Effects of Capital Structure on Firms Financial Performance

Case Study Commercial Banks in Mogadishu Somalia

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ABSRACT

The purpose of this study was is to investigate the influence of capital structure on firms financial performance a case study of commercial banks in Mogadishu Somalia. Results indicates that equity finance, debt finance, optimal capital structure had significant effect on firms financial performance in commercial banks in Mogadishu Somalia. The study findings indicated that there was a strong positive relationship (R= 0.637) between the variables. From the study findings it was conclude that equity finance, debt finance, optimal capital structure had a strong positive relationship on firms financial performance in a commercial banks in Mogadishu Somalia because there was evident that at 100% confidence level.

Keywords: Capital Structure, Equity Finance

INTRODUCTION

In this study investigates or evaluates the impact of Capital structure on Firm's Financial Performance. The capital structure decision is crucial for any business organization in any sector or economy. It is usually difficult for business firms to identify the right combination of debt and equity. The decision is important because of the need to maximize returns to various organizational constituencies. It is also important because of the impact such a decision has on a firm's ability to deal with its competitive environment. Affirm can choose among many alternative capital structures. It can choose to either issue a large amount of debt or very little debt. It can arrange lease financing, use warrants, issue convertible bonds, sign forward contracts or trade bond swaps. It can issue many distinct securities in countless combinations; however, it attempts to find the particular combination that maximizes its overall market value. The term capital structure according to Kennon (2010) refers to the percentage of capital (money) at work in a business by type. There are two forms of capital: equity capital and debt capital. Erasmus (2008) noted that financial performance measures like profitability and liquidity among others provided a valuable tool to stakeholders to evaluate the past financial performance and the current position of a firm. Brigham (2004) referred to Capital structure as the way in which a firm finances its operations which can either, be through debt or equity capital or a combination of both.

1.2 Statement of the problem

According to levy (2008) a statement of the problem is a claim of one or two sentences in length that outlines the problem addressed by the study. The statement of the problem should briefly address the question: What is the problem that the research will address?.The success of

businesses (service industries) in Somalia especially Mogadishu dynamic business environment depend on them being able to effectively determine the optimum and appropriate capital structure that is necessary to ensure that the shareholders get good returns. Many researchers in a world attempted to investigate the effect of capital structure on financial performance still there is no evidence of certain results that is why the researcher decided to investigate the effect of capital structure on financial performance of service companies in Mogadishu.

1.3.1 General objective

The main objective of the study was to investigate the effect of capital structure on firm's financial performance in commercial banks in Mogadishu Somalia.

2.2 Theoretical framework

2.2.1 Pecking Order Theory

The pecking order theory as developed by Myers (1984) stated that firms prefer internal sources of finance; they adapt their target dividend payout ratios to their investment opportunities although dividends and payout ratios are gradually adjusted to shifts in the extent of valuable investment opportunities. In addition, Myers (1984) stated that in the event that external finance is required, firms are most likely to issue the safest security first that is to say they start with debt then possibly convertible debt then equity comes as last resort. In summary, Myers' argument was such that businesses adhere to a hierarchy of financing sources and prefer internal financing when available. Should external financing be required,debt would be preferred over equity. Pandey (2005), also concurred with Myers' argument when he noted that managers always preferred to use internal finance and would only resort to issuing shares as a last resort. He went on to add that the pecking order theory was able to explain the negative inverse relationship

between profitability and debt ratio within an industry however; the theory did not fully explain the capital structure differences between industries.Holmes et al (2003) considered the pecking order theory as an appropriate description of Medium Sized Enterprises' financing practises because debt is by far the largest source of financing and that small and medium enterprise managers tend to be owners of the business who do not normally want to dilute their ownership.

In this theory, the firm is viewed as setting a target debt-equity ratio and gradually moving towards it. The firms seek debt levels that balance the tax advantages of additional debt against the costs of possible financial distress. In particular, capital structure moves towards targets that reflect tax rates, assets type, business risk, profitability and bankruptcy costs. The firm is balancing the costs and benefits of borrowings, holding its assets and investment plans constant Myers, (1984).The firm's optimal capital structure will involve the trade-off between the tax advantage of debt and various leverage-related costs.

Modigliani and Miller (MM), 1958 illustrates that under certain key assumptions, firm's value is unaffected by its capital structure. Capital market is assumes to be perfect in Modigliani and Miller's world, where insiders and outsiders have free access to information; no transaction cost, bankruptcy cost and no taxation exist; equity and debt choice become irrelevant and internal and external funds can be perfectly substituted. The M-M theory (1958) argues that the value of a firm should not depend on its capital structure. The theory argued further that a firm should have the same market value and the same Weighted Average Cost of Capital (WACC) at all capital structure levels because the value of a company should depend on the return and risks of its operation and not on the way it finances those operations. Miller brought forward the next version of irrelevance theory of capital structure.

