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CAPITAL STRUCTURE AND PERFORMANCE OF QUOTED CONGLOMERATES FIRMS IN NIGERIA

By

LAWAL, Tajudeen [4]
E-mail: ltajudeen@yahoo.com

Professor BAYERO, Muhammad A.S [5]
E-mail: bayeroasm@yahoo.com

&

LAWAL, Lukman Ojedele [6]
E-mail: awwalu1969@yahoo.com

Abstract

This study investigates the impact of capital structure on firm performance by analyzing the relationship between financial performance of Nigerian firms, measured by return on asset (ROA) and earnings per share (EPS) with Short term debt and long term debt. Two variables found by most literature to have influence on firm performance, namely size and efficiency are used as control variables. The study covers seven (7) conglomerates firms in Nigeria for the year 2002 through 2011. Panel data for the selected firms are generated and analysed using ordinary least square (OLS) as a method of estimation, in which a series of regression analyses were executed for each model. The study finds that short term debt has significant negative impact on the two accounting measure of performance studied. The result also reveals that long term debt has significant impact on return on asset (ROA) but not with earnings per share (EPS). This study concludes that capital structure has a significant negative impact on financial performance of quoted conglomerates firms in Nigeria for the period under study. This study therefore recommends that quoted conglomerates in Nigeria should reduce the debt levels in their capital structure so as to enhance positive performance to the interest of the stakeholders.

Keywords: Short term debt, Long term debt, ROA, EPS, Conglomerates

Introduction

Financial managers world over are faced with four primary decisions in an organization. These decisions are: financing or capital asset mix decision, liquidity decision, investment decision and dividend decision. These decisions are of great importance to organizations because the survival and growth of the organization depends on them. However, of these decisions, capital structure decision is seen to be the most important because every other decision lies on how a firm plans its capital mix

[4] Currently an M.sc Accounting & Finance student in the Deptartment of Accounting, A.B.U, Zaria, Nigeria
[5] Department of Accounting Usman Dan fodio University, Sokoto, Sokoto State, Nigeria
[6] Deptartment of Accounting, Gombe state University, Gombe State, Nigeria

decision. Capital structure is one of the most important reference theories in enterprises' financing policy and the topic continues to keep researchers pondering over the years. Several researches have been conducted on capital structure and performance both in developed and emerging economies, but despite this the topic is still receiving greater attention from scholars. The decision on capital structure is fundamental for any business organization because of the need to maximize returns to the various stakeholders and also because of fact that such decision has great impact on the firm's ability to deal with competitive environment.

Various theories have been advanced by scholars to explain the financing patterns of firms. These theories include: agency cost theory, Pecking order theory, trade off theory, Modigiliani &Miller theory. However, these theories have been subject of considerable debate due to inherent controversies in them. The controversies in the various theories being propounded to inform such all important decision further make capital structure decision crucial. Hence, capital structure decisions are very important, particularly in relation to performance of a firm in terms of profitability and value of the equity. The choice of an appropriate financing mix constitute a critical decision for the survival and growth of any business organization not only because of the need to achieve the desire goal of the organization, but also because of the impact such informed decision play on the performance of an organization in a competitive environment.

The literature examining the performance implications of capital structure choices is immense in developed economies like USA and Europe, among them are Berger and Bonacorsi (2002), Rajan and Zingales (1975), Zeitun and Tian (2007). However, to the best of our knowledge, little work is empirically carried out about such implications in developing economies like Nigeria. They include Omorogie and Erah (2010); Onaolapo and Kajola (2010). Akintoye (2008) examine the impact of capital structure on the performance of food/Beverage and Tobacco firms in Nigeria using simple ratio as methodology for analyzing the data. We observed that simple methodology may be inadequate for the study of this nature; therefore we try to fill the gap by using a more robust methodology in the conglomerates firms in Nigeria. Another important gap which we intend to fill in this study is the measurement of debt/leverage ratio by many researchers in Nigeria as a ratio of total debt to total asset which is considered as bad measurement of leverage (Welch, 2011). Since researchers investigate the relationships between capital structure and performance in different sectors in Nigeria and there is nothing in the conglomerates firms, we therefore decided to fill the gaps in this sector. Hence, this research will explore the extent to which debt affects firm performance. In addition, it is interesting to differentiate short term debt and long term debt effects since they have different risk and return profiles.

