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EFFECT OF CAPITAL STRUCTURE ON THE VALUE OF LISTED SERVICE FIRMS IN NIGERIA

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Key words: *Capital market, Capital Structure, Debt, Equity.*

ABSTRACT

The study examined effect of capital structure on the value of firm with evidence from the Nigerian capital market. This study was prompted by the need to undertake a quantitative examination of capital structure and the capital market in Nigeria's service sector. Two research questions and a corresponding two research hypotheses were formulated for the study. Ex-post facto research design was employed in the study. The independent variable: capital structure was decomposed into equity ratio and debt_to_equity ratio while the dependent variable was proxied using enterprise value. The sample was restricted to only 16 quoted service companies on the Nigerian exchange group for the period, 2009 to 2023. Data were analyzed using Ordinary least square (OLS) regression with the aid of STATA 14.2. The study found that Equity Ratio (ER) significantly affect the Enterprise value of selected service firms listed on the Nigerian Exchange Group. The study also found no significant effect of debt_to_equity ratio on the Enterprise Value of selected service firms listed on the Nigerian Exchange Group. Consequent on the findings, the study recommends amongst others that Service firms should prioritize optimizing their equity ratio to enhance enterprise value, as higher equity contributions significantly impact firm valuation.

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1. INTRODUCTION

Financing decisions are critical to a business's success, particularly when starting up. Once an entrepreneur decides on the type of business to pursue, financing becomes the next major step. Bawa (2022) emphasizes that a rational entrepreneur would first outline a business plan, and a crucial element of this plan is identifying funding sources. Financing decisions directly impact the survival and growth of any business, which makes efficient financial planning essential to safeguarding shareholder interests (Chandrasekharan, 2012). These decisions are closely linked to capital structure, determining how best to balance debt and equity to fund

business operations (Channar, Maheshwari, & Abbasi, 2015). Firms seek to maximize returns and minimize costs through a careful selection of financing sources. Capital structure therefore refers to how a business organizes its finances through a mix of debt and equity (Manukaji &Egungwu, 2018). While equity can raise a company's market value, it also involves diluting ownership, potentially lowering the control of existing shareholders. Issuing new equity can sometimes signal financial instability, leading to a fall in stock prices. However, equity does not require regular interest payments, reducing financial pressure and the risk of bankruptcy (Fontinelle, 2021; Kelly, 2020).

In Nigeria, the capital structure of service firms listed on the Nigerian Exchange Group (NGX) plays a critical role in their financial performance (Abdulwahab et al., 2023). However, as noted by Ogunmakin, Adebayo, and Omodara (2022), research on capital structure in Nigeria has largely focused on non-financial firms, leaving a gap in understanding the service sector. This sector contributes significantly to Nigeria's GDP (NBS 2024), and its capital structure needs to be explored further, especially given the services sector's major role in the economy. The growth and financial performance of service firms thus rely heavily on effective capital structure decisions, underscoring the importance of this area of study.

1.1 Objectives

The broad objective of the study is to determine the effect of capital structure on the value of service firms listed on the Nigerian Exchange Group (NGX). The specific objectives are to:

i. evaluate the effect of Equity Ratio (ER) on the Enterprise Value of selected service firms listed on the Nigerian Exchange Group.
ii. determine the effect of Debt-to-Equity Ratio on the Enterprise Value of selected service firms listed on the Nigerian Exchange Group.

1.2 Hypotheses

In line with the stated objectives, the study will test the following hypotheses stated in the null form:

H_1: Equity Ratio (ER) does not significantly affect the Enterprise Value of selected service firms listed on the Nigerian Exchange Group.

H_2: Debt-to-Equity Ratio has no significant effect on the Enterprise Value of selected service firms listed on the Nigerian Exchange Group.

