JOSAS
ISSN:2682-6224
Volume 5 No.1 (2021) 112-120
www.wdujournals.com

CAPITAL STRUCTURE AND PERFORMANCE OF LISTED MANUFACTURING FIRMS IN NIGERIA

KALAGBOR, G. KINGSLEY PhD
Department of Accounting
Faculty of Business Studies
Ignatius Ajuru University of Education

OKOBA DOUYE
Department of Accounting
Faculty of Business Studies
Ignatius Ajuru University of Education

AMAH CLETUS
Department of Accounting
Faculty of Business Studies
Ignatius Ajuru University of Education

ABSTRACT: ***This paper examines capital structure and performance of listed manufacturing firms in Nigeria. The objective of the paper is to examine effect of capital structure on the performance of firms in Nigeria. The paper was based on theory and empirical reviews of authors and researchers in the capital structure of firms. The paper concluded that Nigerian firms rely heavily on short term financing rather than long term finance. This difference in long-versus short-term debt, to an extent, might limit the explanatory power of the capital structure theories in Nigeria. It suggests that the theoretical underpinnings of the observed correlations are still largely unresolved. With a future impact that professional and qualified personnel should be charged with the financing decision of firmsin Nigeria since an optimal capital structure is a must for firms in Nigeria if they must compete effectively and survive in times of financial and economic distresses, and attaining an optimal capital structure requires an effective and strategic planning.***

INTRODUCTION

Financing is one of the crucial areas in a firm, a financing manager is concerned with the determination of the best financing mix and combination of debts and equity for his firm. Capital structure decision is the mix of debt and equity that a company uses to finance its business (Shehu, 2019). One of the importance of capital structure is that it is tightly related to the ability of firms to fulfill the needs of various stakeholders. Capital structure represents the major claims to corporation's assets which includes the different types of both equities and liabilities (Babalola, 2018). There are various alternatives of debt-equity ratio, these includes; 100% equity: 0% debt, 0% equity: 100% debt and X% equity: Y% debt (Kennon, 2018). From these three alternatives, option one is that of the unlevered firm, that

is, the firm that shuns the advantage of leverage (if any). Option two is that of a firm that has no equity capital. This option may not actually be realistic or possible in the real life economic situation, because no provider of funds will invest his money in a firm without equity capital. This partially explains the term trading on equity, that is, it is the equity element that is present in the firm's capital structure that encourages the debt providers to give their scarce resources to the business. Option three is the most realistic one in that, it combines both a certain percentsage of debt and equity in the capital structure and thus, the advantages of leverage (if any) is exploited. This mix of debt and equity has long been the subject of debate concerning its determination, evaluation and accounting.

After the Modigliani-Miller (1958 & 1963) paradigms on firms capital structure and their market values, there have been considerable debates, both in theoretical and empirical researches on the nature of relationship that exists between a firms choice of capital structure and its market value. Debates have centered on whether there is an optimal capital structure for an individual firm or whether the proportion of debt usage is relevant to the individual firm's value (Akinyomi, 2016). Although, there have been substantial research efforts devoted by different scholars in determining what seems to be an optimal capital structure for firms, yet there is no universally accepted theory throughout the literature explaining the debt-equity choice of firms. But in the last decades, several theories have emerged explaining firms capital structure and the resultant effects on their market values. These theories include the pecking order theory by Donaldson, (2016), the capital structure relevance theory by Modigliani and Miller (1963), the agency costs theory and the trade-off theory (Bokpin & Isshaq, 2018).

Financial constraints have been a major factor affecting corporate firms performance in developing countries especially Nigeria. The basis for the determination of optimal capital structure of corporate sectors in Nigeria is the widening and deepening of various financial markets. Mainly, the corporate sector is characterized by a large number of firms operating in a largely deregulated and increasingly competitive environment. Since 1987, financial liberalization has changed the operating environment of firms, by giving more flexibility to the Nigerian financial managers in choosing their firms capital structure. Alfred (2017) suggested that a firms capital structure implies the proportion of debt and equity in the total capital structure of the firm. Pandey (1999) differentiated between capital structure and financial structure by affirming that the various means used to raise funds represent the firms financial structure, while the capital structure represents the proportionate relationship between long-term debt and equity capital. Therefore, a firms capital structure simply refers to the combination of long-term debt and equity financing. However, whether or not an optimal capital structure exists in relation to firm value, is one of the most important and complex issues in corporate finance.

