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ABSTRACT

This studyexamined the effect of capital structure on corporate performance withreference to selected companies in Onitsha, Questionnaires and interviews wereused to collect information from the selected companies in Onitsha, AnambraState. Analysis and observations weremade which gave rise to the validity of the conclusion at the end of theanalysis, the major finding were:

1.*That these is a relationshipbetween capital structure and cost of capital.*

2.*That capital structure havesignificant effect on corporate performance (in terms of profitability)*

3.*That there is a high cost ofcapital which hinders the companies borrowing ability.*

Therecommendations for the study among others were:

1.*That companies shouldincrease their efficiency in use of debt capital.*

2.*That since cost of borrowingis so high, if a firm should be able to service fixed charges associated withsenior securities and leasing, it can borrow.*

3.*That for improvedperformance mostly on profitability, the optimum combination of fund from varyingsources which is superior to any alternative combination is necessary.*

Theresearchers then concludes that:

1.*The inability of manycompanies to adopt optimal capital structure has been increasing their cost ofcapital.*

2.*Due to increase in the costof capital for may firms, they were unable to borrow in order to meet up theircapital investment hence the decrease in their performance mostly onprofitability.*

3.*The optimal capitalstructure is one in which the marginal real cost (the sum of both explicit andthe implicit costs) of each available method of financing is the same.*

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CHAPTER ONE

1.1 GENERAL INTRODUCTION

A Corporation, Private or Public need capital toenable it achieves its objectives.Capital structure implies the nature and proportion of elements, whichgo to make up the capital invested in a business corporations that are in needof funds exchange their financial instruments for the money provided by theintermediaries or direct from savers.This money the corporations convert to tangible assets as building,land, plant and machinery, motor vehicles etc.Basically, a corporation uses three main sources of long term andpermanent financing viz: common stock, preferred stock and debt financing(bond). It is the combination

of thesefinances to particular firm that is termed capital structure.
There is need for reasonable balance of differenttypes of securities comprising the capital structure of a firm otherwise thefirm will deplete its financing ability or finance at sub optimal cost. In achieving this, the cost of capital isimportant for it has a major impact on the investment decision and thefinancing structure of the firm of which affect the riskiness and size of thefirm. Specifically, the issue has beenon whether or not financial leverage effects the firm's cost of capital, itsvalue and profitability, hence its corporate performance.
Two major schools of thought (the Traditionalist andModigliani Miller) extreme views on theissues in question have been among those involved in the arguments. According to Modigliani and Miller, in theirproposition which states that "the market value of any firm is independent ofits capital structure and is obtained by discounting its expected return at arate appropriate to its risk class"1 in their proposition 2 however, itstates that the cost of equity is equal to the cost of capital of an unleveredfirm plus the after-tax difference between the cost of an unlevered firm andthe cost of debt weighted by the leverage ratio2. Their long standing and unresolved oppositeviews have become so controversial that it has led many into concluding thatthe literature is marked by serious confusion and contradictions. This particular notion is manifested in thewords of LINTER "the decision rule which have been proposed for determining theoptimal capital structure and reliance on different sources of financing aremutually in-consistent, in the sense that they have led to often substantiallydifferent decision under given sets of circumstance"3.
We are concerned with whether the way in whichinvestment proposals are financed matters; and if it does matter, what is theoptimal capital structure. If we financewith one mix of securities rather than another is the value of the firmaffected? This study will be guide by the definition, which sees capitalstructure as the interrelationships among long term dept, preference share andnet worth (ordinary share capital plus reserves and surplus).
Finally, this study will ask some staff or selectedcompanies in Onitsha, Anambra State how effective and they think their capitalstructure have been and what has been the effects on the corporate performance.

SOURCESOF CAPITAL

This concern on how company or companies can raisethe capital they need for their operations.These ways can be broadly classified into internal and external sources.

