
Equity Financing and Value of Quoted Small and Medium Scale Enterprises: Empirical Investigation of MM Preposition in Nigeria

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Abstract

This study examined the relationship between equity financing and market value of quoted small and medium scale enterprises in Nigeria. The objective was to test the preposition of Modigliani and Miller on capital structure irrelevance. Secondary data obtained from financial statement of 10 quoted small and medium scale enterprises from 2009 – 2018. Market value was modeled as the function of retained earnings, equity capital to total capital ratio, equity capital to total assets ratio and share capital. Panel data methods were employed while the fixed and random effects models were used as estimation technique at 5% level of significance. Fixed effects, random effects and pooled estimates were tested while the Hausman test was used to determine the best fit. Panel unit roots and panel cointegration analysis were conducted on the study. The study found that retained earnings, share capital, equity to total capital ratio and equity capital to total assets ratio account for 31.2 percent variation in the market value of the quoted SMEs. The panel unit root test proved that all the variables are stationary at first differences and conclude that the variables are integrated in the order of 1(I). The cointegration test justifies the presence of long run relationship between debt capital and enterprise value within the periods covered in this study. The Granger causality test indicated no causality of among the variables in the model. From the findings, the study concludes that there is no significant relationship between equity to total capital ratio and market value of quoted SMEs in Nigeria. There is significant relationship between retained earnings and net book value of quoted SMEs market value in Nigeria, there is significant relationship between share capital and net book value of quoted SMEs value in Nigeria, there is no significant relationship between equity to total capital ratio and net book value of quoted SMEs market value in Nigeria and that there is no significant relationship between equity to total capital ratio and net book value of quoted SMEs market value in Nigeria. The study recommends that the management of the SMEs should work very hard to optimize the capital structure in order to increase the returns on equity and assets. They can do that through ensuring that their capital structure is optimal.

Keywords: *Equity Financing, Market Value, Quoted Small and Medium Scale Enterprises, MM Preposition*

Introduction

The need to provide accessible windows for financing small businesses in a sustained manner has not gone unnoticed by government, beginning with structural, institutional and policy reforms to ensure cheaper sources of capital that will enhance corporate investment and realize economic growth as well as full employment. For instance, the establishment of Second Tier Securities Market in 1985, and the commencement of Alternatives Security Market or emerging companies markets, was to provide soft requirements for small businesses in the securities market (Dagogo and Imegi, 2017). The traditional capital structure theory, prior to 1958 was based on the idea of weighted average cost of capital principle, which states that companies issue debt in order to reduce their weighted average cost of capital as debt is considered less costly than equity (Prace, 2004). The Pecking theory which was developed by Steward Myers in 1984 in his paper, “Capital Structure Puzzle” presented two sides of the capital structure issue, which are called static trade-off theory and pecking order hypothesis. The static trade-off theory holds that the capital structure choices may be explained by the trade-off between benefits and costs of debt versus equity. A firm is regarded as setting a target debt level and gradually moving towards it.

Equity unlike long-term debt includes paid-up capital, share-premium, reserves and surplus or retained earnings. Igben (2004) defines paid-up capital as the portion of called-up capital which has been paid-up by shareholders. He defined reserves as the amount set aside out of profit earned by the company, which are not designed to meet any liability, contingency, commitment or reduction in value of assets known to exist in the balance sheet. Furthermore, reserves may be voluntarily created by directors or statutorily required by law. Share premium is the excess amount derived from the issue of shares at a price that is above its par value. And finally, retained earnings are profit invested back into the business in order to create more resources for operations and invariably increase the value of the firm. The role of behavioral finance in explaining the existence of capital structure is debated as a matter of academic dispute. When appraising the relevance and the theoretical understanding of the theories, the theories seem very appealing but failed to explain the real relationship between capital structure and corporate performance of the firms mostly in the developing countries where the financial market and the business environment is not properly regulated or deregulated.

Capital structure not only influences the return a company earns for its shareholders, but also whether the firm survives less fortunate economic shocks. Hence, capital structure is imperative for a firm's survival and growth, as it plays a primary role in its financial performance in order to achieve its long-term goals and objectives. Therefore it is important to examine how trade off theory and capital structure affects enterprise value in a developing financial market like Nigeria.

Empirical studies on the effects of capital structure on corporate value has well been documented in literature, findings of the studies further deepened the controversies as some studies found positive relationship that validate the relevance theory of Gordons (Chen et al., 2004, Tang and Yang, 2007, Ebaid, 2009, Agarwal & Zhao 2007, Tongking 2012) while others found negative relationship that validate the opinion of Miller and Modigliani,(1958) (Onalapo & Kojala, 2010, Park & Tang, 2013, Mustapha et al., 2011, Mitani 2014, Al-Taani 2013).

Despite the variety of studies in this area, there are limited studies conducted in the entrepreneur firms for a period of ten (10) years and measuring value as the average price of shares as most of the studies used only the value as at last day of the year. This approach is inappropriate because investors react to corporate outcomes, which is reflected in the prices of shares, when the news becomes available. Thus, measuring market value as the share price only at the end of the financial year will not give a true picture of the relationship between capital structure and enterprises value. The effect of capital structure on the value large firms are well examined but the effect of capital structure on the value of entrepreneur is lacking in literature, therefore this study examine the effect of capital structure and market value of quoted small and medium scale enterprises in Nigeria.