The corporate sector in the country is characterized by a large number of firms operating in a largely deregulated and increasingly competitive environment. Since 1987, financial liberalization resulting from the Structural Adjustment Program changed the operating environment of firms. The macroeconomic environment has not been conducive for business while both monetary and fiscal policies of government have not been stable. Following the Structural Adjustment Program, lending rate rose to a high side from 1.5 percent in 1988 to a peak of 29.8 percent in 1992; but it declined to 16.9 percent in 2006. The high interest rate implies that costs of borrowing went up in organized financial market,

thus increased the cost of operations. The Structural Adjustment Program (SAP) came with its conditions, policies that liberalized and opened up the Nigerian economy to the outside world even when the nations domestic produce cannot stand in equal comparison to international commodities, causing unfavorable balance of payment as domestic demand for foreign goods increased also led to the high volatility of the exchange rate system thereby rendering business in Nigeria uncompetitive, especially given high cost of borrowing and massive depreciation of Naira, which culminated to increasing rate of Inflation in Nigeria.

Statement of Problem

The study of capital structure has traditionally been carried out by finance researchers and at bestthere has been mixed results. The actual impact of capital structure on corporate performance in Nigeria has been a major problem among researchers that has not been resolved. Hitherto, there has been different methodology, variables, theoretical framework and there is still no concrete conclusive empirical evidence in the literature about how capital structure influences corporate performance of firms in Nigeria.

According to Chandrasekharan (2019), firms size, growth and age are significant with the structure of debt and equity of the firm, whereas, profitability and tangibility are not. Even our own country research works such as; Babalola (2018), revealed that according to the dominant corporate finance paradigm, capital structure choice is a trade-off between the costs and benefits of debt, and it has been refuted that large firms are more inclined to retain higher performance than middle firms under the same level debt ratio. In another study, concluded that the manufacturing industries capital structure in Nigeria is consistent with trade-off theory and the hypothesis tested that the corporate performance is a nonlinear function of the capital structure. Ishaya & Abduljeleel (2018), also reveals that debt ratio is negatively related with profitability whereas equity is directly related with profitability. Akinyomi (2016), revealed that each of debt to capital, debt to common equity, short term debt to total debt and the age of the firms is significantly and positively related to return on asset and return on equity but long term debt to capital is significantly and relatively related to return on asset and return on return on equity. His hypothesis also tested that there is significant relationship between capital structure and financial performance using both return on asset and return on equity. Shehu (2019), profitability variable supports the pecking order theory, the tangibility variable supports the trade-off theory, and the growth theory supports the agency theory while the size variable supports the asymmetry of information theory.

Following the work of Zeitun & Tian, (2017), revealed that short term debt, long term debt and total debt have significant negative relationship with performance using return on asset and return on equity, non tax debt and liquidity also shows negative relationship with performance while tangibility and efficiency has a significant positive relationship with performance. Taiwo (2019),in his findings revealed that the sampled firms were not able to utilize the fixed asset composition of their total assets judiciously to impact positively on their firms performance. Owolabi and Inyang (2019), discussed the factors that constitutes the determinants of capital structure in Nigeria and that firms with a huge portion of capital structure composed of external debt finds it difficult to pay back when due because of some factors such as financial distress, bankruptcy threat etc. Appah, Okoroafor &

Bariweni,(2016), supported the traditional theory of capital structure which asserts that leverage is a significant determinant of firms performance and that there is a significant negative relationship is established between leverage and performance.