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2. LITERATURE REVIEW

2.1 Conceptual Review

2.1.1 Capital structure

Capital structure refers to the mix of debt, equity, and other financing methods a company uses to support its operations and growth. This decision is crucial for businesses, as it directly affects their financial performance, risk profile, and valuation. According to Udobi-Owoloja et al. (2021), capital structure encompasses a blend of long-term financing options such as preference shares, bank loans, ordinary shares, reserves, debentures, and convertible loan stock, alongside short-term liabilities like bank overdrafts and trade creditors. Ubesie, cited in Okeke and Okeke, (2019) further defines capital structure as the way a company finances its assets through a combination of equity, debt, or hybrid securities. This composition is key to a firm's long-term sustainability and survival. Capital structure includes various funding sources, such as retained earnings, equity, and debt financing. It determines how liabilities, equity, and obligations are arranged to shape a firm's value (Osasere and Osagie, 2022; Ullah et al., 2020). The optimal capital structure balances the benefits of debt with its costs, maximizing a firm's market value while minimizing the cost of capital (Schauten and Spronk, 2006). Ratios like the Debt-to-Equity Ratio and Long-term Debt to Capitalization Ratio are commonly used to measure a company's capital structure, assessing its financial risk, profitability, and stability (Segal, 2021; Loth, 2022).

2.1.2 Firm value

Firm value represents the total worth of a company, determined by the market value of its assets, liabilities, and equity. It reflects a company's financial health and potential for future growth (Lawal, cited in Osasere and Osagie, 2022). Kenton (2022) notes that firm value includes the claims of creditors and shareholders, showing the overall financial worth of a company. In this study, firm value is measured through enterprise value (EV), calculated as the sum of the market value of common and preferred equity, debt, and minority interest, minus cash and investments (Tamplin, 2023; Best, 2022).

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2.2 Theoretical Framework

The two theories were used in this study because companies employ the two of them in their capital structure decisions.

2.2.1 The Pecking Order Theory

According to Allen (1993), the pecking order hypothesis was previously suggested by Donaldson (1961) and further developed by Myers and Majluf (1984). It is a financial theory that suggests that companies prefer to finance their investments using internal funds, followed by debt, and finally equity. According to Myers, cited in Priska Ralna and Tri Gunarsih (2012) firms finance their activities with retained earning when feasible. If the retained earnings are inadequate, then debt is used. Only in extreme cases will firms use new equity finance. Thus, the order of financial sources used was the source of internal funds from profits, short-term securities, debt, preferred stock and common stock last. Pecking order theory predicts that the issuance of equity (common stock) is the last alternative sources of funding. BUI, Nguyen and Pham (2023) explains that the pecking order theory suggests that the order in which firms access funding sources is more significant than factors like tax shields and financial constraints. Well performing businesses typically often have little debt due to their internal funds, while poor performing businesses often have high debt due to insufficient internal funding. They observed debt ratio of each firm reflects the cumulative need for external financing over time.

2.3 Empirical Reviews

Fakunle OmoleI and Adewumi (2024) explored the relationship between capital structure and the financial performance of listed non-financial companies on the Nigerian Stock Exchange (NSE). The research design adopted is ex-post-facto due to the nature of data envelopment analysis, a mathematical programming technique used to evaluate decision-making units. The population consists of all 105 non-financial companies listed on the NSE, and a purposive sample of 60 such companies is chosen for the study. Data is collected from the annual reports of these companies for the period 2009 to 2022, focusing on key financial metrics such as debt to equity ratio (DER), leverage ratio (LEV), return on assets (ROA). The fixed effect regression analysis is employed to determine the significance of these variables and their influence on ROA. The findings indicate a positive association between Debt-to-Equity ratio and ROA, implying that a higher ratio is linked to improved firm performance. However, the non-significant p-value suggests that this relationship lacks statistical significance at the 5% level. Conversely, Leverage exhibits a negative influence on ROA, potentially due to

increased interest expenses and financial constraints. However, this negative relationship also lacks statistical significance. Overall, the study's outcome suggests that capital structure has no significant effect on the financial performance of companies listed on the Nigerian Stock Exchange. This work did not reveal the theory from which the model was adapted.

