – term debt to capital ratio and Total debt to capital ratio. Their result indicated that there is a positive relationship between determinants of capital structure and performance of the banking industry.

Nirajini and Priya (2013) examined the impact of capital structure on financial performance of listed trading companies in Sri Lanka. They extracted data from the annual reports of the sample companies from 2006 to 2010. Correlation and multiple regression analysis were used for their analysis. They found out that there is a positive relationship between capital structure and financial performance. They also discovered that capital structure's significant impact on financial performance of the firm showed that debt asset ratio, debt-equity ratio and long-term debt correlated with gross profit margin (GPM), net profit margin (NPM), Return on capital employed (ROCE), Return on Asset (ROA) and Return on Equity (ROE) at significant level of 0.05 and 0.1.

Chunhua and Meiyan (2013) studied the impact of capital structure on firm performance using Information Technology companies listed on Shanghai and Shenzhen stock exchange as sample. They discovered a negative correlation between company's capital structure and profitability.

Al – Taani (2013) investigated the relationship between capital structure and firm performance across different industries using a sample of Jordanian manufacturing firm. The annual financial statements of 45 manufacturing firm listed on the Amman Stock Exchange were used for the study and covered a period of five (5) years, 2005 – 2009. He used multiple regression analysis on performance indicators such as return on asset (ROA) and profit margin (PM) as well as short – term debt to total assets (STDTA), long term debt to total assets (LTDTA) and total debt to equity (TDE) as capital structure variables. The results showed that there is a negative and significant relationship between STDTA and LTDTA and ROA and PM; while TDE is positively related with ROA and negatively related with PM. STDTA is significant using ROA and PM. STDTA is significant using ROA while LTDTA is significant using PM. His final conclusion is that statistically, capital structure is not a major determinant of firm performance.

Salim and Yadar (2012) in their study of capital structure and firm performance from Malaysia listed companies, using four accounting based measure of firm performance (ROA, ROE, EPS and Tobin Q), found out that capital structure (especially TD and STD) impacts negatively, measured by ROE, and they

found this consistent with who documented the same result. However, capital structure (LTD and TD) had negative significant impact on firm's performance, measured by ROA. This they found consistent with the findings of Abor (2007) who indicated that firm's performance is negatively related to capital structure. But their findings are in contrast with champion (1999), Gosh et al (2000), Hardlock and James (2002), Frank and Goyal (2003) and who revealed that there is a positive relation between firm performance and capital structure.

Salteh, et al (2012) investigated the impact of capital structure on firm performance, using five performance measures (including return on equity, return on assets, earning per share, market value of equity to the book value of equity and Tobin's Q) as dependent variable and four capital structure measures (including short-term debt, long- term debt and total debt to total assets, and total debt to total equity) as independent variable. They selected 28 Iranian companies listed in Tehran Stock Exchange (TSE) as a sample. The study covered 2005 to 2009. The results indicate that firm performance, which is measured by (ROE,MBVR & Tobin's Q) is significantly and positively associated with capital structure, while there is a negative relation between capital structure and (ROA, EPS). They concluded that firm performance is positively or even negatively related to capital structure.

Skopljak (2012), using data of Australian 15 Deposit-taking Institutions (ADIs) over the period 2005 – 2007, study the effects of capital structure on performance in the financial sector in Australia, discovered a robust relationship between capital structure and firm's performance. He discovered that at relatively low levels of leverage an increase in debt leads to increased profit efficiency hence superior bank performance; at a relatively high level of leverage, increased debt leads to decreased profit efficiency as well as bank performance. The implications of this finding is that there is an optimal level of debt and that a bank can help optimize the performance of management and general bank performance by simply choosing a capital structure which optimizes managerial incentives while keeping financial distress relatively low.