Khalaf, (2016), revealed that only growth and educational level of firms owners were significant determinants of both long and short term debt ratios, assets structure, gender of owners and export status impacted significantly on long term debt ratios, while business risk, size and profitability of firms were major determinants of short term debt ratio for the firms under investigation. Babalola, (2018), revealed in their study a positive relationship between firms performance and equity financing as well as between firms performance and debt-equity ratio. There is also a negative relationship that exists between firm's performance and debt financing due to high cost of borrowing in the country. Kennon, (2018), in their study suggested that a positively significant relationship exists between a firm's choice of capital structure and its market value in Nigeria.

In light of all this differences in the findings of the above research work constitute huge problems which this research work will tackle so as to achieve the objective of determining the impact of capital structure on firm's performance in Nigeria.

OBJECTIVES

The main objective of the study is to critically examine the effect of capital structure on the performance of firms in Nigeria. The specific objectives are to;

a. Evaluate linkage between the value of the total debt and equity and returns on assets and investment
b. Determine the association between financial leverage and returns on assets
c. Evaluate the capital structure and firms performance in Nigeria

REVIEW OF RELATED LITERATURE

Conceptual Review

Concept of capital structure

Capital structure denotes means an establishment funds its operations using some blend of equity plus debt. Akinyomi, (2016) define it as the technique an establishment applies for financing based on a blend of long-term capital (ordinary and preference shares, debentures, loans, loan stock, etc.) in addition to short-term obligations like overdraft and other payables. Also Owolabi & Inyang, (2019), Kennon, (2018) opined that capital structure is the mixture of diverse securities utilized bya 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. The problem of choosing between equity and debt are faced many firms, especially in funding their long term investment opportunities. To finance the larger volume of a debt depends on the amount of interest on debt, financial distress cost, income taxes, imperfections in the market, taxes that are refuse to pay and corporate income etc. Long term debt will bring about increase in the desire of the firm when there is a decrease in the rate of interest. When there is an increase in leverage will provide an upsurge in financial distress. An increase in leverage of the firm will lead to firm's stock unattractive to investors and this is as a result of increase in financial distress. Firms might find difficult to satisfy a required service obligation, which could lead not only administrative expenses and legal expenses but also bankruptcy.

Leverage depicts the sensitivity of equity ownership in line with fluctuations in the fundamental value of an entity. Notably, leverage ratio can be independent, control and dependent variable in capital structure works. High leverage diminishes agency costs of outside equity and boosts corporate worth by limiting or cheering managers to achieve goals in line with shareholders demands (Akinyomi, 2016).

Nonetheless, such incentive will profit shareholders at debt-holders loss. If not wisely applied, the management of leverage to increase profitability may increase agency problem and cost.

Capital structure, preferred stock and common equity are mostly used by firms to raise needed funds, capital structure policy seeks a trade-off between risk and expected return. The firm must consider its business risk, tax positions, financial flexibility and managerial conservatism or aggressiveness, while these factors are crucial in determining the target capital structure, operating conditions may cause the actual capital structure to differ from the optimal capital structure.

A critical decision for any business organization is a decision for an appropriate capital structure, the decision is not only because of the need to maximize returns to various organizational constituencies, but on an organization's ability to deal with its competitive environment. The prevailing argument, originally developed by Modigliani and Miller (1958), is that an optimal capital structure exists which balances the risk of bankruptcy with the tax savings of debt. Once established, this capital structure should provide greater returns to stock holders than they would receive from an all-equity firm.

In theory, modern financial techniques would allow top managers to calculate accurately optimal trade-off between equity and debt for each firm. However, in practice; many studies found that most firms do not have an optimal capital structure. This is due to the fact that the managers do not have an incentive to maximize firm's performance because their compensation is not generally linked to it. Moreover, since managers do not share firm's profits with shareholders, they are very likely to increase company's expenditures by purchasing everything they like and surrounding themselves of luxury and amenities. Hence, the main concern of shareholders is ensuring that managers do not waste firm's resources and run the firm in order to maximize its value, which entails finding a way to solve the principal-agent problem.

