The Impact of Changes in Capital Structure on Shareholders Wealth: A Case Study of Home Finance Company, Ghana

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ABSTRACT: ***Investors expect a return on the investment decision they make despite the inherent risk associated with them. The greater the risk associated with a particular business activity or venture, the higher the expected return. In many cases investors wish to reduce risk by diversifying their investments with a lot investment portfolio. However, the return an investor or a shareholder will receive cannot be divorced from the type of investment made. For example, a preference shareholder receives a share of profit of an entity before an ordinary shareholder. And what makes it interesting is that debenture holders enjoy preferential treatment over the preference and ordinary shareholders. To this end this work was to ascertain to what extent changes in the capital structure of Home Finance Company impact on shareholders wealth. Historical research design and field design methods were used to compare the impact of changes in the capital structure of HFC Bank on wealth creation for the shareholders. It was realize that although majority of the shareholders had knowledge on their investment, the company had paid low dividend to the shareholders due to long standing debt which they did not appreciate much. The paper recommend that Finance Managers should critically weigh options when making decisions about the capital structure of companies. Shareholders should be able to hold their Management to account when they make far-reaching business decisions.***

KEYWORDS: Capital structure, Shareholder, wealth, equity, debt

I. INTRODUCTION

Every company applies its assets to generate a stream of operating cash flows. After paying taxes, the firm makes distributions to the providers of its capital and retains the balance for use in the business. If a company is all equity financed, the entire after-tax operating cash flow of each period accrues to the benefit of its shareholders (in the form of dividend and retained earnings). If, instead, the company has borrowed a portion of its capital, it must dedicate a portion of the cash flow stream to service this debt. Moreover, debt holders have the first claim to a company's cash flow; shareholders are only entitled to the residual. The company's choice of capital structure determines the allocation of its operating cash flow for each period between debt holders and shareholders.

Thus, financing decisions are considered among the most critical areas for finance managers. It has direct impact on capital structure and financial performance of the companies. Capital structure is directly related with the financing decision of the company. Primarily, it consists of the debt and equity used to finance the firm. A firm's specific mixture of long term debt and equity refers to its capital structure (Ross, 1991).

The primary objective of financial management is the maximization of shareholders' wealth. To achieve this objective, management, the custodians of shareholders' interests, are faced with three important categories of decision making namely, investment, financing and dividend decisions.

The debate over the significance of a company's choice of capital structure is esoteric. But, in essence, it concerns the impact on the total market value of the company (i.e.; the combined value of its debt and its equity) of splitting the cash flow stream into a debt component and earn equity component. Financial experts traditionally believed that increasing a company's leverage, i.e. increasing the proportion of debt in the company's capital structure, would increase value up to a point. But beyond that point,

further increases in leverage would increase the company's overall cost of capital and decrease its total market value.

However, Modigliani and Miller challenged that view in their famous 1958 article. They argued that the market value, the earning power of a company's real assets and that if the company's capital investment program is held fixed and certain other assumptions are satisfied, the combined market value of a company's debt and equity is independent of its choice of capital structure. Since Modigliani and Miller published their capital structure irrelevancy paper, much attention has focused on the reasonableness of these "other assumptions", which include the absence of taxes, bankruptcy costs, and other imperfections that exist in the real world. Because of these imperfections, a company's choice of capital structure undoubtedly does affect its total market value; the significance of corporate leverage is reflected in the articles that have appeared in the financial press following periods like the 1970s when leverage increased significantly. However, the extent to which a company's choice of capital structure affects its market value is debated.

This study analyses capital structure of HFC Bank, a Ghanaian firm in the banking sector, and trading on the stock exchange. The specific objective was to examine the impact of capital structure on the wealth of the shareholders of the firm. This research will help to understand the general practices of capital structure in Ghana including the sensitivity of leverage on each industry. This will also act as a guide for the financial managers to design their optimum capital structure to maximize the market value of the firm and minimise the agency cost.

A. Statement of the Problem

According to Miller and Modigliani (1961), the effect of a firm's dividend policy on the current price of its shares is a matter of considerable importance, not only to management who must set the policy, but also to investors planning portfolios and to economists seeking to understand and appraise the functioning of the capital markets.

This poses the question, to what extent, if any, does dividend policy impact on firm value and therefore the price of a firm's shares?

