

## DEBT Financing and Firms' Financial Performance in Nigeria

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**Abstract:** The study examined the effect of debt financing on firm's financial performance in Nigeria. The study adopted the random sampling techniques to arrive at the sample size of the study. The secondary data was used in the study. Panel econometric tools were used to analyze the panel data of various companies across sectors in the capital market. The results of the analysis revealed that, size of the firm; short term debt and long term debt have positive and significance impact on the financial performance of listed firms in Nigeria capital market. The study concluded that debt financing is very important in firm's financial performance since there is a positive and a significant relationship between the variables and then recommended that larger firms should increase the debt proportion in financing operations in order to increase its financial performance.

**Keywords:** Debt financing, return on asset, Nigeria

### 1. Introduction

The importance of capital structure decision as it concerns growing a company's value cannot be overemphasized. Capital structure is the mix used by a company in financing its business operations. It is very crucial for the survival of any firm and the financial managers of such firms are responsible for the capital structure mix decision. Pandey (2010) sees capital structure as the most crucial decision of company managers because of its effect on the risk and return of shareholders.

Firms' financing sources are divided into equity and debt. The equity sources are derived from equity shares floated on the floor of the exchange, friends, personal fund etc; the debt sources are derived basically from borrowings from worthy investors either through the capital market such as bonds and debentures, preference capital etc.

Akingunola, Olawale and Olaniyan (2017) asserted that the saying "quid pro quo" connoting "something for something" is operational in the finance world. They further posited that all capital providers (shareholders, bondholders or debenture holders) willingly sacrifice their fund because they expect to receive dividend or interest as a return for their fund. As a result, according to them, decision makers while taking financing decision, have to create the sources of finance available, the providers' interest on such funds, and also the cost and benefits of such funds, the finance choice impact on the whole activities, and most essentially the obtainable funds proper mix.

The significance of optimal capital structure as it relates to firm's financial performance has been the issue of debate among various researchers in recent times. It is a fact that the ultimate capital structures of a firm depends on various

factors underlining the performance of the firm. Different finance managers have in various times instituted optimal capital structure as the best in relation to its performance, though, studies carried out by different scholars shows various conflicting results as to which is the best for a firm best possible capital structure.

### 1. Research Objective

The research objective of the work is divided into two parts: the broad objective and specific objective. The broad objective opines the impact of debt capital on a firm performance where as the specific objectives are stated below:

- i. To determine the relationship between the size of the firm and return on asset
- ii. To investigate the nexus between short term debt and return on asset
- iii. To ascertain the relationship between long term debt and return on asset.

### 2. Research Hypotheses

Hypotheses are usually stated in their null form; therefore, the following will be acceptable as the hypotheses for this work;

H<sub>01</sub>: there is no significance relationship between size of the firm and return on asset.

H<sub>02</sub>: there is no significance relationship between short term debt capital and return on asset.

H<sub>03</sub>: there is no significance relationship between long term debt capital and return on asset.

### 3. Review of Related Literature

#### 3.1 Conceptual framework

##### Debt Financing

Optimal debt capital of firms have always been a critical issues in analyzing its performance vis-a-vis other factors relating to its growth such as firm’s size, sale growth, the asset structure and tangibility.

Debt financing involves an action that is bound by time for the repayment of debt and the debt’s interest at an agreed end of the period. It occurs when a firm borrows needed cash resulting to debt to a lender or an investor for a short-term or for long-term capital needs of the firm. According to Miller (2019), when debt financing is resorted to by a firm resorts to, it means that the firm gets its cash needs from additional business or sources, resulting to debt acquired to the “original lender for either short-term needs or long-term capital expenditure.” It is a policy that borrowing money involves having a consideration that the total amount borrowed with the interest will be paid back in the future. The rate of interest charged on the amount borrowed shows the risk level undertaken by the lender for providing the needed fund.

In debt financing, both ownership and control are not given up at anytime. And the interests paid are tax deductible

##### Financial performance

Performance is the most imperative measure for profitable of a company (Matar & Eneizan, 2018). Financial performance predominantly shows the sector of a business outcome as well as results, showing the overall financial health condition of the business sector over a particular time period (Naz, Ijaz & Naqvi, 2016). They further asserted that it shows how well a firm utilizes her resources in minimizing the wealth and profitability of the shareholders. It measures a company’s health condition financially over a given period (Matar & Eneizan, 2018 and Naz, Ijaz & Naqvi, 2016) and shows the performance by the leadership (executive) of the organisation (Matar & Eneizan, 2018). It is very important to users of financial information as it reflects the going concern of the firm.

