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The Financing Behaviour of Firms in a Developing Economy: The Nigerian scenario

Okoyeuzu C. [1]

[1] *University of Nigeria, Enugu Campus. Department of Banking and Finance,* ucheokoyeuzu@yahoo.com

Abstract. The goal of this study is to ascertain the validity of the asymmetry of information idea in explaining the financing choice of firms in Nigeria. The sample covers 60 firms quoted in the Nigerian Stock Exchange. The Nigerian nation does not have a well developed capital market and so remain heavily on internal funding. Using a regression analysis, this study reveals that leverage is a decreasing function of profitability. This supports the pecking order theory. The current economic problems in Nigeria can be attributed not to too much reliance on financial markets, but to too little. There is some sort of misalignments between the capital market and the money market which is likely to affect the efficiency of one in meeting the financing needs of corporations. There should be complementary roles between the two markets. In Nigeria, this expected complementary roles between the two markets lag. While it makes sense, for instance for banks to brave up towards meeting the long term financing needs of firms, it is also very necessary for the other fund providers to design financing products that would help fill up arising financing gaps not covered by banks. We recommend that firms would have to device other strategic ways of diversifying their funding sources. One is by balancing their investments in both fixed and current assets.

Keywords: capital structure. Common stock. Expected return, financial leverage.

1 Introduction

The recapitalization exercise in Nigeria created by the former CBN governor Chukwuma Soludo, means that banks have more cash flow and may be more likely to lend long to corporations. Due to excess liquidity after consolidation, banks had free cash flow, and to confirm the analysis of agency model and free cash flow theory which predict that such scenario makes managers invest in ill acquisition and empire building (Jensen,1988).One of the main lessons learnt is that monetary and fiscal policies are not sufficient to prevent crisis. Strengthening the regulation and above all supervision of financial systems, particularly in emerging markets, is a particularly important goal.

The retarding growth of the real sector of the economy could be blamed on a number of factors amongst which is lack of credit from banks. This situation has continued to border investors and the economy cannot grow in a vacuum. It was observed that 74% of adult Nigerians had no bank account. This raises issues that border on the depth of the country’s banking sector and confidence crisis that may have been due to repeated cases of deposit money banks’ failure. When banks fail to lend to real sector, the economy will continue to be in serious trouble.

Using Nigeria data, this study find supports for the Pecking Order theory .firm will fund all projects using internal equity if possible due to information asymmetry. The self financing behaviour of Nigerian firms may not necessarily be a matter of choice but rather a matter of operational financial market structure. In a situation where the net current asset of a firm is negative, it is an indication that they used the short term fund to finance long term investment. This we observed for most firms in Nigeria. This is against the practice in developed economy where debt duration is properly matched with project duration.

The next section of this work review the literature, section 3 presents our methodology. The result is presented in section 4 while section 5 concludes the work.

2 Review of related literature

Myers and Majlu, 1984 Present a signaling model that combines investment and financing decisions and that is rich in empirical implications. Managers, better than anyone else, are assumed to know the "true" future value of the firm and of any projects that it might undertake. Furthermore, they are assumed to act in the interest of "old" shareholders, i.e., those who hold shares in the firm at the time a decision is made. Finally, 'old" shareholders are assumed to be passive in the sense that they do not actively change their personal portfolios to undo the decisions of management. The presence of information asymmetry between management and stockholders make the management to utilize the financing vehicle with the least information cost.

The pecking order theory predicts that firms will fund all projects using internal equity if possible (information asymmetries are assumed relevant only for external finance). If internal finance is not adequate, then debt financing will be used. Thus, for a firm in normal operations, equity will not be used and financing deficit will match the net debt issues.

As is the case in many other economies of the world, the Nigerian financial system can be broadly classified into two- the money market and the capital market.Invenstible funds can be mobilized from both markets, though the two markets vary greatly in terms of repayment or maturity period of finances and the classes of market participants Banks can indeed participate at varying degrees in both markets, depending on whether they are lending long or lending short. As is applicable in other economies also, basic instruments for raising funds in the Nigerian financial markets are categorized into two major groups-equity instruments and debt instruments.