Literature Review

Capital Structure

Capital structure refers to the different options used by firm in financing its assets (Bhamra, Fisher and Kuehn, 2011). Generally, a firm can go for different levels/mixes of debts, equity, or other financial arrangements. The foundation for theories and research focus on the subject of capital structure began with the introduction of Modigliani and Miller's theoretical model about corporate capital structure in 1958 which is considered to have created the turning point for modern corporate finance theory. The theory provides insight into a firm's capital structure decision in a capital market free of taxes, transaction costs, and other frictions. Following Modigliani

and Miller (1958), most theories such as the Pecking Order Theory, Agency Theory and Trade off Theory have sought to explain capital structure by introducing frictions omitted in the original Modigliani and Miller framework. According to Myers (2001) there is no universal theory of the debt-equity choice, and no reason to expect one. However, there are several useful theories as identified earlier each of which helps to understand the debt-to-equity structure that firms choose. These theories can be divided into two groups -either they predict the existence of the optimal debt-equity ratio for each firm (so-called static trade-off models) or they declare that there is no well-defined target capital structure (pecking-order hypothesis).

Equity Capital

Pandey (1999) defined equity capital as including share-capital, share premium, reserves and surpluses (retained earnings). Typically, equity capital consists of two types which include: contributed capital, which is the money that was originally invested in the business in exchange for shares of stock or ownership and retained earnings, which represents profits from past years that have been kept by the company and used to strengthen the statement of financial position or fund growth, acquisitions, or expansion. Generally, equity strategies are defined as dividend cuts or omissions and equity issues. Firms mostly accept this solution to maintain liquidity to conserve for debt obligations as well as raising funds in purpose of new investment and increase working capital.

Equity finance refers to the sale of an ownership interest to raise funds for business purposes. In order to grow, any company will face the need for additional capital, which it may try to obtain through debt or equity. If the company opts for equity, the owner sells a stake to others. During early growth stages of Company, especially when the company does not have sufficient equity financing can provide capital from investors who are willing to take risks along with the entrepreneur (Berger & Udell, 1998). Similarly, when accompany has prospects of explosive growth, it can raise substantial capital through equity financing. Various types of equity financing are available. Equity investors may combine equity with convertible debt or straight debt. This is done either as a form of extended due diligence, or to meet cash flow requirements while limiting dilution of the principal owner's shareholding. Equity finance represents ownership capital, as equity shareholders collectively own the company. They enjoy the rewards in the form of residual dividends as well as bear the risks of ownership. However their liability is limited to their capital contributions. With reference to a firm with performance or financial distress, a cutting dividend or dividend omission is normally executed. Another aspect of capital structure is for companies to buy back previously issued equity using debt financing. This would be accomplished by taking out a business, commercial, or bank loan in the amount of the equity buyback. In some cases, a company may have a capital structure heavily weighted towards equity. In such cases, buying back previously issued stock and substituting bank loans or other debt financing can optimize the capital structure resulting in a lower overall cost of capital.

Retained Earnings

Retained earnings constitute the sum total of those profits which have been realized over the years since incorporation and which has been reinvested in the business rather than distributed in the form of dividends. These earnings stand to the credit of equity shareholders and the shareholders equity therefore includes them. The process of creating internal savings and their utilization in business is referred to as ploughing back of profits. The dividend decision in a firm is taken in the light of the

firm's operating and financial conditions. Choosing a dividend policy which best suits the existing conditions are not only an important decision but also has significant consequences for a company. The disposal of net income is governed by many considerations.

Corporate Value

Corporate value is a measure of a company's total value. It looks at the entire market value rather than just the equity value, so all ownership interests and asset claims from both debt and equity are included. Corporate value can be thought of as the effective cost of buying a company or the theoretical price of a target company (before a takeover premium is considered). The value of the company can be derived from the assets it owns. However, obtaining the market value of each and every asset can be quite tedious and difficult. What we could do instead is look at how the assets have been paid for. The simple accounting equation can serve as a guide by looking at assets as the application of funds and both liabilities and shareholders' equity as the sources of funds used to finance those assets (Cheng and Tzeng, 2011). Corporate value means current or market value of the company, so it's the market value of liabilities and the market value of equity that we consider. The corporate value represents the right to buy a firm's core cash flow; it's the acquisition cost of the firm. As such, it must incorporate not just the market capitalization but also the net debt and all claims pertaining to preferred stock and non-controlling minority interests as well. The non-operating assets (net cash balances) that do not contribute to the day-to-day-operations of the firm need to be deducted. One method of predicting the enterprise value is based upon the projection of expected future after-tax cash flows, after taking into account investments in capital assets and net working capital. It's treated as a perpetuity that grows at a constant growth rate and is discounted at a weighted average cost of capital

Corporate value metric allows an equity investor to assess the firm on the same basis as an acquirer in a merger-acquisition transaction (Chowdhury and Chowdhury, 2010). The ideal situation would be to find a call option that is similar to the investment so that the value of the option would tell the investor something about the value of the opportunity at hand (Luehrman, 1998). The corporate value can be viewed as a takeover price where the acquirer accepts the debt obligations of the firm but is also entitled to its cash inflows; the net balance of debt or the value of claims on the firm's cash flow becomes the strike price of the Enterprise value option. The mapping of the investment opportunity on the call option leads to the following call option value rule.

