
EFFECT OF DEBT FINANCING ON SHAREHOLDERS WEALTH OF QUOTED MANUFACTURING FIRMS IN NIGERIA

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Abstract

This study examined the effect of Debt financing on shareholders wealth of quoted manufacturing firms in Nigeria using Debt-to-capital ratio and earnings per share. Ex Post Facto research design was adopted. Data were extracted from the sampled firms for period of eleven (11) years covering from 2010-2020. Data were analyzed with descriptive statistics and Coefficient of Correlation and Panel Least Square (PLS) regression analysis was employed by the study to test the hypothesis via E-view 10.0. Data analysis revealed an inverse relationship exists between debt-to-capital ratio and earnings per share. In conclusion, this study found that debt financing has a significant effect on shareholders wealth creation at 5% level of significance. Based on the findings, it was recommended that considering the negative relationship between Debt-to-capital ratio and earnings per share, the firm managers should be careful when considering options of financing and should preferably use internal source of financing such as using owners capital, retained profit and selling assets.

Key words: Debt financing, shareholders wealth, Debt-to-capital ratio and Earning per share

INTRODUCTION

Debt financing refers to the act of borrowing funds from companies and investors through the use of bonds, banks, or financial institutions, in order to support a business's operations. The lender of such fund is repaid the total amount borrowed, plus the interest accumulated on it, at a later point in time (Tabd-Elnaby, 2019). Many businesses do not have sufficient funds to operate, let alone sustain their operations. Hence, they decide to borrow, either from personal sources such as family and friends, as is common to small and medium scale enterprises (SMEs), or impersonal sources such as banks and other financial institutions, as is common with large firms. Several means of external financing exist, however, certain reasons exist which compel business owners to opt for debt financing. Funding through debts proves to be critical to business success as it ensures that the business owner is constantly conscious of running the business well so as to be able to pay back such debts. Also it can be less costly as interest paid on money borrowed for business activities are tax deductible (Fayed & Dubey, 2016).

Related researches on the link between the effects of debt financing on shareholders wealth creation has documented mixed results. Some studies reported a significant negative relationship between debt financing and performance. For instance, Olaniyi, Elelu and Abdulsalam (2015); Iyoha and Umoru (2017); Lahcen (2019). Despite the negative relationship revealed by the above empirical studies, another strand of studies also found a significant positive relationship between debt financing and performance. Ogbonna and Chukwu (2020); Agugom and Ajayi (2020). On the other hand, Basem, Al-Rdaydeh and Ghazalat (2018); Ahfer (2019); Zelalem (2020) documented no correlation between the debt financing and performance. It can be deduced from the above reviews of empirical literature that results from investigations into the relationship between debt financing and performance are inconclusive and requires more empirical studies, thereby creating a gap in knowledge. This present study concentrated on shareholders' wealth creation. Based on the foregoing, it is therefore, imperative to evaluate the effect of debt financing on shareholders wealth creation of quoted manufacturing firms in Nigeria, using Debt-To-Capital Ratio and Earnings Per Share.

LITERATURE REVIEW

Debt-to-Capital Ratio

The debt-to-capital ratio is a measurement of a company's financial leverage. The debt-to-capital ratio is calculated by taking the company's interest-bearing debt, both short- and long-term liabilities and dividing it by the total capital. Total capital is defined all interest-bearing debt plus shareholders' equity, which may include items such as common stock, preferred stock, and minority interest (Hargrave, 2020). The debt-to-capital ratio (D/C ratio) measures the financial leverage of a company by comparing it to total capital. In other words, the debt-to-capital ratio formula measures the proportion of debt that a business uses to fund its ongoing operations as compared with capital (Adam, 2020).

The debt to capital ratio is a liquidity ratio that calculates a company's use of financial leverage by comparing its total obligations to total capital. In other words, this metric measures the proportion of debt a company uses to finance its operations as compared with its capital (Marshall, 2020). This ratio is really a measure of risk and allows us to calculate how well a company can handle a down turn in sales because it highlights the relationship between debt and equity financing. Financing operations through loans carries some level of risk because the principal and interest must be paid to the lender. Thus, companies with higher ratios are considered more risky because they must maintain the same level of sales in

order to meet their debt servicing obligations. A down turn in sales could spell solvency issues for the company. On the other hand, debt loan financing also presents an opportunity for abnormal returns to shareholders. When the loans are used in an efficient manner, that is, if the company earns more on loans than the cost of debt – the shareholders’ returns increase (David, 2020). Investors use the debt-to-capital metric to gauge the risk of a company based on its financial structure. A high ratio indicates that the company is extensive using debt to finance its operations; whereas, a low metric means the company raises its funds through current revenues or shareholders. Likewise, creditors use this measurement to assess whether the company is suitable for a loan or is too leveraged to afford one (Barnier, 2020).

