

# Capital Structure and Market Values of Companies

Dr. Uche ugwuanyi

Department of Accountancy, Enugu State University of Science and Technology, Enugu, Nigeria

## Abstract

The topic for the research has been selected with special interest to reveal the effect or benefit of capital structure and market value of companies. An appropriate capital structure is a critical decision for any business organization and this decision is very important not just because of its need to maximize Shareholder's wealth or increase the market value of companies but also because of the impact such decision has on the company ability to deal with the competitive environment. Furthermore, the institutional composition of the market was reviewed and it was revealed that the Nigeria stock exchange amongst all other participants is the live wire of the medium for the mobilisation of long funds for long term investment. Also the listing requirement of small and medium scale enterprises in the second tier securities market of the NSE equally highlighted. This project encompasses a comprehensive survey of companies, however, the prospect of the market appears to be bright considering the current position of the government and players in the industry in the area of formulation and implementation of favourable policies. The market could assume the expected role of providing long-term financing for the development of small and medium scale enterprises in Nigeria if the institutional frameworks guiding the effectiveness of the operators are strengthened and the profound recommendation by the researcher are religiously implemented.

## 1. Introduction

One of the cornerstones of the modern corporate finance theory is the Capital Structure irrelevancy proposition (Modigliani-Miller 1958). Modigliani and Miller (1958) conclude that the market value of any firm is independent of its capital structure. It is observed that the optimal capital structure is closely related to the growth potential of the firms (Mc Connel and Servaes 1995; Jung, Kim and Stulz 1996) and some other variables such as the size and the industry characteristics. Debt policy and equity ownership structure matter, and the way in which they matter differs between firms (Mc Connel and Servaes). Leland and Pyle (2007) propose that managers will take debt/equity ratio as a signal, by the fact that high leverage implies higher bankruptcy risk (and cost) for low quality firms since managers always have information advantage over the outsiders, the debt structure may be as a signal to the market.

According to Stulz (1990), Mc Connel and Servaes (1995), Jung, Kim, (1996), the influence of the debt on the firms value depending on the presence of growth opportunities. For firms facing low growth opportunities, the debt ratios are negatively related to the firm value.

Pandy (2005:5) posited that the mix of debt and equity is known as a firm capital structure. The manager should rigorously strive to obtain the optimum capital structure for the organizational well being. It should be noted that the firm's capital structure is seen as optimal when its market value of shares is maximized or when its weighted average cost is minimized. In other developing countries of the world and Nigeria in particular not much has been written on the conceptual linkage between market value of companies and capital structure, therefore the financial manager should seek that capital structure which maximizes the value of the firm (optimal capital structure) are brought to bear. The firm optimal capital structure should be represented a balanced between debt and equity. Such advantage that comes from using cheaper debt is just matched by the increase in the financial risk that comes from debt.

## 2. Capital Structure and Market Values of Companies

Capital structure is said to be the mixture of permanent sources of funds a firm uses in financing its operations primarily represented by long term debt, preference debt, preference stock, common equity, debenture which exclude all short term credit i.e. overdraft. The amount of debt that a firm uses to finance its assets are called leverage. A firm with a lot of debt in its capital structure is said to be highly levered while a firm with no debt is to be unlevered. The primary aim of financial leverage is to maximize shareholder wealth or increase the market value of the firm. According to Jerry and Gordon (2005) financial leverage increases variability of the market value of the firm, they are of the view that considerable controversy remains over whether imperfections like bankruptcy, agency cost etc determine optimal capital structure of the firm that increase the wealth of shareholders.

Richard and Robins (2006), observe that the objective of the firm is to maximize the current wealth of shareholders but that equity is more risky than debt and that a rational investor will expect a higher rate of return on equity or market value that ignoring taxation and cost of financial distress that any financial decision taken will affect the capital structure of the company.