The main objective of this study is to examine the impact of capital structure on the performance of quoted conglomerates firms in Nigeria. Specifically the objective is to examine the impact of long term debt and short term debt on return on assets (ROA) and earnings per share (EPS) of quoted conglomerates firms in Nigeria. In line with the objectives of the study, hypotheses are formulated in a null form and are tested in arriving at a dependable solution to the problem under study. There is

no significant relationship between short term debt and return on Assets (ROA) and earnings per share (EPS) of quoted conglomerates firms in Nigeria. There is no significant relationship between long term debt and return on assets(ROA) and earnings per share (EPS) of the selected firms. The study covers a ten year period from 2002 to 2011.

Conceptual and Theoretical Framework

Capital structure has been defined by different authors and scholars. However, these definitions are explicit and have the same meaning. For example, Sa'ad (2010) defines capital structure as the way a firm finances its assets through the combination of equity, debt, or hybrid securities. In short, capital structure is a mixture of a company's debt (long term and short term, common equity and preferred equity. Pandey (1999) defines company's capital structure as the amount of debt level relative to equity on the balance sheet. It is a snapshot of the amount and type of capital that a firm have access to and what financing methods it has used to conduct growth initiatives such as research and development in acquiring asset.

Short term debt may be defined as any debt incurred by a company that is due within one year. It can also be define as any bond or other debt that must be repaid or refinanced within one year (Dictionary.com). According to Frank and Goyal (2003),short term debt consists of all liabilities, which are required to be discharged within one year. They cover those obligations whose liquidation is expected to be made out of current assets. Long term debt includes all liabilities other than short term debt and shareholders' equity (Frank& Goyal,2003). They can also be described as loans and obligations with a maturity of longer than one year usually accompanied by interest payments (Dictionary.com). Zeitun and Tian (2007), explain the concept of performance as a controversial issue in the financial strategy of most corporate organization due to its multidimensional meanings. Performance measures are either financial or organizational. Financial performance such as profit maximization, maximizing profit on assets, and maximizing shareholders benefits are core of firms' effectiveness (Chakravarthy, 1986). Operational performance measures, such as growth in sales and growth in market share, provide a broad definition of performance as they focus on the factors that ultimately lead to financial performance (Hoffer and Sandberg 1987 in Zatun 2007).

The modern theory of capital structure began with celebrated paper of Modigiliani and Miller (1958). They suggest that in the perfect market, financing strategies do not affect the value of the firm and future performance. Modigiliani and Miller demonstrate that if a company's investment policy is taken as given, then in a perfect world, a world without taxes, perfect and credible disclosure of all information and no transaction costs associated with raising money or going bankrupt the extent of debt in a company's capital structure does not affect firms value. However, Modigiliani and Miller (1963) later amended their initial argument. They argue that firm value can be increased by changing the capital structure because of the advantage of debts.

However, Jensen and Meckling (1976), proceed to the contrary and demonstrate that the amount of leverage in a firms' capital structure affect managers' choice of operating activities and that these

activities in turn affect the performance of the firm. Jensen and Meckling argument is that managers do not always run the firm to maximize returns to shareholders. They may adopt non-profitable investments, even though the outcome is likely to be losses for shareholders. They demonstrate that if debt is included in the capital structure of an organization, it will reduce the agency conflicts between manager and shareholders by constraining or encouraging managers to act more in the interest of shareholders. In the same vein, Myers and Majluf (1984), argue that since all firms managers try to get optimal capital structure with least possible, cost, this led in 1984 to the emergence of pecking order theory. The theory suggests that there is no an optimal capital structure for a firm, according to this theory, since there is asymmetric information between managers and investors. Therefore, to minimize this asymmetry information managers prefer to finance using retained earnings, debt and equity respectively.

The two classical publications of Modigiliani and Miller (1958&1963) triggered a stream of studies and hypotheses over time that contributed to the classification of the capital structure puzzles and since then there has been a lot of theoretical and empirical studies on capital structure.

Modigiliani & Miller Theorem:

Modigiliani and Miller (1958) most famous theories of capital structure, the irrelevance theory is considered the basis of modern corporate finance. It can be concluded that the M&M (1958) seminar paper open floor for debate into capital structure. In their proposition, they argue that, capital structure has no impact on the firm's total value assuming that economy is tax free, there is no agency cost and problem of asymmetry information. In reality, the financial market they assumed do not exist in the real life situation even as their theory was used as that time. The advocates of MM theorem argue that by taking assumptions which appears unrealistic actually MM separated the factors under which the capital structure affect firm value.

