

Firms Financing Choice in an Emerging Economy: The Nigerian Context

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Abstract: We investigated the control variables which are also commonly used as determinants of firm-leverage such as firm-tangibility, firm-size and liquidity to determine the firms financing choice in Nigeria. Nevertheless, from our empirical observation we discovered that some of the modern finance-theories that are currently used in explaining capital structure determinants in developed economies are also appropriate for firms in Nigeria.

However, this research employ the most commonly used determinant of capital structure to examine the firm financing choice in Nigeria by investigating 10 firms quoted on the Nigeria stock market between the period of 2007-2011 using Ordinary Least Square. Specifically, the data analysis revealed, that Firm-Tangibility and Liquidity are negatively correlated to quoted firms examined while; firm-size is found to be positively related to firm leverage.

Keywords: firm-tangibility, firm-size, liquidity, firms financing choice.

1. INTRODUCTION

Background of the Study:

Financial decisions of firms are one of the most important primary responsibilities of the financial managers, which is still a subject of debate and investigation that is still ongoing today. In this study we will critically examine the financing choice of firms in emerging economy like Nigeria and to also examine the determinants of capital structure choice of firms that operate in the Nigerian financial market. The role financial market plays in firms financing choice and the aggregate level of variation between debt and equity ratio. In more recent years, the stock markets in developing countries has become increasingly important, due to the rapid rate at which the market is growing, they now command or play a much more central role than they did ten years ago, kudos to trade and financial liberalization which has taken place in the past decades in these countries.

The capital structure choice is significant in this context, due to the fact that financing choice of firms depends on the cost of capital; hence a firm's value depends on its debt and equity mix (Pagano, 1993; Boyd and Smith, 1998; Opler and Titman, 2001). However, in terms of firm financing choice a great different seems to exist between the international community's (developed economies) and local communities (emerging economies). According to Atkin and Glen (1992) firms within the G7 states, generate funds internally; this makes them dominant. While firms in developing states generate funds externally i.e. equity and bank loan, which makes it extremely difficult for the firms to achieve optimum capital level. In spite of the increasing significance of external funding or finance in emerging economies, it poses further complication as a result of the market incompetence and institutional limitations. For instance, in the emerging economies the financial institutions such as the banks, cannot adequately provide the much needed funds to firms in these countries, particularly where the macroeconomic surroundings is excessively risky for long-term loans. Although, the financial liberalisation in the developing countries has helped to broadened the scope of financial instruments made available for firms in the developing economies, utilising this new advantage still remain a major challenge (Domowitz et al. 2000).

According to Mutenheri and Green (2003), financial liberalisation among developing countries like Nigeria has brought significant amount of development to the financial systems. This has given way for stock markets improvement and

transparency in firms financing choice. For firms to survive in the Nigerian business environment, a proper source of raising finance has to be exploited, in order to achieve its primary objective of profit maximisation. Although some existing firms are collapsing due to improper liquidity management, they use funds meant for short-term investment to finance long-term investments so on and so forth (Osaze, 2004). An appropriate financing decision plays vital role in achieving a firms business objectives especially in profit maximisation. Firms financing policy requires managers to identify ways they can fund new investment, which can be through; the use of retained earnings, borrowing through debt instruments and possibly issuing of new shares. However, when funds are sourced through the stock market, it is cheaper and safer for firms, due to the fact that, it allows firms to obtain finance without incurring debt.

Investment choice or decisions can be associated with the way through which funds are raised in the stock market to generate future cash-flow, so as to provide return for investors. The choice of this investment is typically the application of capital budgeting methods as a “project appraisal instruments”. Capital budgeting is a significant tool which firms uses to decide upon the optimal use of inappropriate fund or resource in other to decide whether to accept a particular project or not. Financing choice relates to a mix of finance obtained from the stock market, in respect of the proportionate holding of equity and debt. The optimal capital structure of firms offer huge benefit to corporations, in fact the optimal investment choice or decision enables firms to maximise the current value of shareholders wealth by applying the capital budgeting techniques (Copeland and Weston 1992).

In the 1970s Nigeria experienced huge economic boom, most of the enterprise uses mostly the banking institutions as their main source of funding to finance their investments. After the boom, the later part of the 1980s the rate of interest rose in the stock market from 15% to over 60%. This rise in interest rate then motivated investors to patronise the Nigeria stock market, which increased individual patronage of stocks and bonds listed on the market (Olugunde et al. 2006).