A firm with higher financial performance is likely to attract more investors that the one with lower financial performance. When a firm records high financial performance, it means that the firm effectively and efficiently utilized her resources well. Almajali, Alamro and Al-Soub, (2012) are of the opinion that a higher financial performance of a company means more effective and efficient the firm is using its available resources and afterward “contributes at the macro in the country’s economy.”

A total assessment of financial performance of a firm takes into consideration various methods of measurement. Naz, Ijaz & Naqvi (2016) opined that though diverse ways are used in measuring financial performance, financial ratio is the most common one been used in finance and statistical inference fields.

There are two main different measures of performance, financial and non-financial. Accordingly, Omondi & Muturi (2013) asserted that “financial performance can be measured by growth in profitability, production capacity, sales growth and utilization of the capital and financial resource.”

##### Debt Capital, Risk and Sales Growth of the Firm

The result of increased debt financing in a firm’s finance structure will give rise to a lower agency cost of equity from outsiders. Accordingly, Muritala (2012) opined that the agency theory presupposed that high leverage is anticipated to reduce agency costs thereby increasing efficiency, leading to enhancement in firms’ performance. Business risk is linked with firms that have risk that is higher, that is, more probable to face difficulty financially which may result in bankruptcy. High debt financing in business without corresponding sales growth involves legal observance to payment of principal and interest periodically. In addition, firms that are highly leverage may be subjected to cash depreciation and consequently inability to acquire further debt finances due to high interest payment.

Chadha and Sharma (2015) are of the opinion that a firm that have a growth rate seem to finance her firm with lesser long term debt in the capital structure and greater short term so as to reduce agency costs. The problems of agency cost in growing firm may be more serious as a result of needed flexibility and not rigidity in the firm’s investment. However, Muritala (2012) observed that the growth opportunities of firm serve as an important determinant to firm performance; firms with growth opportunities can create investment profit.

#### 3.2 Theoretical Review

This section review various theories relating to debt capital and firm performance, such theories among others to be review include: trade off theory, pecking order theory and Modgiliani and Miller theory.

##### Trade off Theory

The theory can be traced to the debate over M&M theorem (Ajibola, Wisdom & Qudus, 2018). Trade off theory has to do with cost–benefit analysis performed in business operations. The theory states that the trade-off between the benefits the debts cost is the optimal capital structure. According to Graham and Harvey (2002), the trade off theory connotes firms’ choice of leverage between the benefits and cost of debt and the trade off of costs and benefits of borrowing while holding firms asset constant as a determinant of a firms’ optimal debt ratio. The trade off theory summarized the balance of diverse benefits and cost as it concerns debt for optimal capital structure.

##### Pecking Order Theory

Developed by Myers (1984) as alternative to capital structure theory, the theory upholds the behavior of finance manager in optimizing the capital structure of the firm. The theory “predicts that, due to asymmetric information and transactions cost, firms adopt a hierarchical order of

financing preferences so that internal financing is preferred over external financing” (Olaniyan, Soetan & Olayemi, 2017). According to Chadha and Sharma (2015), external financing is deemed necessary in optimizing the firm debt capital in relation to its sales growth. The major point of finance managers is maximizing the capital structure as a determinant to its performance.

### Modigliani and Miller theory (M&M)

The M&M theory opined the irrelevancy of capital structure in the performance of firm. Modigliani and Miller (M&M), assume that in the determination of a firm’s share value, dividend is irrelevant, reason been that it has no “impact on the shareholder’s wealth.” (Egbeonu, Edori & Edori (2016). According to the theory, in the absence of corporate tax, transaction cost and agency cost (perfect market conditions), the capital mixed in the firm’s statement of financial position is insignificance to the performance.

### 3.3 Empirical Review

This section review various related works carried out by different scholars with their results and recommendation on impact of debt capital on the performance of firms. Among others are:

Aziz and Abbas (2019) empirically investigated debt financing effect on firms’ performance on Pakistan non-financial sector. The study attempted to examine the association of various debts financing on firms’ performance in fourteen (14) sectors of Pakistan by employing the secondary method of data collection. Data were collected from fourteen (14) various sectors (Pakistan Stock Exchange) for nine (9) years period spanning from 2006-2014. Using the correlation analysis to check the strength of the relationship, the result indicates a negative effect though significance on financial performance in Pakistan. Lucy (2014) examined the existence of relationship between capital structure and performance. The research adopted the explanatory non-experimental design for forty-two (42) non-financial companies in Kenya (Nairobi Securities Exchange). The study covered a period of seven (7) years (2006-2012). The study showed a statistical significance and an inverse relationship between the variables.