Management is faced with the dilemma of how to raise funds. Each source of fund differs with respect to maturity, cost, availability and the effect it would have on the capital structure of the firm. With the inception of the Ghana Stock Exchange, Companies have been encouraged to make initial public offers to expand capital base by floating shares and obtain a market for such shares on the exchange. This will definitely lead to a change in capital structure of the firm.

B. Research Questions

This research tried to answer the following questions

1. What types of permanent financing is being employed by HFC Bank?
2. What degree of financial leverage was employed by HFC Bank before and after the initial public offer?
3. What is the impact of a decrease in leverage on the wealth of shareholders?
4. How does a change in the capital structure affect the share holders' wealth?

II. Literature Review

The essence of financial management is the creation of shareholder value. According to Ehrhard and Bringham (2003), the value of a business based on the going concern expectation is the present value of all the expected future cash flows to be generated by the assets, discounted at the company's weighted average cost of capital (WACC). From this it can be seen that the WACC has a direct impact on the value of a business (Johannes and Dhanraj, 2007).

The choice between debt and equity aims to find the right capital structure that will maximize stockholder wealth. WACC is used to define a firm's value by discounting future cash flows. Minimizing WACC of any firm will maximize value of the firm (Messbacher, 2004). Leland and Pyle (1977) propose that managers will take debt-equity ratio as a signal, by the fact that high leverage implies higher bankruptcy risk (and costs) for low quality firms. Since managers always have information advantage over the outsiders, the debt structure may be considered as

a signal to the market. Ross's (1977) model suggests that the values of firms will rise with leverage, since increasing the market's perception of value.

In their second seminal paper on corporate capital structure, Modigliani and Mill (1963) show that firm value is an increasing function of leverage due to the tax deductibility of interest payments at the corporate level. In the 30 years since, enormous academic effort has gone into identifying the relevant costs associated with debt financing that firms presumably trade off against this substantial corporate tax benefit. Although direct bankruptcy costs are probably small, other potentially important factors include personal tax, agency cost, asymmetric information, product/input market interactions, and corporate control considerations. Surveys of this literature include Bradley, Jarrell and Kim (1984), Harris and Raviv (1991), Masulis (1988) and Miller (1998).

Early empirical evidence on the trade-off theory (e.g. Bradley, Jarrell &Kim, 1984) yielded mixed results. However, recent studies examining capital structure response to change in corporate tax exposure (Givoly et al., 1992; Mackie-Mason, 1990; Trezevant, 1992) provide evidence supporting the trade-off theory. Myers (1984) argues that the trade-off theory also fails to predict the wide degree of cross-sectional and time variation of observed debt ratios.

Under some conditions capital structure does not affect the value of the firm. Splitting a fund into some mix of shares relating to debt, dividend and capital directly adds value to the company (Gemmille, 2001).

The issue of whether financial structure influences economic growth or not. Through heterogeneous panel it was found that significant effects of financial structure on real per capita output, which is in sharp contrast to some recent findings (Arestis, Luintel & Luintel, 2004). Firms have increased their level of debt relative to their profit. As a result, firm debt in general has risen substantially. They found that those firms having lower debt have higher value than the firm, which has high debt. Thus, firm can maximize its value by choosing low debt or zero debt (Kinsman & Newman, 1998). When the firm's investment is large, countervailing incentives lead both high and low cost firms to choose the same capital structure in capital structure in equilibrium, thus decoupling capital structure from private information. When investment is small or medium size, the model may admit separating equilibrium in which high cost firms issued greater equity and low cost firms rely more on debt financing (Spiegel & Spulber, 1997). The presence of corporate tax shield substitutes for debt implies that each firm has a unique interior optimum leverage decision and when firms, which issue debt, are moving toward the industry average from below, the market will react more positively then when the firm is moving away from the industry average. The overall finding is that the relationship between a firm's debt level and that of its industry does not appear to be of concern to the market (Hatfield et al., 1994). Debt ratios are found to be decreasing in cash flow or profitability and increasing in the investment of the firm in both countries. The study found positive with pecking order approach and generally inconsistent with the tradeoff approach (Benito, 1999). The firm-specific nature of strategic assets implies that they should be financed primarily through equity; other less specific assets should be finance through debt.

