

Leverage and Financial Performance of Listed Deposit Money Banks in Nigeria

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Abstract

Consideration is given in this paper to the effect that financial leverage may have on financial results of deposit money banks that operate in Nigeria. The measurement of financial performance was done using Return on Assets (ROA), while debts (both long-term and short-term) served as the explanatory variables. The main data for analysis was derived from financial statements of the 14 banks in the sample for the ten-year period 2009-2018. Consequent upon the diagnostic tests, robust Ordinary Least Square (OLS) was chosen as the tool for the analysis. From the regression results, ROA of the banks in the sample was affected significantly by long-term debt ratio and short-term debt ratio, the former negatively and the latter positively. Principally, a conclusion of the paper is that the financial performance of banks in Nigeria is affected positively and significantly by higher short-term debt. Thus, it is recommended among other things that managers of banks should explore ways of debt of short-term nature especially in the area of customer deposit.

Keywords: *Financial Leverage, Short term debt, long term debt, Financial Performance,*

Introduction

Financial structure is the most famous among other notable decisions made by a firm as it is concerned with ascertaining the optimum capital combination for the firm. Firms at every level of development are seemingly at crossroads when faced with the options of either of debt (leverage) and equity or the combination of the two in project and operational financing. The term 'financial leverage' describes the capacity of an organization to utilize debt in its financial structure and have been understood to mean a degree of how much debt and equity a company uses in financing its assets. Financial leverage, which is also known as trading on the

equity, is actually a way of financing that includes using additional borrowed funds to maximize the return on investment, (Ahmed, Ningi & Dalhat, 2018).

The importance of any financial decision cannot be underscored. This is because issues that lead to business collapse can be handled or managed with the aid of certain financial steps that can engender growth and help to attain some other objectives of a corporate body. Similarly, it is known that financial distress is caused primarily by the finance factor. Studies of corporate failures in several climes have shown such to be as a result of financial decisions which for the most part were sub-optimal and resulted in financial structures that were not beneficial. This establishes financing decision as a major and fundamental function in corporate decision-making. Arguably, it is considered as the most important among other functions for the fact that it aids financial managers to decide where, how, and when funds needed for investment would be obtained. As survival of banks is directly dependent on its ownership structure, it is suggested that financial structure can be in form of any of the three alternatives as follows: 0% equity: 100% debt, 0% debt: 100% equity, or X% debt: Y% equity, (Okolo, Okwu, Egbe & Monyei, 2019, Onuorah & Nkwazema, 2016).

Over time, the business of banking in Nigeria has grown and become highly competitive. Banks are distinguished on how efficiently and competitively they employ their resources as they constitute an important component of growing and developing the economy. It is commonly known that growth and stability of any economy, for the most part, depends on the strength or otherwise of players in the industry of banking and allied areas like insurance, mortgage, foreign exchange, and so on. This is because banks serve as the link between surplus-spending and deficit-spending units in the economy. Their major role is the facilitation of funds for productive purposes and enablement of the payment as well as the contract systems.

Valuation of banks and the prices of their stocks are impacted by the interplay of debt and equity. This serves to accentuate the essential nature of the choice of financial structure. It also has various macroeconomic effects as it impacts on the rates of interest, economic growth and securities market development. This is so for the fact that financial results show in a measurable form the extent to which the corporate objectives, especially financial, will be or have been achieved. In essence, how profitable a bank is would rest on how effective it has utilized assets at its disposal in conducting businesses and generating revenue therefrom. This study

investigates the leverage–financial performance nexus of the banks that operate in Nigeria. This is considered very necessary as a way of gauging or measuring the effectiveness of banks in an economy over designated period of time. Another compelling fact is that the asset financing decisions these firms make will ultimately affect their productivity for any given period in terms of returns and risks of shareholders and, ultimately, the share value in the market.

