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Corporate Strategy and Firm performance: Case for the Multinational Banks in Sub Saharan Africa

Kibs Boaz Muhanguzi

Abstract- Various studies have empirically examined the effect of corporate strategy on firm performance but not to the level of this paper's methodological scope regarding time, geographic, and variable constructs. For external validity of research findings, this paper uses a more modern estimation procedure-the system Generalized Method of Moments GMM, on a panel data (2007-2017) for the multinational banks in sub-Saharan Africa. Relevant corporate strategy constructs for firms with multinational operations are adopted. These are; diversification, debt, and equity financing which are examined in relation to firm's performance as measured by return on assets ROA. One provoking question motivating this inquiry is: Does it profit a firm to have operations in many countries when financing is by debt, and or equity? Such corporate strategies are expected to have positive returns. Findings however, show that unlike debt financing strategy, geographical diversification and equity financing positively affect the banks' ROA. Therefore, investors and corporate manager should design their strategic plans from which the best strategies for implementation can be selected. Particularly,corporate decisions on questions about the bank's where to go, and the source of funds for investment should keenly be addressed during strategic planning.

I. Introduction

For any business to attain her desired goals and objectives, there is need for effective strategy formulation and implementation. The extent the firm's corporate strategy affects performance has increasingly received empirical analysis but not to the scope of this paper's combined role of diversification, debt, and equity funding. When firms are contemplating about geographic expansion, often, they are confronted with the question of source of funding. This paper investigates how the three corporate strategy constructs impact on the performance of multinational banks in sub-Saharan Africa.

Bank performance can be measured using two main approaches: financial measures, and market measures. Financial measures include: return on assets ROA, return on equity ROE, return on investments ROI and net interest margin NIM. One key market-based measure of performance is the Tobin's Q approach. Each of these has strength and weaknesses (Marashdeh, 2014). ROA and ROE concern control of the wealth effects of corporate governance mechanisms from the view point of the company management (insiders) while the Tobin's Q represents financial estimation performance by investors (outsiders).

Profit maximization is one common objective of firms. Increasing profitability involves determining which corporate strategies are working and which ones need improvement. Mahira (2011) defines profitability as the measure of management efficiency in the use of organizational resources in adding value to the business. Profitability is the ability of a given investment to earn a return from its use (Soumadi& Hayajneh 2012). Pouraghajan and Bagheri (2012) explain that profitability is the final measure of economic success achieved by a company in relation to the capital invested.

The corporate strategy entails any decision made by corporate managers to ensure that company stakeholders are satisfied at all times. With this as the goal, corporate managers must choose a less costly source of capital that results in long-term profit maximization and increased returns to the firm's stockholders (Muritala et al., 2012). Corporate strategy influences all levels of strategy formulation including business (middle-level) and functional level (lower-level). It is majorly how the corporate managers define the strategy of the company as a whole, that firms targets are met (Management Strategic, 2010).

The corporate strategy focuses on a fundamental set of questions that guide decision making: "In what businesses to invest? Where and when? Why? What budget? What will be the source of funding? (Chathoth&Olsen,2007;Schwatz et al., 2015). This study dwells on where to go (diversification as a growth strategy), at what cost (capital budget) and source funds (debt or equity), questions.

The corporate strategy entails dimensions among others, one that includes measures about growth (Zook & Rogers, 2001). Some growth alternatives include expansion into existing businesses, diversification into new businesses, internal development, acquiring firms, and collaborative ventures, licensing and franchising (Ilori (2015). Growth through geographic diversification has far-reaching benefits including risk hedging, tapping cheaper sources of production inputs and the fresher market for products (Parola et al., 2014). However, this strategy

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has a challenge of raising the required capital. Once capital has been solicited, the extent this and geographic diversification impact on performance, is what motivates this study.

Source of finance for investment as a corporate strategy: for varying reasons, a firm may decide to use either debt or equity financing. The decision regarding the source is one key strategic decision that firms need to make for sustainability.

According to Muchlis et al., (2013) and Martis (2013), equity holders are the owners of the firm, and they have a long term commitment to the firm in the trust that it will grow in the near future. In contrast, debt holders are the creditors of the firm, and they have no long-term commitment to the firm as they are more interested in the timely repayment of their interest and principal.