Theoretical Review - Irrelevance Theory

Modigliani and Miller (1958) propounded the capital structure theory, in the field of investment, where the capital structure represents the mix of debt and equity used by firms to finance long-term investment. Debt is the component of capital loaned by other parties or investors and subject to repayment (Serrasqueiro et al., 2016). Serrasqueiro et al. (2016) examined the capital structure decisions of high-tech SMEs and non-high-tech SMEs in Portugal. The outcome of the study revealed that information asymmetry has an impact on the relationships between SMEs and creditors on capital structure decisions of service and manufacturing SMEs (Serrasqueiro et al., 2016). Small businesses rely on internal sources for financing business projects (Daskalakis et al., 2014; Foo, Jamal, Karim, & Ulum, 2015; Serrasqueiro et al., 2016). The internal sources of funding constrain SMEs' ability to finance big projects (Daskalakis et al., 2014).

The capital structure theory led the most dominant discourse in corporate finance (Foo et al., 2015; Serrasqueiro et al., 2016). Modigliani and Miller (1958) set the stage for succeeding scholars on investment choices where current markets are immaterial (Serrasqueiro et al., 2016). The capital structure theory led to vigorous debates in areas of corporate finance and academics (Serrasqueiro et al., 2016). Despite the diversity of the capital structure literature, relatively few scholars have explored the financing decisions of SMEs (Foo et al., 2015; Serrasqueiro et al., 2016). Most of these researchers have ignored the uniqueness of SMEs, which represent most of activities contributing to gross domestic product (GDP) and employment in most countries (Foo et al., 2015). One possible explanation for the limited research is that SME data are often insufficient and sometimes inaccurate because of private ownership, and owners may not disclose information (Foo et al., 2015; Serrasqueiro et al., 2016). The proponents of the capital structure theory simplified the procedure for companies but did not adequately describe the opportunities available to small businesses, thereby offering limited advice on capital choices to small enterprises (Foo et al., 2015; Serrasqueiro et al., 2016).

The main propositions of the MM theorem are:

- **Proposition I:** the market value of any firm is independent of its capital structure.
- **Proposition II:** the rate of return on equity grows linearly with the debt ratio.
- **Proposition III:** the market value of any firm is independent of its dividend policy.

Proposition I: the irrelevance of capital structure

The MM theorem demonstrates that in a perfect market firms cannot benefit from changes in their capital structure. It is assumed that:

- 1) Two identical companies choose a different capital structure;
- 2) There are only two ways of financing the business: either through equity or bond issuance;
- 3) The cost of borrowing money is the same for individual investors and companies;
- 4) Profits are perpetuities, as firms do not invest;
- 5) Information is perfect and costless;
- 6) There are no transaction costs or income taxes;
- 7) Agency costs are not considered, thus there is no conflict of interest between management and shareholders.

To better understand the theorem, the following demonstration assumes that the firm pays a proportional τ income tax. In fact, corporate taxation was introduced in a second version of the theorem, which was published in 1963.

To obtain the market value of the *unlevered firm* (U) – i.e. the firm which finances itself with equity only – one of the alternatives is to start from its net income, which is:

$$EBIt(1 - \tau) \tag{1}$$

From equation (3) it is possible to determine the firm's cash flow by adding the depreciation (Dep) accumulated in the same accounting period. According to the hypotheses, the firm does not make any new investment other than replacing the consumed assets, thus the investment (I) is equal to the depreciation. The free cash flow of the unlevered company (FCF_U) will then be:

$$FCF_U = EBIT(1 - \tau) + Dep - I = EBIT(1 - \tau) \quad (2)$$

This result demonstrates that when considering cash flows as perpetuities, the FCF_U is equal to the firm's $EBIT$ after taxes. If the cost of capital of the unlevered firm is defined as k_o , the company's present value will be:

$$V_U = \frac{FCF_U}{k_o} = \frac{EBIT(1 - \tau)}{k_o} \quad (3)$$

To calculate the value of the *levered firm* (L) – i.e. the firm which uses both debt and equity to finance its operations – it is necessary to identify the remuneration of both shareholders and bondholders. The cash flow attributable to the first group consists on the net profit (P) plus depreciation (Dep) minus the investments (I), while the remuneration to the second group is the bonds' interest rate (kd). The total free cash flow for the levered company ($FCFL$) is:

$$FCF_L = NP + Dep - I + k_d D = (EBIT - k_d D)(1 - \tau) + Dep - I + k_d D$$

$$FCF_L = EBIT(1 - \tau) + \tau k_d D \quad (4)$$

The first addendum of equation (4) is the cash flow generated by the unlevered firm. It is assumed that the risk for this component is the same for both companies (levered and unlevered) so its cost of capital will be equal to k_o . The second addendum embodies the tax shield which arises from the use of debt. As long as the company's profits remain constant over the years, it is possible to assume that the tax shield has the same risk as bonds' interest rate (kd). The levered company's present value will then be:

$$V_L = \frac{EBIT(1 - \tau)}{k_o} + \frac{\tau k_d D}{k_d} = \frac{EBIT(1 - \tau)}{k_o} + \tau D$$

$$V_L = V_U + \tau D$$

The levered firm's value is equal to the unlevered firm's value plus the present value of the tax shield. However, the original MM theorem does not include any market imperfections nor taxes ($\tau = 0$), therefore the proposition I of MM states that:

$$V_L = V_U \quad (6)$$

Proposition II: The Rate of Return on Equity

The proposition II of MM states that the rate of return on equity grows linearly with the debt ratio, as the equity risk increases with the increase of debt. According to the proposition I (when taxes are considered), it is possible to write the levered firm’s balance sheet as:

$$\begin{array}{ll}
 V_U(\text{unlevered firm's value}) & D \text{ (debt / bonds)} \\
 \tau D(\text{tax shield}) & E \text{ (equity)}
 \end{array}$$