There is no gainsaying the fact that multiples of studies are found in the many areas that corporate financial structure covers. However, it is apparent that a generally accepted theory for the equity-debt mix with regards to which to use between book-value and market-value of financial structure has not been established. In essence, though several arguments have been raised concerning the level of debt that should be used in financing firm operation, there is still no consensus as to which of the measures has a more significant relationship with financial performance. For instance, Fumani and Moghadam (2015) and Dasuki (2016) show that the relationship between the long-term debt ratio and profitability is negative. The same was found for short-term debt ratio. This empirical result would seem to suggest that profitable firms use more equity relative to debt in funding their operations. On the contrary, Adnan, Amir, Qasim, Naveed and Wasiq (2016) as well as Akingunola, Olawale and Olaniyan (2017) among others found the relationship to be positive. An inference from their results is that debt is capable of helping managers enhance the financial performance of their firms through improved productivity and, by extension, avoidance of bankruptcy.

Another observation especially from studies carried out on leverage in Nigeria is that most of the research works carried out especially on firms in the banking sector do not separate the component of debt into long-term and short-term to see their individual impact on financial performance. This present study is an attempt to address this pertinent issue. Aside this introduction, the next three sections of the study has literature review, methodology, and result and discussion in that order. The last part contains the conclusion and the recommendation of the study.

Literature Review

The degree to which an investor or a corporate body uses borrowed funds to operate is referred to as financial leverage. Abor (2005) describes it as the part of the assets of a company that has been financed by the use of debt. One of the fallouts of a firm being highly levered is the risk of being bankrupt if the company is not able to

meet the interest obligation on the debt. Such a firm may also not be able to secure loans in future. Leverage, per se, is not to be considered as a negative management step because the wealth of shareholders of the firm can be increased by it and there are also tax advantages related to borrowing. But also, high financial leverage results in high finance cost and high finance cost have negative effect on earnings per share. A firm that utilizes more debt compared to equity is perceived to be highly levered and profitability is a measure of earning power of a firm, (Utami, Pardanawati, & Septianingsih, 2018). This synchronization of debt and asset was required to be fulfilled in order to reserve the bank's financing to the customer, which then leads to increased profitability. Anarfo (2015) posts the observation that, capital structure decisions that are poor would result in higher cost of capital and low financial performance. This would mean that financial risk of the firm is increased financial risk and may ultimately lead to extinction of the firm.

The theoretical base of this work is Pecking Order Theory which was brought to fore by Myers and Majluf (1984). The foundation of this theory is the supposition that information available to managers is much more than those available to investors and, as such, managers can use the asymmetry of information to determine the appropriate structure between equity and debt to finance the operations of the firm. The theory states that, ordinarily, managers display the preference of sourcing funds in the order of retained earnings, then debt, and, finally, equity financing which serves as the last resort. This is illustrated in the diagram that follows:

Diagram 1- Pictorial Illustration of the Pecking Order Theory



Source- Corporate Finance Institute (2015)

Naturally, a firm would finance investments in the first place with internal resources, then debt, which itself is divided into safe debt and risky debt. Equity

serves a last resort. To Khan, Sajid, Waseem, and Shehzad (2016), one of the implications of this is that firms have no debt-equity ratio that is targeted since their needs for finance determine the choice of their leverage ratio. Following on and echoing Ferreira and Vilela (2004), cash is actually used as a buffer between the need for investment and the need for retained earnings. This would then mean that leverage falls automatically as a company increases its internal financing.

Several studies abound in this area of study though with mixed outcomes. For instance, Rajin (2012) centred on what influence financial structure had on Return on Investment (ROI) and market value on India's telecommunication companies. It was found that financial structure and ROI associated positively but financial structure and market value associated negatively. The focus of Al-Taani (2013) was the debt-financial performance relationship of 45 listed firms in Jordan for the period 2005-2009. No significant association was found between debt metrics and the metrics of financial performance metrics that were considered.

