Impact of Capital Structure on the Performance of Deposit Money Banks (A Study of Selected Deposit Money Banks in Nigeria)

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Abstract
The research work was designed to evaluate the impact of capital structure on the performance of banks in Nigeria. The focus of the research is to identify the relationship that exist between highly geared capital structure and lowly geared capital structure on performance indices such as return on equity and return on assets. Four (4) banks were used and their audited financial statements analyzed to generate both the dependent and independent variables for twelve years (2002-2013). The statistical tool applied is ordinary least square and the result shows that highly geared capital structure is increases performance of deposit money than lowly geared capital. The recommendations made are that banks should employ more of debt capital in order to maximize return on investment, even when external debt is to be used, the banks should search for low interest bearing loans so that the benefit from the loan will exceed the financial cost associated with it etc.

Keywords: *capital structure, performance, bank.*

Introduction

Capital structure is the mix of long term source of fund such as debenture, long term debt, preference share capital and equity share capital including reserve and surpluses and retained earnings (Pandey 2005). It is a way firm finances its assets across the blend of debt, equity or hybrid securities (Saad 2010). Capital structure decision is fundamental for any business organization because of the need to maximize return to the various stake holders and also because of the fact that such decision has great impact on the firms' ability to deal with competitive environment. (Awunyo and Badu 2012).

One crucial issue confronting managers today is how to choose the combination of debt and equity to achieve optimum capital structure that would minimize costs and maximize return to the owners of the business. Optimum capital structure means the minimum weighted average cost of capital that maximizes the value of the organization (Saeed 2013). Every manager of organizations attempt to ascertain a particular combination that will minimize costs and maximize profitability and the firms value but unfortunately, they do not have a clear cut guideline that they can consult when taking decision in connection with optimal capital structure (Saeed 2013).

Modigliani and Miller (1958) advocated that market value of the firm is independent of its capital structure. Although their theory is based on non-existing assumptions of perfect market conditions, which include no taxes, no transaction cost etc. The ruling decisions add no value and are of no concern to managers. Indication would suggest that this do not exist in reality.

Traditional school advocates that leverage increase the firms' value and thereby increase the wealth of the shareholders. However Barclay and Smith (2005) asserts that much debt can destroy a firm's value by causing financial distress and over investment and too little debts can also lead to underinvestment and negatively affect returns particularly in large and matured firms. It therefore becomes imperative to make a right choice in determining optimal capital structure that will ultimately result in the growth, the value of investment made, the various categories of investors particularly equity investors (Watson and Head 2007).

Nigeria is targeting being one of the twenty (20) most developed economics of the world by 2020. The role of the banking sector in achieving this aim cannot be under estimated. The banking sector must therefore be strong in performing the basic function of financial intermediation so that depositor's confidence can be secured and also be in a position to compete favorably in the global financial market. This study is therefore aimed at examining the effects of capital structure on the performance of Nigerian deposit money banks.

Objective Of The Study

The general objective of the study is to determine the impact of capital structure on the performance of banks in Nigeria. The specific objectives are:

1. To investigate the impact of lowly geared capital structure on firms performance
2. To investigate the impact of highly geared capital structure on firms performance.

Research Questions

The following research questions are necessary:

1. What impact has lowly geared capital structures on firms' performance?
2. What impact has highly geared capital structures on firms' performance?

1.1 Statement Of Hypotheses

The following hypotheses are stated below:

H_1: Lowly geared capital structure has no significant impact on firms' performance

H_2 Highly geared capital structure has no significant impact on firms' performance.

Theoretical Framework

All modern researches have issues with the Modigliani and miller (1958) proposition which states that in a world of perfect capital market and no taxes, a firm's financial structure will not influence its cost of capital. This proposition submitted that firms in a given
risk class would be unaffected by financial gearing (Weston and Copeland 1998). Borigham and Gapenski (1996) argued that an optimal capital structure can be attained if there exist a tax sheltering benefits provided an increase in debt level is equal to the bankruptcy costs. They suggest that managers of a firm should be able to identify when the optimal capital structure is attained and try to maintain it at that level. This is the point at which the financing costs and cost of capital are minimized thereby increasing firms' value and performance.

Tradition view advocated that the value of the firm can be increased or the cost of capital can be reduced by the judicious mix of debt and equity capital. This theory very clearly implies that the cost of capital decreases within the reasonable limit of debt and then increases with leverage (Solomon 1963). Thus, an optimum capital structure exist and occur when the cost of capital is minimum or the value of the firm is maximum. The cost of capital declines with leverage because debt capital is cheaper than equity capital within reasonable or acceptable limit of debt. The statement that debt funds are cheaper than equity funds carried the clear implication that the cost of debt plus the increase cost of equity together on a weighted basis will be less than the cost of equity which existed on equity before debt financing (Barges 1963).