The unlevered firm’s value does not include the benefit of financial leverage. When debt is increased to D , the firm value increases by τD . The expected cash flow from the left part of the balance sheet can be written as:

$$V_U k_o + \tau k_d D \tag{7}$$

As there is a risk connected to the firm’s real activities, their expected return is k_o . The tax shield has the same risk as the debt, thus its expected return is k_d . The expected cash flow for the bondholders and shareholders together is:

$$k_d D + k_e E \tag{8}$$

Equation (8) demonstrates that the expected return on equity is k_e , whereas the expected return on debt is equal to k_d . Since the model assumes that earnings are perpetuities and that there is no growth, flow to equity is entirely distributed as dividends. Consequently, (10) is equal to (9).

$$k_d D + k_e E = V_U k_o + \tau k_d D \tag{9}$$

Dividing both sides of equation (9) by E , subtracting $k_d D$ from sides and reorganizing, the result is:

$$k_e = \frac{V_U}{E} k_o - (1 - \tau) \frac{D}{E} k_d \tag{10}$$

Since the levered firm’s value (V_L) is equal to $V_U + \tau D = D + E$, the unlevered firm’s value is equal to $V_U = E + (1 - \tau) D$. As a result, the equation (12) can be written as:

$$k_e = \frac{E + (1 - \tau) D}{E} k_o - (1 - \tau) \frac{D}{E} k_d \tag{11}$$

Collecting the terms with $(1 - \tau) \times (D / E)$, we obtain the equation (12), which is the proposition II of MM theorem:

$$k_e = k_o + \frac{D}{E}(1 - \tau)(k_o - k_d) \quad (12)$$

When $\tau = 0$, the rate of return on equity of a levered company is equal to the rate of return on an unlevered firm's equity (k_o) plus a risk premium which depends on the company's debt ratio. Higher the debt ratio, higher the risk to the firm's shareholders, as the residual rights on the company's assets is subordinated to the right of debt owners to be paid before everybody else. Hence, the k_e required by the shareholders will also be higher.

If taxation is considered, there are some interesting implications. To understand them better, it is necessary to define the WACC (weighted average cost of capital), i.e. the rate that the firm is expected to pay on average to all its security holders to finance its assets. If $\tau = 0$, The WACC will be:

$$WACC = \frac{D}{D + E}k_d + \frac{E}{D + E}k_e \quad (13)$$

In a perfect market, the WACC is constant, and it is always equal to k_o . The equation (13) therefore confirms what said so far: the rate of return on the investment k_o does not change after an alteration of the capital structure. This result does not hold when taxation is included. As the debt is tax-advantaged if compared to equity, it is possible to demonstrate that the WACC of a levered firm declines with the increase of the debt ratio in a world with corporate taxation.

$$WACC = \frac{D}{D + E}k_d(1 - \tau) + \frac{E}{D + E}k_e \quad (14)$$

As debt is usually cheaper than equity, the theorem states that in a world with corporate taxation, an optimal capital structure does exist, and it is made by 100% of debt (and consequently 0% of equity).

Empirical Review

Sabrin, Sarita, TakdirabdSujono (2016) sought to know the impact created by firm's profitability on the value of manufacturing companies in Indonesia stock market. Secondary data was gathered from the publication in the Indonesia Stock Exchange (ISE) from year 2009 to 2014 where the many manufacturing companies were group as per sectors they serve. Return on assets (ROA), return on capital employed (ROCE), growth per earnings ratio (GPER) as metrics for the profitability and Tobin's Q s, Price per Earning Ratio (PER) and market to book value (MTBV) as measures for firm value. Sampling was done purposively by selecting all manufacturing companies that researchers deemed fit for inclusivity. Path analysis for the data revealed that profitability indeed has a role on the firm value. This could be said to be coming as result of regularity and signals sent by the act of paying dividend. The use of purposive sampling methods may be put into question due to subjectivity of the scholars that may results into a bias.

Chen and Chen (2011) researched on the influence of profitability on the firms listed in Taiwan. Return on assets was used as metric for profitability while firm value was taken to mean the market price per share at the end of the year. Taking financial data from year 2005 to 2009, 647 companies were selected for study after deleting incomplete data. Using multiple regression analysis, it was confirmed that profitability indeed has a positive effect on firm value. Together with this study also found that leverage negatively influence market value per stock, however, the researchers did not check model significance which this study will do.

Andawasatya, Indrawati and Aisjah (2017) investigated importance of profitability to the firm value through capital structure for the manufacturing companies in Indonesia stock market. Through the use of determined criteria, a total of 67 companies were selected for analysis. The results of mediating test showed that the capital structure is able to mediate the relationship between the profitability and firm size to firm value; beside that, it may not able to mediate the relationship between the growth opportunities for firm value.

Yang et al. (2010) proved that the greater is firm profitability, the more distributable earnings there are for shareholders, and thus the expected firm value will be higher. ROA shows the management efficiency of the enterprise's assets and is also a positive measure of firm value. Based on this, thus it can be hypothesis that profitability has a positive effect on firm value.

Efni (2017) sought to find the mediating effect of investment decision on corporate risk and value using companies listed in Indonesia. Data was gathered from analysis in company property and real estate sectors listed in Indonesia Stock Exchange for a period of 9 consecutive years starting 2001 and ending 2008 that have a complete financial report on the study period. This research study used descriptive analysis and inferential to prove examine the relationship between the study variables with the five structural models. Analyzing the patterns of relationships between variables, the company's risk and investment decisions it was found that they are able to increase the value of the company, while the dividend policy and funding decisions are not able to increase the value of the company. Originality from this research was from the use of companies in the property and real estate sector with specific criteria Indonesia and the data used in this study were secondary data in the form of financial statements. This information cannot then be applied in Kenyan situation thus need for further studies.

