



ISSN: 2249-7196

IJMRR/July 2016/ Volume 6/Issue 7/Article No-6/923-933

Alhassan Haladu / International Journal of Management Research & Review

AN ASSESSMENT OF NIGERIA'S CAPITAL STRUCTURE AND ITS DETERMINANTS FROM GLOBAL RECESSIONS

Alhassan Haladu*¹

¹Ph. D. Accounting, Tunku Puteri Intan Safinaz School of Accountancy (TISSA-UUM),
College of Business, Universiti Utara, Malaysia.

ABSTRACT

Capital structure is a very important component of business organizations. It is an index of many variables that may affect both short-run and long-run decisions as interested parties both within and outside the organization may use it to determine many future activities. In Nigeria our economy is highly in need of foreign capital for the long-term financing of businesses. The 2008 recession adversely affected the capital structure of most of the businesses operating in Nigeria especially financial institutions. Foreign investments were withdrawn to finance deficits abroad. This paper aims at investigating the causes of the global economic meltdown and how it helps shaped Nigeria's capital structure's relationship with determinant variables. Documentary sources were the main source of data used for this paper. The massive level of poverty in the country served as a favorable breeding ground for the impacts of the global economic meltdown to be very effective. In addition, the openness of our economy which is import dependent makes it vulnerable to global economic impacts. Thus the result was massive outflow of capital and drastic restructuring in most financial institutions which lead to unemployment and high inflation rates. It is therefore, advisable for the government to set up a committee on global economic matters to advice from time-to-time on global economic performances so as to avert being taken unawares in case of future occurrence of economic crisis.

1. INTRODUCTION

The extent to which a business could function as a going-concern depends largely on its capital mix. The various sources for funding a business are mainly Equity and Debt financing. This makes up the capital structure of a business. It is the duty of the proprietors of a business to determine how these two sources should be combined or mixed. The long-term success of a business depends on which source serves as its major finance base: Equity or Debt. Developing countries like Nigeria lacks enough capital for investment therefore, most of the investments in their economy depends on foreign capital. Like its counterpart of the 1930's, the 2008 global recession greatly threatened world economies. Foreign governments not only come to the aid of businesses at home but also most foreign investments were withdrawn to support investments back at home. In Nigeria, the impact on our economy was catastrophic. At first it was underrated but later proved to be a shock to the

authorities. The economic consequences were dire. Some of which include a fall in the value of the naira, high unemployment rate, fall in foreign exchange reserve, inflation, etc.

The main objective of this paper is to investigate the underlining causes of the crisis and its effect on capital structure together with its determinants. The instrument used for this research work was mainly documentary. Facts and materials were obtained from documentary sources and analyzed through content analysis. After a thorough scrutiny, it was discovered that the meltdown had serious negative consequences on our economy, like setting in inflation and devaluation of the naira. With regards to capital structure most of the investments which depended on foreign capital collapsed. For this reason it is advisable for the government to always be on the alert by setting up an economic emergency committee so that it cannot be taken unawares by future occurrence of economic crisis in the international community.

2. REVIEW OF RELEVANT LITERATURE

2.1 Capital Structure

Capital structure is about the proportionate relationship between Debt and Equity. This Debt-Equity (Debt-Equity ratio) relationship seems to ignore Preference Stocks which are also an important source of finance to businesses. The importance of studying capital structure is that it influences the cost of capital and the market value of the firm (Hampton, 1992). Theories on capital structure therefore seek to find a Debt-Equity mix that will optimize the value of the firm and reduce the cost of capital. Pandey (2000) refers to the mix of long-term sources of fund like Equity, Preference Stock, Debt, Reserves and Surplus as the capital structure of a company. Planning of the capital structure is necessary if the difficulties in raising fund and proper use of it are to be avoided. Therefore an optimum capital structure that gives the maximum market value per share should be targeted. Moreover, capital structure deals with how a company finances its operations and it is made up of ordinary shares, Preference shares and Debt capital (Akinsulire, 2008). If these three sources of Finance are maintained the Weighted Average Cost of Capital (WACC) will remain constant (Akinsulire, 2008). However, the WACC changes will to a large extent affect the market value of the business. A very good capital structure should be characterized by the following (Pandey, 2000):

- a. It should be capable of generating maximum returns to shareholders at minimum cost.
- b. Risky instruments such as debts should be avoided where possible.
- c. The structure should be flexible enough to provide the firm with funds as at and when needed.
- d. A good capital structure must also be within the debt capacity of the company. That is, there should be enough cash within the company's capacity to meet the interest and principal of creditors promptly.
- e. The capital structure should be such that the owners will be in position to control the company.