Khan (2012) studied the relationship of capital structure decisions with the firm's performance using 36 engineering firms in Pakistan listed on the KSE as sample for the period 2003 -2009 using the panel econometric technique, Pooled Ordinary Least Square regression. His findings show that financial leverage measured by short term debt to total assets (STDTA) and total debt to total assets (TDTA) has a significant negative relationship with the firm's performance measured by Return on Assets (ROA), Gross profit margin (GM) and Tobin's Q.

Pouraghajan et al (2012), carried out a study of the impact of capital structure on the financial performance of companies listed on the Tehran Stock Exchange. For this purpose, they tested a sample of 400 firm-years among Companies Listed on the Tehran Stock Exchange in the form of 12 industrial groups during the years 2006 to 2010. Variables used to measure the financial performance of companies are return on assets ratio (ROA) and return on equity ratio (ROE). They discovered, from the results, that there is a significant negative relationship between debt ratio and financial performance of companies, and a significant positive relationship between asset turnover, firm size, asset tangibility ratio, and growth opportunities with financial performance measures. However, the relationship between ROA and ROE measures with the firm age is not significant. In addition, the research results show that by reducing debt ratio, management can increase the company's profitability and thus the amount of the company's financial performance measures and can also increase shareholder wealth Based on the differing conclusions of the various researchers above, this topic, capital structure and firm performance will continue to attract attention of scholars and researchers as no definite conclusion has been reached concerning the impact of capital structure on firm performance.

Given the above literature review the following hypothesis is tested on the assured relationships between identified variables:

H_0: There exists no significant positive relationship between capital structure variables and corporate performances of quoted firms in Nigeria.

H_i There exists a positive significant relationship between capital structure variables and corporate performances of quoted firms in Nigeria.

3.0   DATA AND METHODOLOGY

The research design for this study is the survey design. The population for this study is all seventeen quoted banks in Nigeria. The strata sampling technique was used as listed banks in the upper strata of banks with high capital structure are brought under study. Ten most capitalized banks were sampled for the study.

Secondary data on equity, debt and annual profits before tax of the ten sampled banks were obtained from their annual reports for the period 2005 to 2012 for the study.

The data used for this study are valid and reliable as they were obtained from annual reports of selected banks which have been subjected to independent audit by an external auditor and prepared in accordance with the requirements of the Companies and Allied Matters Act Cap C20, 2004, the requirements of the Nigerian Stock Exchange and the Banking and Other Financial Institutions Acts Cap B3, 2004.

Data for this study were analyzed using the Ordinary Least Square (OLS) to determine the nature of the relationships between firm's capital structure and banks' financial performances.

The ordinary Least Square (OLS) model:
$$BP = a + \beta_1 EQ + \beta_2 DB + \mu_i$$ --------- 1)
Where: BP = Bank Performance as measure by PBT
EQ= Bank Equity finance
DB= Bank Debt finance
μ_i = random or stochastic term (error term)
is used in this study as similar studies Fosu (2013) in South Africa, Abor (2007) in Ghana used it in similar studies.

4.0   ANALYSIS AND FINDINGS

The descriptive analysis of the variables used in this study is presented in Table 4.1 below, and it contains their mean, maximum, minimum and standard deviation values:

Table 4.1: Descriptive Values of Variables

Variables	Minimum	Maximum	Mean	Standard deviation
BP	-5,581.1	39,968.3	16,779.3	16,669.5
EQ	55,542.6	258,396.8	136,683.2	73,040.4
DB	0	76,674.9	27,981.9	21,889.8

The table shows that bank financial performance(BP), represented by profit before tax has an average profit before tax of N16,779.3m and it ranges from a minimum of a loss of N5,581.1m to a maximum profit before tax of N39,968.3 with a standard deviation of N16,669.5m.