Firms are likely to suffer increased costs and decreased performance if they do not adopt suitable governance structures in their transactions with potential suppliers of funds (Kochhar, 1997). It is considered "customer-driven" financial distress where prices for the firm output decline whenever firm has poor financial status. "Employee driven" financial distress originates from loss of intangible assets when firm revenue decline. Babenko (2003) examines the state tax effect on optimal leverage and yield spreads to find out the optimal capital structure at the time of financial distress. A negative relationship exists between the ownership of shareholders with large blocks, on the one hand, and the degree of control, on the other hand, with regard to firm value, the second relationship being significant. However, endogenous treatment of these variables then reveals a positive effect for the ownership of the major shareholders on firm value.

Leland and Pyle (1977) and Ross (1977) propose that managers will take debt/equity ratio as a signal, by the fact that high leverage implies higher bankruptcy risk (and cost) for low quality firms. Since managers always have information advantage over the outsiders, the debt structure may be considered as a signal to the market. Ross's model suggests that the value of firms will rise with

leverage, since increasing leverage increases the market's perception of value. Suppose there is no agency problem, i.e. management acts in the interest of all shareholders. The manager will maximize company value by choosing the optimal capital structure; highest possible debt ratio. High-quality firms need to signal their quality to the market, while the low-quality firms' managers will try to imitate. According to this argument, the debt level should be positively related to the value of the firm.

Assuming information asymmetry, the pecking order theory (Myers & Majluf, 1984) predicts that firm will follow the pecking order as an optimal financing strategy. The reason behind this theory is that if the manager act on behalf of the owners, they will issue securities at a higher price than they are truly worth. The more sensitive of the security, the higher the cost of equity capital, since the action of the manager is giving a signal to the market that the securities is overpriced.

Stulz (1990) argues that debt can have both a positive and negative effect on the value of the firm (even in the absence of corporate taxes and bankruptcy cost). He develops a model in which debt financing can both alleviate the overinvestment problem and the underinvestment problem. Stulz (1990) assumes that managers have no equity ownership in the firm and receive utility by managing a larger firm. The "power of manger" may motivate the self-interested managers to undertake negative present value project. To solve this problem, shareholders force firms to issue debt. But if firms are forced to pay out funds, they may have to forgo positive present value projects. Therefore, the optimal debt structure is determined by balancing the optimal agency cost of debt and the agency cost of managerial discretion.

III. Methods

This research is analytical in nature and employed the survey method in assessing the impact of the changes in capital structure on the shareholders wealth of the HFC bank of Ghana. The study gathered the information from secondary source through the internet and the bank officials at the headquarters. Other financial reports from the Ghana stock exchange concerning the banks trading of the stock market was also obtained from the Ghana stock exchange fact books. Questionnaires were also administered. The purpose was to generate data so as to analyse it to set the trend of activities of the performance of their business and its impact on the shareholders wealth.

HFC Bank was incorporated on 7th May, 1990 and hence had a lot of financial statement across the years. However for this study, data on a ten-year period was used, that is from January 1, 2001 to December 31, 2011. A randomly selected sample of shareholders were interviewed to crosscheck some of the information from the financial statement. The chosen shareholders were spoken to either through phone or face at places convenient to them. Every precaution was taken to ensure that maintenance of confidentiality throughout the process was adhered to in order to eliminate biases.

The accumulated data was analysed using appropriate tools.

IV. Results and Analysis

A. Primary Data Analysis

On the issue of the capital structure of HFC Bank, the respondents stated their individual reasons for investing in this bank. As shown in Figure 1, about 38.9% of the respondents invested in HFC Bank with a view to the future. As such, their immediate concern is not a dividend pay-out but a real growth in their wealth for the future. As much as 22.2% of the shareholders mentioned growth of their savings or investing for their family as the main motive for buying shares in HFC Bank.

Only 16.7% of the shareholders bought shares with the sole aim of getting regular dividends. This is an indication that people invest not mainly for dividends but for future gains. Figure 1 is a chart of the investment reasons of HFC shareholders