Yisau, Oke and Odukoya (2024), examined the factors that influence capital structure decisions in Nigerian consumer goods publicly traded companies by accounting for the economic growth effect. The study used secondary data from the annual reports of 15 of the mentioned corporations, spanning ten years from 2011 to 2020. The association between the leverage ratio and the six explanatory variables in the model was investigated using the Panel Least Square regression approach. The dependent variable is leverage measured by debt to equity ratio while the explanatory variables and their proxies are: profitability- ratio of operating income to total asset; tangibility- ratio of tangible (Fixed) assets to total assets; growth-the percentage change in total assets and size- Natural Logarithm of total assets; Non-debt tax shield-depreciation divided by total assets and Economic Growth - natural log of real GDPt divided by GDPt-1. The study's findings showed that while non-debt tax shield is not statistically significant, asset tangibility, firm size and economic growth all positively and significantly affect leverage. Furthermore, profitability and firm growth are negative and have a large impact on leverage. This study simply revealed determinants of capital structure in consumer goods. The study is four years later than the year of publication.

Abdulwahab, Badara, Aliyu and Abubakar (2023), in their work sought to look into the impact of capital structure choices on the financial performance of services firms quoted on the Nigerian Exchange Group (NGX). The study's population consists of Nigeria's 25 quoted services companies as of December 31, 2020, whereas a sample of 11 service firms where studied because of unavailability of data. The study period was from 2011 – 2020 and used ex-post facto design. The generalized least square model was employed for the analysis of the data. The dependent variable performance is measured by earning per share while the independent variable capital structure is measured by: short term debt ratio, retained earnings to total asset, long term debt ratio, equity ratio, and four control variables: firm size, profitability, asset turnover ratio, and liquidity While both retained earnings and total debt have a positive and significant influence on earnings per share, short-term and long-term debts, and equity were insignificant, according to the findings. This study focused on firm performance and only used only one performance proxy (earning per share). It did not also

tell us the sampling technique use to select the sample size. This paper studied only performance using only earning per share as the performance measure.

Akinrinola, Tomori, Audu (2023) explored the effects of capital structure on financial performance of quoted manufacturing firms in Nigeria. The study used panel least square multiple regression to examine secondary data gathered from the 14 sampled organizations' financial statements from 2011 to 2020. The null hypothesis that there is no statistically significant link between total-debt-to-total-equity and return on assets of manufacturing entities in Nigeria was accepted. The study rejected the second hypothesis relating to long-term-debt -to-total-assets. The study did not reveal the work from where its model was adapted.

Evbayiro-Osagie and Enadeghe (2022) examined the impact of capital structure on return-on-assets (ROA) performance of nonfinancial firms in Sub-Sahara Africa for a period of nine (9) years (2012-2020). A total of forty (40) non-financial firms were studied using their capital structure variables of long term debt to equity (LTDQ), total debt (TD), total debt to equity (TDQ), and total debt to total assets (TDTA) as well as their ROA performance. The panel data analysis technique was employed. It was found that LTDQ, TD and TDQ have positive impact on ROA performance; while TDTA has a negative impact on ROA performance, and all variables were significant at 1 percent level. The study did not reveal the sampling technique used in sample size selection.

Ogunsola and Ogheneoparobo (2022) investigated the effect of total debt ratio on the financial performance of listed deposit money banks in Nigeria and how asset liquidity influences financial performance of listed deposit money banks in Nigeria. Capital structure variables are: Debt to equity ratio, Total debt to total asset ratio, Asset liquidity while performance is proxied by Return on asset. The study adopted the ex-post facto research design. The data for this study were obtained from secondary source that was derived from financial statements of a sample of ten (10) deposit money banks listed on the Nigerian Exchange Group (NGX). The data covered the period 2011– 2020. The findings of the OLS regression analysis revealed that debt equity ratio (DER) has significant negative impact on financial performance. However, findings revealed that total debt to total asset ratio (TTR) has a significant and positive impact on the financial performance, while asset liquidity (ASL) has a negative and significant impact on financial performance of the sampled banks in Nigeria. This study did not reveal the work from where its model was adapted.