Similarly, Olokoyo (2013) studied “Capital structure and corporate performance of Nigerian quoted firms: A panel data approach.” The result was based on 2003-2007 accounting and marketing data from one hundred and one (101) firms that are quoted in Nigeria. Employing the fixed-effect estimation, random-effect estimation as well as a pooled regression model and an identification tests and the Hausman’s  $\chi^2$  statistics were computed to test if the fixed effects model estimator is alternatively appropriate to the random model. Among other findings, the studies found out that firm’s leverage have significant and negative impact on accounting performance of firms. Osuji and Odita (2012) in their examination of capital structure impact on financial performance in Nigerian firms used 30 firms (non-financial) listed on the Nigerian Stock Exchange from 2004-2014

using the ordinary least squares to analyze the panel data collected, found that capital structure of firms has significant and negative impact on firms performance.

Mustafa and Osama (2013) used 76 Jordanian firms from a period from 2001-2006 to study on the impact of capital structure on corporate performance. Employing the ordinary least square (OLS) came into conclusion that capital structure negatively and statistically associates with firms’ performance but there is insignificant impact of gearing on highly geared and lowly geared firm’s performance. Uremadu and Onyekachi (2018) while studying capital structure impact on corporate performance in Nigeria on the consumer goods sector employed the multiple regression of ordinary least square employed the multiple regression of ordinary least square (OLS) method to analyze compiled data. The study showed a negative but insignificant impact. Various studies from different scholars like Olajide, Funmi and Olayemi (2017), Nwude, Itiri, Agbadua and Udeh (2016), Varun (2014), Onalapo and Kajola (2010), Ebiad (2009), and Kinsman and Newman 1998) employing different data analysis all came to the conclusion that capital structure have significant and negative impact on firm’s performances.

Some other studies have shown a positive relationship.

Ajibola, Wisdom and Qudus (2018) in their study of listed manufacturing firms in Nigeria’s capital structure and financial performance concluded that there is a positive impact of capital structure on financial performance. Mubeen and Kalsoom (2014) examined capital structure impact on financial performance and shareholders’ wealth. 155 Pakistan firms in the textile sector was the sample of the study. Result of the analysis concluded that there is a positive impact of capital structure on both financial performance and shareholders wealth. Nirajmi and Priya (2013) confirmed a positive relationship between capital structure and financial performance after their analysis of data using correlation and multiple regressions in a similar study.

Apart from the above studies, other studies like Berger and Di Patti (2006), Chen (2004), Franck and Goyal (2003) and Hadlock and James (2002), all concluded that there is a positive relationship between capital structure and firm performance using different data analysis method and sampling.

Other result from various studies shows a mixed impact of capital structure on performance.

Zeitan and Tian (2007) in their study came to a conclusion that there is a mixed effect of capital structure on firms’ performance. Abeywardhana and Magoro (2017) empirically studied “debt capital and financial performance: A comparative analysis of South Africa and Sri Lankan listed companies.” The study analyzed data from 2011-2015 of the “wholesale and retail sector companies in South Africa and Sri Lanka”. The fixed-effects (within) regression method was adopted in the data analysis. The result shows a negative impact of short term and long term debts on

financial performance in both sectors in South Africa but in Sri Lanka, short term debt showed a negative impact while long term debt showed a positive impact. Akingunola, Olawale and Olaniya (2017), taking evidence from non-financial firms in Nigeria studied capital structure decision and firm performance. Using a sample of 22 firms in the non-financial firms listed in the Nigerian Stock Exchange for 2011-2015 (5 years period). The study after analyzing the panel data set using pooled, fixed effect and random effect methods, and the Hausman’s test in selecting the appropriate model shows that short term debt to capital and total debt to total equity effects performance significantly and negatively while short term debt to total asset and long term debt to total asset that have a significant and positive effect on return on equity and total debt to total equity has negative and significant effect.

But Philips and Sipahioglu (2004) concluded in their study that no significant link exist between capital structure and firms performance.