For a sample of forty cement and automobile firms listed on the stock exchange of Pakistan, Adnan, Amir, Pir, Naveed, and Wasiq (2016) investigated the impact of capital structure on profitability in the seven years between and including 2005 and 2011. Short-term debts were reported to have positively impacted financial performance. Similarly, Nwaolisa and Chijindu (2016) used a sample of fifteen companies in the agricultural and healthcare sectors of the Nigerian economy for twenty-one year period 1993-2013. The results of the regression analysis suggested that short term debt did not impact ROE, ROA and NPBT. Dasuki (2016) was a study of one hundred and eighty manufacturing firms listed on the Borsa Stock Exchange for the ten-year period 2004 to 2013. The study reported that the ratio of long-term debt to total debt has negative and significant effects on financial performance on ROA, but was not significantly as regards ROE.

Examples of studies in Nigeria include Uwalomwa and Uadiale (2012) which was based on the data of a sample of thirty-one firms listed on Nigerian stock exchange for the period 2005-2009. The method of analysis was Ordinary Least Squares (OLS) technique. It was reported that financial performance was affected positively by short-term debt in the period of study. Likewise, Ubesie (2016) found that long term debt has insignificant negative effect on financial performance. This was the result of the consideration of capital structure on the financial performance of conglomerates quoted on the floor of the Nigerian stock exchange for the five-year period 2011-2015.

In Akingunola, Olawale and Olaniyan (2017) which evaluated the effect of decisions about capital structure on decisions financial performance of listed non-financial firms in Nigeria, twenty-two firms were considered. Both short-term debt and long-term debt had negative effects on ROA and positive effect on ROE. Ajibola, Wisdom and Qudus (2018) examined the impact of capital structure on financial performance of quoted manufacturing firms in Nigeria in the period 2005 to 2014. The study revealed a statistically insignificant effect of short-term debt ratio on ROE and ROA. This was similar to the findings of Nwude and Anyalechi (2018) which focussed on the impact of financing mix on the performance of deposit money banks. Abdulkarim, Ahmadu, and Sulaiman (2019) explored the impact of financial leverage on the financial performance of quoted agricultural firms in Nigeria for period 2005-2017. The report showed that long-term debt ratio had significant impact on the profitability of the sampled firms and concluded strongly that long-term debt may not be ideal as a source of fund firms in Nigeria's agricultural sector.

Methodology

The correlational research design was employed in this study. Secondary data were principally used and were sourced from the annual reports and accounts of fourteen deposit money banks which were listed on the Nigerian Stock Exchange. The period of study is 2009 to 2018. Multiple regression was employed as the tool of analysis with the aid of STATA 13.

The model for the study is specified as follows:

$$ROA_{i,t} = \beta_0 + \beta_1 SD_{i,t} + \beta_2 LD_{i,t} + \beta_3 FSIZE_{i,t} + \beta_4 FAGE_{i,t} + \epsilon_{i,t}$$

Where:

ROA = return on assets

β_0 = the intercept

$\beta_1 \beta_2$ = the parameters to be estimated in the equation

SD = short term debt

LD = long term debt

FSIZE = firm size

FAGE = firm age

t = Time subscript

e = Stochastic error term

Result and Discussion

Table 1- Descriptive Statistics

Variable	No of obs.	Mean	Std deviation	Min	Max
ROA	140	.019	0.3	-.091	.11
LD	140	.124	.098	6.91e-06	.45
SD	140	.75	.16	.41	2.11
FSIZE	140	1.49e+12	1.17e+12	1.57e+11	5.57e+12
FAGE	140	41.64	32.17	3	124

Source: Author's computation using STATA 13

Table 1 above shows the descriptive statistics for the variables. Return on assets which is the dependent variable of the study has a minimum value of -9.1% and a maximum value of 10.52%. The average value of the ROA is 1.9% with standard deviation of 2.58% signifying that there is a low dispersion across the sample firms return on asset from the mean. The table also shows that short term debt to total assets (SD) has minimum and maximum value of .4062 and 2.112 respectively, with an average value of .7580 and a standard deviation of .1644.