$$\text{Debt-to-Capital Ratio} = \frac{\text{Total Debt}}{\text{Total Debt} + \text{Shareholder's Equity}}$$

Earnings per Share

Earnings per share (EPS) is the portion of a company's profit allocated to each outstanding share of common stock and serves as a proxy of the company's financial health. EPS is the portion of a company's net income that would be allocated to each outstanding share if all the profits were paid out to its shareholders (Chen, 2020). Earnings per share (EPS) are an important financial measure, which indicates the profitability of a company. It is calculated by dividing the company’s net income with its total number of outstanding shares. It is a tool that market participants use frequently to gauge the profitability of a company before buying its shares (Folger, 2020). EPS is the portion of a company’s profit that is allocated to every individual share of the stock. It is a term that is of much importance to investors and people who trade in the stock market. The higher the earnings per share of a company, the better is its profitability (Coleman, 2020). Earnings per share (EPS) are a figure describing a public company’s profit per outstanding share of stock, calculated on a quarterly or annual basis. EPS is arrived at by taking a company’s quarterly or annual net income and dividing by the number of its shares of stock outstanding.

Debt-to-Capital Ratio and Shareholders Wealth Creation

A financing decision of an organization may affect its debt to capital mix which has implication for the shareholders’ earnings and risk which in turn will affect the cost of capital and the market value of the organization (Naz, Ijaz & Naqvi, 2016). The wealth maximization requires that the shareholders funds rose by issuing shares or by obtaining earnings which are utilized such that organization earns a return on them equal to the returns expected by shareholders. If the organization fails to earn expected rate, the market value of the share will fall and the shareholders’ wealth will be reduced. Similarly, funds raised by issuing debt and preference capital will reduced the market value per share (Olaniyan, Soetan & Olayemi, 2017; Miller (2019). The ability of management to obtain and use funds effectively is a key to the success or failure of the organization. Organizations are therefore able to increase their social responsibility to the environment in which they operate through income retained from optimum mix of capital (Egbeonu, Edori and Edori, 2016).

There are several studies conducted to determine the effect of debt-to-capital ratio and shareholders wealth creation. For instance, the studies by Eze and Uzochukwu (2020); Aziz and Abbas (2019); Uremadu and Onyekachi (2018) posit that debt in capital structure maximizes shareholders’ wealth, while Abeywardhana and Magoro (2017); Matar and Eneizan (2018) documented an inverse relationship between debt-to-capital ratio and shareholders wealth.

Review of empirical Studies

Enekwe, Agu and Eziedo (2014) determined the effect of financial leverage on financial performance of the Nigeria pharmaceutical companies over a period of twelve (12) years (2001 – 2012) for the three (3) selected companies. Proxies on measures of the independent variables such as: debt ratio (DR); debt-equity ratio (DER) and interest coverage ratio (ICR) in determining their effect on financial performance for Return on Assets (ROA) as dependent variable. The ex-post facto research design was used for this study. The secondary data were obtained from the financial statement (Comprehensive income statement and Statement of financial position) of the selected pharmaceutical companies' quoted on the Nigerian Stock Exchange (NSE). Descriptive statistics, Pearson correlation and regressions were employed and used for this study. The results of the analysis showed that debt ratio (DR) and debt-equity ratio (DER) have negative relationship with Return on Assets (ROA) while interest coverage ratio (ICR) has a positive relationship with Return on Assets (ROA) in Nigeria pharmaceutical industry. The results also revealed that all the independent variables have no significant effect on financial performance of the sampled companies. The results further suggested that only 16.4% of the variations on the dependent variable are caused by the independent variables in the model suggesting that 83.6% of the variations in financial performance are caused by other factors outside our model. Ahmadu (2015) investigated the relationship between financial leverage and financial performance of deposit money banks in Nigeria, with specific reference to how debt- equity ratio and debt ratio affect return on equity of deposit money banks in Nigeria. The study selected 11 deposit money banks from Tier 1, Tier 2 and Tier 3 classification of banks using convenience sampling technique for the period 2005- 2013. The study adopted both descriptive and correlation analysis in describing the data set and in investigating the relationship between financial leverage and financial performance. Findings from the correlation analysis revealed that there is significant relationship between debt- equity ratio and financial performance proxy by return on equity. However, the findings also indicated that there is no significant relationship between debt ratio and financial performance surrogated by ROE. Furthermore, findings from the descriptive analysis showed that about 84% of total assets of deposit money banks in Nigeria were financed by debts, confirming that banks are highly levered financial institutions. Cwynar, Wiktor and Dankiewicz (2015) examined the capital structure determinants in firms operating in Poland to test to what degree the financing patterns were steady during the observed period (2001-2012). Specifically, in conducting the survey, the study was motivated by the following research questions which constituted the objectives of the study: (1) which factors – country -or firm-specific – are more relevant in explaining leverage in Poland, (2) which theory – trade-off or pecking order – gains greater support in Poland, and (3) what is the significance of the optimal capital structure notion in Poland. The results showed that financing patterns changed importantly during the last 20 years, which manifests itself mainly in gradual increase in debt ratios with a dominant role of short-term debt, along with the decrease in the importance of country-specific factors (especially in large-sized, listed firms). Bhargav (2017) examined the impact of financial leverage on cost of capital and shareholder value. The primary objective of the study was to offer empirical evidence to establish whether there exists any association between financial leverage and cost of capital, and between financial leverage and shareholder value. An empirical analysis of 28 companies included in the Bombay Stock Exchange's flagship index 'Sensex' was conducted for a period of three years ranging from 2013 to 2015. A multiple step-wise regression method was used to analyze the association between financial leverage and cost of capital as well as financial leverage and shareholder value. The study revealed that financial leverage and cost of capital are negatively correlated. The debt-equity ratio is found to have a statistically significant negative association with market value added, residual income and