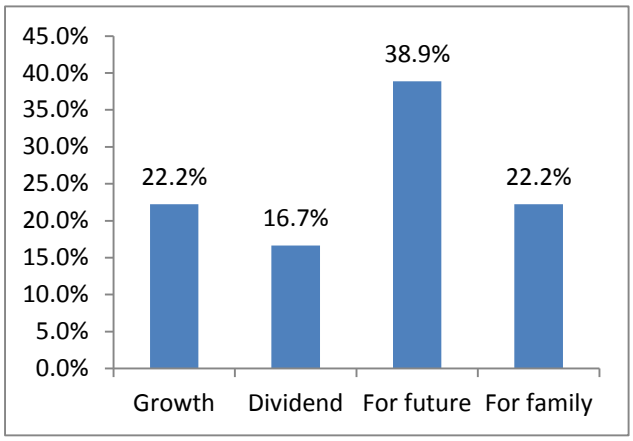

Figure 1: A chart of the investment reasons of HFC shareholders

Source: Field Data, 2012

To the question of whether shareholders are happy with the dividends received over the years, an overwhelming 77.8% responded 'No'. Only 22.2% thought the dividend paid was good, as shown in Table 1. This was in contrast to the earlier position investing not because of dividend

Table 1: Are Shareholders Satisfied with Dividend?

Satisfied with Dividend	**No. of Respondents**	**%**
Yes	4	22.2%
No	14	77.8%
Total	**18**	**100%**

In line with the dissatisfaction of the dividend paid, respondents described the performance of the bank's management as average, polling 44.4% of the total sample drawn. In fact, 33.3% described the performance of management as poor with 16.7% and 5.6% going for 'Good' and 'Excellent' respectively. This result is shown in Figure 2. This result was particularly interesting since shareholders have voted in support of all policy decisions at every Annual General Meeting preceding even 2001. Notwithstanding the prevailing economic challenges, it is obvious that the shareholders expect more than was delivered to them

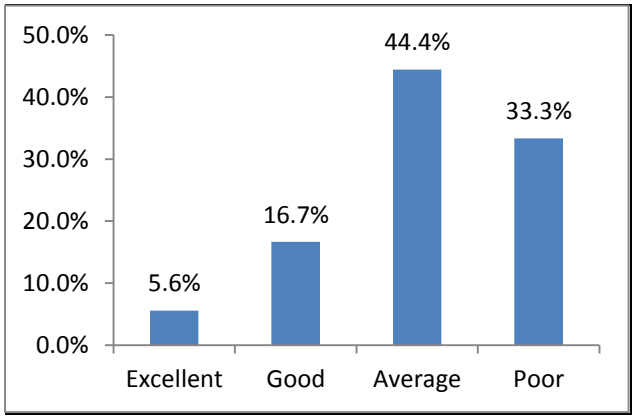

Figure 2: Management Performance

B. Secondary Data Analysis

Debt-to-Equity Ratio

From Figure 3, it is apparent that HFC Bank has relied heavily on debt to finance its operations for many years during the period under review. This reliance on debt financing peaked in 2007 when the debt-to-equity ratio exceeded 60%. The bank recorded its lowest ratio in the 2005 financial year. Since peaking in 2007, there has been a steady decline in the ratio to under 20% in the 2010 financial year. This steady decline in debt/equity ratio is attributable, in part, to fiscal discipline by management and the equity injection by shareholders through the share offer in 2009

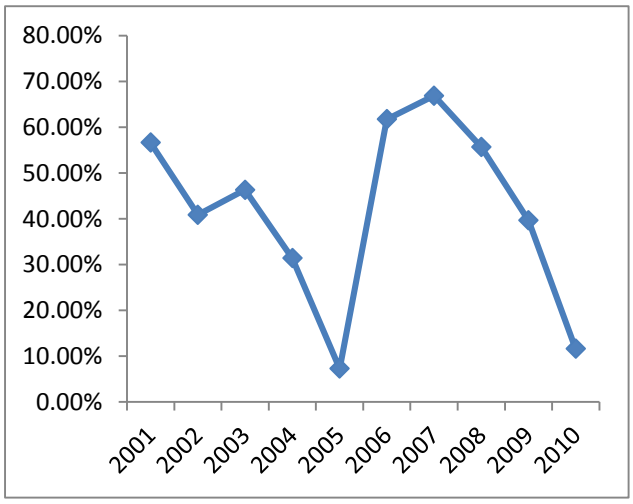

Figure 3: Debt to Equity Ratio

This also started declining from the initial high 4.66% recorded in 2001to a very low point in 2003. There was a surge in 2005 followed by a decline again before the cautious growth brought it to the current position as shown in Figure 4. It is easily recognized that the

dividend yield of HFC Bank has an inverse relationship with the debt-to-equity ratio. Dividend yield rises when debt stock reduces. This trend has significant policy implication for finance managers, because they can utilize debt to form optimal capital structure to maximize the wealth of shareholders.