A. INTERNAL SOURCE OF CAPITAL

An existing business can raise its capital asset bywithholding some part of the revenue it has generated. Such internally generated capital can takeone of several forms.

i. Depreciation Capital

Depreciation capital can be created that meanskeeping some of the earnings aside as provision for capital consumption duringthe process of production. This amountcan rightly be regarded as a cost item since it compensation for the part ofthe fixed equipment that is being lost during use.
The inability to make allowance for thisdepreciation has led to the failure of businesses after take off. Once a damaged key component of the capitalequipment cannot be replaced, the

production process is stopped.

ii. Ploughing Back Profit

Some part of the profit made by the businesses iskept back in the business instead of sharing it out as dividend or personalincome to the owners. Such ploughed backfunds are alternatively called retained earnings or undistributed corporateprofits in the case of corporate bodies.When this is done, it means that the operation of the business can beexpanded without involving it in any debt.The risk of liquidating the enterprise is reduced.

B. EXTERNAL SOURCES OF CAPITAL

Funds are raised from external bodies and can bedone in one of several ways again. Thesebodies may not have any ownership relationship with the business before. Alternatively, those that were part ownersmay add more to their original combination. Examples of such external sources are discussed below.

i. Bonds and Debentures

Bonds like debenture and mortgages can be sold tothose external agencies that care to buy. Interest on those bunds are calculated as cost for the purpose oftaxation. Therefore before profits canbe declared for tax to be imposed, the amount of interest paid must have beendeducted.

These bond holders lay claim on the assets of thebusiness first before the shareholders in case of liquidation.

ii. Issuance and Sale of PreferredStocks

This class of shares can be sold to new persons thatwere never part of the previous ownership.Such shares might as well be bought more by previous part owners whomerely wish to increase their shareholding.Holders of preferred stocks are paid dividends before the common stockholders. But they cannot be served untilthe creditors have been settled.

iii. Issuance of New Common Stocks

New shares of common stocks or ordinary shares orequity shares can be declared and sold to either existing shareholders or newones. This is the last group to benefitfrom the earnings of the business.

iv. Direct Loans

Direct Loans can be syndicated from various types offinancial institutions or individual moneylenders. They earn interest on the amount lent out anddo not qualify to have a share of the profit.

These creditors can force the business toliquidation when the loans cannot be settled as agreed. A court of law will declare the business arenew exposed to public auction in an attempt to settle the debts owed.

v. Grants and Aids

Governments and non-governmental organizations canasset businesses with nominal or real capital in support of the productionefforts. This source of capital is theonly one that does not involve the firms concerned in direct costs. The donor agency bears the full cost of suchassistance. It is not a debt on therecipient.

1.2 STATEMENT OF THE PROBLEM

The use of debt as part of the capital of a businesscould either help or worsen the situation of a firm depending on how well thedebt was used. Generally, long-termborrowing is required for purchase of new fixed assets or expansion ofproduction capacity. Equally, a firm mayuse its retained earnings, which is shareholders money or raise more moneywithin the organization through the issue of new shares. If loan credit is morethan equity capital (owner’s fund) it is wrong and risky because this willincrease the probability of bankruptcy. On the other hand, corporations need to borrow for its expansion andgrowth. But as usual, the choice of capitalstructure of a firm in the financing of capital projects determines to a largeextent the value, profitability and risk of a firm to its shareholders.

Therefore, the study wants to seek answers to thefollowing questions.

1. If a firm is financed with one mix of securities rather than another,is the value of the firm affected?
2. Does it matter, the way in which investment proposals are financed?
3. Does capital structure have anyeffect on corporate performance?
4. What is the optimal capital structure for a firm?
5. How may corporation establish proper capital mix?

1.3 PURPOSE OF THE STUDY

1. The researcher want to find out what happens to the total valuation ofthe firm and to its cost of capital which the ratio of debt to equity, ordegree of leverge is varied.
2. To determine whether companies in Onitsha have been adopting adequatecapital mix
3. To identify problems affecting or that have been hindering companiesfrom adopting an adequate capital structure and suggest possible solutions.