The popular view was that banks in Nigeria preferred to lend on short-term, and to some favoured economic sectors .One of CEO of one of the banks argued that banks could only make short-term loans because most deposits are of short-term (SUN, newspaper, 15 January 2006) it was as a result of the above reason that banks are not able to lend to the real sector whose needs comprise most long-term funds.

The recapitalization exercise rated for instance means that banks now have more access to long-terms external finances and may be more likely to lend long to corporations. Consolidation was not an end in itself but a means to an end. When the former CBN governor embarked on consolidation exercise, it was to make the banks bigger and more reliable, and also to drill down in the pyramid so that people who before now did not have access to credit would have it. For people to have access to credit it was not enough for the banks to be bigger and strong but, there should be data on the people who are potential borrower. (Chuka Uroko 2010).

The vast majority of the population, having no access to credit, has been unable to acquire productive property. Just as a farm cannot survive without water, no business can start or expand without capital. One can own the farm, but the value of the farm depends on the owner's access to water. If governments control access to credit, the funds will go to the groups in control of government policies and no one else. Favoured enterprises are protected from possible competition, while citizens get the privilege of paying higher prices to support the favoured industries.

The Nigerian government had equally started perceiving the inherent problems and gaps created in the country's financial system due to the absence of a viable capital market. As argued by Demirguc and Maksimovic (1997:48), three serious consequences that are inherent in a condition of absence of or illiquidity in organized stock exchange they include: less opportunities for risk diversification, inability of firms to optimally structure their financing packages, and lack of information generating machinery necessary to allow creditors and investors evaluate the prospects of new and existing firms.

Firms then were restricted to rely only on their internally generated funds and bank loans that were then not much available.

Considering the social economic peculiarities of the Nigerian nation, the proposed study attempts to establish some empirical bases to analyze the financing behaviour of Nigerian firms by examining the relationship between financial leverage and profitability of Nigerian firms.

3 Research methodology

A cross section of 60 firms was investigated. Data was obtained from annual financial reports and securities and exchange commission over a ten year period (1996-2005)

3.1 Specification of models

This study made use of dependent variable-leverage and we control for other determinants of debt issuance.

Dependent variable

Financial leverage was the dependent variable. The narrow concept uses the long-term debt ratio; the broad concept uses the total debt ratios. Both approaches alternately make use of book value and market value measures. In countries where accounting data are not uniformly available, the choice of total debt ratio has been found to be more prevalent. Our study made use of the ratio of total debt over total book value of debt plus the market capitalization of equity. Debt ,for the purpose of this study ,includes all borrowings or credit arrangement for which the firm (beneficiary) incurs periodic charges such as interest, rent, discount, commissions etc. that are expensed over the periods to which they relate and are thereby tax-deductibles. Among some works that used total debt as their measure of leverage were (Dittmar, 2004, Booth et. al.2001and Pandy, 2004)

Profitability is proxies by the ratio of earnings before interest and taxes (EBIT) to total assets

(Mako, 2001, Dittmar, 2004) adopted the ratio of EBIT to total assets. This is in line with (Li et. al .2006; Rajan and Zingales, 1995 and Booth et. al.2001).

Following Rajan and Zingales (1995, and Booth et. al.2001) we employ the market –to-book ratio (MB)-the market value of equity divided by the book value of equity –as a proxy for growth opportunities. Here, MB increases with firm growth opportunities, indicating an expected inverse association with leverage.

Determinants of debt ratio

The basic model for establishing the nature and extent of relationship between the leverage ratio (ị) and firm's attributes identifies eight exogenous variables. these variable are the corporate tax rate (ح), the non-debt tax shelter ratio (r), firm size (s), future growth opportunities (v), profitability (□), capital market conditions (m), tangible assets (c) and earning volatility (σ). Accordingly, the theoretical model can be written in its general form as:

l = f (ح, r, s, v,π, m, c, σ)

4 Data presentation and results

Constant	Marginal tax rate (τ)	Non-debt tax shutter (r)	Size (s)	Growth (v)	Capital market (m)	Collateral (c)	Profitability (π)	Earnings volatility (σ)	Std. error of estimate	R^2	Adjusted R^2	Durbin Watson	N

0.14	-0.01	0.75	0.09	-0.00	-0.00	-0.24	-0.03	-0.00	0.18	0.59	0.58	2.12	600
(3.05)	(-0.91)	(3.44)	(4.75)	(-1.36)	(-0.47)	(-15.42)	(-4.33	(-0.33)					

Table 4.1a below presents the results of our time-series leverage regression on our eight (8) regressors.