Some important assumptions have been made on Capital structure which, a good capital structure is expected to meet. They include:

- a. Gearing ratio changes immediately shareholders subscribe to it.
- b. Earnings are constant.
- c. There are no retain-earnings.
- d. Business risk is constant.
- e. Taxation is ignored.

2.2 Types of Long-Term Finances

2.2.1 Equity Shares: Equity Shares are the interest of a shareholder in a business. It is the amount of money the shareholder has invested into the business. Equity forms the most important and most reliable source of income to modern business. It is a share capital in which the holder is entitled to an unfixed dividend. They received dividend only after all other shareholders have been paid their dividend. If the company is performing well they enjoy, but if the company is performing poorly then they suffer. In other words when profit is zero they received nothing but when profits are high they get the biggest share.

2.2.2 Preference Shares: Preference shares are shares, which attracts fixed rate of interest. They are called “preference” because holders are given preferential treatment over Equity shareholders. They are paid first before any Equity shareholder. The interest on these shares is fixed irrespective of the profits made. The implication is that when profits are low holders enjoy their fixed dividend but when high they only get a fixed amount (except for “Participating or cumulative” Preference shareholders) and the rest goes to Equity shareholders.

2.2.3 Debt Financing:

a. Debentures: Although they can be redeemed or converted into shares at future dates, they are strictly speaking not shares but loans to the business. In the event of dissolution holders are paid back in full their money. Commonly referred to as long-term loans, Debentures are a kind of special creditors to the business whose capital should be paid back after a certain period. A special type of Debenture known as Mortgage Debentures are tied to certain fixed assets of the company in the event of liquidation (Brealey & Myers, 1996). Holders of such type of shares are entitled to a certain amount of fixed interest on their loan annually.

b. Bonds: These are long-term debt instruments issued by governments and corporations. Suitable mostly for multi-nationals and government corporations, Bonds can provide a lucrative source for long-term financing.

c. Bank Loans: These are credit facilities offered by banks to individual business organizations. In developed countries like Japan, United States, China and Western Europe Loan capital is very cheap; in some cases the cost could be as low as 1% or below. This cannot be said about developing countries like ours where the cost of capital can be as high as 50%. Banks and other financial institutions are the major issuers of such loans. Because of the lack of trust, high cost of capital and the complexity and difficulty of attaining collateral,

these sources have proved to be very difficult in developing countries and in some cases even impossible.

d. Retain Earnings: The objective of businesses today more than profit maximization. Survival and growth are now major policy of business organizations anywhere in the world. Management of businesses should lay more emphasis on growth and survival because firms that are growing needs financing to withstand unforeseen economic disasters like depressions. If growth is to be attained, maintained and sustained regular sources of finance must be available to the business. There is no better source than internal sources. Proprietors of businesses should therefore, avoid paying out all their profit as dividend. Some of the profit should be kept as retain earnings. Retain earnings are “the most significant and reliable sources of financing the growth of a business” (Brealey & Myers, 1996). This is so because outside finance is unreliable, uncertain and costly. There should therefore, be a policy on profit sharing between the proprietors and the business. A balance should be maintained between the amount retained in the business and that paid as dividend especially for limited liability companies. Recommended ratio should be 3:2 share for retain earnings and dividend paid. Businesses that always retain part of their profit will find it easier to get readily available fund for expansion and growth.