1.4 RESEARCH HYPOTHESIS

In evaluating this research work, we postulate thefollowing hypothesis in determining the effect of capital structure oncorporate performance. The hypothesisare formulated in both: Null Hypothesis (H0) and Alternative Hypothesis (H1)

1. H0: Capital structure does not have significant effect oncorporate performance.

   H1: Capital structure has significanteffect on corporate performance.

2. H0: Equity financing does not increase thevalue of the firm more than debt financing.

   H1: Equityfinancing increase the value of the firm more than debt financing.

3. H0: A corporation should not avoid the useof debt as part of its capital.

   H1: A Corporation should avoid the use ofdebt as part of its capital.

4. H0: Weighted average cost of capital isnot an aid to determine proper capital mix.

   H1: Weighted average cost of capital is anaid to determining proper capital mix.

1.5 SIGNIFICANCE OF THE STUDY

It is important to point out that on completion ofthis work by the researcher, it would be of

immense significance to thefollowing:

RESEARCHERS: Other researchers on the same or similartopic would find this work helpful as it will form a base of review of relatedliterature and also a stepping-shine for future researchers.

ECONOMY: This work will help toimprove the national output and thereby national income. This is because of improvement in theefficiency and effectiveness of the operations as well as the over all successof companies, which will be achieved through adequate utilization andmanagement of capital structure as prescribed by the researcher.

CORPORATION: Thestandard of corporations will be increased as a result of the knowledgeacquired from this research work.

MANAGEMENT: This efficiency of themanagement would be recognized as a result of their knowledge on how adequatecapital mix could be achieved.

SHAREHOLDERS: The wealth of theshareholders will be maximized due to efficiency of management.

1.6 SCOPE AND LIMITATION

SCOPE:

The study will be based on “effect of capitalstructure on corporate performance”. Theresearcher will restrict his work to selected companies in Onitsha AnambraState.

Any other reference to materials, place, items,activities, periods is just for purpose of clarity and vivid under standing ofthe topic and not within the scope.

LIMITATIONS:

The following constraints faced the researcher andlimited his efforts in elaborating the research work.

FINANCE: The researcher is a fulltime student and has been discouraged from traveling to or visiting all thecompanies in Onitsha to collect data for her study due to lack of fund. She has therefore chosen very few companiesbecause of proximity and ease of contact to the management.

TIME: This project work has justfew weeks time.

LIMIT: It would have been desiredfor a longer time to exhaust the topic and extend the coverage but it was notpossible. A minimum of six months couldhave been appreciated.

PRESSUREOF ACADEMIC WORK: Theresearcher have been hindered by pressure of academic work from achieving theextensive research this work should have deserved.

1.7 DEFINITION OF TERMS

~~**Corporation:**~~ A corporation is anassociation of persons or a group of persons set up by law and authorized toact as individual person which is invested with perpetual succession.

~~**Capitalstructure:**~~ Capital structure implies the nature and proportion of element, whichgo to make up the capital invested in a business.

~~**Costof Capital:**~~ This is the rate of return that must be achieved from an investment tosatisfy the investors required rate of return.

~~**Financing:**~~ Is the act of issuance ofdistribution of and purchase of liability and equity claims issued for thepurpose of generating revenue producing assets.

~~**FinancialLeverage:**~~ This is a measure of the proportion of debt capital present in thecapital structure of the firm.

~~**Risk:**~~ This is variability of afirm's returns.

~~**CommonStock:**~~ Is the cushion on which debt is acquired by a corporation and has nomaturity date.

~~**PreferredStock:**~~ Is a hybrid security that haspreference over common stock with respect to dividend and sharing in assets.

~~**Debt**~~: Payment which must be, buthas not yet been paid to somebody.

1.8 REFERENCES

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2. Modigliani and Miller, (1968); The cost of capital corporation financeand theory of investment, Arch or and D' Ambosio p. 425.
3. Ibid: p426
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