Table 4.1b Results of book leverage regression using time seies data

Constant	Marginal tax rate (τ)	Non-debt tax shutter (r)	Size (s)	Growth (v)	Capital market (m)	Collateral (c)	Profitability (π)	Earnings volatility (σ)	Std. error of estimate	R^2	Adjusted R^2	Durbin Watson	N
0.27	-0.01	0.03	0.07	-0.00	-0.00	-0.21	-0.03	-0.00	0.23	0.43	0.42	1.88	600
(4.96)	(-1.53)	(0.13)	(3.07)	(-1.21)	(-0.11)	(-10.82)	(-3.59)	(-0.62)					

Confirming the pecking order theory which is an asymmetric information model of capital structure, the relationship between leverage and profitability is negative. This contradicts the trade- off model of capital structure. Asymmetric information plays a role in financing decisions especially in the choice between internal and external financing firms that have greater internal funds which use less of debt to finance real investment. Such internal funds primarily come from retained earnings. This finding was also reported in Gaud, et al (2005).

THE PECKING ORDER THEORY

The pecking order theory starts with asymmetric information- a term indicating that managers know more about their companies' prospects, risks, and values than do outside investors. Our findings suggest that retained profit is the quickest source of finance for most companies. By implication, a firm may never have a preference for external finances as long as it is able to meet its investment needs via internal equity funds. But, in the presence of financial deficits as is mostly the practical case, the need for external finance becomes pressing. The inverse relationship between profitability and leverage is consistent with the pecking order.

Therefore, the pecking order theory implies an inverse relationship between profitability and debt usage .Our result was a strong confirmation of the pecking order in the financing behaviours of Nigerian quoted firms. The result is also well in line with the empirical findings of (Fama and French, 2002) who agree that the negative relation between profitability and leverage is consistent with the Pecking Order.

5 Conclusions

The result of this empirical study suggest that some of the insight from modern finance theory are portable to Nigeria in that certain firm – specific factors that are relevant for explaining Capital Structure in the Western countries are also relevant in Nigeria. Nigeria managers use factors similar to those used by their peers in developed countries. However, there are differences across countries on several dimensions due to distortions caused by Macro economic instability and financial market inefficiency, - thus reaffirming the earlier findings of (Booth et. al .2001) that those factors that explain capital structure of firms in developed economies are similar to those that explain such in developing economies.

Firms follow that course of action which takes the least effort. Self finance is a cheaper source of funds especially if the costs associated with the alternative sources are extremely high. In a developing economy however, it is not in the interest of the economy for self financing to dominate. This is because self financing is inherently incapacitated in the provision of huge capital or the required amount of capital to power the desired level of economic development firms in countries with weaker creditors right may be forced to use more internally generated funds as external capital is likely to be expensive and or rationed.

From our empirical analysis, we can stand to argue that the financing behaviour of the Nigerian firms may not necessarily be a matter of choice but rather a matter of constrained operational and financial market structure. We therefore give the following recommendations.

While the findings in developed countries are mostly applicable to Nigeria, the capital structure of Nigerian companies has some different features. One possible reason is that Nigerian bond market is still in an infant. Corporate bond is still a mystery to many investors. The Nigerian bond market has been largely a mono product market –0nly the government bonds being traded. Public bond market virtually does not exist .Banks are the major or even the only source of firms' external debt. In order to provide more financing opportunities for Nigerian firms, it is desirable for Nigeria to accelerate the development of its bond market. A well developed capital market will reduce dependence on banks .This will increase the efficiency of the Nigerian capital allocation process and complement bank products and services.

Banks supervision should ensure that the existing deposit money banks introduce products and adopt marketing approaches that will attract more account holders and thus permit many Nigerians to access banking services and credit without difficulties.

Firms would have to device other strategic ways of diversifying their funding sources. One is by balancing their investments in both fixed and current assets.

Lastly, we need to emphasize that even if all other factors that impact negatively on the capital development are to be arrested while corruption still soars high in the country, all efforts will come to naught.

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