Capital structure is the combination of the debt and equity structure of a company. It can also be referred to as the way a corporation finances its assets through some combination of equity, debt or hybrid securities; that is the combination of both equity and debt. A firm's capital structure is then the composition of its liabilities. The various components of a firm's capital structure according to Inanga and Ajayi (1999) may be classified into equity capital, preference capital and long-term loan (debt) capital. Equity capital refers to the contributed capital; money originally invested in the business in exchange for shares of stock; and retained profits; profits from past years that have been kept by the company to strengthen the balance sheet, growth, acquisition and expansion of the business. Preference capital refers to an hybrid that combines the features of debentures and equity shares except the benefits while debt capital refers to the long term bonds used by the firm in financing its investment decisions while coming up with its principal and also paying back interest.

Such other component of capital structure includes preferred stock, common equity,

profitability, gearing, leverage, returns on asset and returns on equity. Preferred stock is a class of ownership in a corporation that has a higher claim on the assets and earnings than common stock. Preferred stock generally has a dividend that must be paid out before dividends to common stockholders and the shares usually do not have voting rights. The precise detail as to the structure of preferred stock is specific to each corporation. However, the best way to think of preferred stock is as a financial instrument that has characteristics of both debt (fixed dividends) and equity (potential appreciation). Common equity is the amount that all common shareholders have invested in a company. Most importantly, this includes the value of the common shares themselves. However, it also includes retained earnings and additional paid-in capital. Profitability is expressed in terms of several popular numbers that measure one of the two generic types of performance: how much they make it with what they have got and how much they make from what they take in. It is a measure of the amount by which a company's' revenue exceeds its relevant expenses. Gearing is a measure of a company's financial leverage and shows the extent to which its operations are funded by lenders and shareholders inclusively. Leverage involves buying more of an asset by using borrowed funds with the belief that the income from the assets will be more than the cost of borrowing. Returns on assets is an indicator of how profitable a company is relative to its total assets. This also gives an idea as to how efficient management is at using its assets to generate earnings. Returns on equity measures the rate of return on the ownership interest (shareholders' equity) of the common stock owners. It measures the firms' efficiency at generating profit from every unit of shareholders' equity.

Elements of capital structure

The capital structure of an entity is broadly classified into two major groups, which are:

Equity capital: This involves the capability to source external and also issue out equity shares right certified by a share certificate. Modigliani & Miller, (1958) the equity shareholders own part of the firm. At financial period ending, companies issue dividend to shareholders from the profit made by the firm (Ishaya, & Abduljeleel, (2018).

Debt capital: Shehu, (2019) posits that debt capital is the long span obligation an entity applies in funding its investment activities which is accompanied with a long repayment period. The cost of debt in an entity's capital structure hinge on the state of its financial position.

Financial performance

There are numerous measures adopted by a firm in gaging its financial performance and arising from this; there is lack of consensus as to the measure or variable which should be applied to proxy performance of a firm. Different measures applied in measuring performance and which have been used by different authors in examining capital structure and profitability include the returns on equity, returns on asset, 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 Appah, Okoroafor & Bariweni, (2016) is the ability of a company to make profits from all its operations (operating, investing and financing activities). For a firm 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 worth of the firm's market 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 (Bokpin, & Isshaq, 2018).

Theoretical Review

Pecking Order Theory

The pecking order theory of capital structure as introduced by Donaldson (2016) is among the most influential theories of corporate leverage. It goes contrary to the idea of firms having a unique combination of debt and equity finance, which minimize their cost of capital. The theory suggests that when a firm is looking for ways to finance its long-term investments, it has a well- defined order of preference with respect to the sources of finance it uses. It states that a firms first preference should be the utilization of internal funds (i.e. retain earnings), followed by debt and then external equity. He argues that the more profitable the firms become, the lesser they borrow because they would have sufficient internal finance to undertake their investment projects. He further argues that it is when the internal finance is inadequate that a firm should source for external finance and most preferably bank borrowings or corporate bonds. And after exhausting both internal and bank borrowing and corporate bonds, the final and least preferred source of finance is to issue new equity capital.