- Tradeoff Theory

  The trade-off theory explains firms' choice of leverage by a trade-off between the benefits and costs of debt. A trade-off of costs and benefits of borrowing, holding the firm's assets are viewed as determiner of a firm's optimal debt ratio. Main focus of a firm is to substitute debt for equity, vice versa in order to find optimal debt ratio and maximize value of the firm. Hence, trade-off theory can be summarized as balancing the different benefits and costs associated with debt financing to have optimal capital structure.

- Agency cost Theory

  Jensen and Meckling (1976) who are founders of the agency cost theory, subsequently define the agency relationship inside the firm as: "A contract under which one or more person (the principal) engages another person (the agent) to perform some service on their behalf which involves delegating some decision making authority to the agent". According to the agency theory, the way of professional management style, which is the separation of ownership and management may result agency conflicts that is caused by insufficient work

)erquisites, choosing inputs or outputs according to one's preferences. Due to these reasons, a firm nay fail to maximize its value. However, the theory suggests that choosing best/optimal capital structure may mitigate agency conflicts and decrease agency cost. Therefore, according to the heory, high leverage/debt ratio help a firm to reduce its agency cost and mitigate agency conflicts. This debt ratio also encourages managers to act more in the interests of shareholders. As a result, he firm's value increases.

Pecking order Theory

The so called pecking-order theory or pecking-order hypothesis was developed by Stewart Myers in 1984, as a way of describing the corporate finance behaviour that he has observed and based on that ne pointed out three major points that corporate finance managers tends to adhere to and that is nighly relevant for capital structure choices. Myers' (1984) three points are provided below:

Managers want to maintain stable shareholder dividends over time, despite possible fluctuations in earnings, stock prices or investment opportunities. Mangers prefer internal financing compared to external financing, i.e. funds which are raised through the issuing of either new debt or equity shares. If external financing is necessary, managers opt for the least risky option first and so on.

Prahalantan and Ranjani (2011) examine the impact of capital structure choice on the performance of listed companies in Colombo stock exchange Sri Lanka. The results reveal that short term debt have a significant negative impact on gross profit margin. The result also reveal that there is no significant relationship between short term debt and firm performance measured by return on equity (ROE) and return on asset(ROA) respectively. Khan (2012) study the effect of short term debt on the performance of selected firms in the engineering sector of Pakistan economy. The results reveals that there is a negative and significant relationship between short term debt and firm performance measured by return on asset (ROA), gross profit margin (GM) and Tobin's Q. The result also shows that there is an insignificant negative association between short term debt and return on equity (ROE). Phansamon & Yalcin (2012) study the influence of short term debt on the performance of Swedish listed firms. The study reveals that short term debt has a significant impact on the firm performance measured by return on investment(ROI), return on equity(ROE) and return on asset (ROA). Amjed (2012) examine the effect of short term debt and performance of firm in the chemical sector of Pakistan. The study reveals that there is significant positive impact between short term debt and profitability. Also the study reveals that there is negative relationship between short term debt and return on equity (ROE) and return on asset (ROA). Nour (2012) in his study finds long term debt has no significant impact on all the performance measured by return on equity (ROE), return on asset(ROA), earning per share(EPS), MBVR and Tobin's Q. Umar et al(2012) conclude that long term liabilities have positive impact on return on equity(ROE). Ebaid (2009) reports that there is no significant relationship between long term debt and all three performance measures used in his study that is return on asset(ROA), return on equity(ROE) and gross profit margin(GM). Heng and San (2011) investigate the relationship between capital structure and corporate performance of 49 Malaysian Construction companies. The study finds that long term debt has a significant positive impact on earnings per share (EPS) and return on capital

(ROC). Premkanth et al (2011), conclude that significant negative relationship exist between long term debt and return on equity (ROA). Uwalomwa et al (2012), finds that long term debt has significant negative impact on return on assets (ROA).