The role of an optimal capital structure is very important in maximizing share holder wealth, it is also very important in maximizing market value or share price of a firm. Pandey (2005) opines that the primary motive of a company using financial leverage is to magnify the shareholder fund under favourable economic condition. The basis of his assumption is that fixed charged fund such as loans from financial institution and bank can be obtained at a cost lower than the firm's rate of return on net assets. Thus when the difference between the earnings generated by assets financed by debt funds and the cost of these funds is distributed to the shareholders, the earnings per share (EPS) or return on equity (ROE) increases thereby increasing the market value of the company.

Modigliani and Miller (1958) in another submission posited that, the value of the firm remains constant regardless of the debt level stating that as the debt level is increased the cost of equity also increases just enough to have weighted average cost of capital (WACC) constant therefore causing the cash flow generated to be only influenced on the value of the firm thereby rendering capital structure irrelevant. According to them the firm can only increase the wealth of shareholder by making good investment decision.

Manager should choose a capital structure that maximizes the market value of the firm's shareholders. In the view of William (2006), corporate managers should always ensure that their companies are being financed at the lowest possible cost, so that shareholders could confidently entrust their savings to companies that guarantee maximum return for minimum risk. He further explained that existing shareholders should consider the uses of debt to be good news and not using debts to be bad news. He opines that major empirical studies have shown that stock price rises when a firm announces leverage increasing events, such as debt for equity exchange affect debt financed, cash tender offers to acquire control of another company. On the other hand, leverage decreasing involving payment with a firm's own share is always associated with share decline. The distinct but separate issues of the relevance of capital structure decision on a firm's value have received considerable attention in recent literature.

According to Donald Tuttle Wayne and banker (2001), they are of the view that from the result of studies carried out by them, have re-established that in a perfect and complete contingent claims market, financing decision will have no impact on a firm's value. Stated differently, the value of a sum income stream arising from addition of partitions is always equal to the value of the original income stream.

### 3. Debt Financing

Financing a business by borrowing most often seems to be cheaper than using equity due to the following reasons.

1. Low rate of returns to lender than shareholders. Debt financial security provides a lower risk for the financial providers due to the fact that they have prior claim on annual income and on liquidation.
2. Service as a means of tax reduction since the debt interest can be offset against pre tax profits.
3. The issuing and transaction cost associated with getting and servicing debts are less than ordinary shares.

Financials gearing relates to the aspect of debt in the capital structure, and it is usually measured in relation to the balanced sheet figures.

There is a school of thought which subscribes to the argument that changes in the capitalization rate share prices and corporate value are concomitant of the firm distribution policy, (Hill, 1998).

However, it would be noticed that the total risk associated with investment policies is a part of the determinants of a company's weighted average cost of capital and the firm's value, risk is inter-related with two variables, business risk and financial risk. The impact of financial risk tends to be serious with the influx of debt into firm's capital structure and this financial risk is the increase risk of equity holders due to financial gearing. It does not arise from a company's investment; it is due solely to the capital structure or more specifically to the level of gearing. When a company introduces fixed interest debt into its capital structure it increases its financial risk, this is partly because the interest must be paid whatever happens to earnings. If the company is in default it runs the risk of compulsory winding up, this is particularly so where the providers of debt finance have security for their investment. The financial risk of a company's capital structure can be measured by a gearing ratio. Business risk is variability in earnings before interest and tax (EBIT) associated with a company's normal operations. It is the risk of the company's operation without regard to how the company is financed. This risk varies considerably between industries and even between companies within the same industry and may alter significantly over time as consumer taste and technology change.

Generally, business risk depends on:

1. The state of the economy
2. Government's action
3. Competitor's action
4. Labour relations
5. Fire and accidents

Specifically business risk is influenced by the following factors:

1. Demand Variability: The most stable the demand for a company's product (other factors remaining the same) the lower is its business risk.
2. Sales price variability: A company with relatively stable prices is expected to have lower business risk –all other factors remains the same.
3. Input price variability: The more stable the input prices, the lower the level of business risk.