refined economic value added (EVA). Interest cover was found to have a statistically significant positive correlation with residual income and refined economic value added; however, it is not significantly correlated to market value added. Amenawo and Ajaude (2017) evaluated capital structure and the performance of quoted companies in Nigeria. The focus was to identify the relationship that exists between capital structure and performance indices such as the net profit margin, return on assets and return on equity. The theoretical component of the study attempted to evaluate the major contending theories of capital structure with the purpose of finding the best empirical explanation for corporate financing choice of a cross section of 94 Nigerian quoted companies. The result showed that Capital mix has a significant relationship with the earnings per share of quoted firms in Nigeria. Debt equity ratio has a significant positive impact on the return on assets of quoted companies in Nigeria and debt asset ratio has a significant inverse relationship with the return on assets of quoted companies in Nigeria. Also debt equity ratio has a significant inverse impact on the return on equity of quoted companies in Nigeria and debt asset ratio has a significant positive impact on return on equity of quoted companies in Nigeria. Basem, Al-Rdaydeh and Ghazalat (2018) examined the influence of financial leverage on the growth of Jordanian firms. A sample of 91 firms from Jordan was analyzed via panel data regression method for the period between 2006 and 2015. As a result, the findings portrayed the irrelevance between financial leverage and growth of assets, but a significantly positive correlation with the growth of sales and employment. The study revealed that growth of sales and employment had been significantly and positively correlated with firm size. The study displayed the ability to gain external financing to ascertain successful progress. Ateyah (2018) examined the impact of capital structure on earnings per share of the market capitalization of companies listed in Amman Stock Exchange, Jordan during the period 1978-2016. The study used E-views program to analyze the data, as the analysis showed that there is statistically significant positive relationship between the leverage, dividends and the market capitalization. As well as, a positive relationship between the net income after taxes and the market capitalization of listed companies in Amman Stock Exchange. The study found that there is no statistically significant between earnings per share and market capitalization, and this means that investors are interested in dividends and net income after taxes in the demand on shares, but they do not care about earnings per share when they demand shares. Umobong and Diette-Abayeh (2019) examined capital structure composition and financial performance of food and beverage firms using secondary data obtained from Nigeria stock exchange from 2012-2017. Leverage composition; short term debt to total asset, long term debt to total asset and debt-equity ratio were regressed against market performance proxies earnings yield, price/earnings ratio and Tobin Q. Variables were subjected to Hausman test for selection of appropriate model. Findings indicated significant positive relationship between short term debt over total asset ratio and Tobin Q, long term debt to total asset relate significantly positively with Tobin Q and earnings yield Also, there is significant positive relationship between Debt Equity ratio and Earnings yield. The study also found significant negative relationships between Short term debt and Earnings yield, Long term debt and P/E ratio, and between Debt Equity ratio and Tobin Q. Ahfer (2019) investigated the effect of financial leverage on wealth of shareholders of organizations in Sri Lanka. The financial data from 60 listed companies in the Colombo Stock Exchange covering eight different sectors for a period of ten years from 2012 to 2017 were gathered and analyzed. The results did not show any clear relationship between financial leverage and shareholders' wealth among the selected sample companies. Besides, as the size of the sampling is small any findings could not be conclusively established as dependable. The findings provided evidence, which are contrary to strength of most western theories. Hence, Sri Lankan firms should bear this in mind when deciding the optimal capital mix. Ogbonna and Chukwu (2020) employed panel generalised