Methodology

This study adopted cross-sectional research design as it attempt to find the relationship between capital structure and performance of quoted conglomerates firms in Nigeria. Capital structure is proxy by short term debt (STDTC), long-term debt (LTDTC). Two control variables SIZE and EFFICIENCY are used in the study. Performance on the other hand which is the dependent variable is proxy by return on asset (ROA) and earnings per share (EPS). For the purpose of this study only secondary source are utilized. The method of data collection employed is also secondary i.e annual reports of the sampled conglomerate firms in Nigeria for the period of 2002-2011, and the Nigeria stock exchange fact books 2005, 2009 and 2011 edition. The population of this study comprises of all quoted conglomerates firms in Nigeria that are quoted on the floor of Nigerian stock exchange as at 31st December, 2011. As at 31st December 2011, a total of eight conglomerates firms are quoted on the Nigerian stock exchange. The eight quoted conglomerates firms in Nigeria represent our studied population. Seven firms were selected as sample of the study. The firms are: A.G Leventis (Nigeria) Plc, Chellarams Plc, John Holt Plc, PZ Cussons Nig plc, SCOA (Nigeria) Plc, UACN and Unilever Nigeria Plc. The only firm that was left out is Transnational Corporation of Nigeria and the reason is that it was incorporated in the year 2004 and quoted on the Nigerian stock exchange in the year 2006 so it does not meet the criteria for selecting the firms. Multiple linear regression (panel regression) technique was used with the application of SPSS-Statistical package. The panel regression method are developed and used for the study as it increase efficiency by combining time's series and longitudinal data. Panel data involves the pooling of observation on a cross-section of units overtime periods. Furthermore, panel data facilitates the identification of effect that cannot be detected using purely cross section or time series.

Model Specification and Variable Measurement

This study assumes a linear relationship between capital structure (independent variable) and performance (dependent variable) of Conglomerates firms in Nigeria. The study also assumes that the performance of Conglomerates firms in Nigeria is affected by its capital structure decision. Therefore, to reveal the relationship between capital structure and performance of the selected firms, the estimation procedure used by Awunyo & Badu (2012) was adopted with slight modification in the contents of measurement of variables.

$$yit = \alpha i + \beta_1 xit + eit$$

Where:

yit is performance measure (Return on asset (ROA), Earnings per share and net margin (NM)

αi = refers to time – invariant firm specific effects

β_1 = beta coefficient

Xit = the independent variables and control variables

eit = random disturbance or error term.

ROA it = $\beta o+\beta_1$ STDTCit+β_2LTDTCit+ β_4SIZEit+ β_5EFFit+ eit ..... Model 1

EPS it = $\beta o+\beta_1$ STDTCit+β_2LTDTCit+β_4SIZEit+ β_5EFFit+ eit ..... Model 2

Where:

ROA it = ratio of after tax profit to total asset of firm i in period t

EPS it = ratio of after tax profit to total number of ordinary shares in issue for firm in period t

STDTC it = ratio of short term debt to total capital of firm i in period t

LTDTC it = ratio of long term-debt to total capital of firm i in period t

SIZE it = natural logarithm of Turnover (log of turnover)

EFFit = ratio of turnover to total asset of firm i in period t.

Results and Discussion

This section presents the analysis and findings of this study. The hypotheses formulated are tested in this section in order to determine the impact of the independent variables on the dependent variables.

Descriptive Analysis of model 1

ROA it = $\beta o+\beta_1$ STDTCit+β_2LTDTCit+ β_4SIZEit+ β_5EFFit+ eit ..... Model 1

Table 2: Descriptive statistics and correlation of model 2

Variable	Mean	Std dev.	Min.	Max.	Skewness	Kurtosis	N valid	EPS	STD	LTD	SIZ	EF
EPS	0.460438	1.2866971	-5.4272	3.3967	-2.330	9.754	70	1.000				
STD	0.303726	0.3465404	0.000	1.5790	1.465	1.781	70	-0.602** (0.000)	1.000			
LTD	0.026235	0.0625375	0.000	0.3046	3.461	12.091	70	-0.121 (0.320)	0.133 (0.273)	1.000		
SIZE	6.9973E0	0.3581823	6.4484	7.7347	0.300	-1.009	70	0.309** (0.009)	-0.299* (0.012)	-0.216* (0.073)	1.000	
EFF	1.3748E0	0.6215267	0.3271	2.6737	0.314	-0752	70	-0.180 (0.136)	-0.468** (0.000)	-0.086 (0.479)	-0.004 (0.974)	1.0

Dependent variable: Earning per share (EPS)

**correlation is significant at the 0.01 level *correlation is significant at 0.05 level

Source: output of data analysis by authors (2013) using SPSS

	Dependent Variables	
Independent Variables	**M1**	**M2**
Short-term debt	-0.623 (0.000)	-0.614 (0.000)
Long-term debt	-0.170 (0.086)	-0.002 (0.822)
Size	0.014 (0.890)	0.121 (0.253)
Efficiency	0.065 (0.554)	0.110 (0.326)
R^2	0.416	0.390
Adjusted R^2	0.381	0.352
f-statistics	11.598	10.388
Sig F.change	0.000	0.000
Durbin Watson	1.326	1.446

Source: Output of data analysis by authors 2013 using SPSS

The figures in the parentheses above represent the P-values represent the Beta coefficients.

