



The Effect of Financial Leverage on the Value of Listed Deposit Money Banks in Nigeria

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Abstract

This study seeks to provide evidence on the Effect of Financial Leverage on the Value of Listed Deposit Money Banks in Nigeria. The analysis was conducted on seven (7) out of fifteen (15) Deposit Money Banks listed in the Nigeria Stock Exchange (NSE) for the period of 2006-2015. The major focus of this study was to investigate empirically firm specific variables such as, firm leverage, long term debt/total capital, debts/total assets and debts/equity on the value of seven (7) listed Deposit Money Banks in Nigeria. The study used only secondary data. The data were collected from annual reports and accounts of the sampled banks for the period of study. To achieve the research objectives, ordinary least square (OLS) and generalized least square (GLS), descriptive statistics and correlation method were employed in carrying out the analysis using STATA Version 12.00. The result of the study reveals a positive and significant relationship between total debt/total asset and the firm's value proxied by Tobin's Q. The study shows that total debt/total capital has negative and insignificant effect on the firms' value and at the same time debts/total equity shows negative but significant relationship on the value of Listed Deposit Money Banks in Nigeria. Therefore, it is recommended that management of Listed Deposit Money Banks in Nigeria should increase the use of debts to total assets ratio order to maximize the shareholders' wealth and reduce total debt to total capital and total debt to total equity ratio as it is dangerous for the firm in the Nigeria banking industry. Moreover, mechanism should be put in place to ensure proper use of financing mix that will offer the prospect of enhancing value for shareholders in the sector.

Keywords: Financial leverage; firms' value, TQ, deposit money banks, Nigeria

1.0 Introduction

Financial theorists have long argued that the decision-making objective of every business is geared towards maximizing firms' value. Managers and practitioners have often criticized them for being too single-minded about value maximization and for not considering the broader aspects of corporate strategy or the interests of other stakeholders (Damodaran, 2012). Determining the source

of finance and the amount that can be obtained from fund providers are among the most important decisions that every firm has to make. These decisions are made in such a way as to ensure the maximization of profit, value and overall welfare of the firm. Capital from the accountants' point of view is seen as the amount of money or wealth capable of being employed in the production of more wealth (Wikipedia 2014). The total



value of the firms depends on how it makes its investment decisions, as the higher the yield on investments the higher the income to the firm, and the higher the income to the firm, the higher the flow of gains to the owners of the firm (Barine, 2012). Therefore, finance manager is expected to ensure the maximization of the economic welfare of the owners of a firm and this is represented by the market value of the firm.

The value of the firm is defined as the amount of utility and benefits resulting from the shares of the firm by the shareholders (Rouf, 2011). In the same vein, Leland and Toft (1991) state that the value of a firm is the value of its assets plus the value of tax benefits enjoyed as a result of debt minus the value of bankruptcy cost associated with debt. Modigliani (1980) points out that, the value of a firm is the sum of its debt and equity and this depends only on the income stream generated by its assets. Pandey (2004) opines that the value of a firm is the sum of the values of all its securities, that is, the sum of its equity and debt if it's a leveraged firm and the value of only its equity if it is an unleveraged firm. The net income is obtained by subtracting interest on debt from net operating income. On the other hand, the value of debt is the discounted value of interest.

Miller and Modigliani (1963) affirm that the relationship between profitability and firm's value emanates from the attempt by firms to earn part of their profit by deducting interest from using debt financing. To them, profitable firms tend to be highly levered as a result of embarking on debt financing to shield part of their profits from taxation. As a result, they have higher value than less profitable firms which are less levered. However, less profitable firms may be highly levered by getting on into debt financing, because they do not have a sufficient amount

of profit to plough back. When a firm is financed with more of debt in its capital structure it is said to be more levered and when a firm is financed with less debt in its capital structure it is said to be less levered. This means more debt signifies leverage, while less debt signifies unleveraged. Value maximization is very important because it helps to achieve the overall corporate objectives, to keep the organization in business, and to create a greater prospect for future opportunities in domestic and as well as in the global market (Amarjit & Neil, 2011).