Debt Financing: acquiring debt capital is a process that is contingent on the availability of funds in the global credit markets, interest rates, and a corporation's existing debt obligations. For example, if credit markets are experiencing a contraction, it may be difficult for the corporation to sell corporate bonds at favorable rates. In particular, it may be challenging to get high advance rates for asset-backed securities. If a firm becomes over-leveraged, it may be unable to pay its debt obligations leading to insolvency (Karadeniz et al., 2009). However, debt is less costly to acquire than other forms of financing.

Equity Financing: Preferred stock, common stock, and components of retained earnings are considered equity capital. A multinational firm should carefully analyze its equity cash flows and mitigate the risk associated with currency fluctuations. Otherwise, it may lose equity due to changes in exchange rates. Also, the issuance of new shares may cause stock prices to fall because investors no longer feel company shares are worth their pre-issuance price. Offering stock in global financial markets costs multinationals more than acquiring debt, but it may be the right financing option if a corporation is already highly leveraged (Seetanah, Seetah, Appadu, Padachi, 2014).

The traditional theory of finance and capital, given some market assumptions, whether or not the investment is financed with equity or debt makes no difference (Modigliani & Miller, 1958). Popularly, this theory is termed the capital structure irrelevance. No matter how the firm chooses its finances, the value of the company will be the same. Proponents of this theory argue that financial leverage is in direct proportion to the cost of equity. An increase in debt component, the equity shareholders perceive a higher risk to the company. Hence, in return, the shareholders expect a higher dividend, thereby increasing the cost of equity. The theory assumes that debt holders have an upper-hand as far as the claim on earnings is concerned. Thus, the cost of debt reduces (Karadeniz et al., 2009). But in a world with taxes, the value of a levered firm is higher than that of a similar firm that is not levered, by an amount equal to the corporate tax rate. Given this postulation, how would a firm's choice of these two funding source affect a firm's profitability?

According to the pecking order hypothesis (Myers, 2001), firms prefer to finance their activities using retained earnings. If internal equity is not enough, then the use of external debt is preferred. Raising funds from external source should be the last resort. It is generally the most expensive type of funding. Due to adverse selection, firms prefer internal to external finance. When outside funds are necessary, firms opt for debt than equity because of lower information costs associated with debt issues. This theory maintains that businesses should adhere to a hierarchy of financing source by choosing internal funds first, and external funds last. Thus, the form of debt a firm chooses can act as a signal of its need for external finance (Fama, French, 2002). Leary and Roberts (2010) expand the pecking order model by incorporating factors that are typically used in other theories. They find that over 80% of observations support the pecking order hypothesis. However, market timing theory postulates that firms try to time the financing of their activities in a period when equity or debt is cheap.

According to agency theory, a high level of debt is one way to control spending by management that is not productive to firm profitability (Korajczyk & Levy, 2003). Whenever management decides to behave contrary to the owners' expectations, debt financing becomes a corporate strategy to maximize returns through minimizing agency conflicts. Whenever the principal-agent conflicts arise, organizational performance declines.

Stakeholder co-investment theory suggests that a multinational firm structures her finance sources relative to other firms to keep the confidence of all stakeholders in the business. In other words, an industry standard is set, and firms have a strict target debt-equity ratio.

Tax bankruptcy trade-off theory (Myers, 2001) takes into account the trade-off between the tax benefits of debt and the potential cost of bankruptcy. It assumes equity financing is too expensive. In essence, use debt financing by taking into account the pros and cons of debt.

Cross-border banking has been a critical part of Africa's financial history since colonial times (Thorsten et al., 2014). After independence however, investors saw a wave of nationalization across the continent that left many colonial banks bought off by the government. The 1980's financial liberalization and privatization rejuvenated the activity of private enterprises. Failing state-owned and private banks were sold mostly to global investors or multinational banks (Thorsten et al., 2014). Economic liberalization, formation of economic

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zones (SADC, EAC, ECOWAS), and deregulation further increased the number of foreign banks, and by the mid-2000s many African banking systems were yet again dominated by foreign banks (IMF, 2011). By 2010, several indigenous (African-founded) banks had operations outside their mother countries: Eco bank, Bank of Africa, Standard Bank and United Bank for Africa (Mlachila, Seok, & Masafumi, 2013).

Sub-Saharan Africa is a developing region of the world that has a big proportion of foreign-owned banks (Claessens & Horen, 2012) though many African banks have started their international expansion in their home region over the last decade (Mlachila et al., 2013). Some factors account for the fast spread of multinational banks in sub-Saharan Africa: globalization, regional integration, generally improved business climate (political and socioeconomic), rapid growth and forward shifts in customer needs, improved physical and socio-infrastructure, and technological advancement (Mlachila, Seok & Yabara, 2013).