2.3.1 Dept financing

Business enterprises use debt in their businesses, because it offers them potential to increase the volume of their operations and increase the average return on their equity funds. The use of debt will have this effect only if the rate of return on the investment is greater than the rate of return

on the debt, Watkins (2002). The borrowing firm takes a chance to use debt in the hope that it will elevate the firm to a more valuable level, by increasing the turnover and therefore increase the profits. The financial leverage chance will arise if the rate of interest charged to the firm is lower than the internal rate of return (IRR) for the company, in which case the firm will be making enough to pay the interest charged and the principal repayment and retain the surplus for the shareholders. On the other hand the firm may experience a financial leverage risk that the returns of the business are not enough to cover the interest charged. This occurs when the rate of interest exceeds the internal rate of return of the company. To avoid liquidation, the firm will have to use part of the shareholders' funds to repay the interest and principal. This could eventually lead to erosion of the equity and the collapse of the business. The simplest way to assess whether borrowing has increased the return on equity is to contrast the return on the investment with the loan interest rate. When the return is higher than the loan interest rate, there is positive leverage (that is the return on equity increases as more is borrowed, Rowland (2002)

2.3.2 Equity finance

Equity financing works in the opposite way because it involves selling a portion of your company to shareholders in exchange for cash. If your company is successful, the costs incurred will be much higher. If it fails, it will be far less expensive. Equity eliminates the disadvantages of debt in that it does not divert capital from the business in order to pay down debt, and it also shares in the business risk along with the entrepreneur King said (2008). Equity financing isn't for everyone, but it does provide a welcome alternative to debt financing for many business owners. In fact, equity financing cannot be charged with the two biggest gripes business owners level against debt financing: the constraint it places on available cash flow and the risk associated with personally guaranteeing a loan.

2.3.3 Both equity and dept finance

Usually, debt finance is less expensive for the company according for the equity finance because lenders require lower rate of return than ordinary shareholders. Due to the fixed and prior claims on the annual cash flow and liquidation debt present a lower risk than shares for the finance providers(Arnold, 2008). Additionally, in many cases there are securities provided and covenants included to further decrease the risk for the creditors (Arnold, 2008) . In contrast to interest payments on debt, dividend payments to the holders of ordinary shares do not reduce the company's taxable profit. The lower corporate tax bill also reduces the effective cost of debt compared to the cost of equity. The administrative and issuing costs of debt are lower than for ordinary shares (Pike and Neale, 2006).However, debt finance increases the risk of bankruptcy because the company is legally obligated to pay the agreed interest irrespective of whether or not the company is profitable (Pfeil, 2002).This exposes the shareholders to risk additional to the inherent business risk of the trading activities. In conclusion, debt is beneficial because of its relatively low costs but there are limits to the excessive use of leverage (Pike and Neale, 2006).

4.5 Research Results and Findings

The study investigates the effects of equity finance on firms financial performance. Table 4.9 summarizes respondents' level of agreement on how equity finance affect firms financial performance. Most of the respondents agreed that There is a strong relationship between Equity finance and firms financial performance and coherent as shown by a mean of 2.96. Most of the respondents also agreed that the Equity finance increases the firm's financial performance, reporting a mean of 3.15.

4.9 Equity finance

	N	Mean	Std. Deviation
There is a strong relationship between Equity finance and firms financial performance	81	2.96	1.470
Firms get good return when they are making equity finance only	81	2.99	1.479
Equity finance increases the firm's financial performance	81	3.15	1.352
The best decision of finance is when the firms makes equity finance	81	3.15	1.433

4.5.2 Debt finance

The study also assessed the effects of debt finance on firms financial performance. From the findings indicated in table 4.10 most of the respondents agreed that There is strong relationship between debt finance and firms financial performance mean of 2.83 being obtained. And also findings shows that the respondents agreed that the Firms get good return when they are making

dept finance only with mean of 3.11. and lastly the majority of the respondents agreed that there is a positive effect in a debt finance and firms financial performance.

Table 4.10 Debt finance

	N	Mean	Std. Deviation
There is no impact on firm's financial performance with making more dept finance	81	2.99	1.240
Firms get good return when they are making dept finance only	81	3.11	1.387
Dept finance decreases the firm's financial performance	81	3.04	1.209
There is strong relationship between debt finance and firms financial performance	81	2.83	1.233

4.5.3 Optimal capital structure

The study investigates the effects of optimal capital structure on firms financial performance. Table 4.11 summarizes respondents' level of agreement on how optimal capital structure affect firms financial performance. Most of the respondents agreed that The most firms prefer the mixture of capital structure as a finance source as shown by a mean of 2.73. Most of the respondents also agreed that There is effect of optimal capital structure on firms financial performance indicating a mean of 2.81. The results of the study shows that the optimal capital structure plays crucial role in a firms financial performance.