The study built on Midigliani and Miller theory which state that financial structure is invariant with market value of the firm.

Components of A Firms' Capital Structure

the various components of firm's capital structure according to Inanga and Ajayi (1999) may be classified into equity capital, preference capital and long-term loan (debt) capital.

a) Equity Capital

Pandey (1999) defined equity capital as including share-capital, share premium, reserves and surpluses (retained earnings). Typically, equity capital consists of two types which include: contributed capital, which is the money that was originally invested in the business in exchange for shares of stock or ownership and retained earnings, which represents profits from past years that have been kept by the company and used to strengthen the Balance Sheet or fund growth, acquisitions, or expansion. The cost of equity capital of a firm using the dividend growth basis can be expressed as: $Ke=do\ (1+g)/Pe\div g$ ……2.1

Where

Ke equals the cost of equity capital;

Do, the current dividend per share;

Pe, the Ex-dividend market price per share and

g. the expected constant annual growth rate in earnings and dividend per share.

b) Preference Capital

The preference share capital is a hybrid in that it combines the features of debentures and those of equity shares except the benefits its cost can be expressed as:

KP=PDIV/Po …….2.2

Where: *KP* equals the cost of preference share;

PDIV, the expected preference dividend and

P0, the issue price of preference shares.

c) Debt Capital

The debt capital in a firm's capital structure refers to the long-term bonds the firm used in financing its investment decisions because the firm has years, if not decades, to come up with the principal, while paying interest only in the meantime. The cost of debt capital in the capital structure depends on the health of the firm's balance sheet. This can be expressed as:

Kd = Int/Bo ……2.3

Where: *Kd* equals the before-tax cost of debt;

Int, the interest element and *Bo,* the issue price of bond (debt). The aftertax cost of debt capital will be:

Kd (1-T). Where: *T* is corporate tax rate.

Capital Structure and Assets of Firms

The firm's asset structure plays an important role in determining its capital structure. The degree to which the firm's assets are tangible should result in the firm having greater liquidation value Titman and Weasels, (1988)

Harris and Raviv, (1991). Bradley. (1984) assert that firms that invest heavily in tangible assets also have higher financial leverage since they borrow at lower interest rates if their debt is secured with such assets. It has been suggested that bank financing will depend upon whether the lending can be secured by tangible assets Berger and Udall (1998). Empirical results show a positive relationship consistent with theoretical argument between asset structure and leverage for the firms (Bradley, 1984; Friend and Lang, 1988; Mackie-Mason, (1990); Rajan and Zingales, 1995; Hovakimian et *al.,* 2004. Kim and Sorensen 1986 however found a significant and negative coefficient between depreciation expense as a percentage of total assets and financial leverage. Other studies specifically suggest a positive relationship between asset structure and long-term debt, and a negative relationship between asset structure and short-term debt Chittenden (1996); Michaela's (1999); Hall (2004). Found positive relationships between

asset structure and both long-term and short-term debt. Marsh (1982) also maintains that firms with few fixed assets are more likely to issue equity. In a similar work, Mackie Mason (1990) concluded that a high fraction of plant and equipment (tangible assets) in the asset base makes the debt choice more likely. Booth (2001) document a positive correlation between tangible fixed assets and debt financing; they link this to the maturity structure of the debt. From the foregoing, a positive significant relationship between tangibility of assets and leverage of Nigerian firms is expected.

Capital Structure and Growth of Firms

Growth is likely to place a greater demand on internally generated funds and push the firm into borrowing (Hall, 2004). According to Marsh (1982), firms with high growth will capture relatively higher debt ratios. In the case of small firms with more concentrated ownership, it is expected that high growth firms will require more external financing and should display higher leverage Heshmati, (2001), maintain that growing firms appear more likely to use external finance — although it is difficult to determine whether finance induces growth or the opposite (or both). As enterprises undergo various stages of growth, that is micro, small, medium and large scale, they are also expected to shift financing sources. They are first expected to move from internal sources to external sources (Aryeetey, 1998). Another relationship exists between the degree of previous growth and future growth. Michaelas (1999) argue that future opportunities will be positively related to leverage, particularly short term leverage. They argue that the agency problem and the cost of financing are reduced if the firm issues short-term debt rather than long- term debt. Myers (1977), however, is of the view that firms with growth opportunities will have a smaller proportion of debt in their capital structure. This is because the conflicts of interest between debt and equity holders are serious for asset that gives the firm the option to undertake such growth opportunities in the future. He argues further that growth opportunities can produce moral hazard situations and small-scale entrepreneurs have an incentive to take risks to grow.