Furthermore, extent literatures on the relationship between financial leverage and firms' value reported mixed conclusion. These studies include those conducted by Rajan and Zingales (1995), Huang and Song (2006), Gropp and Heider (2009), Baharuddin, Khamis, Mahmood and Dollah (2011), and Barine (2012), among others. Some studies reported negative relationship between leverage and firm value, some positive and others reported no definite relationship. For example, Chen (2002) examined the impact of total debt to total assets on Tobin's Q and reported negative relationship for high growth firms and positive relationship for low growth firms. Rayan (2008) studied the impact of debt to equity ratio (financial leverage) on the firm's value. His study reported negative impact of financial leverage on Return on equity (ROE), Return on Asset (ROA), Operating Profit Margin (OPM), Earnings per Share (EPS), and insignificant impact on Economic Value Added (EVA) and Price Earnings Ratio (PER). Comparatively few studies on financial leverage and firms' value were carried out in Nigeria. These include the studies by (Ogbulu & Emeni 2012; Collins, Filibus & Clement 2012; Isaac 2014). Among all the previous studies on financial

leverage and firm value, the researcher had not found similar work been carried out with regard to banking industry in Nigeria. An attempt was also made by Moldasheva (2012) who studied firms listed on the Kazakh stock exchange but recommended further research in other sectors due to the limited empirical literature available; hence, the need for a study. It is in light of the above issues that this study was conducted to see how this observed relationship can have positive impact on the variables identified on the value of listed deposit money banks in Nigeria and also add value to the existing literature as a result of limited studies that have been conducted so far in this area using Nigerian context.

This literature gap will be filled by this study. However, based on the literature gap identified, three hypotheses were formulated for testing this research work.

Ho: There is no significant relationship between total debt to total equity and the value of deposit money banks in Nigeria.

Ho: There is no significant relationship between total debts to total assets and the value of deposit money banks in Nigeria.

Ho: There is no significant relationship between total debts to total capital and the value of deposit money banks in Nigeria.

This study is expected to contribute in many folds: first, the management of listed deposit money banks in Nigeria will benefit toward policy making on the appropriate financing mix that will improve their performance. Second, policy makers of various organizations could borrow leaf from the findings, which should enhance their ability to plan the capital structure of their organizations so as to maximize the value of their firms and consequently the shareholders' wealth. Third, regulatory authorities will be able to gather ideas on how capital costs and value of a firm change

as the degree of leverage is altered. Such information would enable management to anticipate the effect of changes in leverage in their determination of required rate of return in order to maximize the market value of the firm. Finally, researchers are expected to utilize the pool of available literatures in the subject matter and providing a frontier for future areas of investigation. The remaining part of the paper consists of literature review and theoretical framework, methodology, result and discussion and conclusion with recommendations.

2. Literature Review

Leland and Toft cited in Ogbulu and Emeni (2012) defined the value of a firm as the value of its assets plus the value of tax benefits enjoyed as a result of debt minus the value of bankruptcy cost associated with debt. Pandey (2004) defined value of a firm as the sum of the values of all its securities, that is, the sum of its equity and debt if it is a leveraged firm and the value of only its equity if it is an unleveraged firm. The value of the firm's equity is the discounted value of its shareholders' earnings called net income, that is, the net income divided by the equity capitalization rate or expected rate of return on equity. The net income is obtained by subtracting interest on debt from net operating income, and the value of debt is the discounted value of interest on debt.