Chen and Chen (2011) investigated the influence of profitability on firm value and the moderating effect of firm size and capital structure. Panel research design was adopted and secondary data collected from annual financial statements of Taiwanese listed companies in 2005 to 2009. In this study firm size was operationalized as natural logarithms of total assets, profitability as return on assets, leverage as debt to equity ratio, and firm size as market price per share. Results of the study revealed that there was a positive and significant relationship between profitability and firm value. Leverage had inverse and significant influence on firm value. Firm size had positive and significant influence on firm value. Firm value an investigation on the relationship between capital structure and firm value of companies listed in NSE from 2009 to 2013 was brought forth by Kulati (2014). The study adopted descriptive research design and secondary data was collected from annual financial statements of 38 listed companies. Multiple regression analysis was applied to analyze the data. Results of the study revealed positive and significant relationship between firm value and

capital structure. Moreover, 65.4% of changes in firm value were accounted for by capital structure and firm size. Although, panel data was applied in the study, panel diagnostic tests were excluded from the study.

Literature Gap

The relationship between capital structure and enterprise value has well been documented in literature. Existing literature has focused more on the effect of the capital structure on corporate profitability. This study focused on the existing relationship between capital structure and market value of quoted small and medium scale enterprises.

Methodology

This study used quasi-experimental research design approach for the data analysis. This approach combines theoretical consideration (a prior criterion) with the empirical observation and extracts maximum information from the available data. It enables us therefore to observe the effects of explanatory variables on the dependent variables. In order to Test the MM prepositions, this study focused on Nigerian quoted small and medium scale enterprises, listed on stock exchange. The chosen time period is 2009 - 2019, which is a total 10 years. According Nigeria Stock Exchange reports 2019, there are 10 quoted small and medium scale trading in the second tier security market. Therefore the population of this study 10 quoted small and medium scale enterprises. Our original sample consisted of 10 quoted SMEs. All non - quoted Nigerian firms, are excluded, thus including these could mislead the results. The above the sample size of the study is the existing 10 quoted Nigerian SMEs. The reason for the sample size is for easy source and reliability of required data from the annual reports submitted to the exchange.

Model Specification

In order to achieve the objectives of this study and test of the hypotheses, a functional relationship in form of multiple linear regression model consisting of dependent and independent variables will be formulated. The regression models are presented as follows;

Trade-Off Variables

$$MV = \beta_0 + \beta_1 RE_{it} + \beta_2 ECTCR_{it} + \beta_3 ECTAR_{it} + \beta_4 SHC_{it} + \mu_{it} \quad (15)$$

Where

MV = Market value of the quoted SMEs

RE = Retained Earnings

ECTCR = Equity capital to total capital ratio

ECTAR = Equity capital to total assets ratio

SHC = Share capital

μ_{it} = Stochastic or disturbance/error term.

α_0 = Constant or intercept.

3.8 Methods of Data Analysis

The study used multiple regression defined as an equation with one dependent variable and more than one independent variables, the technique used in this study is the Ordinary Least Square (OLS) estimation technique. The test instruments in the OLS are the T-statistic and F-test which were used to test the significance of variables and the overall significance of the regression respectively. Other test instruments also employed were the Durbin Watson test which was used to test the presence or absence of auto correlation between and among the explanatory variables and the adjusted R square used to test the percentage variation of the dependent and the independent variables.

Pooled Regression

According to Brooks (2014) we started by testing pooled regression by using ordinary least squares (OLS) first as it is the simplest to do with panel data. This will lead to assumptions of no heterogeneity and no time-specificity, thus the disadvantage - the information is lost in time dimension and cross-section dimension.

Redundant Fixed Effect Test

The study used redundant fixed effect test, also called likelihood ratio test, to test whether the data can simply be pooled and estimated using a standard ordinary least squares regression model effects panel regression model can be employed (Brooks 2014). The study used exercise redundant fixed effect test by E-views, with the null hypothesis that a pooled sample can be employed.

Fixed Effects Model vs. Random Effects Model

Fixed effects models allow the intercept in the regression model to differ cross-sectionally but not over time, while all of the slope estimates are fixed both cross-sectionally and over time (Brooks, 2014). With time-fixed effects models, the average value of $y(i,t)$ is assumed to change over time but not cross-sectionally, hence the intercepts would be allowed to vary over time but be the same across entities at each given point in time (Brooks, 2014). Although fixed effects model is easy to apply, there are drawbacks. Gujarati (2004) argues that when introducing many dummy variables, the degrees of freedom would decrease. Problems with many dummy variables can also cause the possibility of multicollinearity to increase. With both entities fixed effects and time fixed effects, a model would contain both cross-sectional and time series dummies (Brooks, 2014).

Hausman Test

Since random effects model is invalid when heterogeneity exists, meaning that error term is correlated with explanatory variables, Hausman test is often used to test whether a variable can be treated as exogenous or whether that variable needs a separate structural equation. Hausman test refers to a test for whether a random effects approach to panel regression is valid or whether a fixed effects model is necessary (Brooks, 2014). We exercise Hausman test by E-views, with the null hypothesis that random effects model can be applied.