1.1 Statement of problem:

The problem of financing choice in Nigeria has been given dominant attention (especially long-term projects). The Nigeria government has introduced various approaches, by establishing new developmental finance bodies such as Rural Banking Scheme, Credit Scheme and World Bank Assisted SME Loan project etc. However, most of this approaches are still bank based, which favours short-term financing, while the long-term finance still appeared to be neglected (Asoqwa, 2004).

1.2 Objectives of this Study:

This study aspires to achieve the following main objectives:

- a. To explore current firms financing choices or decisions and practices in Nigeria;
- b. To determine the extent to which a firm’s size and asset life affect leverage;
- c. To also determine the extent a firm’s liquidity affects its leverage.

1.3 Research Hypotheses:

The following hypotheses are formulated to enable this research accomplish its stated aims:

- H₁ : There is a positive relationship between firm-tangibility and leverage;
- H₂ : There is a positive relationship between firm-size and leverage (i. e debt capacity of a firm);
- H₃ : There is a negative relationship between liquidity and leverage.

2. LITERATURE REVIEW

Numerous theories have been put forward in describing the capital structure of a firm. The word capital structure can be defined as a relative proportion of equity and debt in financing an enterprise; it is a long-term source of financing used by corporations. However, managers can decide on which mix of capital structure to use, they could also choose the capital structure mixed that best maximise their shareholders value and wealth and at the same time maximise the firms cost of capital (Ross, S. et al. 2007). According to Barges, A. (1963) looking at the traditional view of capital structure, debt capital is more economical than equity. The implication of this statement is that when the cost of capital is added to the increased cost of equity collectively on a weighted basis will be smaller than the equity cost which exist on equity before the debt financing. A proper capital mix results is known as “optimal capital structure” it provides firms with greater benefits.

Different techniques are also applied in measuring or estimating the cost of capital such as WACC (weighted average cost of capital). The weighted average cost of capital is one of the key traditional metric used in the literature of corporate finance. WACC is planned to stand as the cut-off line in capital budgeting choice or decisions. Managers aim to view venture which are equal or surpass the difficulty rate in other to maximise the stockholders wealth, whereas those that fall short are seen as dilutive to value.

In financial term, leverage involves buying more of an asset by using borrowed funds, with the belief that the income from the asset or asset price appreciation will be more than the cost of borrowing. Almost always this involves the risk that borrowing costs will be larger than the income from the asset, or that the value of the asset will fall, leading to incurred losses.

For the purpose of this research, we would be explaining the explanatory variable which affects leverage. A suitable explanatory variable choice is possible debatable (Titman and Wessels, 1988; Supanvanij, 2006; Zou and Xiao, 2006 and Oliver, 2009). For this study to correctly-identify which capital structure hypothesis that will be significant to emerging economy firms, in the Nigeria context, this study concentrates on a number of variables that has been applied in previous literatures. The chosen explanatory-variables are some of the capital structure determinant that has been identified through the existing hypothesis and empirical research. The chosen variables are the firm size, asset tangibility and liquidity. These factors have shown up more consistently in previous studies, these has been linked with leverage studies carried out by Bradley et al. (1984); Long and Maltiz, (1985); Harris and Raviv, (1991); Rajan and Zingales, (1995); Booth et al. (2001); Deesomsak, et al. (2004); Antoniou, et al. (2007); Ezeoha, A. E. (2008) and Fernandes, N. (2011). However, the availability of data meticulously limits our inclusion of other determinants. The table below shows the determinant of leverage by different theories:

Table 1. Leverage Determinants

Leverage Determinants	Pecking Order Theory	Trade-off Theory	Agency Theory
Asset Tangibility	Positive (+)	Negative (-)	Negative (-)
Firm Size	Positive (+) or Negative (-)	Positive (+)	Negative (-)
Liquidity	Positive (+)	Positive (+)	Negative (-)

Source: Olayinka, A. (2011).

Positive-impact; + negative-impact; -

Previous study conducted by Zou, H. and Xiao, J. Z. (2006), in their studies also investigated the corporate financing behaviours of the listed Chinese companies. They were able to find evidence that the Chinese financing setting, which is mainly characterised by stringent regulatory-control over equity-financing and dominance of state-ownership; is largely consistent with Chinese view of firms having built-in incentives for raising-equity. That is the Chinese firm financing behaviour favours equity financing which is principally consistent with Rajan and Zingales, (1995) on their G-7 countries study.