Firm value is an economic measure reflecting the market value of a whole business (Kurshev & Strebulaev, 2005). According to Ehrhard and Bringham (2003) it is a sum of claims of all claimants: creditors (secured and unsecured) and equity holders (preferred and common). Firms' value is one of the fundamental metrics used in business valuation, financial modeling, accounting, portfolio analysis, etc. Firm value is calculated by adding a corporation's market capitalization, preferred stock, and

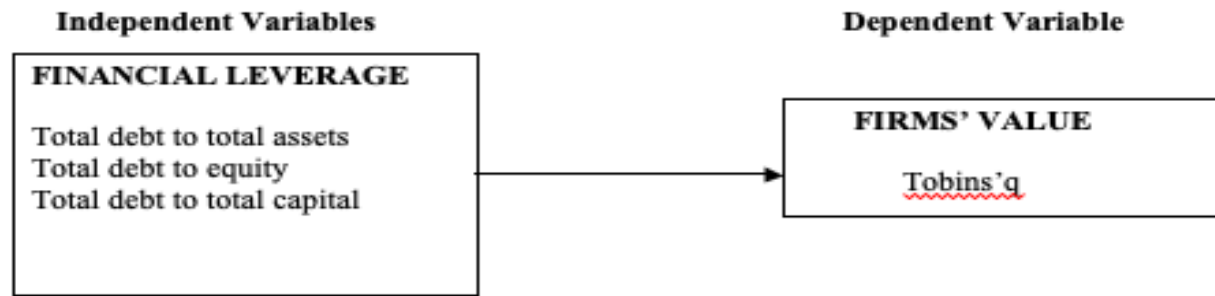


outstanding debt together and then subtracting the cash and cash equivalents found on the balance sheet (Ehrhard & Bringham, 2003). In other words, firms' value is what it would cost to buy every single share of a company's common stock, preferred stock, and outstanding debt.

According to Morgaritis and Psillaki (2010), financial leverage is the combination of debt and equity capital maintained by a firm with different sources of funds, particularly to the long-term fund/capital. To them, it is a framework that shows how equity and debt is used for financing operations. They went ahead to argue that it is very vital to find an optimal leverage or optimal combination of debt and equity since leverage maximizes the value of the firm and further claim that, the essence for leverage is to determine the best possible use of debt in financing business operation. According to Weston and Brigham (1992), optimal capital is the one that maximizes the market value of the firm's outstanding shares. In the view of Ward and Price (2006), financial leverage is the proportion of capital which is financed by debt in contrast to equity. Therefore, the higher the leverage, the higher the amount of debt in the capital structure of a firm. Ugwuanyi (2012) states that the amount of debt that a firm uses to finance its asset is called leverage. A firm financed with more of debt in its capital structure is said to be highly levered while a firm financed without debt is said to be unlevered. He further argued that financial leverage increase

variability of the market value of the firm. He found that increase in leverage should have positive and significant impact on market value of firms Ugwuanyi (2012). This means an increase in leverage increases firm value. To this end, the prime aim of financial leverage should be to maximize shareholder wealth or increase the market value of the firm. If leverage would increase the value of the firm, investors would deem this to be a positive signal of the size and stability of future cash flows.

There are several theories on leverage being propounded by different scholars. The trade-off theory rationalizes reasonable debt ratios. It is argued that the firm will borrow up to the point where the marginal value of tax shields on additional debt is just offset by the increase in the present value of possible costs of financial distress (Myers, 2001). Several empirical studies confirm the assumptions of the static trade-off theory like that of Harris and Raviv (1991) and Smith and Watts (1992), who found negative relationship between leverage and the research and development expenditures. Various theories like trade off, pecking order and agency explained the relationship between leverage and firm value, but trade off theory was found to be more relevant in the study of the relationship between leverage and firm value. This is because it considers comparison between tax advantages and disadvantages of various sources of finance and their impact on value in determining the sources of finance for a firm



Source: Designed by the researcher

Figure 1. Model of the study

3. Methodology

The population of study is made up of the 15 deposit money banks quoted on the Nigeria stock Exchange as at 31st December 2015. The cross-sectional survey research design was adopted in this study. This is because the data used in this study were collected at a particular point in time for each and every year. The sample size of the study was drawn from the population of the study was arrived at using the three-point filter:

- i. A bank must be listed in the Nigerian Stock Exchange on or before the beginning of the period covered in the study (2006), and remains with the same identity up to the end of the period covered in the study (2015). This is to enable the researcher obtain the data from the annual report and accounts of the sampled banks;
- ii. The financial reports and account of a bank must be available for all the years covered in the study; and
- iii. A bank must have started using debt financing from the base period of the study (2006) up to the end of the maximum period covered in the study (2015).