2.3 Approaches to Capital Structure

a. Net Income Approach (NIA): In the process of lowering the overall cost of capital and increasing the value of the firm, the NIA seeks to increase the proportion of debt in the capital structure on the assumption that the Equity capitalization rate and Debt capitalization rate will remain constant with changes in leverages (Weisbrod & Hansen, 1968). It is also assumed that the Equity capitalization rate is greater than the Debt capitalization rate. The implication is that increase use of debt will increase the share holder’s earnings and this will increase the value of the firm because of the higher value of Equity. Consequently, there will be a fall in the overall cost of capital (i.e. the Weighted Average Cost of Capital).

b. Net Operating Income Approach (NOI): This approach does assume that changes in capital structure have no effect on the market value and cost of capital of the firm. It assumed the capitalization rate to be constant. The issue of cost of debt rising after a given point is baseless (Akinsulire, 2008). Therefore, changes in the capital mix of the business will have no effect whatsoever on the value and cost of capital of the enterprise.

c. Traditional Approach: This approach states that debt is cheaper than Equity therefore, borrowing more will increase the value of a company (Akinsulire, 2008). The cost of capital increases while the market value of the firm increase with increase leverage up to a prudent debt level until it reaches optimum. Then the cost of capital will increase together with the market value of the share. This approach assumes that value is maximize where WACC is at its lowest and it also assumes an optimum capital structure by compromising the NIA and NOI approaches.

d. Modigliani and Miller Hypothesis: Also known as M-M Approach, it made three propositions which are:

- The company’s value is determine by real assets.

- Increase in the rate of returns depends on the debt/equity ratio.
- The cut-off point for investment in the company will be the WACC (Akinsulire, 2008).

The approach argues that without taxes the cost of capital and market value of the firm remains constant throughout all degrees of leverage (Akinlo, 2011; Hampton, 1992; Fernandez, 2007). The assumptions are that there is perfect competition in the securities market, firms are grouped into homogenous risk classes, investor’s risks depend on random fluctuations of NOI and the value of the securities may be different from their estimate.

e. EBIT-EPS Approach: Earnings before interest and tax (EBIT)-Earning per share (EPS) approach is saying that EPS is maximized when more of debt financing is used. This is because interest charges are deductions allowed for tax purposes while dividends are not (Pandey, 2000). If however a company is not able to earn a rate of return on its assets higher than the interest paid more debt will have adverse effect on EPS.

2.4 Relationship between Capital Structure and some Determinant Variables

Before the 2008 global recession, financial leverage has an inverse relationship with growth and asset tangibility (Akinlo, 2011). This indicates that prior to the recession firms that were growing did not in any way rely on debt financing. A summary of the relationship between capital structure and determinants like sales growth, assets tangibility, liquidity, firm size and GDP growth could be seen from the table below (Akinlo, 2011):

Table 4.1: Association between Capital Structure and Determinants under the Following Theories

Determinants	Theories			
	Packing Order Theory	Trade Off Theory	Signaling Theory	Agency Theory
Sales Growth	+	-	-	-
Tangibility	+	+	Not Applicable	-
Liquidity	+	+	Not Applicable	-
Profitability	-	+	-	+
Firm Size	+/-	+	-	-
GDP Growth	+	+	+	+

Source: Adopted from Akinlo (2011)

The pre-recession period also showed that debt ratio had a significant inverse impact on firm’s financial performance (Onaolapo & Kajola, 2010; Osuji & Anthony, 2012). Osuji and Anthony (2012) however, measured profitability in terms of Return on Assets (ROA) and Return on Equity (ROE).

In a study conducted on the question of whether capital structure enhances firms’ performance, Adewale and Ajibola (2013) discovered that debt ratio have had a positive relationship with firms performance. They also observed that determinants like asset tangibility could serve as a driving factor to capital structure. The relationship between debt ratio and profitability is negatively related while that of equity and profitability is positively related (Chechet & Olayiwola, 2014). The nature, degree and direction of corporate ownership on capital structure was investigated by Ezeoha and Okafor (2009). Their result

showed that the discrimination between indigenous and foreign firms are major determinants of debt financing. Capital structure theories was what determines corporate ownership.

In evaluating the determinants of corporate capital structure in Nigeria, Ogbulu and Emeni (2012) were able to prove that a significant and positive relationship exists between firm size and capital structure. For firm age the association with capital structure was significantly negative. However, no significant association whatsoever exists between tangible asset, growth and profitability (Ogbulu & Emeni, 2012). The work of Uwuigbe (2013) gives an inverse and significant association between board size and capital structure. He also discovered a positive relationship between CEO duality and capital structure that is significant. Profitability, tangibility and company size are positively related to capital structure (Salawu, 2008). Growth is negatively related to financial leverage (debt ratio).