Table 1: Measurement of Variables and a-Priori Expectations

Variable	Measurement	Notation	Expected Relationship
Market value	Log of end of the year share trading price	MV	Dependent variable
Retained earnings	Log of Percentage of total capital	RE	+
Equity capital to total capital ratio	Log of Percentage of total capital ratio	ECTCR	+
Equity capital to total Assets ratio	Log of Percentage of total assets ratio	ECTAR	+
Share capital	Log of Percentage of total capital	SHC	+

Results and Discussion of Findings

Table 2: Analysis of Panel Unit Root

Method: Series: MV	Statistic	Prob.**	Cross-sections	Obs
Panel A: Panel unit root at levels				
Levin, Lin & Chu t*	-0.26937	0.3938	9	72
Im, Pesaran and Shin W-stat	1.46296	0.9283	8	64
ADF - Fisher Chi-square	7.29887	0.9671	8	64
PP - Fisher Chi-square	23.9910	0.0897	8	72
Series: RE				
Levin, Lin & Chu t*	-3.46856	0.0003	8	64
Im, Pesaran and Shin W-stat	0.04981	0.5199	8	64
ADF - Fisher Chi-square	15.0951	0.5177	8	64
PP - Fisher Chi-square	28.5628	0.0271	8	72
Series: SHC				
Levin, Lin & Chu t*	-0.15247	0.4394	8	64
Im, Pesaran and Shin W-stat	1.30109	0.9034	8	64
ADF - Fisher Chi-square	5.74498	0.9906	8	64
PP - Fisher Chi-square	20.9997	0.1785	8	72
Series: ECTCR				
Levin, Lin & Chu t*	-1.66234	0.0482	10	80

Im, Pesaran and Shin W-stat	-1.17269	0.1205	10	80
ADF - Fisher Chi-square	30.3187	0.0649	10	80
PP - Fisher Chi-square	59.4083	0.0000	10	90
Series: ECTAR				
Levin, Lin & Chu t*	-2.22349	0.0131	10	80
Im, Pesaran and Shin W-stat	-0.35039	0.3630	10	80
ADF - Fisher Chi-square	23.5576	0.2622	10	80
PP - Fisher Chi-square	39.8196	0.0053	10	90

Panel B: unit root at difference

Series: D(MV,2)				
Levin, Lin & Chu t*	-17.2049	0.0000	8	48
Im, Pesaran and Shin W-stat	-5.07219	0.0000	8	48
ADF - Fisher Chi-square	56.9027	0.0000	8	48
PP - Fisher Chi-square	79.9143	0.0000	8	56
Series: D(RE,2)				
Levin, Lin & Chu t*	-7.20202	0.0000	8	48
Im, Pesaran and Shin W-stat	-3.77823	0.0001	8	48
ADF - Fisher Chi-square	48.2963	0.0000	8	48
PP - Fisher Chi-square	117.585	0.0000	8	56
Series: D(SHC,2)				
Levin, Lin & Chu t*	-4.77261	0.0000	7	42
Im, Pesaran and Shin W-stat	-1.45440	0.0729	7	42
ADF - Fisher Chi-square	23.9731	0.0462	7	42
PP - Fisher Chi-square	60.6707	0.0000	5	35
Series: D(ECTCR)				
Levin, Lin & Chu t*	-0.97341	0.1652	10	70
Im, Pesaran and Shin W-stat	-11.3492	0.00060	10	70
ADF - Fisher Chi-square	31.9528	0.0438	10	70
PP - Fisher Chi-square	83.3569	0.0000	10	80
Series: D(ECTAR,2)				
Levin, Lin & Chu t*	-5.50894	0.0000	10	60
Im, Pesaran and Shin W-stat	-2.13829	0.0162	10	60
ADF - Fisher Chi-square	40.1006	0.0049	10	60
PP - Fisher Chi-square	119.153	0.0000	10	70

Source: Computed by Researchers from E-view 9.0

From the estimated model, the stud accepted the alternative hypothesis and rejected the null hypothesis for the following reasons. First and foremost, the output file of the results indicates that all the variables are the stationary first difference. This has an implication of the rejection of the null hypothesis and acceptance of the alternative hypothesis because of no significant trend yet availability of stationary data.

Table 3: Presentation of Regression Results

	Coefficient	Std. Error	t-Statistic	Prob.	Coefficient	Std. Error	t-Statistic	Prob.
	PANEL A: FIXED EFFECT MODEL				PANEL B: RANDOM EFFECT MODEL			
RE	0.014693	0.008654	1.697872	0.0931	0.014835	0.008371	1.772239	0.0796
SHC	0.104305	0.159940	0.652150	0.5160	0.007968	0.064166	0.124175	0.9014
ECTCR	-0.189849	0.131178	-1.447265	0.1515	-0.130418	0.122880	-1.061350	0.2912
ECTAR	0.085711	0.122169	0.701583	0.4848	0.098698	0.109708	0.899645	0.3706
C	-0.820349	1.116101	-0.735013	0.4643	-0.150057	0.473456	-0.316941	0.7520
R2	0.759288				0.552471			
Adj R2	0.722902				0.312575			
F-Stat	20.86722				4.315202			
F-prob	0.000000				0.000936			
DW	1.228507				1.123684			
	Cross-section random effects test comparisons							
RE	0.014693	0.014835	0.000005	0.9485				
SHC	0.104305	0.007968	0.021463	0.5108				
ECTCR	-0.189849	-0.130418	0.002108	0.1955				
ECTAR	0.085711	0.098698	0.002889	0.8091				
	Correlated Random Effects - Hausman Test							
Test Summary		Chi-Sq. Statistic	Chi-Sq. d.f.	Prob.				
Cross-section								
random		5.016557	4	0.2856				

Source: Computed by Researchers from E-view 9.0

Table 3 presents the result of Hausman test. The result shows the chi-square value of 5.016557 alongside the probability value of 0.2856 which implies that there is no enough evidence to reject the null hypothesis of random effect model is appropriate. From the foregoing, it thus stands that among the two estimators (fixed effect model and random effect model) used for analysis in this study, random effect estimates presented is most efficient and consistent estimate that can track the true nature of the nexus between capital structure and market value of the quoted small and medium scale enterprises.