Given the above historical, theoretical, conceptual and contextual background, this study examines how corporate strategy in terms of geographical diversification, and debt and equity financing impact on multinational banks' profitability within sub-Saharan Africa. More than my interest in strategic management and international business and finance, this study's purpose is relevant to corporate managers, academics, and investors in strategic matters concerning: whether to expand operations into new countries, and how to raise funds for such strategies.

II. Related Literature Review

Nowadays, corporate organizations are increasingly paying attention to strategic planning (Ilori, 2015). To establish the relationship between corporate strategy and firm performance, Arasa and K'Obonyo (2012) find a strong relationship between the two variables.

Werner and Moormann (2009) apply static and dynamic regression analyses on firms' data (1998-2007) to investigate the role of corporate strategy on the efficiency of firms. Their results show a positive correlation.

Empirical studies on the effect of growth strategy on performance produce inconsistent findings. For example, Parola et al., (2014) use cross-sectional data and a 2-stage sampling procedure to investigate the effect of corporate strategy on the profitability of firms for a sample of 144 firms from 44 countries (2008-2012). They find investment for growth with a positive impact on corporate profitability. Monroe (2006) while using content analysis of Journal articles (1980-2004) on studies that have investigated the relationship between corporate strategy and firm performance finds a positive relationship.

Extant literature on the effect of funding source and the firm's performance has mixed results. For example, those that find a positive relationship between debt and the firm's profitability index ROA include: Abor (2007 who uses a panel data on 160 Ghanaian and 200 South African SMEs; Javed, Waqar and Muhammad's (2014) work on 63 companies listed on Karachi Stock Exchange, Pakistan (2007-2011), Goyal (2013) and Muchlis et al., (2013). On the contrary, Salteh *et al.* (2009), Chakraborty (2010), Onaolapo (2010), Karadeniz et al. (2009), Muritala (2012), Soumadi and Hayajneh (2012), Manawaduge et al., (2011) and Fama and French (2005) find a firm's high debt detrimental to ROA. Lower leverage (equity financing) is associated with higher ROA (Seetanah et al, 2014) while Chadha and Sharma (2015) find no impact.

Generally, most empirical literature posits a negative relationship between higher debt and firm performance. However, from a counter perspective, debt financing can positively affect firms' performance. For example, from the agency theory's perspective, as more debts lead to more interest expense, it creates higher risk of bankruptcy; as a result, managers have to perform better to avoid bankruptcy and associated costs, which in turns improves firm performance. How this could be so with the multinational banks in sub-Saharan Africa, requires further investigation.

a) Empirical approach

This paper follows a positivist research philosophy to be able to explain and predict what happens to bank performance as a result of the defined corporate strategies. In line with Saunders et al.'s (2009) suggestion, this study's objective can be achieved through developing research hypotheses alongside a designed strategy to achieve them.

b) Data and sample description

From the 2016's ten best performing multinational banks (Mutiso, 2016), panel data (2007-2017) is collected from 43 countries. A cross section of 126 banks gives a total of 1386 observations. Since observations are more than 1000, the sample is adequate for measuring bank performance using different financial measures (Mlachila, Seok, & Masafumi, 2013). Main sources of this data are the World Bank's bankscope database, bank's websites, World Bank's database, the IMF's World Economic Outlook.

c) Variables and their measurement

Empirical literature guides variable identification and how to measure them. From Marashdesh (2014), (Munyambonera 2013) and Panayiotis *et al.* (2005) measures of bank performance, this study adopts banks' profitability index of return on assets (ROA) to measure multinational bank performance. ROA shows the percentage of total income on total assets.

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Diversification is identified as a corporate strategy using Parola et al. (2014) growth approach. It indicates the number of countries; a specific bank has operations. Debt financing as a corporate strategy measures the percentage of total capital obtained through borrowing. Equity financing as a strategy processes the proportion of bank capital obtained through the sale of shares and retained earnings. The assumption is that, rather than through borrowing, when a firm uses equity means of financing, her profitability rises more.