The importance of these results is that there has been mixed results on the relationships between capital structure and its determinants. While some results show direct or positive relationships others show inverse or negative relationships. These relationships have been discovered to be significant or insignificant. The nature and degree of impact also differs from study to study. The important thing worth noting is that capital structure can influence or be influenced by certain determinant variables that may be of serious consequences when there is a recession. Controlling these variables during boom time is therefore very advisable.

2.5 The 2008 Global Economic Meltdown

Many history were indeed made in 2008 starting with the United States (US) Presidential election which saw the US elected an African-American as President for the first time. The Republican Party of the US also had for the first time a female as running mate to its Presidential candidate. The negative history made however, was one of the worse global economic recessions took place. It all started with sub-prime mortgage loans in the US and gradually swallowed the whole of the American economy. Earlier in 2007, liquidity has forced the government of the United States to take over Finnie Mae and Freddie Mac. In the same year Merry Lynch was acquired by the Bank of America. Financial institutions like Lehman Brothers, Morgan Stanley and Goldman Sachs Group were all affected (Sheka, 2009). A bailout plan of \$85 billion announced by the government earlier for American Insurance Group (AIG) was insufficient, so by October 2008 the US Congress passed a \$700billion bailout package (Sheka, 2009). Stocks plunge to their lowest level in years; jobs were being lost at a rate that has not been seen in years. Efforts to curtail it to the United States failed. Then the meltdown spread its tentacles to the developed world. Soon Japan, Germany, the United Kingdom, and France were all engulfed. Shares of firms were falling worldwide and financial institutions were collapsing. There were large cries of bailouts. Crisis meetings were organized in Europe and America. Relief packages were hurriedly put together but it seemed the matter was more serious than earlier anticipated (Rano, 2009).

The next target was the newly developed economies. Thus China, Taiwan, Singapore, Brazil, Australia, and Republic of Ireland were all engulfed by the storm. By now the term "Recession/Depression" was firmly on the lips of the international press. The world economic recession was well underway. Countries yet to be affected took precautionary measures. Those with no alternative folded their hands in prayer. In Nigeria, the then able

Governor of the Central Bank of Nigeria said “Nigeria Banks do not have liquidity problem as they have sufficient paid up capital” (Sheka, 2009). This statement left the country completely unprepared for the economic meltdown. Little did anyone realized that our economy is not only import dependent but also the value of the country’s major source of revenue (Crude Oil) is determine by forces operating in the international market. Above all, our economy is an open economy hence making it prone to activities in the international market. When it finally came to Nigeria, it took financial analysts and policy makers by surprise. The naira lost almost 50% of its value, and financial institutions came down crashing. There was massive capital outflow by foreign investors from the country. Banks laid off most of their staff and major salary restructuring occurred in most organizations. Inflation assumed a new high resulting in a worsen condition for the standard of living of Nigerians.

3. METHODOLOGY

This work is a conceptual review of factors that led to the 2008 economic recession and its impact on capital structure. The study covered the entire Nigerian economy with emphasis on firms that are listed in NSE. Being a non-empirical research, emphasis was laid on past literature. These were reviewed and analyzed to show the causes and effects of the depression on capital structure in Nigeria related in terms of some determinant variables. In the light of these materials for the entire research was based on secondary data. Analysis was done through content analysis of the literatures covered.

4. DISCUSSION

4.1 Causes and Effects of the 2008 Global Economic Meltdown on the Economy

Though not directly responsible for the Global Economic meltdown in 2008, Nigeria was a major victim among developing nations of this recession. So many reasons have been forwarded as major causes of this economic catastrophe in the economy. In the first place prior to the coming of the global meltdown Nigeria was battling with massive global poverty brought about by the Structural Adjustment Program (SAP) of the late 1980s. The general economic deregulation pursued by the G8 starting in 1980 and accelerated in the 1990s set the stage for this disaster. This led to serious social inequality. This foundation coupled with the news of the global economic meltdown and the diminishing values of shares abroad, ignited the problems of the global economic meltdown in Nigeria. The speculation by the business environment that there is no way that Nigeria will escape this negative windfall affected most businesses.