The secondary source of data was employed. The data were collected from annual reports and statements of account of the banks under consideration. The multiple regression method of data analysis was adopted in this

study. To be specific, the Ordinary Least Square (OLS) technique was adopted. Since this study sets out to test the relationship (association) between firms' value and financial, the OLS correlation method is appropriate.

3.1 Model Specification

This research adopts and modifies the model from the study by Collins et al. (2012). It was modified by adding one more measure of financial leverage (Total debt to total assets). The model was modified because it did not include more measures of financial leverage in terms of ratios, which are the most widely used measures of financial leverage. This study modified it to include more measures of financial leverage in terms of ratios. It will use Tobin's Q as proxy for Firm's Value as used by (Ryan, 2008) and (Gill & Abradovich, 2012) and three ratios (TDTA, TDTQ and TDTC) as proxies for financial leverage. The model to use in this study was presented in a relational form as follows:

$$TQ = f(TDTA, TDTEQ, TDTC)$$

With the linear expression of the model thus, it can be seen as follows:

Model

$$TQ = a_0 + \beta_1 TDTA_{it} + \beta_2 TDTEQ_{it} + \beta_3 TDTC_{it} + Y_4 PROF_{it} + Y_5 SIZ_{it} + Y_6 TANG_{it} + \mu$$

In the above model firm's value is TQ while financial leverage was denoted by three proxies as $\beta_1 TDTA_{it} + \beta_2 TDTEQ_{it} + \beta_3 TDTC_{it}$



Where:

$\alpha_0, \beta_1, \beta_2$ and β_3 are parameters to be estimated.

TQ = stands for firm value in the model

$TDTA_{it}$ = Total debt to total assets

$TDTEQ_{it}$ = Total debt to total equity

$TDTC_{it}$ = Total debt to total capitalization

$PROF_{it}$ = Profitability of firm at time t

SIZ_{it} = Size of firm at time t

$TANG_{it}$ = Tangibility of firm at time t

μ = error term.

4.Data Analysis and Result

The purpose of this study as mentioned in the introductory section of this paper is to examine the relationship between financial leverage and firms' value of listed deposit money banks in Nigeria. The regression result obtained from the ordinary least square is presented below:

Table 1. Regression Result

Rgressor	Coefficient	Standard Error	T-Ratio	(Prob)
Tobin q	-0.01183	0.00049	-24.22	(0.000)
TDTE	1.01453	0.01725	58.80	(0.000)
TDTA	-0.00048	0.00137	-0.35	(0.727)
R^2		0.9774		
Adjust R^2		0.9753		
F-stat F (6, 60)		637.12 (0.000)		

From the above regression result using the Ordinary Least Square (OLS) estimation technique, it would be observed from the adjusted coefficient of determination ($2R = 0.9774$) that about 98% of systematic variation in the dependent variable (firm value) is explained by the independent variables. This implies that the model is fit with a highly predictive power. The F-test which measures the existence of linear relationship between the dependent and independent variable revealed that a highly significant relationship exists between the variables. The F-calculated value of 637.12 is by far higher or greater than the F critical value of 0.10 at 5% level of significance. Also, from the result, the Standard Error of Regression (SER) is 2% which is considered relatively good enough to confirm the predictive power of the model. Therefore, with the SER value, the model above is a very good model for policy making

purposes. This implies that the result can be used to draw policy suggestion. Furthermore, the analysis of the parameter estimates and their t-ratios; indicative of the individual statistical significance of the explanatory variables shows that a significant positive relationship exist between TDTA and Firm Value given that the t-calculated (58.80) is greater than the t-theoretical values at 5% (2.06) and 10% (1.70) levels of significance respectively. This indicates that as TDTA increases, the Firm Value also increases. Thus, we reject the null hypothesis that says DTDA is not positively related to Firms' Value. Conversely, the results also reveal that TDTEQ is inversely related to Firm Value. This is at variance with theoretical expectation. The relationship is also statistically insignificant at 1% and 5% significance levels respectively. Consequently, accept the null hypothesis



that says TTEQ and TDTC is not positively related to Firms' Value.