Two control variables: country size and bank size, are used in the analysis. Because the study area-sub-Saharan African economies-is diverse in size, this study uses logarithm for per capita income to measure country size. While log bank assets are used to measure the size of the bank (Pasioras et al. 2007; Shahidul & Nishiyama, 2015), the hypothesis is that larger banks perform better than smaller banks and bank performance is better in rich than poor economics. These two variables are transformed into natural logarithm to allow linear regression since their prior values were higher in thousands. Appendix table 1 shows the summary of variables and their measurement.

d) Estimation strategy

This paper uses corporate strategy constructs (diversification, debt and equity) as determinants of bank performance. A panel model in equation (2.1) shows theoretical variable relationships. Such a specification was previously used by Panayiotis *et al.* (2005) on Greece banks, and Marcos and Peter (2006).

$$ROA_{ist} = \beta_1 Diversfn_{ist} + \beta_2 Debt_{ist} + \beta_3 Equity_{ist} + \beta_4 Log_{Assets\ ist} + \beta_5 Log_{YPC\ ist} \quad (2.1)$$

Where:

ROA_{ist} Shows performance of bank *i* in country *s* in period *t*;

β_i Are the parameters to be estimated following a null hypothesis that β_i =0. In other words, that all the corporate strategy constructs have no effect on bank profitability. Details of variables on the right hand side of equation 2.1 are in appendix table 1.

Because profits often show a tendency to persist over time, the previous year's profits may affect the current profits. Thus, a dynamic model specification that includes a lagged dependent variable among the regressors emerges as in equation 2.2:

$$ROA_{ist} = \gamma ROA_{ist-1} + \beta_1 Diversfn_{ist} + \beta_2 Debt_{ist} + \beta_3 Equity_{ist} + \beta_4 Log_Assets_{ist} + \beta_5 Log_YPC_{ist} \quad (2.2)$$

Following literature on the effects of globalization and economic liberalization (Claessens *et al.,* 2012; Munyambonera, 2013), this study assumes the banking industry in sub-Saharan Africa to be highly competitive, and states the corresponding hypothesis on the coefficient for the lagged dependent variable as $\gamma = 0$.

The one-year lag for profits $y_{is,t-1}$ has a parameter γ which measures the speed of adjustment to equilibrium. The coefficient γ is the correlation between Y_{it} andY_{it-1}. A value of γ between zero and one implies that profits persist, but they will eventually return to their normal (average) level (Baltagi, 2008). A value close to zero means that the industry is fairly competitive (high speed of adjustment) while a value of γ close to 1 implies less competitive structure (very slow adjustment). The parameter γ, shows the degree to which change (or shock) affects the system (Panayiotis *et al.*, 2005).

Since the lagged dependent variable is included in the equation, the regressor $Y_{i,t-1}$ correlates with the error term. This biases the standard panel estimates if the simple ordinary least squares estimator (OLS) approach is used. As a solution, Baum (2013) recommends use of the Generalized Method of Moments GMM estimator for dynamic models.

By construction, the residuals of the differenced equation should possess serial correlation, but if the assumption of serial independence in the original errors is warranted, the differenced residuals should not exhibit significant AR(2) behavior. The evident statistically significant AR(2) statistic implies that the second lags of endogenous variables are inappropriate instruments for their current values (Baum, 2013).

A system GMM estimator θ in dynamic panels is a set of coefficients $\beta, \gamma, \rho, \delta_\alpha^2 \delta_\varepsilon^2$ whose values must be tested for stationarity, reliability, efficiency, and robustness. Two tests for this estimator are: first, the Arrellano-Bond (1991) test for autocorrelation, and second, the Hansen j-test for over-identification (Baum, 2013). The *Stata14* command for these tests is David Roodman's (2009) *xtabond2*. This study uses *clustering* option because many variables in the sample are specific only for countries and not for banks themselves.

e) Empirical findings

Appendix table 2, has a summary of the 2 regression results. In the model I, all the variables are included except the control variables. In the second regression: model II, control variables are introduced. Importance of running these regressions is to check for results robustness with and without the control variables. Accordingly, in both models I&II, the coefficients for the corporate strategy constructs together with the lag for the ROA did not change so much. They remained significant at the same percentage levels.

Note that from the appendix table 2, the system GMM estimation uses the Arellano-Bover dynamic panel

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estimator. The p-values are shown in brackets. Respectively, ***, **, * indicate significance level at the 1%, 5%, and 10% level. The row for the Hansen J-test reports the p-values for the null hypothesis of instrument validity. The values reported for the Diff-in-Hansen test are the p-values for the validity of the additional moment restriction necessary for system GMM (Baum, 2013). The values reported for AR (1) and AR (2) are the p-values for first and second order autocorrelated disturbances in the first differences equations. Variable names in the first column are in appendix table 1.