From the empirical review, there are many conflicting results on the relationship between capital structure and performance. Some studies showed positive and significant relationship, others showed negative and significant relationship. Again some of the studies showed negative and insignificant relation while some others showed a mixed relationship. A study even showed that there is no relationship between the two.

This study therefore examined the relationship and took a position on the subject matter.

**4. Methodology**

The impact of Debt capital on the performance of firm has been analyze differently by various scholars in time past; however, in performing such analytical techniques, various econometric tools such as panel least square, random and fixed effect, Huasman statistic will be employ to produce results that can be relied upon in making forecasting for future references. The following tools are decomposed properly for better understanding.

**Variance ratio techniques**

The ratio was first developed by Lo and Mackinlay in 1988; it is a non parametric test that tests the hypothesis that a

given data demonstrate a random walk hypothesis, symbolically:

$$VR_{z(q)} = \frac{VR(h) - 1}{\theta \sqrt{h}} \mu(0,1)$$

$$VR_{z(q)} = \frac{VR(h) - 1}{\theta(h)^{0.5}} \mu(0,1)$$

$$\theta(h) = \frac{2(2h-1)(h-1)}{3h(nh)}$$

Where:

VR is the variance ratio;  $\theta(h)$  represent the asymptotic variance ratio and  $n(h)$  is the number of observation

**Model specification**

The Model is specified into fixed effect model and random effect model accordingly:

**Fixed effect model**

$$ROA = \alpha_0 + \alpha_1 SF_{it} + \alpha_2 STD_{it} + \alpha_3 LTD_{it} + \theta_{it} + \delta_{it}$$

Where: ROA = return on asset, SF = size of the firm, STD = short term debt, LTD = long term debt,  $\theta_{it}$  = stochastic term,  $\delta_{it}$ = specific fixed effect.

**Random effect model**

$$ROA = \beta_0 + \beta_1 SF_{it} + \beta_2 STD_{it} + \beta_3 LTD_{it} + (X_{it} + \mu_{it})$$

Where  $X_{it}$  is the unobserved random effect that varies across the various selected sectors companies in the stock market.

**5. Apariori Expectation**

The apariori results relates to the expectation or relationship between variables in the both model; therefore we expect both long and short term debt to be directly significance to the firm performance while size of the firm to be inversely related to performance of the firm.

**6. Data Presentation and Analysis**

The section presents the data and the difference techniques used in analyzing the data to produce better results. The data comprise eight years (2011 – 2018) financial fundamentals of three quoted firms categorize into three different sectors in the stock market (banking, insurance and industrial goods,); the different sectors were selected on the basis of recent reforms conducted on the sectors. However, the three firms are structured into balanced panel data to ease the analyzing processes; please find the data below.

**Table 1:** Figures of variables from sample companies audited accounts

Years	SF	LTD	ROA	STD
2018	3889	2,804.00	142,275.00	10,240.00
2018	7050	3,906.50	216,330.00	8,440.00
2018	42823.18	3,079.00	258,050.00	16,324.92
2017	30720.29	1,625.10	299,670.00	10,985.00
2017	17634.24	3,531.80	4,130.00	
2017	65026	8,310.10	42,900.00	1,480.00
2016	119887	6,077.60	215,150.00	400
2016	75400	9,504.70	441,480.00	9,105.00
2016	20190	10,776.90	111,480.00	8,350.00

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2015	45362	1,902.60	18,534.00	3,010.00
2015	571909.5	1,275.90	30,864.50	520
2015	35231	1,002.50	48,636.00	1,500.00
2014	123158.5	4,030.30	67,739.00	400
2014	318500	6,905.50	20,870.00	400
2014	304808	14,019.00	133,597.00	2,320.00
2013	155600	7,606.00	203,408.00	12,835.00
2013	1668	2,629.50	70,135.00	298,367.80
2013	83572	12,042.00	15,540.00	99,740.00
2012	1661963	19,265.00	17,360.00	8,170.00
2012	51846.84	43,943.00	86,767.00	46,740.00
2012	136244.9	71,731.00	15,150.00	186,949.06
2011	307000	97,610.00	175,600.00	166,385.00
2011	438729	137,290.00	4,690.00	142,288.00
2011	121000	115,475.00	1,670.00	408,244.06

Source: audited financial report of selected firms.