The beta coefficient -0.623 in the table (M1) signifies that the short term debt and return on assets (ROA) of quoted conglo one (1) predicts that there is no significant relationship betw (ROA). The findings of this study are consistent with the fir Also, the beta coefficient -0.170 in the table (M1) signifies between long term debt and return on assets (ROA) of quo Hypothesis two (2) predicts that there is no significant relat return asset (ROA).Based on the p-value (0.086) from the abov hypothesis. The above results is consistent with the findings (2012), who report that long-term debts has significant negati but inconsistent with the findings of Prahalatan et al (2011) between long-term debt and return on asset (ROA).

The beta coefficient -0.614 in the table (M2) signifies that th short term debt and earnings per share (EPS) of quoted conglo

also consistent with the findings of Umar et al (2012), who report that current liabilities have negative impact on earnings per share (EPS). However, the result is inconsistent with the findings of Nour (2012), who find no relationship between short-term debt and earnings per share. Also, the beta coefficient -0.002 in the table (M2) signifies that long term debt has negative and insignificant impact on earnings per share (EPS) of quoted conglomerates firms in Nigeria. The implication of the above results is that long term debt has no significant impact on earnings per share (EPS) of quoted conglomerates firms in Nigeria. This result produce evidence that whatever the amount of long term debt may be on the finance of the selected firms, it has no impact on earnings per share (EPS) of quoted conglomerates in Nigeria. The result of the finding is consistent with the finding of Nour (2012) who reports that long term debt has no significant impact on earnings per share(EPS) of firms in Palestine stock exchange. However, the above result is inconsistent with the finding of Heng and San (2011) who report that long term debt has significant positive impact on earnings per share (EPS).

The two control variables size (SIZE) and efficiency (EFF) used in this study present a positive and insignificant impact on return on asset (ROA) of the sampled conglomerates firms. The implication of this result is that both size and efficiency have no significant impact on return on assets (ROA) of the sampled conglomerates firms.

The result in table 3 above indicates that adjusted (R^2) of the explanatory variables have the power of explaining 38.1% and 35.2% of the variations in return on asset (ROA) and earnings per share (EPS), the remaining percentage maybe other factors not captured in this study. The F statistics and sig. F change are normally used to determine the fitness of a regression model. In this study, of statistics and sig F change in model 1 showed 11.598 and 10.358and 0.000 respectively. This means that the regression model used in model 1 and 2 of this study are fit at 1% level of significance it also indicate that the regression model1and2 are well fitted and captured important variables that affect the return on assets (ROA) and earnings per share (EPS) of the selected conglomerate firms in Nigeria during the period from 2002 through 2011.

Conclusion and Recommendation

In conclusion, the findings of this study reveal that short term debt has a significant negative impact on return on assets (ROA) and earnings per share (EPS) of quoted conglomerates firms in Nigeria for the period under study. The findings of this study also reveal that long term debt has a negative impact on the return on assets of quoted conglomerates firms in Nigeria. This implies that as the sampled firms used more of both short term debt and long term debt to finance their activities, there is a drastic decrease on the return generated on total utilization of the firms assets that is return on assets (ROA). The study therefore concludes that the more the firms used both short term debt and long term debt on their capital mix, the more negative impact it will be having on their performance. However the findings of this study reveal that long term debt has no significant impact on earnings per share (EPS) of the quoted conglomerates firms in Nigeria. This therefore implies that even when

the firms employ long term debt in their capital mix, it does not have any impact on the earnings that is being paid to the shareholders. As a result of this finding the study concludes that shareholders should not have any concern about the level of long term debt in financing mix of conglomerates firms in Nigeria. In general, this study therefore recommends that quoted conglomerates firms in Nigeria should reduce the debt levels in their capital structure so as to enhance positive performance to the interest of the stakeholders.

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APPENDIX 1

LIST OF THE FIRMS IN THE SECTOR

A.G LEVENTIS (NIGERIA) PLC

CHELLARAMS PLC

JOHNHOLTS PLC

PZ CUSSONS (NIGERIA) PLC

SCOA (NIGERIA) PLC

UACN PLC

UNILEVER PLC

TRANSNATIONAL CORPORATION OF NIGERIA PLC

APPENDIX 2

LIST OF THE FIRMS USED IN THE STUDY

A.G LEVENTIS (NIGERIA) PLC

CHELLARAMS PLC

JOHNHOLTS PLC

PZ CUSSONS (NIGERIA) PLC

SCOA (NIGERIA) PLC

UACN PLC

UNILEVER PLC