The average value of SD of the sample firms showed that the financial structure of the deposit money banks in Nigeria consist more of short term debt as the sampled average is 75.8% of their total assets. This could result from their operation as the banks deals in collection of deposit from customer that is mostly short term in nature. It is not surprising as the standard deviation showed that it is a common practice across the banks during the period of the study as the table display a low variation with a standard deviation of 16.51

Further, the table reveals that long term debt to total asset (LD) has an average value of .1248 and a standard deviation of .098, showing that there is a low variation of the individual sample banks long term debt from the mean. LD has a minimum value of 0.0000069 and a maximum of .446. The standard deviation shows it is a common trend across the banks. Also, firm size reveals a mean value of 1.49 trillion and a standard deviation of 1.17 trillion which shows that the banks are similar in sizes. The finally control variable firm age reveals an average value of 42 years incorporation with a standard deviation of 32 years.

For good inference to be drawn from the analysis, the result of diagnostic test conducted is presented in Table 2 below. The diagnostic test included test for normality of the residual, multicollinearity test, and heteroscedasticity test

Table 2- OLS Diagnostic test

Variables	VIF	Tolerance value
LD	1.33	0.75
SD	1.29	0.77
FSIZE	1.09	0.92
FAGE	1.05	0.95
Other Tests	Chi square	P-value
Normality of residual	19.92	0.0000
Heteroscedasticity	2.11	0.146
Autocorrelation	3.80	0.073

One of the assumptions of OLS regression model is that the explanatory variables are not perfectly correlated (absence of multicollinearity). According to Gujarati (2004) Tolerance less than 0.1 and the VIF value 10 and above imply the presence of multicollinearity in the estimates. However, the results from Table 2 suggest that there is no existence of excessive correlation among the independent variables, because the smallest Tolerance Value (TV) is 0.75, while the highest Variance Inflation Factor (VIF) is 1.33.

Another assumption considered is that of normality of residual. The normality of residual was tested using Jacque Bera tests at 5% level of significant. The results in the table 3 above show that the chi square is significant with a p-value of 0.000, which suggest that the residual is not normally distributed. Based on the assumption of OLS assumption of no serial/ auto correlation, the study used Wooldridge test for autocorrelation in panel data. The test reveals a chi square of 3.80 and a p-value of 0.073 which is insignificant as it is higher than 5% level of significance. Hence the study concluded that there is low auto correlation in the study.

To check the homoscedasticity assumption of the regression model, the heteroskedasticity test was conducted using the Breusch-Pagan/Cook-Weisberg test. The result reveals that χ^2 is 2.11 and the $\text{prob} > \chi^2$ is 0.146 which is insignificant at 5% level of significance. This indicates the residual is

homoskedastic and there is no presence of the effects of heteroskedasticity. Thus, there is constant variance in the residuals.

Due to panel nature of the data, panel analysis was conducted by the instrument of the Hausman specification test. The objective of this was to make a decision relating to the choice of either of fixed model or random effect model. The result presented in Table 3 below

Table 3- Panel Analysis Test

Tests	Chi square	P-value
Hausman specification test	1.17	.883
Langragian multiplier test	2.02	0.078

Table 3 shows that at 5% level of significance, the χ^2 is 1.17 and the $\text{prob} > \chi^2$ is 0.883 which is insignificant. This non-significance of the p-value shows that Hausman test favours the interpretation of the random effect model. The study then proceeded to carry out the Breusch and Pagan Lagrangian multiplier test for random effects to examine the random effect result and pooled OLS regression result. The outcome is a chi square of 2.02 and p of 0.078 indicating that there is no panel effect. Hence, the study had to interpret the OLS.