**Fixed Effect Analysis**

The fixed effect technique was carried out to ascertain the time fixed effect of the company’s performance across the various sectors over time; the result is shown below;

Dependent Variable: ROA

Method: Panel Least Squares

Date: 08/06/19 Time: 12:13

Sample: 2011 2018

Periods included: 8

Cross-sections included: 3

Total panel (unbalanced) observations: 23

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	125248.3	36732.50	3.409742	0.0033
SF	-0.032589	0.069456	-0.469209	0.6449
STD	-0.101022	0.324118	-0.311684	0.7591
LTD	0.097547	0.730208	0.133588	0.0453

Effects Specification

Cross-section fixed (dummy variables)

R-squared	0.491185	Mean dependent var	114691.1
Adjusted R-squared	0.341534	S.D. dependent var	114483.1
S.E. of regression	92898.41	Akaike info criterion	25.93586
Sum squared resid	1.47E+11	Schwarz criterion	26.23207
Log likelihood	-292.2624	Hannan-Quinn criter.	26.01036
F-statistic	3.282196	Durbin-Watson stat	1.454498
Prob(F-statistic)	0.029567		

The global statistic from the result above shows that 34.2% variations in the dependent variable are caused by changes in the independent variables. The akaike criterion and the F statistic show that the model is a good fit for the analysis. Though, the durbin Watson statistics revealed the presence

of autocorrelation existing between the models. The individual coefficient reveal that both size of the firm and short term debt are insignificant and inversely related to the firms performance while long term debt is significance and positive to its performance.

**Random Effect Analysis**

The random model is used to determine the random effect of the variables across the various sectors; the result is shown below:

Dependent Variable: ROA

Method: Panel EGLS (Period weights)

Date: 08/06/19 Time: 12:28

Sample: 2011 2018

Periods included: 8

Cross-sections included: 3

Total panel (unbalanced) observations: 23

Linear estimation after one-step weighting matrix

White cross-section standard errors & covariance (d.f. corrected)

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	144104.0	14573.89	9.887821	0.0000
SF	-0.076493	0.013480	-5.674727	0.0000
STD	-0.245991	0.050775	-4.844742	0.0001
LTD	-0.458080	0.173768	-2.636152	0.0163

**Weighted Statistics**

R-squared	0.385511	Mean dependent var	162376.4
Adjusted R-squared	0.288487	S.D. dependent var	163572.1
S.E. of regression	104656.0	Sum squared resid	2.08E+11
F-statistic	3.973336	Durbin-Watson stat	0.959916
Prop (F-statistic)	0.023537		

**Unweighted Statistics**

R-squared	0.177085	Mean dependent var	114691.1
Sum squared resid	2.37E+11	Durbin-Watson stat	0.960295

The result of the random effect shows that individual coefficients are positive and significant to firms’ performance. The global statistic also shows that 28.8% of variations in the dependent variable is caused by changes in

the independent variables. Although, the durbin Watson statistic shows also the presence of autocorrelation between the variables.

**Hausman Test**

The hausman test is used to determine the appropriate model between the fixed and random effect performed above; below is the display:

Correlated Random Effects - Hausman Test

Equation: Untitled

Test period random effects

Test Summary	Chi-Sq. Statistic	Chi-Sq. d.f.	Prob.
Period random	2.502435	3	0.4749

\*\* WARNING: estimated period random effects variance is zero.

Period random effects test comparisons:

Variable	Fixed	Random	Var(Diff.)	Prob.
SF	-0.136339	-0.101481	0.004355	0.5974
STD	-0.434315	-0.332211	0.039702	0.6083
LTD	-0.132890	-0.117799	0.394791	0.9808

The Hausman test follows the chi-square distribution, therefore, the probability result which is insignificant reveals that the random effect model is appropriate. We therefore choose the random effect to determine the nexus between the variables in the model.

## 7. Conclusion and Recommendations

The study was conducted on debt capital and firms’ performance in Nigeria. Based on the result of the analysis, the study concluded that the relationship between debt capital and firms’ performance is positive and significant. This result therefore supports the results of Ajibola, Wisdom and Qudus (2018), Mubeen and Kalsoom (2014), Nirajmi and Priya (2013) Berger and Bonaccors (2006), Chen (2004), Franck and Goyal (2003), and Hadlock and James (2002).

The research work conducted above has produced an insight of the relevance of debt capital in the companies’ statement of financial position as it affects firms’ performance; the recommendation below is extracted from the above findings:

- i. Large firms should sort for debt financing more than equity financing as it positively affects the firms’ performance.
- ii. Debt capital is tax deductible which is translated to increase in performance of the firm.
- iii. Interest payment is easily canceled as the firm financial performance increases.

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