The result of random effect estimation reveals that the adjusted R-squared (R^2) value is 0.312575 that is 31.2 percent implying that the independent variables such as retained earnings, share capital, equity to total capital ratio and equity capital to total assets ratio account for 31.2 percent variation in the market value of the quoted SMEs. However, the F-statistic value is 4.315202 and its p-value is 0.000936 indicating that the independent variables jointly can impact significantly in market value of the quoted SMEs. The Durbin-Watson reveals that there is no serial correlation in the variables.

Furthermore the beta coefficient of constant is negative with the value of -0.150057 and its p-value is 0.7520 indicating that when all the independent variables are held constant, there will be a negative variation up to the tune of 0.1 units in market value of the quoted SMEs and it is significant.

The coefficient value of retained earnings is 0.014835 and p-value is 0.0796 implying that retained earnings has a positive coefficient and not significant to influence market value of the quoted SMEs. The coefficient value of share capital is 0.007968 and its p-value is 0.9014 meaning that share capital is positive and not significant to impact on market value of the quoted SMEs, the coefficient value of equity capital ratio is -0.130418 and its p-value is 0.2912 meaning that equity ratio is negative and not significant to impact on market value of the quoted SMEs while the coefficient value of equity to total assets ratio is 0.098698 with p-value of 0.3706 implying that equity capital to total assets has positive impact on market value of the quoted SMEs but not significant. Furthermore, the Cross-section random effects test comparisons shows that there are significant differences between the fixed and the random effect models. The analysis above enables us to test for cointegration.

Table 4: Presentation of Cointegration Test

	<u>Statistic</u>	<u>Prob.</u>	<u>Weighted Statistic</u>	<u>Prob.</u>	
Panel v-Statistic	-16.12728	0.0000	-13.62344	0.9999	
Panel rho-Statistic	11.36101	0.0145	9.671693	0.0062	
Panel PP-Statistic	-7.862052	0.0000	-1.429861	0.0764	
Panel ADF-Statistic	-6.050464	0.0068	0.086065	0.5343	
	<u>Statistic</u>	<u>Prob.</u>			
Group rho-Statistic	9.588471	0.0098			
Group PP-Statistic	-1.590559	0.0559			
Group ADF-Statistic	1.491556	0.9321			
Cross section specific results					
Phillips-Peron results (non-parametric)					
Cross ID	AR(1)	Variance	HAC	Bandwidth	Obs
Afrik Pharmacuetical Plc		Dropped from Test			
Anino International Plc	-0.056	3.62E-23	1.39E-23	5.00	9
Capital Oil Plc	0.082	0.005417	0.001084	8.00	9
Chellarams Plc		Dropped from Test			
Juli Plc	-0.290	0.000149	0.000149	0.00	9
Mc Nichols Plc	-0.306	0.003725	0.000993	8.00	9

Omoluabi Mortgage Bank	0.457	0.006875	0.006875	0.00	9
Rak Unity Pet Coy Plc	-0.326	0.001281	0.001080	2.00	9
Smart Products Nig. Plc	Dropped from Test				
The Initiates Plc	-0.722	0.117323	0.037048	8.00	9
Augmented Dickey-Fuller results (parametric)					
Cross ID	AR(1)	Variance	Lag	Max lag	Obs
Afrik Pharmacuetical Plc	Dropped from Test				
Anino International Plc	-0.427	3.59E-23	1	--	8
Capital Oil Plc	-0.588	0.004055	1	--	8
Chellarams Plc	Dropped from Test				
Juli Plc	-0.253	0.000135	1	--	8
Mc Nichols Plc	-0.849	0.003435	1	--	8
Omoluabi Mortgage Bank	0.366	0.007583	1	--	8
Rak Unity Pet Coy Plc	-0.741	0.001299	1	--	8
Smart Products Nig. Plc	Dropped from Test				
The Initiates Plc	-1.456	0.111241	1	--	8

Source: Computed by Researchers from E-view 9.0

In this outcome result shows that probability value is more than 5%, meaning that we cannot reject the null hypothesis and six results shows that probability value is less than 5% meaning that we can reject the null hypothesis. Our null hypothesis is, there is no co-integration and the alternative hypothesis is there is co-integration. Here out of eleven corresponding probabilities, 10 can reject the null hypothesis meaning that majority can reject the null hypothesis. So we can take the decision that we should reject null hypothesis and can accept the alternative hypothesis meaning that our independent variables such as (capital structure) are co-integrated, meaning that they have long run associations. From the above results, we test for causality using Granger causality test.

Table 5: Presentation of Granger Causality Test

Null Hypothesis:	Obs	F-Statistic	Prob.
RE does not Granger Cause MV	80	0.78466	0.4600
MV does not Granger Cause RE		0.42358	0.6563
SHC does not Granger Cause MV	80	0.48547	0.6173
MV does not Granger Cause SHC		1.61608	0.2055
ECTCR does not Granger Cause MV	80	0.62996	0.5354
MV does not Granger Cause ECTCR		2.06704	0.1337
ECTAR does not Granger Cause MV	80	0.37637	0.6876
MV does not Granger Cause ECTAR		0.17527	0.8396

Source: Computed by Researchers from E-view 9.0

As summarized in Table 5 the results show that there is no causal relationship among the variables in the model. This means we accept the null hypothesis, the no causal relationship between the variables is contrary to the expectations of the stud and can bet traced to management financing policies.