The Regression Result

Table 4 below presents the regression result of the dependent variable (ROA) and the independent variables of the study (LD and SD)

Table 4- OLS Regression Result summary

Variables	Coefficient	Std error	T-value	P-value
LD	-.077	.024	-3.19	0.002**
SD	.037	.014	2.68	0.008**
FSIZE	.016	.007	2.51	0.013*
FAGE	-.0002	.00005	-4.13	0.000**
Constant	-.196	.0834	-2.35	0.020*
R² Overall	0.276			
F-statistic	10.06			0.0000***

***,**significant at 5%, 1% .Source: Robust OLS regression result using STATA 13**

Table 4 above presents OLS regression result selected for the research work based on the Hausman test. The regression result reveals that the independent variables, Debt financing (short term debt and long term debt) and the control variables are able to explain close to 28% of the variations in the financial performance of the sampled listed deposit money banks. In essence, financial performance of the sampled banks is explained to the tune of 72% by other factors not captured in the model. The F- statistics chi square is 10.06 with a p-value of 0.0000 which reveals that the model is fitted at 1% significant level and the coefficient of all the variables jointly have effect on financial performance of listed deposit money banks in Nigeria.

On the relationship between long term debt to total equity and return on asset, Table 5 above reveals a negative coefficient of $-.077$ and a p-value of 0.002 implying significance at 1% level. Based on this, there is no sufficient evidence to accept the null hypothesis (H_0) that long term debt does not significantly affect financial performance of listed deposit money banks in Nigeria. In essence, long term debt affects return on assets of listed deposit money banks in Nigeria in a negative manner. The statistics suggest that a percentage increase in long term debt will decrease return on asset by 7.7%. This means that any increase in long term debt will or can cause deterioration in the return on assets of the listed deposit money banks in Nigeria. This could result from the interest charged by the providers of long term funds to the banks.

The observation posted above is consistent with the pecking order theory that outlines a debt correlates negatively with profitability. This finding is also in line with previous studies like Dasuki (2016), Ubesie (2016), and Akingunola, Olawale and Olaniyan (2017) who reported that high level of long-term debt in the financial structure can decrease financial performance. However, it is contrary to the findings of studies like Ajibola, Wisdom and Qudus (2018), Ezenwakwelu (2018), and Abdulkarim, Ahmadu and Suleiman (2019) whose results suggest that increase in debt do not impact the financial performance of firms.

As regards the effect of short term debt on financial performance, the result in Table 5 establishes that short term debt to total assets positively and significantly influenced the financial performance of listed deposit money banks in Nigeria during the period under review. This is indicated by the sign of the coefficient which is $.037$ and is significant at 1% considering the p-value which is 0.008. An inference from this is that 1% increase in short-term debt will likely increase ROA

by as much as 3.7%. Thus, high short-term debt ratio would possibly result in improve earnings to banks. This may be due to less interest payable on short-term debt especially the depositors who lodge their money in the banks.

This finding as regards the effect of short-term debt is in line with the studies of Uwalomwa and Uadiale (2012), Adnan, Amir, Pir, Naveed, and Wasiq (2016), and Ajibola, Wisdom and Qudus (2018). These previous studies all reported that short-term debt to total assets positively affects financial performance (ROA). However, this is different from the results of some studies including Nwaolisa and Chijindu (2016) as well as Joseph (2016).

Conclusions and Recommendations

This study has examined the effect of leverage on financial performance. The domain was the financial sector and the sample used was fourteen deposit money banks listed on the Nigerian Stock Exchange for the ten-year period 2009-2018. While debt ratios (long-term debt to equity and short-term debt to equity) were used to proxy leverage, Return on Assets served as the dependent variable of the study and was used to proxy financial performance. It was found that, for banks operating in Nigeria, long term debt has a negative effect on financial performance of the listed deposit money banks while, conversely short term debt has positive and significant effect. Thus, the result indicates that debt financing strongly influence financial performance.

Based on this, the study concludes that short term debt which is mostly characterized by customers deposit positively improves the financial performance of listed deposit money banks in Nigeria. Conversely, long term debt negatively influences the return on asset of listed deposit money banks in Nigeria and consequently would lead to declines in the financial performance of listed deposit money banks in Nigeria.

A recommendation of this study is that managers of banks should properly harness the deposits and others short term liabilities of the banks to enhance the productivity of their assets and consequently improve their financial performance. Another is that the board of directors should monitor the manager's decisions on long term debt finance to avoid interest and repayment conditions that can jeopardize the financial performance of the banks and, consequently, their future survival.

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