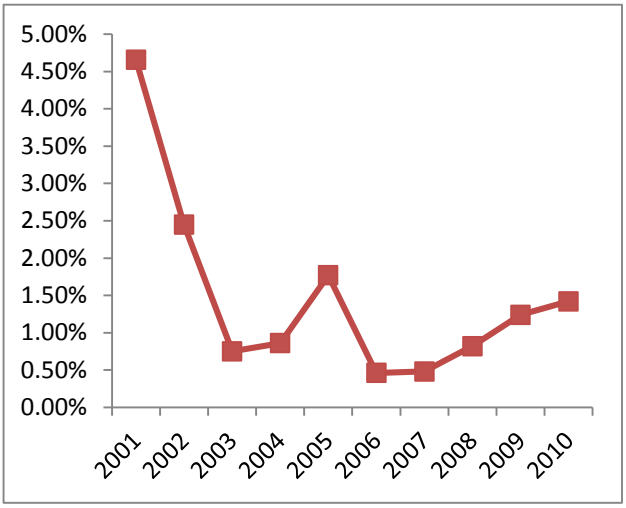

Figure 4: Dividend Yield of HFC Bank

Earnings per Share & Dividend per Share

Earnings and dividends per share are also seen in the figures below to follow a similar trend as the dividend yield. These also move in opposite directions to the debt stock of HFC Bank. This finding was expected; because earnings and dividends are declared out of the annual profit gained from the bank's operations. With an unusually high level of loans, all the gains made from tax-savings are to financiers as interest.

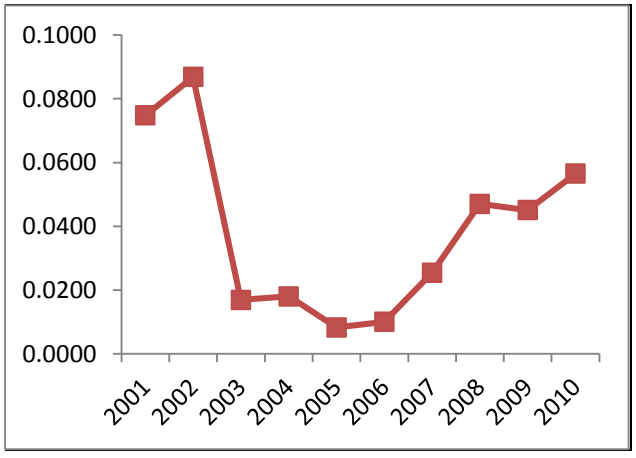

Figure 5: Earning per share

It is also observed that dividend payment and return on equity (ROE) has positive significant relation with Stock Market. These results confirm that if companies pay Cash Dividend, it will positively affect its Stock Market Prices while Earnings per Share do not have any statistically insignificant relation with Stock Market Prices. This shows that though many shareholder claim to be interested in Earnings per Share, it does not significantly explain the variations in Stock Market Prices because many shareholders are actually only concerned with the amount of profits which is paid to them as dividends, whether that amount is paid out of current profit or from previous year profit. The dividends per share paid out over the period under review is presented in Figure 6.

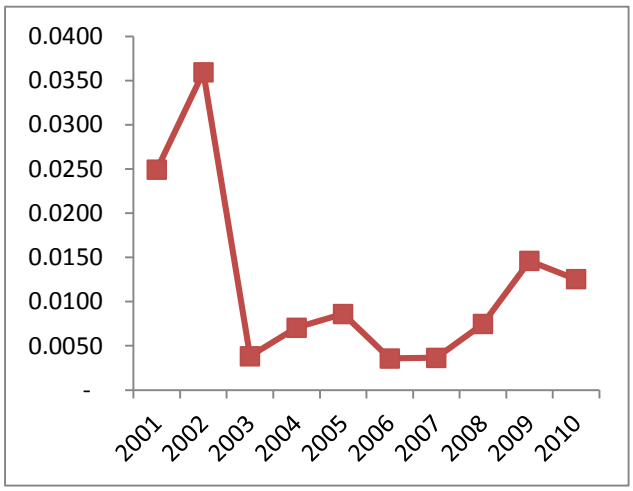

Figure 6: Dividends per share

Return on Equity

The analysis also showed that the return on equity reported by the bank correlates with changes in the debt/equity ratio (Figure 7). Thus, the higher the debt stock at any particular time, the lesser the return made on the equity of the shareholders.