Discussion of Findings

The regression results found that retained earnings have positive and significant relationship to market value of quoted SMEs such that a unit increase will lead to 0.1 percent increase on the market value of the quoted SMEs. This finding confirms our a-priori expectation based on the opinion of Gorrdon that capital structure is relevant and effect corporate values. The findings are contrary to the opinion of Modigliani and Miller (1958) which says that capital structure is irrelevant. The findings further validates reforms in the Nigeria financial market such as the deregulation of stocks prices in 1993 and the internationalization of the capital market with the introduction of Central Security Claraing System. It could be recalled that the deregulation of Nigeria financial market in the last quarter of 1986 was aimed at removing barriers to effective performance of the financial market and enhance easy source of capital to investors. The findings further confirm the tradeoff theory of capital structure.

The regression results found that equity to total equity capital ratio have negative and significant relationship to market value of quoted SMEs such that a unit increase will lead to 0.13 percent decrease on the market value of the quoted SMEs. This finding contradicts our a-priori expectation based on the opinion of Gorrdon that capital structure is relevant and effect corporate values. The findings are contrary to the opinion of Modigliani and Miller (1958) which says that capital structure is irrelevant. The findings further validates reforms in the Nigeria financial market such as the deregulation of stocks prices in 1993 and the internationalization of the capital market with the introduction of Central Security Clearing System. It could be recalled that the deregulation of Nigeria financial market in the last quarter of 1986 was aimed at removing barriers to effective performance of the financial market and enhance easy source of capital to investors. The findings further confirm the tradeoff theory of capital structure.

The regression results found that equity to total equity to total assets ratio have positive and significant relationship to market value of quoted SMEs such that a unit increase will lead to 0.9 percent increase on the market value of the quoted SMEs. This finding contradicts our a-priori expectation based on the opinion of Gordon that capital structure is relevant and effect corporate values. The findings are contrary to the opinion of Modigliani and Miller (1958) which says that capital structure is irrelevant. The findings further validates reforms in the Nigeria financial market such as the deregulation of stocks prices in 1993 and the internationalization of the capital market with the introduction of Central Security Clearing System. It could be recalled that the deregulation of Nigeria financial market in the last quarter of 1986 was aimed at removing barriers to effective performance of the financial market and enhance easy source of capital to investors. The findings further confirm the tradeoff theory of capital structure. The regression results found that share capital have positive and significant relationship to market value of quoted SMEs such that a unit increase will lead to 0.9 percent increase on the market value of the quoted SMEs. This finding contradicts our a-priori expectation based on the opinion of Gordon that capital structure is relevant and effect corporate values. The findings are contrary to the opinion of Modigliani and Miller (1958) which says that capital structure is irrelevant. The findings further validates reforms in the Nigeria financial market such as the deregulation of stocks prices in 1993 and the internationalization of the capital market with the introduction of Central Security Clearing System. It could be recalled that the deregulation of Nigeria financial market in the last quarter of 1986 was aimed at removing barriers to effective performance of the financial market and enhance easy source of capital to investors. The findings further confirm the tradeoff

theory of capital structure. Proponents of the trade-off theory suggested that an optimal capital structure maximizes the value of the firm by balancing the prices and benefits of an additional unit of debt (Ghazouani, 2013; Serrasqueiro et al., 2016). In tradeoff theory, the interests of agents are dependable and valuable to the leader (Aabi, 2014). Firms achieve an optimal level of debt by balancing the benefits and costs of debt (Serrasqueiro et al., 2016). The findings is in line with the empirical findings of Imad (2015) that the firms' leverage level affect the firms' value for the Jordanian listed companies included in the sample test and the findings of Saeed and Badar (2013) the findings showed positive impact on the return on assets. The results were compatible with Aghabeygzadeh and Akbarpour (2011) as they found a positive impact as well.

Conclusion

The study found that retained earnings, share capital, equity to total capital ratio and equity capital to total assets ratio account for 31.2 percent variation in the market value of the quoted SMEs. The panel unit root test proved that all the variables are stationary at first differences and conclude that the variables are integrated in the order of 1(I). The cointegration test justifies the presence of long run relationship between debt capital and enterprise value within the periods covered in this study. The Granger causality test indicated no causality of among the variables in the model. From the findings, the study concludes that there is no significant relationship between equity to total capital ratio and market value of quoted SMEs in Nigeria. There is significant relationship between retained earnings and net book value of quoted SMEs market value in Nigeria, there is significant relationship between share capital and net book value of quoted SMEs value in Nigeria, there is no significant relationship between equity to total capital ratio and net book value of quoted SMEs market value in Nigeria and that there is no significant relationship between equity to total capital ratio and net book value of quoted SMEs market value in Nigeria.

Recommendations

1. The management of the SMEs should work very hard to optimize the capital structure in order to increase the returns on equity and assets. They can do that through ensuring that their capital structure is optimal.
2. The Management of Nigerian SMEs should increase their commitments into capital structure in order to improve earnings from their business transaction.
3. There is need to caution against the apparent benefits of greater leverage simply as a device for controlling managerial opportunistic behavior. First, debt and equity represent different constituencies with their own competing, and often mutually exclusive, goals. Second, as the level of debt increases, the capital structure can change from one of internal control to one of external control.
4. Corporate financial decision makers should employ more of long-term-debt than equity in their financial option. This is in line with the pecking order theory.

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