method moments to examine the controversy facing the dynamic relationship between market value of firms (MvFs) and capital structure. The study made use of twenty four quoted firms from ten sectors in Nigeria between 2010 and 2017 inclusive. However, this study revealed that both equity and debt capital instruments at first difference impacted positively and significantly on the MvFs. That means the study supported the argument that capital structure is relevant to MvFs. The study suggested that firms should have a mix of both debt and equity in their financing structure in order to enhance the market value of the firm. It should be done in an optimal way so as to achieve the desired objective of increase in market value of the firm. Panova (2020) investigated the basic theories of capital structure and their applicability to SMEs considering the specificities of their functioning. The study identified the determinants of SMEs own and borrowed funds ratio and the main driving forces of their financial decisions. The study identified the reasons why SMEs have difficulties in attracting borrowed funds and problems with collateral provision. The study presented the dynamics of the capital structure and the composition of the borrowed funds in Russian SMEs. The research was based on the panel data of Russian manufacturing SMEs in the period of years 2010–2018. The panel data were unbalanced to avoid a survival bias. The financial ratio selected as variables was calculated using consolidated financial statements published by Russian Federal State Statistics Service. The statistical relations between the indicators were performed by a fixed effects regression with a dummy. The results of the research identified that current liquidity and asset structure have the statistically significant negative impact on the financial leverage in Russian manufacturing SMEs. Orji, Nwadiolor and Agubata (2021) examined the effect of Debt Financing on Performance of Firms in Nigeria. The study measured debt financing using the variables of long term debt financing(LTDF), short term debt financing (STDF) and preferred stock financing (PSF) while Firms Performance on the other hand was measured using Return on equity (ROE). Three hypotheses were formulated to guide the investigation and the statistical test of parameter estimates was conducted using OLS Regression Model. The research design used was Ex Post Facto design and data for the study were obtained from the NSE Factbook, Annual Reports and Accounts. The findings of the study showed that Debt Financing has significant and positive effect on Firms Performance in Nigeria at 5% significant level. The study concluded that debt financing has improved firms performance over the years.

METHODOLOGY

Research Design

The research design employed in this study is the *ex-post facto* research design. An *Ex-post Facto* research determines the cause-effect relationship among variables.

Purposive sampling technique was adopted in the determination of the sample size based of the availability of company's data from 2010 to 2020. In view of this, twenty one (21) listed manufacturing companies served as the sample size of this study. Data that were extracted from the annual reports and statements of account of the sample listed manufacturing companies.

Method of Data Analysis

The analysis of data for this study was based on the secondary financial data obtained from publications of the Nigerian Exchange (NGX) Group and the annual reports and accounts of the listed manufacturing firms in Nigeria covering 2010-2020. Descriptive statistics, Coefficient of Correlation and Panel Least Square (PLS) regression analysis were employed by the study.

Model Specification

This study adapted the model of Agung and Andi (2019):

$$ROE = \beta_0 + \beta_1 DER + \beta_2 TLR + \beta_3 CDR + \xi$$

Where:

ROE: Return on Equity

DER = Debt-to-Equity Ratio

TLR: Total Liability Ratio

CDR: Cash Flow to Debt Ratio

ξ : Error Term

The following models were employed to estimate the relationship between the discrete components of debt Financing and earnings per share. Hence, the composite multiple regression equation is:

$$EPS_{it} = \beta_0 + \beta_1 DCR_{it} + \beta_2 FSZ_{it} + \mu_{it}$$

Where:

β_0 = Constant term (intercept)

β_1, β_2 , = Regression co-efficient

β_5 = slope (coefficient or parameter estimate) of DCR

β_7 = slope (coefficient or parameter estimate) of FSZ

μ_{it} = idiosyncratic error (unobservable factors) that vary over time and affect shareholders' wealth creation

i = individual firms (1,2,3,... 21)

t = time periods (1,2,3,... 11)

EPS_{it} = Earnings per Share of firm i in period t

DCR_{it} = Debt-to-Capital Ratio of firm i in period t

FSZ_{it} = Firm Size of firm i in period t

Decision Rule

Reject H_0 if the P-value of the test is less than α -value (level of significance) at 5%, otherwise accept H_1 .