Wafaa, S. (2010), also investigates the capital structure determinant of Kuwait and Saudi Arabia emerging countries and the influence or impact their financial market growth have on the financing choices of firms that operates in these markets. Their outcome shows that the capital structure of firms quoted in these stock markets can be explained with capital structure determinants and that the financial market growth in these countries is a significant tool for firms financing choices. Nevertheless, the findings also indicate that the financial markets in both countries are negatively and significantly associated to the leverage-ratios, which signifies as equity market becomes advance the level of their liquidity improves. These improve liquidity enables firms financing in this countries to issue more equity, thereby reducing their reliance on debt-financing.

Franklin, A. et al. (2012), their studies examines financing of firms in India. They carried out survey on small and medium firms of which they evaluate the legal and business environment, India financing system and the different growth patterns of India firms. They found out that banks and market funding are not better to alternative-financing in a rapid growing economy like India and China. Although, alternative funding includes; funding of all non-bank and non-market source.

The Independent Variables:

1. Tangibility of Asset:

The tangibility of asset is another determinant. According to Fernandes, N. (2011) in their studies found out that tangibility of assets is a very significant factor used in explaining leverage-ratio of a firm. A firm with a large sum of fixed-asset can invariably borrow money at a comparatively less interest rate, based on the fact that such firm can use their assets collateral to lenders. The trade off theory states that tangibility of assets can be used as collateral, in the event of financial distress it serves as securities to creditors (Titman and Wessels, 1988; Rajan and Zingales, 1995; Fama and French, 2000).

2. Firm Size:

The size of a firm in general, is accepted be a very significant determinant of a firm's ability to raise fund or capital through debt/equity from the stock market. Most of the research or studies carried out suggest that a positive relationship exist between leverage and size. Titman and Wessels, (1988), affirms that larger firms due to the level of their diversification make them less-vulnerable to bankruptcy when compared to smaller-firms.

3. Liquidity:

Liquidity which is also one of the determinants is defined as the ratio of current-assets to current-liabilities. It is the ratio which indicates or shows a firm ability to meet its short term financial obligations; it helps to measure a firm's level of liquidity. Trade off hypothesis is of the view that a positive relationship thus exist between leverage-ratio and liquidity, this because high liquidity-ratio can comparatively support high debt-ratio as result of the firm settling its short term financial obligations on time. While the pecking order hypotheses hold a contrary view, the theory predicts that firms with high level of liquidity tend to borrow less.

3. DESIGN AND RESEARCH METHODOLOGY

Research Methodology:

There are now numerous empirical works that looks at firms financing choices in general. The research technique employ in this study involve quantitative analyses of secondary data. This section presents the research design, population of the study, the method of data collection and also specifies the sort of statistical tools or modelling techniques applied and the motive for applying the techniques.

For the purpose of this study, secondary data will be source to undertake analysis of this research. This study will make use of the balance-sheets of listed firms published. The main source of the data are obtained from the Thomson-one Banker Data Based, Nigerian Stock Exchange website and the NSE fact-books.

Research Design:

The research design applied in the work is analytical survey; it will be used to analyze the firms financing choice in Nigeria and the influence financial market growth has on the financing decision of corporations.

Population of the Study:

Welman and Kruger, (2005), described population as a group, organisation and individual, human creation or events. The population relevant to this study is companies that are quoted in the Nigerian Stock Exchange till date. As at the time of this research, there are 203 listed financial and non-financial business firms in the Nigerian Stock Exchange (www.nigeriastockexchange.com). Consequently, 10 quoted non-financial firm's data were finally selected, about 50 observations from the 10 companies over a 5-years period [2006-2011]. This study utilizes data obtained from the balanced sheet of the chosen firms. The module or unit of our analysis were non-financial firm quoted on the Nigerian Stock Exchange (NSE).

Sample Size and Selection of the Study:

This study adopts the stratified random sampling selection techniques. It justified due to the fact that each industrial-sector will be appropriately represented. According to Efayena, (2007) assert that capital structure of non-financial and financial firms both should be studied separately, in other to avoid misrepresentation. Hence, we focus on the non-financial business companies. Therefore, we picked our sample from the industrial sectors such as the consumer units as classified in the NSE fact-book. From aforementioned, a total of 10 non-financial quoted companies in Nigerian Stock Exchange were selected. The firms selected and their applicable industries are scheduled in Appendix 1.