Pecking Order theory tries to capture the costs of asymmetric information which states that companies prioritize their sources of financing (from internal financing to equity) according to the principle of least effort, or of least resistance, preferring to raise equity as a financing means of last resort. Hence, internal funds is used first, and when that is exhausted, debt is issued, and when it is not sensible to issue any more debt, equity is issued.

Static Trade-Off Theory

Basically, this theory postulates the non-existence of optimal capital structure. Khalaf, (2016), the trade-off theorist, posit that a firm sets its target debt level and then

works towards it. The theory refers to the idea that a company chooses how much debt finance and howmuch equity finance to use by balancing the costs and benefits. It identifies the benefit of financing with debt, the tax benefit of debt, as well as a cost of financing the company with debt, financial distress including bankruptcy costs of debt. The static trade off theory of capital structure predicts that firms will choose their mix of debt and equity financing to balance the costand benefits of debt.

Empirical Review

Akinyomi (2016), using three manufacturing companies selected randomly from the food and beverage categories and a period of five years (2007-2015) using the static trade-off and the pecking order theory point of view. He adopted the use of correlation analysis method and revealed that each of debt to capital, debt to common equity, short term debt to total debt and the age of the firms is significantly and positively related to return on asset and return on equity but long term debt to capital is significantly and relatively related to return on asset and return on return on equity. His hypothesis also tested that there is significant relationship between capital structure and financial performance using both return on asset and return on equity.

Appah, Okoroafor and Bariweni (2016), using 32 quoted firms in Nigeria Stock Exchange within a period of seven years (2005-2015) from the Modigliani and Miller, pecking order, static trade-off and agency theory point of view. They employed the panel study and revealed that short term debt, long term debt and total debt have significant negativerelationship with performance using return on asset and return on equity, non tax debt and liquidity also shows negative relationship with performance while tangibility and efficiency has asignificant positive relationship with performance.

Babalola (2018), using 31 manufacturing firms with audited financial statements for a period of fourteen years (1999-2017) from static trade-off point of view. He employed the triangulation analysis and the study revealed that capital structure is a trade-off between the costs and benefits of debt, and it has been refuted that large firms are more inclined to retain higher performance than middle firms under the same level debt ratio.

CONCLUSION AND IMPLICATION OF PAPER

This paper empirically reviewed the impact of capital structure on the performance of some listed firms in Nigeria. Taking into consideration, five firms from the total listed firms on the Nigeria stock exchange namely; GUINNESS NIGERIA PLC, VITAFOAM (NIG). PLC, 7-UP BOTTLING COMPANY PLC, BERGER PAINTS PLC.

A remarkable difference between the capital structures of Nigerian firms. Nigerian firms presumably prefer short term finance and have substantially lower amounts of long term debt. This reveals that Nigerian firms rely heavily on short term financing rather than long term finance. This difference in long-versus short-term debt, to an extent, might limit the explanatory power of the capital structure theories in Nigeria. It suggests that the theoretical underpinnings of the observed correlations are still largely unresolved.

The paper exposes the relationship that exists between the capital structure and firms performance. The capital structure is the mix of debt and equity finance by the firms.

The paper revealed that most firms use equity finance at a far higher level than debt finance partly due to ignorance and the stringent policies of debt finance in Nigeria. The high cost of debt finance is another militating factor against the firm's debt finance

usage. The high cost of debt finance made it inaccessible for expansion by the firms. The paper discovered that in the Nigerian peculiar circumstance the suggested Modigliani and Milan 99% to 1% debt equity ratio cannot work, and in fact most firms finance by 99% to 1% of Equity to debt ratio. The study also revealed that the optimal capital structure orchestrated by Modigliani and Millar is impracticable and unattainable in the peculiar circumstances' of the firms in Nigeria. The return and the overall performance of the firms are influence by the capital structure mix.