Table 4.11 Optimal capital structure

	N	Mean	Std. Deviation
most firms prefer the mixture of capital structure as a finance source	81	2.73	1.432
The optimal capital structure is the best method of source of finance	81	3.11	1.414
There is effect of optimal capital structure on firms financial performance	81	2.81	1.266

The purpose of optimal structure is to maximizes the value and financial performance of the firms	81	3.04	1.436

4.5.4 Firms financial performance

The study investigates and asked the respondents the measurement of firms financial performance. Table 4.12 shows respondents' level of agreement on how to measure firms financial performance. Most of the respondents agreed that The best method of measuring financial performance is to calculate return on assets as shown by a mean of 3.30. Most of the respondents also agreed that The measurement of performance of the business must give an indication of how wealthier the shareholder indicating a mean of 3.19

Table 4.12 Firms financial performance

	N	Mean	Std. Deviation
The best method of measuring financial performance is to calculate return on assets	81	3.30	1.436
There is strong relationship between capital structure and	81	3.30	1.229

financial performance of the firms			
The optimum capital structure maximizes shareholder wealth, as a result of the return investment	81	3.26	1.358
The measurement of performance of the business must give an indication of how wealthier the shareholder	81	3.19	1.343

4.6 Regression analysis

According this study a multiple regression analysis was conducted to evaluate or test the effect of capital structure on firms financial performance on commercial banks in Mogadishu, Somalia. The study was used statistical package for social sciences (SPSS V 20) to compute the measurements of the multiple regressions.

4.6.1 Model summery

Adjusted R^2 squared is coefficient of determination which indicates the variation in the dependent variables due to change in the independent variables. From the findings in the table 4.13 the value of adjusted R squared is 0.383 and indicates that there was variation of 38.3% 61.7% on firms financial

performance of commercial banks in Mogadishu Somalia due to changes in equity finance, debt finance and optimal capital structure at 80% confidence interval. This shows the significant that 38.3% of the variations in the financial performance of commercial banks in Mogadishu Somalia are accounted for by the variations in the independent variables and the remaining 38.3% are accounted by other factors contained in the standard error. R is the correlation coefficient which shows the relationship between the study variables. From the findings shown in the table above there was a strongly positive relationship between the study variables as shown by 0.637

Table 4.13 Model summery

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.637[a]	.406	.383	.57030

5.2 Summary of the findings

The main objective of the study was to establish the variables of equity finance, debt finance, optimal capital structure on effect on firms financial performance in the commercial banks in Mogadishu- Somalia**.**

5.2.1 Equity finance

The first objective of the study was to investigate equity finance influences in firms financial performance in commercial banks in Mogadishu- Somalia. Results indicates that equity finance significant effect on firms financial performance in commercial banks in Mogadishu Somalia.

The study findings indicated that there was a positive relationship (R= 0.637) between the variables. A unit increases in equity finance would lead to increase in the firm's financial performance of commercial banks in Mogadishu by a factor of 0.445. Equity eliminates the disadvantages of debt in that it does not divert capital from the business in order to pay down debt, and it also shares in the business risk along with the entrepreneur King said (2008). Equity financing isn't for everyone, but it does provide a welcome alternative to debt financing for many business owners. In fact, equity financing cannot be charged with the two biggest gripes business owners level against debt financing: the constraint it places on available cash flow and the risk associated with personally guaranteeing a loan.

5.2.2 Debt finance

The second objective of the study was to investigate debt finance influences in firms financial performance in commercial banks in Mogadishu- Somalia. Results indicates that debt finance significant effect on firms financial performance in commercial banks in Mogadishu Somalia. The study findings indicated that there was a positive relationship between the debt finance and firms financial performance. A unit increases in debt finance would lead to increase in the firm's financial performance of commercial banks in Mogadishu by a factor of 0.215 and a unit change in optimal capital structure would lead to increase in the financial performance of commercial banks in Mogadishu by a factor of 0.098. The simplest way to assess whether borrowing has increased the return on equity is to contrast the return on the investment with the loan interest rate. When the return is higher than the loan interest rate, there is positive leverage (that is the return on equity increases as more is borrowed, Rowland (2002)

5.2.3 Optimal capital structure

The third objective of the study is to investigate the effect of optimal capital structure on firms financial performance in commercial banks in Mogadishu Somalia. The result shows that the is a influence of optimal capital structure on firms financial performance. A unit change in optimal capital structure would lead to increase in the financial performance of commercial banks in Mogadishu by a factor of 0.098. The administrative and issuing costs of debt are lower than for ordinary shares (Pike and Neale, 2006). However, debt finance increases the risk of bankruptcy because the company is legally obligated to pay the agreed interest irrespective of whether or not the company is profitable (Pfeil, 2002). This exposes the shareholders to risk additional to the inherent business risk of the trading activities. In conclusion, debt is beneficial because of its relatively low costs but there are limits to the excessive use of leverage (Pike and Neale, 2006)

5.3 Conclusions

The general objective of this study was to establish the impact of Capital Structure on firms financial performance in a commercial banks in Mogadishu Somalia. To achieve the objective of the study secondary data was used in this study. Data was collected by the review of documents, annual reports of the sampled companies published books. The study findings indicated that there was a strong positive relationship (R= 0.637) between the variables. The study also revealed that 61.7.0% of capital structure can be explained by the independent variables. From the study findings it was conclude that equity finance, debt finance, optimal capital structure had a strong positive relationship on firms financial performance in a commercial banks in Mogadishu Somalia because there was evident that at 100% confidence level.

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