Model Specification:

In light of this, the empirical model we adopt to test our hypothesis takes the form below:

$$LV_{it} = \lambda_0 + \sum_{it}^n \lambda_1 + Z_{it} + \xi \text{-----} 1$$

Where LV_{it} = the dependent variable, which is defined as the debt-ratio of a firm at time t. while;

λ_0 = represent the common intercept

$\lambda_1 - \lambda_3$ = these are the coefficients of the independent-variables

ξ = represent the error-term

However, to be more explicit, in a situation where model one is completely specified, for fixed-effects, random-effects and OLS correspondingly, one can achieve the equations below:

$$LV_{it} = \lambda_0 + \lambda_1 SIZE_{it} + \lambda_2 TAN_{it} + \lambda_3 LIQD_{it} + \xi_{it} \text{-----} 2$$

$$LV_{it} = \lambda_0 + \lambda_1 SIZE_{it} + \lambda_2 TAN_{it} + \lambda_3 LIQD_{it} + \eta_{it} \text{-----} 3$$

$$LV_{it} = \lambda_0 + \lambda_1 SIZE_{it} + \lambda_2 TAN_{it} + \lambda_3 LIQD_{it} + \xi_{it} + \eta_{it} \text{-----} 4$$

In this regard, leverage represent the dependent-variable while Asset Tangibility, Firm Size, Liquidity represent the three independent variables following the consistent work and latest findings of the variables that are defined in literature reviews closely linked to corporate financing decisions which is in line with the work of Rajan and Zingales, (1995); Shah and Hhan, (2007); Love et al. (2007) and Leary, (2009).

Table 2: Leverage (Dependent Variable) and the Explanatory Variables (Independent Variables)

List of Variables	Proxies'
1. Leverage (dependent variable)	LEV= $\frac{\text{Total-Liabilities}}{\text{Total-Assets}}$
2. Firm Size (independent variable)	SIZE= Natural Logarithm of Total Assets
3. Asset Tangibility (independent variable)	TAN= $\frac{\text{Fixed-Assets}}{\text{Total-Assets}}$
4. Liquidity (independent variable)	LIQD= $\frac{\text{Current-Assets}}{\text{Current-Liabilities}}$

4. RESULT AND DISCUSSION

Presentation of Result:

The outcome or results shown beneath are in the form of tables from which we will draw deduction from the data, in relation to the hypothesis set out in the study.

Table 3. A summary of OLS regression results of the firms

	Firms	I/V	Beta	t-test	Sig. (Prob)	Accept or reject H ₀	F-test	Sig.	R ²
1	CADBURY-LA	TAN	-1.387	-.567	.672	Accept	11.699	.211	.972
		SIZE	.348	.508	.701	Reject			
		LIQD	-.987	-2.572	.236	Reject			
2	NESTLE-LA	TAN	-.207	-.268	.834	Accept	.311	.829	.483
		SIZE	-.035	-.226	.859	Accept			
		LIQD	-.255	-.931	.523	Reject			
3	PZ-LA	TAN	-.522	-2.963	.207	Accept	29.529	.134	.989
		SIZE	.166	1.361	.403	Reject			
		LIQD	.024	.208	.869	Accept			
4	UNILEVER-LA	TAN	-1.349	-77.774	.008 [^]	Accept	7480.849	.008 [^]	1.000
		SIZE	.049	14.983	.042 [*]	Reject			
		LIQD	-.595	-134.969	.005 [^]	Reject			
5	DANGSUGAR-LA	TAN	.463	.280	.826	Reject	10.512	.222	.877
		SIZE	.101	.436	.738	Reject			
		LIQD	-.206	-3.339	.185	Reject			
6	GUINNESS-LA	TAN	-.970	-10.518	.060	Accept	45.346	.109	.993
		SIZE	.023	.962	.512	Reject			
		LIQD	-.263	-11.188	.057	Reject			
7	NB-LA	TAN	-2.170	-6.790	.093	Accept	39.926	.116	.992
		SIZE	.304	6.834	.092	Reject			
		LIQD	-.375	-9.846	.064	Reject			
8	FLOURMILL-LA	TAN	-.620	-1.333	.410	Accept	.691	.685	.675
		SIZE	.074	.729	.599	Reject			
		LIQD	-.037	-.203	.872	Reject			
9	JBERGER-LA	TAN	-.493	-.718	.604	Accept	.521	.740	.610
		SIZE	.008	.579	.666	Reject			
		LIQD	-.470	-.666	.626	Reject			
10	AIRSERVICE-LA	TAN	-.143	-1.433	.388	Accept	161.214	.058	.998
		SIZE	.319	2.967	.207	Reject			
		LIQD	-.188	-6.956	.091	Reject			

Where * is significant at 5%; ^ is significant at 1%; H₀ is null hypothesis and I/V is independent variable