According to Hill (2001) says there will naturally evolve a question as to why extreme leverage is an exceptional observable phenomenon rather than the rule in the real world. And in a reply, he said that when a firm introduces more debt into the capital structure, equity holders feel exposed to high financial risk. Thus the demand for equity falls so that the market value also falls so that the equity capitalization rate increase even when the cost of debt is seen to be constant and EPS is not being compromised.

#### **4. Income Gearing**

The capital gearing measures rely on the appropriate valuation of net assets in the balance sheet. It is often quite faulty to rely only on assets when trying to judge a company's ability to pay back debts, thus, a more appropriate measure of gearing is one concerned with the level of a firm's income relative to the interest cover ratio the greater the chance of interest payment ratio, default and eventual liquidation. The inverse of interest cover measures the proportion of profit paid out as interest and this referred to as income gearing.

Some factors that has bearing on the general level of capital structure

##### *4.1 A Financial Distress*

The higher the level of debt, the higher the financial distress and eventually liquidation and this does not sound nice for the shareholders and the debt holders.

The cost of financial distress usually comes with a risk that poses an effect on the firm's value that seems to offset the tax relief of the increased debt level. Even if firms try as much as possible to avoid liquidation. Its relationship with external parties would be damaged such parties as suppliers, customers, banks and other lenders, would want to take a safety – first approach.

Some factors that could significantly influence the risk of a firm's financial distress cost are:

1. The sensitivity of the firm's revenues to general levels of economic activities
2. The proportion of fixed to variable cost.
3. The liquidity and marketability of the firm's asset.
4. The ability of the firm to generate cash.

##### *4.2 Agency cost*

This cost usually arises from what people see as the principal-agent problem. Finance providers of most firm are not able to manage the firm's, so they employ agent (managers) and these acts in the way or interest of the finance providers or shareholder. Therefore the agency cost pass on as higher interest rate and the loss of value that is cost by marginal act.

##### *4.3 Borrowing Capacity*

It has a relationship with agency cost. Lenders tend to prefer secured lending which set an upper limit on gearing. They like to have assurance that even if the worst happen that the firm can not meet the interest obligations, they would like to hold on to an assets which when sold will set off the loan. The gearing level may not be determine by theoretical inform management decision but by the limit of total borrowing imposed by leaders.

##### *4.4 Marginal preferences*

It may be noticed that managers, are quite cautious of borrowing. Liquidation affects not only shareholders but managers and other employee as well as the general public.

1. **The external finance function:** it identifies all sources of funds, evaluate the investor's opportunity returns expected and eventually select the optimal mix which minimizes the combine cost.
2. **The internal control function:** it allocated funds among products, service and market by selecting those investment opportunities that maximizes NPV and share price.

In other words the cost of capital incorporates both the financing and investing decision (debt and equity) and it does not represent the cost incurred by employing funds and it does not restrict itself to the explicit returns to shareholders and interest on borrowing.

There also exist some implicit opportunity costs to be considered apart from that associated with retained earning which should be included in the cost of calculation and this includes financial risk confronting providers of capital. In addition, there are implicit cost also associated with depreciation and other non cash expenses. There also exists corporate expenditure that does not necessarily produce demonstrative result.

## 5. Behaviour of Share Prices

The following analysis could be very useful in explaining the behavior of share prices.

### 5.1. Technical Analysis:

The premises of technical analysis are derived from empirical observations of financial market over hundreds of years. It is the use of numerical series generated by market activity to predict future trends. The analysis does not even concern itself with whether it is moving on a particular direction or not.

Technical analysis believe that if a particular stock is rising steadily, than an analyst will buy such stock and continue to process it until it is certain that such stock price up tend has revised or ended. The belief of technical analysis is that price action in a market discounts everything i.e. because every possible bit of information is immediately included in the price of a security. It is not necessary to explicitly analyze the fundamental economic and political factor that might influence the price.

Prices moves in trends the analyst relies on empirical evidence to say that trend upward, downward or sideways.

That history tends to repeat itself, they believe that investors often tend to repeat their attitudes and as a result investor actions in the market place are often repeated as well. Therefore, price movement pattern will develop on a chart that a technical analyst believes will have predictive qualities.