The other factor responsible for the economic meltdown in Nigeria was loose regulatory apparatus. Business regulations were and are still grossly violated in Nigeria. Most business doesn’t follow the rules and regulations governing business transactions in the country as stipulated in the constitution and other business regulatory documents. In addition to this the uncoordinated and late intervention by the government (CBN) worsens the whole thing.

The rising in-liquidity of local financial institutions especially banks fuelled by corruption was another major contributor to the economic meltdown in Nigeria. It could be recall that by 2006 the government has forced all banks to acquire a minimum capital base of

N25billion. This money instead of properly invested was siphoned by corrupt Chief Executive Officers (CEOs) of banks and other financial institutions. Nigeria also depends for most of its industrial input from abroad. To obtain this the necessary foreign exchange is needed. During the recession, the currencies of most developed countries like the dollar strengthened and increase in value. This makes it expensive in naira terms to import major industrial components, thus seriously affecting the cost of production which ultimately resulted in inflation.

Finally, the price of the country's major source of revenue Crude Oil, crashed from a high of about \$150 to below \$60 per barrel. This resulted to the preparation of a supplementary budget and massive government cuts on capital projects. As a result of these factors the economy suffered serious setbacks. The most important ones are those outlined below:

- a. It decreases asset value, especially investment stocks.
- b. Consumer confidence was lost.
- c. Consumption decline drastically.
- d. Economic activities also decline.
- e. Unemployment rose.
- f. The 2009 budget came under pressure as 90% of revenue was dependent on the export of Crude Oil. A supplementary budget was therefore necessary.
- g. Our foreign reserve was touched and it fell from around \$70billion to \$40billion.
- h. The exchange rate rose against the naira causing the naira to initially lose about 50% of its value.
- i. Money repatriated to Nigeria from the Diaspora fell. Remittances reduced causing more hardship for the recipients.
- j. Premium income held by insurance companies also fell.

4.2 Effects of the 2008 Global Economic Meltdown on Capital Structure

These could be viewed from the perspective from which they affect the market value of Equity and the weighted average cost of capital (WACC).

- a. Shares value dropped from ₦169.64 billion to ₦134.4 billion between August and September 2008 (Sheka, 2009).
- b. Stock market value of Equity fell by ₦2.2 trillion in January 2009 alone (Sheka, 2009).
- c. The market closed for the year 2008 at ₦6.957 trillion. This is a far cry from the gain of the ₦6 trillion and a growth rate of 74.7% in 2007 (Nse, 2009).
- d. Foreign investors "withdrew some \$4 billion from the Nigerian stock exchange and precipitated its steep decline" (Sheka, 2009).
- e. Foreign hedge fund managers went out together with a sum of ₦556 billion to supplement investment in their country due to the financial crisis (Sheka, 2009:7).

f. Marine portfolio which accounts for a proportion of the insurance industry's premium income fell by over 20% in the first quarter of 2009 (Nse, 2009). This was as a result of a squeeze in the import bill.

g. Foreign banks recall about \$3 billion credit line from local banks (Luke, 2009).

5. CONCLUSION AND RECOMMENDATIONS

5.1 Summary

The 2008 economic meltdown which started in the USA due to failure in the subprime mortgage market took the Nigerian economy by surprise. The foundation for this has already been laid by massive poverty and high rate of unemployment. Being a developing country, Nigeria is not only import dependent but most of our investment especially in the financial and banking sectors which forms the basis for investment in the economy depends on foreign capital. Therefore, the global depression touched on all sectors of our economy. This led to the capital market in the country almost collapsing. Shares lost their values drastically, foreign investors withdrew their monies and there were massive retrenchment in financial institutions especially banks. Although actions were taken by the government, it came too late. There was bitter news for people who have invested in the economy.

5.2 Conclusion and Recommendations

To avert this type of catastrophic event in the future it is advisable that the following be observed.