The following implication of this paper serves as recommendation;

Long term debt finance is mostly used by highly tangible firms, hence, policies that would encourage growing firms accumulate huge tangible assets should be pursued. Hence, tax rebates and exemptions can be granted.

To maximize the market values, the major focus of quoted firms in Nigeria when deciding their choice of capital structure is to establish a positive significant relationship between their capital structure choice majorly total debt and debt-equity mix and their performance.

A most optimal capital structure is the debt-equity mix that best maximize firms value, therefore, firms should strive to optimize their capital structure by an appropriate mix of debt-equity capital. The firms should therefore strike a balance between their choice of capital structure and the effect on its performance as it affect the shareholders risks, returns and the cost of capital.

Also, professional and qualified personnel should be charged with the financing decision of firmsin Nigeria since an optimal capital structure is a must for firms in Nigeria if they must compete effectively and survive in times of financial and economic distresses, and attaining an optimal capital structure requires an effective and strategic planning.

REFERENCES

Abdul, G. K. (2018). *The relationship of capital structure decisions with firm performance: A study of the engineering sector of Pakistan.* COMSATS institute of information technology, Vehari

Akinyomi, O. J. (2016). Effect of capital structure on firms performance: Evidence from Nigerian Manufacturing company. *International Journal of Innovative Research and Studies.* ISSN 2319-9725 2(9)

Alfred, D. D. (2017). *Corporate finance: Issues, investigations, innovations and applications* (2nd ed.). High rise publication.

Appah E., Okoroafor E. O., & Bariweni B. (2016). Capital structure and operating performance of quoted firms in the Nigerian Stock Exchange. *Research Journal of Finance and Accounting* ISSN 2222-1697 (Paper) ISSN 2222-2847 (Online) 4(5)

Babalola Y. A. (2018). Triangulation analysis of capital structure and firms performance in Nigeria. East Ukrainian National University [Vol. Dahl] 91034 Lugansk, Ukraine

Berger, A. N & Wharton, F. (2015). Capital structure and firm performance: A new approachto testing agency theory and an application to the banking industry.

Bokpin, A. G., & Isshaq, Z. (2018). Stock market development and financing decisions of listed firms in Ghana. African Journal of Business Management, 2 (10), 209-216.

Chandrasekharan, C. V.(2019). Determinant of capital structure in the Nigerian listed firms. International Journal of Advanced Research in Management and Social Sciences ISSN:2278-6236 1(2).

Donaldson, G. (2016). Corporate debt capacity: A study of corporate debt policy and the determination of corporate debt capacity. Division of Research, Harvard School of Business Administration.

Ishaya, L. C. & Abduljeleel, B. O. (2018). Capital structure and profitability of Nigerian quoted firms: The agency cost theory perspective. American International Journal of Social Science 3(1).

Kennon, J. (2018). An introduction to capital structure: why capital structure matters to your investments. [Online] Available: www.about.com (July 20, 2018).

Khalaf, A. (2016). The relationship between capital structure and firm performance: evidence from Jordan. *Journal of Finance and Accounting*. 1(3) 41-45. doi: 10.11648/j.jfa.20160103.11

Modigliani, F. & Miller, M. H. (1958). The cost of capital, corporate finance and the theoryof investment. American Economic Review, 48, 261-97

Owolabi, S. A. & Inyang, U. E. (2019). Determinants of capital structure in Nigerian firms: a theoretical review. *E-Canadian Journal of Accounting and Finance*, 1(1).

Pandey, I. M. (1999). *Financial management* (8th ed.). Vikas Publishing House PVT Ltd.

Shehu U. H. (2019). Determinants of capital structure in the Nigerian listed insurance firms. International conference on management (ICM 2019) proceeding

Taiwo A. M. (2019). An empirical analysis of capital structure on firms performance in Nigeria, *International Journal of Advances in Management and Economics*. ISSN: 2278- 3369 1(5) 116- 124

Zeitun, R. & Tian, G. G. (2017). Capital structure and corporate performance: evidence from Jordan. Australasian Accounting Business and Finance Journal. Volume I.