The proponents of technical analysis believe or hold that fundamental factors are indeed pertinent and reflected in the price behavior of stock in the market. Therefore it is possible to predict the future prices behavior of a stock by a diligent study of historical price movement of stock market.

According to Graham (1962), technical analysis agrees that stock prices do indeed fluctuate around their intrinsic value but also contend that fundamental impact of investor's emotions often demonstrated on an unscientific and sometimes irrational manner.

### 5.2. Fundamental Analysis:

The analysis here believes that there are some differences between the true values and market prices of share that can be exploited by inventors to beat the market.

They considered fundamentals such as company related factors, industry related factors, economic and political factors etc in determining the behavior of stock prices in the market. These sets of analyst believe that there exists at any point in time a basic intrinsic value force particular stock based on certain variables. Therefore it is on this ground that the value of stock is obtained. They also believe that a stock would be bought when the market price is below the intrinsic value and vise versa.

## 6. The Random Walk Hypothesis

Essentially the hypothesis claims that stock price movement follow a Brownian motion with either independent or uncorrelated increments. The hypothesis may thus be generated from the weak or efficient market hypothesis, which is based on the assumption contained in the price movement. The assumptions of the efficient market hypothesis imply that price adjustment is independent and random. The random walk also argues that the successive price movement of stock in the market remains independent of each other because as said earlier there is no serial correlation between

price changes from one period to another. Hence they say it is the force of demand and supply on the floor of the stock market that actually causes price movement.

### **7. Summary of Findings**

This study examines the relationship that exists between capital structure and market value of companies. In this research work, theoretical and literature issue were discussed. In addition, regression analysis was used to investigate the impact of capital structure on the value of a company. Below are listed finding from the research carried out.

1. It was observed that the variable of equity (shareholder fund) has significant relationship with the market value. Which agree with the findings of Richard and Robbins (2006). They observed that the objective of the firm is to maximize the current wealth of shareholders but that equity is more risky than debt and that a rational investor will expect a higher rate of return on equity or market value, than ignoring taxation and cost of financial distress that any financial decision taken will affect the capital structure of the company.
2. It was observed that the increase of debt in the capital structure increases shareholders wealth and also increases shareholders risk. This agree with Jerry and Gordon (2005), financial leverage increases the variability of the market value of the firm, they are of the view that considerable controversy remains over whether imperfections like bankruptcy, agency cost etc determine optimal capital structure of the firm that increase the wealth of shareholders.

### **8. Recommendations**

From the finding above, the following recommendations are hereby suggested to aid the management of Nigerian companies in capital structure decision that maximize the market value and increase it shareholder's wealth.

1. Nigerians companies should try to ascertain the optimal capital structure to be adopted as a policy in order to create a balance in satisfying the shareholders' desire and management of capital structure decision.
2. Even with the possibility of factor limiting against most companies in developing countries like Nigeria from getting loans, it has been found out that cost of debt is often cheaper than cost of equity so we recommend that companies consider the use of debt capital thoroughly, especially at the early growth stage of the company.
3. It also recommends that strategic planning culture should be imbibed in order to ascertain the long term financial mix capital structure should be beefed up through gradual retention of profit which could be long term benefit to shareholder in terms of returns and retention of control.
4. It also recommends that there should be reinvestment of more of a company retained earnings in profitable investment so that in the long run share price will be on the rise as the level of capital structure will significantly influence it.

### **9. Conclusion**

This research work has succeeded in bringing to light that, there actually exists a conceptual linkage between capital structure and market value of companies and that companies should however strive to ascertain capital structure that increases the market value of company. Most companies use debt to finance their activities as well as equity or shareholder's funds. But in line with the traditionalist view of capital structure theory, there is a point where a company reaches when using debt to finance its operation. At this point it becomes unreasonable for a company to employ further use of debt. The need to attain an optimal capital structure is very important to Nigerians companies because their market values are directly boosting the Nigerian economy.

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