The benefits of this growth, if realized, will not be enjoyed by lenders who will only recover the amount of their loans, resulting in a clear agency problem. This will be reflected in increased costs of long-term debt that can be mitigated by the use of short term debt. Empirical evidence seems inconclusive in this regard as there is much controversy about the relationship between growth rate and level of leverage. Some researchers found positive relationships between sales growth and leverage (Titman and Wessels, 1988);

Other evidence suggests that higher growth firms use less debt (Kim and Sorensen, 1986; Stu, 1990; Rajan and Zingales, 1995). Michaelas *(*1999) found future growth to be positive relative to leverage and long-term debt. Hall (2004) showed positive associations between growth and both long-term debt and short-term debt ratios, while Chittenden (1996), found mixed evidence. Dividend payout of a firm could affect choices of capital in financing growth. Generally, firms with low dividend payout are able to retain more profits for investments. Such firms would therefore depend more on internally generated funds and less on debt finance. On the other hand, firms with high dividend payout are expected to rely more on debt in order to finance their growth opportunities.

Capital Structure and Profitability f Firms

The pecking order theory of capital structure shows that if a firm is profitable, then it is more likely that financing would be from internal sources rather than external sources. In other words, firms tend to use internally generated funds first and then resort to external financing. This implies that profitable firms will have less amount of leverage (Myers and Majluf, 1984). By this, profitable firms that have access to retained profits can rely on them as opposed to depending on outside sources (debt). (2004). Titman and Wessel (1988) agree that firms with high profit rates would maintain relatively lower debt ratios since they can generate such funds from internal sources.

Empirical evidence from previous studies seems to be consistent with the pecking order theory. Most studies found a negative relationship between profitability and capital structure Friend and Lang, (1988); Chittenden, 1996; Michaelas, (1999) and Hall (2004) also suggest negative relationships between profitability and both long-term debt and short-term debt ratios. Also consistent with the pecking order theory, work of Titman and Wessel (1988), Rajan and Zingales (1995), Antoniou, (2002) in developed countries, Booth, (2001), Pandey (2001), and Chen (2004), in developing countries all find a negative relationship between leverage ratios and profitability. We therefore propose based on the pecking order theory that a negative relationship exist between profitability and leverage. Thus it is expected that leverage level of Nigerian commercial banks is significantly negatively related to the profitability.

METHODOLOGY

Research design is the framework for collecting and analyzing data (Ihenetu 2008). The researcher adopted an empirical design for the study. Here, the researcher wants to know the impact made by capital structure on the performance of deposit money banks operating in Nigeria.

The data was sourced from secondary sources. Text books, annual publications, internet materials etc. were used by the researcher. The manipulative data were sourced from the annual report of the selected banks under study.

Twenty one (21) deposit money banks operating in the country constitute the population of the study. The banks were first reduced to twenty five (25), then twenty four (24) after consolidation and subsequently now twenty one (21). These banks make up the population of the study.

Four (4) banks were sampled through purposive sampling method for the study. The banks are Eco Bank, First Bank, GTB, and Zenith Bank. The choice of these banks was predicated on their proven track record and consistent management policies. The sample size is (11) years (2002-2013).

Operational Measurement Of The Variables

The variable consists of independent and dependent variables. The independent variable is debt to equity which proxied capital structure. The dependent variables consist of return on equity, return on capital employed, return on assets and earning per share

Independent Variables

Debt to equity (DTE) $= \frac{\text{Long-term Debt}}{\text{Equity}}$

Dependent Variables

Return on Equity (ROE) = Profit after Tax / Equity

Return on Assets (ROA) = Profit after Tax / Total Assets

In order to evaluate the relationship between capital structure and performance of the banks, ordinary least square method was applied. The formular is given as

ROE = a+ bDTE + e

ROA = a+ bDTE + e

Where a = constant intercept

b = coefficient of independent variable.

e = error term

Other variables have been defined above.

Data Presentation, Analysis and Discussion of Findings

Data from financial statement of the chosen banks were presented and analyzed. Answers on the research questions will be tested in order to validate the true position of the theoretical framework. The hypotheses will be either accepted or rejected depending on the outcome of the result.