1. Stimulus packages should be given by the Federal government to help boost institutions that are affected. This is far better than witch hunting and prosecuting CEOs of financial institutions after damages might have been done to the economy.
2. A global financial emergency monitoring team should be set up to warn government for precautions against any such occurrence in the future.
3. The SEC (Security & Exchange Commission) and NSE (Nigerian Stock Exchange) should reduce fees charged by a considerable margin so as not to scare away participants in the stock market.
4. An upward and downward limit on daily price movement of stocks should be set in order to prevent the total collapse of stocks.
5. Where there are liquidity problems, the cash reserves and liquidity ratio should be reduced to a manageable percentage.
6. The Economic and Financial Crimes Commission (EFCC) and other anti-corruption bodies should be empowered and encouraged to prevent and not to fight corruption so as to encourage foreign investments.
7. Nigerians should be galvanized to wake up from their indifference to national issues and invest their talents in the development of the country's economy.
8. Well articulated cost control managers should be employed by financial institutions and put in charge of sensitive positions of cost.

9. Financial institutions must also instill more confidence in their existing and potential clients and shareholders (Ojo, 2009) so as not to discourage them. Without this confidence they will be forced to withdraw their capital.

REFERENCES

- [1] Adewale MT, Ajibola OB. Does capital structure enhance firm performance? Evidence from Nigeria. *IUP Journal of Accounting Research & Audit Practices* 2013; 12(4): 43-55.
- [2] Akinlo O. Determinants of capital structure: evidence from Nigerian panel data. *African Economic and Business Review* 2011; 9(1): 1-16.
- [3] Akinsulire O. Financial management. Ceemol Nigeria Limited, Lagos, 2008.
- [4] Brealey RA, Myers SC. Principle of corporate finance. McGraw-Hill Company, Inc. USA, 1996.
- [5] Chechet IL, Olayiwola AB. Capital structure and profitability of Nigerian quoted firms: the Agency Cost theory perspective. *American International Journal of Social Sciences* 2014; 3(1): 139-158.
- [6] Ezeoha AE, Okafor FO. Local corporate ownership and capital structure decisions in Nigeria: a developing country perspective. *Corporate Governance: The International Journal of Business Society* 2009; 10: 249-260.
- [7] Hampton JJ. Financial decision making: concepts, problems and cases. Prentice-Hall of India, New Delhi, 1992.
- [8] Luke O. Global economic depression and Nigerian economy, 2009. www.ngrguardiannews.com/editorial-ption/article02//indexpage2.11th
- [9] Nse J. Global economic meltdown take toll on marine insurance business. *Nigeria General Discussion Blog Website/Forum*, 2009.
- [10] Ogbulu OM, Emeni FK. Determinants of corporate capital structure in Nigeria. *International Journal of Economics and Management Sciences* 2012; 1(10): 81-96.
- [11] Ojo SA. The global economic meltdown and its effects on the well-being of Nigerians and Nigeria's development. Wednesday, 14 October 2009 01:00 *Nigerian Compass*.
- [12] Onaolapo AA, Kajola SO. Capital structure and firm performance: evidence from Nigeria. *European Journal of Economics, Finance and Administrative Sciences* 2010; 25: 70-82.
- [13] Osuji CC, Anthony O. Impact of capital structure on the financial performance of Nigerian firms. *Arabian Journal of Business and Management Review (Oman Chapter)*, 2012; 1(12): 43-61.
- [14] Pandey IM. Financial management. 8th Edition. Vikas Publishing House PVT Ltd. New Delhi, 2000.
- [15] Rano, Usman SA. The current global economic depression: Is it the re-emergence of the 1930's great depression. A departmental seminar paper. Department of Economics, Bayero University Kano (BUK), 2009.

[16] Salawu RO. The determinants capital structure of large non-financial listed firms in Nigeria. *The International Journal of Business and Finance Research* 2008; 2(2): 75-84.

[17] Sheka GI. Nigeria and the global financial crisis: what needs to be done? A paper presented at Gombe State University, Nigeria, 2009.

[18] Uwuigbe OR. The effects of board size and CEO duality on firms' capital structure: a study of selected listed firms in Nigeria. *Asian Economic and Financial Review* 2013; 3(8): 1033-1043.