Okore and Nwadiubu (2022) determined the effect of debt equity ratio on gross profit margin ratio, analyze the effect of debt equity ratio on net profit margin ratio, assess the effect of debt equity ratio on return on equity and, examine the effect of debt equity ratio on return on asset. The research adopted the causal research design. Secondary data were used to determine the effect of debt equity ratio on gross profit, net profit, return on equity and return on asset. The population of the study was the entire quoted companies in the food and beverage industry. From the population, a sample of five listed companies from the food and beverage sector were used. Data were collected from the annual financial report published by the various companies. The dependent and independent variables were observed over a period of ten years, that is from 2009 to 2018. Debt equity ratio was the independent variable in all four hypotheses while the dependent variables were gross profit, net profit, return on equity and return on asset. Data were analyzed using Panel Least Square method. The results showed that equity capital had positive and significant impact on profitability, debt capital had negative but significant impact on profitability of food and beverage firms in Nigeria. Based on the findings, the study concludes that firm performance is positively and significantly responsive to capital structure. The study did not reveal the theory on which the research was based as well as the work from where the its model was adopted.

Opoku-Asante, Winful, Sharifzadeh and Neubert (2022) investigate, using a sectorial analysis, the relationship between capital structure and financial performance and consider the effect of debt maturity on the relationship between capital structure and financial performance, considering the debt maturity, using 425 cross-sectional firm-year samples from firms in Ghana and Nigeria from 2014 to 2019. The study population was all 131 non-financial public firms in Ghana and Nigeria at the close of December 2019. A total of 85 firms were sampled for the study. Capital structure was represented by the total debt to equity ratio, long-term debt to equity ratio, and short-term debt to equity ratio to financial performance represented as the return on equity and return on assets. The empirical findings suggested a significant negative relationship between capital structure and financial performance. Debt maturity did not affect the relationship between capital structure and financial performance. However, the Industry influences the direction of the relationship between capital structure and financial performance. Also, debt maturity influences the capital structure performance relationship in specific sectors but not the market. This study did not reveal the model from where the study model was adapted. The research excluded 2019 and 2020 because of COVID lockdown, so the study was for 4 years not five years as was stated. A longer time frame would have given a better outcome.

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The existing literature explores the capital structure decisions of Nigerian listed firms across various sectors, including manufacturing, conglomerates, non-financial firms, financial institutions, and oil and gas. However, limited research has been done on the service sector, particularly regarding the direct effect of capital structure on firm value. Ahmadu and Abdulkarim (2019) focused on performance measured by return on equity, leaving a gap in studies using holistic measures like Enterprise Value (EV). Additionally, the proxies for firm value, such as share price or Tobin's Q, have also been inadequately explored. This study seeks to fill these gaps by investigating the effect of capital structure on firm value within Nigeria's service sector, providing valuable insights for managers, investors, and policymakers regarding optimal capital structure decisions and value creation.

3. MATERIAL AND METHOD

The study used *ex-post facto* research design, utilizing secondary data from the Nigerian Exchange Group (NGX), to examine the relationship between capital structure and firm value. The population of this study comprises all the 22 service firms listed on the Nigerian Exchange (NGX) Group as at 31st December 2023. The study used purposive sampling technique to determine the firms that made up the study sample size. The basis for this sampling technique was availability of annual reports for the stipulated years of the research work. Nyimbili and Nyimbili, (2024) explained that purposive sampling procedures are used in most research papers because they are found in any research paradigm and help in ensuring that quality sample is located without biases so as to increase the reliability and trustworthiness of the findings. 16 firms which had complete and consistent financial statement for the stipulated period. 12 years' data were investigated from 2009 – 2023. Secondary data were used in the study and were sourced from the annual reports of the selected service firms for a fifteen-year period that spanned from 2009 to 2023. The study conducted descriptive statistics to provide an understanding of the data in terms of the mean, standard deviation, maximum, and minimum. Correlation analysis was also conducted to express the relationship between the independent and dependent variables employed in this study. However, to achieve the objective of the study, the ordinary least square (OLS) regression was employed. The estimation result was evaluated based on individual statistical significance test (t-test) and the overall statistical significance test R-squared (adjusted) while the goodness of fit of the model was tested using the F-statistics. Based on the theoretical literature and earlier empirical studies, the present study adapted the model of Bello, Pembi and Vandi (2020) which is expressed in econometric form thus:

JOURNAL OF GLOBAL ACCOUNTING
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https://journals.unizik.edu.ng/joga

EV = f(dEquity, eRatio, revGwth, logMC)……Eqn 1

This can be mathematically stated as follows:

$$\boldsymbol{EV_{it}} = \beta_0 + \beta_1 dEquity_{it} + \beta_2 eRatio_{it} + \beta_3 revGrwth_{it} + \beta_4 logMC_{it} + \mu_{it} \ldots\ldots\ldots \text{Eqn 2.}$$

The apriori expectation based on the literature reviewed and related theories is stated as follows; β1X1it <0, β2X2it <0, β3X3it >0, β4X4it <0. The basis for this expectation flows from the outcome of the literature review and empirical findings.

Where:

β0	=	Constant
β_1- β_6	=	Slope Coefficient
μ	=	Stochastic disturbance
i	=	ith company
t	=	period

Table 1: Description of Variables

SN	Label	Variable type	Measurement	Source
1	Debt-to-equity ratio	Independent variable	Total debt/total equity	Abdulwahab, Badara., Aliyu, and Abubakar, (2023)
2	Equity ratio	Independent variable	Total Equity / Total Assets	Abdulwahab, Bada, Aliyu, and Abubakar,(2023)
3	Enterprise value	Dependent variable	Market value of common equity + market value of preferred equity + market value of debt + minority interest – cash and investments.	Ferdinando, (2023),

JOURNAL OF GLOBAL ACCOUNTING
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https://journals.unizik.edu.ng/joga

4	Revenue Growth	Control Variable	[(Revenue$_1$ – Revenue$_0$)/ Revenue$_0$] x 100/1	Abdulwahab, Badara., Aliyu, and Abubakar, (2023)
5	Market capitalization	Control Variable	Log transformed valueof market capitalization	Tamplin (2023)

Source: Researcher's Compilation, (2024)

The decision rule is based on the sign and significance of the computed *t-statistic* from the regression output. The level of significance was set at $p < 0.05$. Hence, if the p value of the *t statistic <0.05* (the chosen alpha level) the null hypothesis is rejected; and the variable is postulated to have a significant effect. This can otherwise be stated as thus: Accept H_0 and reject H_1- when the probability value is above 5%; Accept H_1 and reject H_0- when the probability value is less than 5%.

4. RESULT AND DISCUSSIONS

4.1 Data Analysis

4.1.1 Descriptive Statistics

This study examined the effect of capital structure on the value of service firms listed on the Nigerian Exchange Group (NGX) between the periods of 2009-2023. Table 4.1 displays the descriptive statistics for the study where it described the nature of the variables used. It also displays the number of observations of each variable and the description of their mean, standard deviation, maximum, and minimum values.

Table 2: Descriptive Statistics

Variable |	Obs	Mean	Std. Dev.	Min	Max
enterprice~e |	240	6.70276	.4888167	5.493221	7.783386
debttoequi~o |	240	.2360574	22.6083	-343.17	12.22
equityratio |	240	.3192768	.5626015	-2.954504	1.198159
revenuegro~h |	240	1.797861	42.49105	-115.7625	224.3014
logofmarke~n |	240	6.166053	.4303066	5.258733	7.015237

Source: Author (2024)

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Table 2 provides a summary of key variables. The mean enterprise value is 6.70, with moderate variability (Std. Dev. 0.49), ranging from 5.49 to 7.78. The average debt-to-equity ratio is 0.24, but with high variability (Std. Dev. 22.61), ranging from -343.17 to 12.22. The equity ratio has a mean of 0.32 and a wide range from -2.95 to 1.20, indicating some firms may have negative equity. Revenue growth averages 1.80, but there is significant variation (Std. Dev. 42.49), ranging from -115.76 to 224.30. The log of market capitalization has a mean of 6.17, with moderate variation between 5.26 and 7.02. The high variability in debt-to-equity ratio and revenue growth suggests significant financial disparities among firms, indicating diverse financial strategies among the firms.