Data Presentation

The data used for analysis are presented below:

Lowly Geared Capital Structure And Performance Indices

	ECO			FBN		
YEAR	DTE	ROE	ROA	DTE	ROE	ROA
2002	0.0051	0.5090	0.0230	0	0.2461	0.0163
2003	0.0144	0.5364	0.0299	0	0.4077	1.0269
2004	0.0127	0.5139	0.0237	0	0.2873	0.0355
2005	0.0369	0.3081	0.0247	0	0.2727	0.0323
2006	0.0233	0.3287	0.0269	0	0.2633	0.0297
2007	0	0.6881	0.0239	0.2827	0.2373	0.0241
2008	0.9057	(0.0007)	(0.0001)	0.0866	0.0897	0.0262
2009	0	0.0523	0.0072	0.0499	0.2497	0.0017
2010	0	0.1020	0.0126	0.7003	1.7882	0.0124
2011	0	0.1417	0.0121	0.9243	1.1422	0.0065
2012	0	1.1319	0.0144	0.1878	4.7071	0.0238
2013	0	0.0692	0.0066	0.1179	4.3289	0.0182

Source: Author's computation based on various bank's financial statements

Highly Geared Capital Structure And Performance Indices

	GTB			ZENITH		

YEAR	DTE	ROE	ROA	DTE	ROE	ROA
2002	1.0002	2.1404	0.0361	1.0300	3.4130	0.0379
2003	1.5371	2.5692	0.0385	1.0202	2.8570	0.0393
2004	2.3550	2.7044	0.0339	1.0040	3.3520	0.0269
2005	2.3033	1.7769	0.0318	1.0203	2.3820	0.0217
2006	3.0792	2.6352	0.0259	27.7975	2.5048	0.0189
2007	1.4516	3.2533	0.0272	4.7375	3.7794	0.0198
2008	8.2083	3.1419	0.0299	4.1290	5.5569	0.0277
2009	1.3285	3.2998	0.0298	2.8985	1.7464	0.0139
2010	1.7954	3.2947	0.0355	1.8065	2.0579	0.0180
2011	15.6057	3.5101	0.0339	1.3422	2.6310	0.0190
2012	11.4976	5.7941	0.0526	0.9643	6.1029	0.0393
2013	15.8363	5.8133	0.0449	3.8317	5.3137	0.0290

Source: Author's computation based on various bank's financial statements

Data Analysis

The data presented were used in the analysis of the study. They also formed the basis for testing the hypotheses. Ordinary least square was used for the analysis. The result was summarized below:

Highly Geared Capital Structure	t-cal	t-tab	Sig.
ROE	1.833	1.8125	Significant
ROA	-1.973	1.8125	Significant
Lowly Geared Capital Structure			
ROE	-0.337	1.8125	Not significant
ROA	-0.813	1.8125	Not significant

Summary of SPSS print out

Decision Rule

Accept alternate hypothesis (H_a) if the t-cal is higher than the t-tab and reject null hypothesis (H_o), otherwise accept H_o and reject H_a.

Decision

Highly geared capital structure has significant impact on the selected performance indices because the calculated value is more than the table value where as lowly geared capital structure has no significant impact on the various performance indices because the table value is more than the calculated value hence we conclude that highly geared capital structure is preferable to lowly geared capital structure.

Discussion of Findings

The research conducted on the impact of capital structure on firms' performance using selected deposit money banks in Nigeria reveals that highly geared capital is preferable to the lowly geared capital structure. The calculated value of the indices of highly geared capital is higher than the table value ie 1.833 and -1.973 is higher than 1.8125 for ROE and ROA respectively whereas the table value of the indices of lowly geared capital structure is higher than the calculated value ie 1.8125 > - 0.337 and – 0.813 for ROE and ROA respectively.

Modigliani and Miller (1958) have theoretically argued and proved that capital structure is irrelevant in a perfect market condition, characterized by the capital market with no taxes, no transaction costs and homogenous expectations; other works that assume several market imperfections on the contrary suggested that capital structure decisions are relevant since it can affect shareholders wealth. Modigliani and Miller (1963) in existence of corporate taxes suggested that firms should use as much debt capital as possible in order to maximize their value by maximizing the interest tax shield

Summary of Findings

The researcher discovered that highly geared capital structure has positive impact on return on equity.

Also highly geared capital structure has inverse relationship with return on assets.

Furthermore, the researcher discovered that lowly geared capital structure has no significant impact on return on equity.

Finally, lowly geared capital structure has no significant impact on return on assets

Recommendations

Based on the findings, the following recommendations were made:

1) The banks should employ more of debt capital in order to maximize return on investment.
2) Even when external debt would be used, the banks should search for low interest bearing loans so that the tax shield benefit of the loan will exceed the financial distress associated with it.
3) Government should lies with the stake holders in the financial sector in order to develop bond market to enable the banks to raise long term debt so as to avoid over reliance of debt which is associated with high cost.
4) Increase tax relief is likely to enable the banks to have enough profit after tax that would increase retain earnings to improve internal investment.
5) More effort should be made by banks to increase their assets, as this will help them to be well positioned for better performance.

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