DATA ANALYSIS AND RESULT

Table 1 Descriptive Statistics

	EPS	DCR	FSZ
Mean	1.0362	0.8108	10.1831
Median	1.0100	0.8000	10.3100
Maximum	1.4100	1.1800	10.5400
Minimum	0.5500	0.5100	9.5700
Std. Dev.	0.2659	0.1988	0.2922
Skewness	0.2480	0.1585	-0.6422
Kurtosis	2.0801	2.2788	2.3442
Jarque-Bera	9.5916	0.3361	11.1265
Probability	0.0089	0.8453	0.0004
Sum	13.4700	10.5400	132.3800
Sum Sq. Dev.	0.8487	0.4741	1.0249
Observations	13	13	13

source: E-Views 10 Descriptive Output, 2022

Interpretation

Mean is the most commonly used measure of central tendency. The standard deviations show the deviation/dispersion/variation from the mean. It is a measure of risk. The standard deviation is a measure that summaries the amount by which every value within a dataset varies from the mean. It is the most robust and widely used measure of dispersion. skewness is the measure of how much the probability distribution of a random variable deviates from the normal distribution. Table1 delineates that the probability distribution for EPS (0.2480); DCR (0.1585) is a positively skewed distribution, while the probability distribution for FSZ (-0.6422) is a negatively skewed distribution.

Multicollinearity Test

Table 2: Pearson Correlation Matrix

	EPS	DCR	FSZ
EPS	1.0000		
DCR	-0.3256	1.0000	
FSZ	0.0388	0.6203	1.0000

Source: E-Views 10 Correlation Output, 2022

From the findings on the correlation analysis in table 4.2, the study revealed that there is a negative relationship between DCR and EPS by correlation factors of -0.3256 while a positive association exists between FSZ (0.0388) and EPS. Multicollinearity is the occurrence of high intercorrelations among the independent variables in the regression model. Multicollinearity can lead to wider confidence intervals that produce less reliable probabilities in terms of the effect of independent variables in a model.

Test of Hypothesis

H₀: Debt-To-Capital Ratio has no significant effect on Earnings Per Share of quoted manufacturing firms in Nigeria.

H₁: Debt-To-Capital Ratio has significant effect on Earnings Per Share of quoted manufacturing firms in Nigeria.

Table 3: Panel Least Square Regression Analysis testing the effect of DCR and FSZ on EPS

Dependent Variable: EPS
 Method: Panel Least Squares
 Date: 08/16/22 Time: 18:22
 Sample: 2010 2020
 Periods included: 11
 Cross-sections included: 21
 Total panel (balanced) observations: 231

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	7.157685	0.416738	17.17551	0.0000
DCR	-0.085669	0.038736	-2.211620	0.0280
FSZ	0.031146	0.057263	0.543909	0.5870
R-squared	0.036115	Mean dependent var		1.004610
Adjusted R-squared	0.005859	S.D. dependent var		0.493791
S.E. of regression	0.492342	Akaike info criterion		1.454733
Sum squared resid	54.05543	Schwarz criterion		1.573951
Log likelihood	-160.0217	Hannan-Quinn criter.		1.502818
F-statistic	57.13642	Durbin-Watson stat		1.626982
Prob(F-statistic)	0.000000			

Source: Researcher's computation using E-Views 10.0, 2022

Interpretation of Regression Analysis

The panel regression result in Table 3 shows that the sign of beta coefficients of DCR ($\beta_1 = -0.085669$) are consistent with expectations about the relationship between debt financing and earnings per share. This implies that DCR, has inverse relationship with EPS, thus exert negative effect on EPS of manufacturing firms under review period. The t-statistics with their probabilities associated with the coefficients indicate that, at 5% (0.05) level of significance, It is also indicated that DCR ($x_1 = 0.0280 < 0.05$) has a negative but statistically significant relationship with EPS, while, FSZ ($x_2 = 0.5870 < 0.05$) exerts a positive but non-significant effect on EPS.

Decision

This study therefore submits that there is a significant relationship between debt financing and shareholders wealth creation and that the debt financing exerts a significant effect on shareholders wealth creation of manufacturing firms in Nigeria at 5% significant level.

CONCLUSION AND RECOMMENDATION

This study examined the effect of Debt-to-capital ratio on shareholders wealth creation of quoted manufacturing firms in Nigeria for a period of eleven (11) years covering from 2010-2020. Data analysis revealed an inverse relationship exists between debt-to-capital ratio and earnings per share. In conclusion, this study found that debt financing has a significant effect on shareholders wealth creation at 5% level of significance. Based on the findings, it was recommended that, considering the negative relationship between Debt-to-capital ratio and earnings per share firm managers should be careful when considering options of financing and should preferably use internal source of financing such as using owners capital, retained profit and selling assets.

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