Gearing

Gearing focuses on the capital structure of the business, which is the proportion of finance that is provided by debt relative to the finance provided by equity (or shareholders). The gearing ratio is also concerned with liquidity. However, it focuses on the long-term financial stability of a business. Gearing (otherwise known as "leverage") measures the proportion of assets invested in a business that are financed by long-term borrowing.

From Figure 8, HFC Bank had a very high gearing in 2007 but has gradually toned it down to just 23.22% in 2010. Theoretically, the higher the level of borrowing (gearing) the higher are the risks to a business, since the payment of interest and repayment of debts are not "optional" in the same way as dividends. However, gearing appeared to be a financially sound part of HFC's capital structure the bank has strong, predictable cash flows.

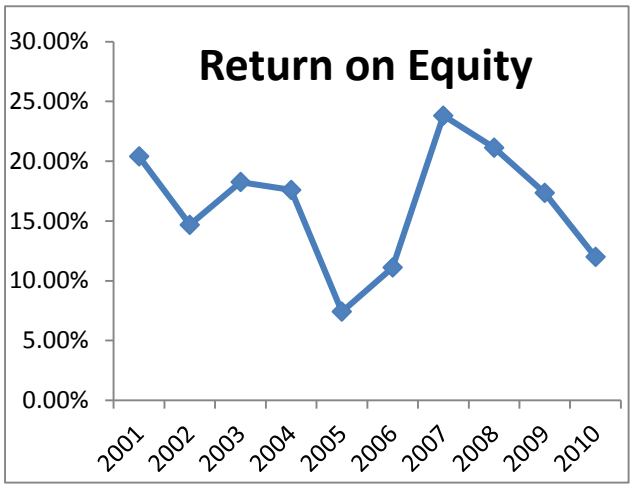

Figure 7: Return on Equity

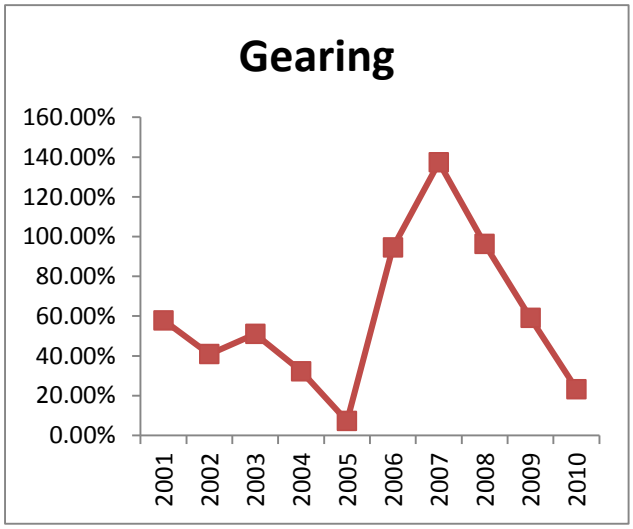

Figure 8: Gearing

V. CONCLUSION AND RECOMMENDATIONS

A. Conclusion

To see the relationship between capital structure and HFC Bank's value in Ghana, this paper considered share price as proxy for value and different ratios for capital structure decision. The interesting finding of this paper suggests that maximizing the wealth of shareholders requires a perfect combination of debt and equity.

Whereas cost of capital has a negative correlation in debt (loan) decision, it has to be as minimum as possible. It is also seen that by changing the capital structure composition a firm can increase its value in the market. Borrowing more gives firms advantages in tax savings because of interest payments. Nonetheless, this could be a significant policy implication for finance managers, because they can utilize debt to form optimal capital structure to maximize the wealth of shareholders.

The dividend yield results also reveal that both long-term and short-term debt ratios appear to have inverse associations with profitability in HFC Bank over the period. This result clearly supports the pecking order hypothesis. In that, profitable firms initially rely on less costly internally generated funds and subsequently look for external resources if additional funds are needed. It is expected that as the bank become more profitable it will require less debt finance as indicated by the declining debt-to-equity ratio.

B. Recommendations

- Finance Managers should critically weigh their options when making decisions about the capital structure of companies.
- Financing decisions should be made to favour shareholders for they are the owners of the business.
- Shareholders should be able to hold their Management to account when they make far-reaching business decisions.
- Regarding future line of research, this study can be improved upon if the number of firms and he performance measures are increased.

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