Table 3: OSL Regression

Source	**SS**	**df**	**MS**	**Number of obs** = **240**
Model	23.7200009	4	5.93000023	Prob > F = 0.0000
Residual	33.3870741	235	.142072656	R-squared = 0.4154
Total	57.107075	239	.238941736	Adj R-squared = 0.4054
				Root MSE = .37693

enterpricevalue	Coef.	Std. Err.	t	P>|t|	[95% Conf.	Interval]
debttoequityratio	-.0007825	.0010852	-0.72	0.472	-.0029205	.0013554
equityratio	-.2531547	.0435037	-5.82	0.000	-.3388618	-.1674476
revenuegrowth	-.0013722	.00058	-2.37	0.019	-.0025149	-.0002296
logofmarketcapitalization	.6152564	.0570532	10.78	0.000	.5028553	.7276574
_cons	2.992535	.3536263	8.46	0.000	2.295852	3.689217

Source: Author (2024)

Table 3 presents the results of the OLS regression model examining the factors influencing enterprise value. The model is significant (Prob > F = 0.0000) with an R-squared value of 0.4154, meaning approximately 41.54% of the variation in enterprise value is explained by the independent variables. The model's overall significance indicates that the relationships between the variables and enterprise value are generally statistically meaningful.

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4.2 Test of Hypotheses

4.2.1 Hypothesis one

H_{01}: Equity Ratio (ER) does not significantly affect the Enterprise Value of selected service firms listed on the Nigerian Exchange Group.

The OLS regression results indicate that the equity ratio significantly affects enterprise value ($p = 0.000$), leading to a rejection of the null hypothesis ($H0_1$). The significant positive effect of equity ratio on enterprise value is supported by Osasere and Osagie (2022) who found that equity ratio has a significant positive effects on firm value. It also aligns with the findings of Evbayiro-Osagie and Enadeghe (2022) who found a significant positive impact of equity on firm performance. This finding is also consistent with Andrew *et al.* (2021), who observed a positive relationship between equity ratio and return on equity and earnings per share, reinforcing the idea that a strong equity base is crucial for enhancing firm value.

4.2.2 Hypothesis two

H_{02}: Debt-to-Equity Ratio has no significant effect on the Enterprise Value of selected service firms listed on the Nigerian Exchange Group.

The OLS results indicate that the debt-to-equity ratio does not significantly affect enterprise value ($p = 0.472$), supporting the null hypothesis ($H0_2$). This is in agreement with Fakunle and Adewumi (2024), who found a non-significant relationship between debt-to-equity ratios and financial performance of non-financial firms on the Nigerian Exchange Group. Additionally, Ogunsola and Ogheneoparobo (2022) found a significant negative impact of debt-to-equity ratios on the performance of deposit money banks in Nigeria, which also suggests that an increased debt load may harm enterprise value in certain sectors, but not necessarily in service firms.

CONCLUSION AND RECOMMENDATIONS

The study examined the effect of capital structure, specifically equity ratio and debt-to-equity ratio, on the enterprise value of selected service firms listed on the Nigerian Exchange Group. The results revealed that while the equity ratio significantly affects enterprise value, the debt-to-equity ratio does not have a significant influence. These findings highlight the need for service firms to carefully manage their equity proportions to optimize their market value, while their debt-to-equity structures may not be as critical in driving enterprise value. Based on the findings, the study therefore recommended that:

i. Service firms should prioritize optimizing their equity ratio to enhance enterprise value, as higher equity contributions significantly impact firm valuation.

ii. Firms should exercise caution in increasing debt levels, as debt-to-equity ratios did not show significant effects, suggesting that higher debt may not always translate into better enterprise value.

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