4.1 Discussion

Following the above regression results of TDTA, TDTEQ, TDTC as components of capital structure, only TDTA was found to be the major determinant of firm's value. This is consistent with the findings. This finding is in line with the findings of Rayan (2008) on 113 Johannesburg firms in South Africa, and that of Ruan, et al (2011) who reported negative relationship between TDTA and Firm Value measured in Tobin's q , though their study described and supported the objective condition for capital structure being the intermediate variable between managerial ownership and firm value. However, it contradicts the result of Chen et al (2010) which indicates strong positive effect between TDTA ratio and firm value measured in Tobin's Q at threshold level. It is also inconsistent with the result of the study by Sudiyatno et al (2012) on the manufacturing firms listed in Indonesia Stock Exchange, 2008 to 2010. The reason for this agreement is because both the finding of this research work and the findings of the above-mentioned theories took cognizance of the market imperfections present in the real world.

Furthermore, this study reveals that in an emerging economy like Nigeria, the regression results as shown in table 4.3 indicate that TDTEQ is negative and insignificantly related to Tobin's q at 10% level of significance in OLS estimations. The implication of this is that increases in TDTEQ, other independent variables remain constant decreases the firms' value (Tobin's q) in Nigerian deposit money banks significantly. This finding is consistent with the findings of Antwi, Mills and Zhao, (2012), Ahmad, Abdullah and Roslan (2012) and Chen and Chen (2011). It is argued by

Rayan (2008) who used Return on Equity as proxy for Firm Value instead of Tobin's Q , he indicated an inverse relationship between financial leverage and firm value. The result also coincides with the studies in Nigeria by Ogbulu and Emeni (2012) and Lawal (2014), even though both studies used debt and equity as two separate proxies for financial leverage instead of using ratio. Both studies reported negative relationship between equity and firm value. shows that TDTC is negative and highly insignificantly related to firms' value of deposit money banks in Nigeria in OLS estimation. Therefore, any increase in total debts to capital will lead to insignificant decrease in firms' value of deposit money banks in Nigeria. This result is in coincidence with that of Raj and Ajit (1996) who reported statistically significant relationship between TDTC and Firm Value, though it is inconsistency with their result at micro level which indicates no definite relationship between change in the capital structure and the value of a firm. The result is also in line with the findings of a study in Nigeria by Collins, et al. (2012), which empirically examined the effect of a firm's capital structure on its market value, and reported a negative relationship between a firm's total-debt/total-capital ratio and its market value. It is therefore, recommended that.

The management of Nigerian listed deposit money banks should make appropriate efforts in improving the use of total debts to finance assets, as the regression result of the study has empirically proved that the higher the total debts to total assets the more the value of Nigerian listed deposit money banks so that their value can be enhanced. This can be done through increase in issuance of more debts instruments and borrowings for the purpose of financing assets and investments. This study was



restricted to relationship between financial leverage and firms' value in the listed Deposit Money Banks of Nigeria. The proxies adopted for financial leverage in this study are Total Debt to Asset, total debt to Capital and Total debt to Equity and Tobin' Q was used as a proxy of firms' value. Other studies can pay attention to the following. Since this study is done on banking industry, it is recommended that similar studies can be carried out on the manufacturing, service industry, agricultural sector etc of the economy. Future researchers may extend study period and may also take all the deposit money banks that are listed in the Nigeria stock exchange (NSE) using same proxies. Other studies can pay attention to other determinants of financial leverage (i.e. times interest earned and fixed charge coverage) and firms' value (i.e. return on assets, return on equity firms' growth etc) in the institutions.

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