

CAPITAL STRUCTURE PRACTICES AND PROFITABILITY OF CONSUMER GOODS MANUFACTURING FIRM IN NIGERIA

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ABSTRACT

Capital structure is about putting in place the structure, mechanism and processes that may ensure the firm is directed and managed in a way that enhances long-term equity value through accountability of managers and enhancing organizational performance. Capital structure refers to a set rules and incentives by which the management of a company is directed and controlled. Hence, sound capital structure will have effect on profitability and long-term value of the firm for shareholders. However, the study recommends that management of Nigeria listed consumer goods firms should work hard to optimize the capital structure of their firms in order to increase the profitability of the firm and enhance firm's value.

Keywords: *Capital Structure, Profitability, Consumer Goods*

INTRODUCTION

Surely, every entity requires finances in order to facilitate their operations, regardless whether it is new or has been operating for a long time. The significance of funds in business cannot be underestimated, as it's crucial for any successful operation. Many firms require funds to facilitate their expansion or provide working capital for day-to-day operations. This kind of financing needed is referred to as capital. In real life capital can be generated internally or externally. Internally generated funds are usually obtained from retained earnings and don't render obligation in any form. However, for the externally generated capital, entities are forced with a burden of having to reimburse creditors and shareholders, through interest payment, dividend payment, value creation and profit maximization (Cheche and Olayiwola, 2014). The financial decision of a firm is vital in determining the optimal capital structure mix. Measuring the firm managerial and financial prowess to adjust and direct its numerous leverages to maximize its value, growth and generate optimum returns. Firms have diverse levels of leverage, the determination of the best mix to enhance performance by managers remains a puzzle to be solved in corporate finance theory and finance literature. Capital structure comprises of long-term debt, specific short-term debt, common equity, preferred equity and retained earnings. Firms performance is calculated by its capacity to generate optimum returns from its assets, maximize the value and wealth of the shareholders. The financing decisions of firms vary according to the rate of risk related to each financing option as well as the relationship between risk and return, Abu-Rub (2012).

Shubita and Alsawalhah (2012), defined capital structure as a combination of equity and debt, which firms employ in order to facilitate their operations. A firm can choose to raise funds by issuing stocks, debt or other necessary sources of financing such as; convertible bonds, warrant, forward contract, overdrafts etc. Since capital structure impacts wealth maximization as well as the ability of a firm to be sustained in a competitive market, making the right capital mix decision becomes paramount. Nevertheless, the identification of an effective capital structure has proven to be a difficult task for many firms. The difficulty arises from the challenges encountered in generating a model which will deliver accurate result for optimum capital structure (Koech, 2013). For this reason, the issue of capital structure has been attracting keen attention from key industrial players such as analysts, investors and company officers. The attraction stems from the fact that capital structure decisions are crucial in financial management. Not only does capital mix affect the profitability of an organization, but also, it's vital in sustaining the going concern status of companies, in period of financial crisis. With the eruption of financial crises at an international level, many underperforming corporations have had to deal with financial stress encompassing

both the local and international markets. At the same momentum, the availability of debt has drastically shrunk and risk exposure has amplified throughout the year, which has led to the increase in cost of capital; a burden that many firms are trying to get rid of. This has therefore placed immense pressure on firms as they try to come up with corporate structure that would address the issues, and bring maximum returns to shareholders (Martins, 2013).

Profitability is the index that shows the efficiency of an organization. In other words, it is the measure of efficiency and guilds management to achieve even greater efficiency. Profitability according to Owolabi & Obida (2012), is the ability of a business to make returns higher than the cost of financing their core operations to ensure the continued survival of the company. This implies that profitability is the ability of a company to make a profit from its operating, investing and financing activities to maximize the values and wealth of the shareholders. Often, listed companies in Nigeria do find it difficult to make profit; this does affect their performance which may be attributed to inadequate finance or where the finance is available at a cost too expensive (Akintoye, 2016; Lambe, 2014; Akinyomi & Olagunju, 2013; Salawu, 2009)

Consumer goods are any tangible commodity which are produced and subsequently purchased to satisfy the needs of the buyer. These needs include the current need and the perceived needs of the individual buyer in the future. The consumer goods happen to be of three categories which are the durable goods, non-durable goods and services. The consumer goods firms are firms that deal with consumer goods available for the buyers. These firms work in other to create goods that will meet the need of the buyer at any point in time.

Capital Structure practices

Capital structure is the way a company finances itself by combining long term debt, short term debt and equity capital (Asiao et al, 2009). It shows how a company finances its overall operations and growth by using different sources of funds. Capital structure of firm varies with its size, type and some other characteristics or determinants such as age of company, company risk and liquidity (Al-Najjar and Taylor, 2008). The purpose of managing capital structure is to mix the financial sources in order to maximize the wealth of shareholders and minimize the company's cost of capital (Ross et al, 2005). Therefore, one of the financial manager's responsibilities is to manage and decide the optimal capital structure. This decision on capital could be critical because it may affect the company's overall performance and it involves a trade-off between risk and return. A rise in debt will increase the company's risk and the expected return and high risk means an increase in debt which could lead to a decrease in stock price and an increase in the expected return of stock prices.