Table.3 above, presents a summarized result of the ordinary least square multiple regression analysis of the relationship between dependent variable (leverage) and three independent variables (TAN = tangible assets, SIZE= size of total assets, and LIQD=liquidity). Nevertheless, the detailed results of the analysis are presented as appendices (1 to 10) to this dissertation. In order to present a neat interpretation and discussion of these results of this study, the interpretation will be done on the basis of each hypothesis at a time. The detailed OLS multiple regression results can be found on the appendices to this research

Hypothesis 1:

Tangibility: Tangibility appeared to be negatively related to leverage which is evidence of the agency-model which predicts negative-relationship between firm-tangibility and leverage; therefore we do not hesitate to “Accept” our first null hypothesis (Ho). Generally most empirical studies demonstrate a positive relationship between tangibility and leverage. As suggested by agency theory firms with high-leverage would prefer to under -invest. Which could result in these firms transferring wealth from creditors to shareholders in order to exploit the alternative nature-of-equity (Jensen and Meckling 1976)? More also, the negative association of tangibility and leverage in this study could be that the Nigerian firms tend to access the equity market more, which could also be as a result of the low nature of debt-market in Nigeria or the aggregation of data factor. As demonstrated by most empirical studies carried out in developing countries there is a negative relationship between tangibility and leverage while developed countries has exhibits more of a positive relationship (Um, 2001 and Bauer, 2004).

Hypothesis 2:

Size: A firm size is viewed as a very important factor in a firm’s ability to raise funds (i.e. debt and equity) through the financial market (Booth et al. 2001). As explained in the literature review most empirical results show a positive association between size and leverage. Studies such as Rajan and Zingales, (1995), Booth et al. (2001) and Antoniou et al. (2007) in general discover that size is positively related to leverage and further suggested that leverage increases with the firm value. This is very much in line with our expected or predicted hypothesis, and it also corresponds with the trade-off-theory which states that there is a positive relationship between leverage and firm size; this is because large firm tends to have lower agency cost when compared to smaller firm. Therefore larger firm are more leverage due to the fact that they are less- prone to bankruptcy.

Hypothesis 3:

Liquidity: As describe by the pecking-order-theory firms in general, prefer to use internal fund as their main source of finance. A firm with high amount of liquidity has the ability to meets its short term financial obligations; more-also a firm that has sufficient liquid-asset might not necessarily have to raise external debt as a result they tend to have low leverage (Antoniou et al. 2002). However, in this study we expect to have a negative relationship between liquidity and leverage, the outcome of our result shows that it follows the financing hierarchy of the pecking-order-theory. In line with our expectation, researchers such as Ozkan (2000), Antoniou et al. (2002) and Eriotis, et al. (2007) find a negative relationship between liquidity and leverage. A firm with more liquidity implies that it has more current-asset when compare to the firm current-liabilities.

From the interpretation of the outcome which was based upon the analysis above, the following were our principal findings in this research:

- Firm-Tangibility shows from our findings that negative relationships do exist between financial-leverage, which confirms the prediction of the agency model.. Never-the-less, most empirical studies carried out on less-developed market has shown negative association, such as Um, (2001) and Bauer, (2004).
- Firm-Size: our outcome shows that firm-size has a positive relationship with leverage for business-firms in Nigeria.
- Liquidity: The outcome of our findings shows that liquidity is negatively related with leverage of business-firms in Nigeria. This negative association imply that business-firms in Nigeria finance most of their business activities by following the financing-hierarchy of the pecking-order-hypothesis.

5. CONCLUSION

The study provide some pragmatic revelation on firms financing choice and financing practices of firms quoted in the Nigeria stock market with the inefficient and complex financial-system. We explore control variables which are also commonly used as determinant of firm-leverage like firm-tangibility, firm-size and liquidity and the impact they have on firms financing pattern in Nigeria. Nevertheless, from our empirical observation we discovered that some of the modern finance-theories use in explaining capital structure determinants in developed economy is also suitable in emerging economy like Nigeria.

However, this research employ the most commonly used determinant of capital structure to examine the firm financing choice in Nigeria by investigating 10 firms quoted on the Nigeria stock market between the period of 2007-2011. Specifically, based on our data analysis result we found that Firm-Tangibility and Liquidity are negatively correlated to quote firms investigated while, firm-size is found to be positively related to firm leverage. This study adopts ordinary least square multiple regression technique examines the financing choice of the selected firms.

This study contributes to the small number of empirical research which includes firms financing decisions among the capital structure determinants in emerging economies. We are of the view that the control variables such as Tangibility, Size and Liquidity which are some of the determinants of capital structure are vital instruments use to ascertain the financial market impact on firms financing choices.

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