The minimum equity capital is N55,542.6m with a maximum of N258,396.8m and has a mean of N136,683.2 and a standard deviation of NN73,040.4m. Debt capital, on the other hand, has a minimum of N0.0m and a maximum of N76,674.9, with a mean of N27,981.87 and standard deviation of N21,889.8m.   Thus, bank equity experienced the highest level of variation with bank financial performance.
Table 4.2:

Correlations

		BP	EQ	DB
Pearson Correlation	BP	1.000	.894	.638
	EQ	.894	1.000	.437
	DB	.638	.437	1.000
Sig. (1-tailed)	BP	.	.000	.023
	EQ	.000	.	.103
	DB	.023	.103	.
N	BP	10	10	10
	EQ	10	10	10
	DB	10	10	10

The correlation between bank financial performance and equity is strong and positive at 0.894, (89.4%). The correlation between bank financial performance and debt is strong and positive at 0.638, (63.8%).

Table 3: Regression Coefficients

Model	Unstandardized Coefficient		Standardized coefficient	t	Sig
	B	Std. Error	Beta		
(Constant)	-13461.217	4807.618		-2.800	.027
EQ	.173	.034	.760	5.120	.001
DB	.233	.113	.306	2.064	.078

Using the ordinary least squares model on average data on sampled banks equity, debit and profit before tax, we have the resultant regression equation:

$$BP = -13461.217 + 0.173EQ + 0.233DB \text{ (table 3)}$$

Table 4 : R^2 Analysis

Model	R	R Square[b]	Adjusted R Square	Std. Error of the Estimate	Durbin-Watson
1	.936[a]	.875	.840	6678.20244	2.535

4.01   REGRESSION ANALYSIS

The regression equation from the analysis is:

$$BP = -13461.217 + 0.173EQ + 0.233DB$$

The estimated coefficient of EQ is 0. 173, with a t-test value of 5.120 with a P-value of 0.001. EQ is statistically significant at 5% level of error proving that the value of β_1 is different from zero. By this, the null hypothesis is not accepted, and the alternative hypothesis is accepted. Thus, there is statistically positive and significant relationship between bank equity and bank financial performance. That is, a percent increase in equity, leaving a debt unchanged, will make bank financial performance improve.
The estimated coefficient of DB is 0.233, with a t-test value of 2.062 with a P-value of 0.078. DB is statistically significant at 10% confidence levels. Since a positive relationship exists between DB and BP, the null hypothesis is rejected, and the alternative hypothesis is accepted. Thus, there is statistically positive relationship between debt and bank financial performance. The coefficient of β_2 shows a positive relationship between bank financial performances. That is, a percentage increase in debt, leaving equity unchanged, will make Bank financial performance improve.

The constant value of the regression likewise shows a figure of -13461.217 with a t- value of -2.800 which is significant at 1% level of significance. This shows a negative reaction to bank financial performance when equity and debt become zero, as reflected by the constant. This seems so because it does not make business sense as no business can commence without any capital.

R^2 Analysis

The R^2 value of the regression equation is 0.875, this means that 87.5% of variation in bank financial performance is explained by the derived regression equation.

Durbin – Watson Value
The Durbin -Watson value of 2.535 shows that there exist no auto correlation within the values of the study variables.

5.0   CONCLUSIONS AND RECOMMENDATIONS

Findings of this study shows that the correlation between bank financial performance and equity is strong and positive at 0.894 (89.4%) and the correlation between bank financial performance and debt is strong and positive at 0.638 (63.8%). The overall result shows that 87.5% of the variation in bank financial performance is explained by capital structure (equity and debt).

Therefore, we concluded that bank debt has a positive and significant effect on the financial performance of banks in Nigeria. Additionally, bank equity has a positive and significant relationship with bank financial performance; and bank debt and equity positively affect bank financial performance.

To improve financial performance of banks in Nigeria:
1. The management of Nigerian banks' should consider the use of more debt in their capital structure mix as this will reduce the overall cost of capital as a result of its tax advantage.. Moreover, increase bank financial performance;
2. The management of quoted banks in Nigeria should increase the use of equity capital in financing to improve earnings of their banks; and
3. Investors of quoted banks in Nigeria should also consider the capital structure of any bank before investing in them as the strength of a bank's capital mix determines the level of returns.

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