Capital structure concerns the composition of the liability of a company, which is relative to the several financial sources in the composition of the total obligation. Capital structure decision is very vital for any organization, every organization wants a mix of arrangements that eventually achieves or increases its performance and/ or profitability and overall value. Different alternatives available to firms to finance itself sometimes are through issuing of shares, securities or sometime from debt. Firms take the combinations, which increase their efficiency, performance and / or profitability and its value.

Capital structure decisions are very difficult in an uncertain economy such as in Nigeria investment climate with the existence of the macroeconomic environment factors such as high interest rates in double figures and volatility in the economy and the political situations are big factors or problem for the combination of capital structure. However, many theories and practical approaches exist on capital structure.

The optimal capital structure of a firm is the capital structure with minimum cost implications which maximizes the total value of the term. It could be obtained using a combination of debt and equity financing that would give the firm a minimum cost of capital and enhanced market value. The amount of debt contained in a firm's optimal capital structure is referred to as its debt capacity. The debt capacity has implications on the borrower. Borrowed funds usually carry fixed change

interest expense. The borrower is under obligation to pay interest to debt-instrument holders irrespective of whether profits or losses are made. If a borrower fails to pay the fixed interest charges in time, the creditors are at liberty to take legal action against the borrower to get the payments and in extreme circumstances, it may force the borrower into liquidation (Nude, 2003)

Profitability

Profitability is the ability to make profit from all the business activities of a firm, company, organization or an enterprise. Profitability provides a better way to measure management efficiency in the use of available resources in adding value to the firm (Myers 1984). It is a relative term measured in terms of profit. Soumadi and Hayajneh (2012) posited that, "profitability is the ability of a given investment to earn a return from its use", the main objective of firms is the maximization of profit. Due to market competition, business managers would have to practice and learn to achieve a sustainable level of profitability. The capital of every firm is dependent on the ability of the firm. The capital structure of a firm is determined by both debt and equity, this means that for a firm to access credit it must be profitable (Ramachandran & Raju, 2012). In other words, the borrowing capacity of a firm is determined by profitability. It is the main factor which is used in determining the capital structure of firms. This concept is measured by profit margin, return on investment or return on asset. In terms of measuring the profitability of firms, return on assets is sufficient and essential for growing firms mostly in food industry (Ramachandran & Raju, 2012). The success of a firm can be measured solely by profitability in relation to the capital employed by the firm. This economic success achieved by the firm is determined by the net profit generated during the course of business. (Majumdar, 1997).

Firm Size

The size of a firm has been viewed as one of the specific characteristics that determine capital structure. Theoretically viewed, the effect of size on the leverage is ambiguous (Bauer, 2004). Raja and Zingales (1995) states that, "larger firms tend to be more diversified and less often, so size (computed as the logarithm of net sales) may be an inverse proxy for the probability of bankruptcy. If so, size should have a positive impact on supply debt. However, size may also be a proxy for the information outside investors, which should increase their preference for equity relative to debt. The relationship between size and capital structure of a firm has been empirically proven to be positive by several works such as; Barclay and Smith, (1996); Friend and Long (1988); Barton et al (1989) Mackie-Mason (1990); Kim et al, (1998); Al-Sakran (2001), Hovakimian et al; (2004) as contained in Joshua, (2008). The studies hold a point that larger firms tend to use debt while smaller ones are more likely to use equity, in their respective finances. Aryeetey et al. (1994) in their study on the Ghanaian firms found that, smaller firms have greater problems with credits than smaller ones. It was shown that the success of large firms applying for bank loans are higher than the smaller enterprise. The relationship between firm size and long-term debt ratio was found to be positive. However, a negative relationship exists between size and short-term debt ratio in the studies of Caesar and Holmes (2003). Esperanca et al (2003) and Hall et al (2004) as stated in Joshua (2008). Smaller firms seem to use short term finance than the larger firms, because their transaction costs when they issue long term debt or equity are higher (Titman & Wessels, 1998). However, Ferri and Jones (1979) conclude that the firm size does influence the corporate capital structure but not positively as it was hypothesized.

CONCLUSION

Firstly, there is a significant relationship between equity financing and variables (ROA, ROCE and GPM) of profitability. We therefore conclude that equity is amongst the determinants of profitability of listed consumer goods manufacturing firms in Nigeria.

In addition, there is a significant relationship between debt financing and variables (ROA, ROCE and GPM) of profitability. We therefore conclude that debt is one of the variable of capital structure that contribute to profitability of listed consumer goods manufacturing firms in Nigeria.

RECOMMENDATIONS

In line with the findings of the study, the following recommendations are made;

- i. The management of Nigerian listed consumer goods manufacturing firms should work very hard to optimize the capital structure of their firms in order to increase the profitability of the firm. They can do that through ensuring that their capital structure is optimal.
- ii. Stakeholders of listed consumer goods manufacturing firms in Nigeria should increase their commitment with equity financing or debt financing in order to improve financial performance of their business operation. This is in line with the findings of this study that the equity/debt financing of listed manufacturing firms in Nigeria influences performance positively.
- iii. The management of listed consumer goods manufacturing firms in Nigeria should be concerned about the level of their firm size for better performance. This is because the findings of this study revealed that there is no significant relationship between the variables and profitability.

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