In both regressions, the lagged dependent variable ROA has a positive coefficient that is statistically significant. This coefficient implies that profits in the previous year positively impact on banks' performance in the current year. More specifically, in model II, other factors held constant, a one percent increase in the previous year's profits brings about a 2.6 increase in the current year profits and vice versa. This result implies that bank performance today will necessarily be higher if was high in the previous year. Following the coefficient interpretation by Panayiotis et al. (2005), in terms of market structure for the banking industry in the region, the statistically significant coefficient for the lag (1) of ROA shows a low degree of profit persistence among multinational banks. Since the coefficient is near to zero than one. It signifies high level of competition among the multinational banks within sub-Saharan Africa. This finding concurs with the previous empirical study by Munyambonera (2013) in the same region.

On whether expansion into new territories would make banks reap more, the coefficient for diversification in model II is 0.0324, and is not far different from that in model I where control variables are eliminated. This coefficient is significant at 5% significant level. The result implies that a corporate strategy by a bank to run into one more country for business raises her profits by 3.2 percent, other factors held constant. This signifies great importance attached to geographic diversification. Firms reap more by operating beyond their territories. The positive relationship between diversification and ROA in this paper is similar to that by Parola et al. (2014).

The study finds debt financing as a corporate strategy to raise capital for investment with a negative relationship with banks' ROA. From model II, raising the USA $1 through borrowing reduces a bank's profit margin by 6.5 percent. This effect is significant at a 5% significance level. This negative relationship between debt and profitability of banks is explained by Mlachila, Seok and Yabara' s (2013) situational factors in the sub-Saharan Africa manifesting high cost of borrowing, poor debt management, and generally high investment risks in the region emanating from political instabilities, poverty, poor infrastructure, and poor governance. This negative relationship concurs with the previous empirical results from Seetanah et al, (2014) and Muritala (2012). The negative relationship between debt and profitability as measured by ROA extends to multinational banks like any other firms.

The coefficient for equity is positive and significant in both regressions suggesting that as banks finance their investment plans through equity, their profit raise. For example, in model II, the profitability of a multinational bank goes up by 3.6 percent when a USA $1 capital is raised from equity=selling shares. Should multinational banks bench on equity financing?!! The discussion on such a result emanates from investment theory. Since the corporate strategy yields positive returns, there is no cause for worry. However, following pecking order theory, external equity should be as a last resort.

The coefficients for the control variables: bank size and country size are positive and significant. Because their values are linearly transformed into logarithms, they are interpreted as elasticities. For example, other factors held constant, as bank size and country size expand by the USA $1000 and the USA $1 respectively, profitability response by multinational banks becomes 1.01 and 0.07 respectively. Notice that for bank expansion, 1.01 is elastic whereas for economic growth, the response of 0.07 is inelastic. To investors, the message here is that increase in per capita income does not necessarily raise demand for bank services in sub-Saharan region. This inelasticity is explained by high level of poverty, income inequality, high banking competition, and the geographic inequality in the distribution of these banks-where more concentrate in urban areas. The response for profits to country size is elastic in a sense that it equally pays the multinational banks not to cluster in relatively rich than poor countries. This finding explains the current rapid spread of multinational banks into countries with relatively low levels of per capita income moving away from the well-to-do economies like South Africa and Nigeria.

In both regressions-model I&II, the results of the Arrellano Bond (AR2) test for zero autocorrelation are all positive and insignificant across the models. As expected, there is evidence for first-order autocorrelation and no significant second-order autocorrelation. Likewise, the Hansen p-values in the test for over identification, and the validity of the additional moment restriction are all above 0.10 implying that: first, both models are well fitted, and second, additional moment conditions are valid.

Notice also that the number of instruments, denoted as j in the table of results, is lower than the number of multinational banks in the sample used. For example, in model II, j=104 lower than 126 banks, meeting the basic condition for keeping the results reliable.

Because the Arellano-Bond test for zero autocorrelation in first-differenced errors and the Hansen test for over-identifying restrictions and the difference-in-

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Hansen tests of exogeneity of instrument subsets suggest that the underlying assumptions are not violated, we conclude that the estimation results in both regressions are efficient, robust and reliable, and the models are properly specified.

III. Conclusion and Implications

From the results above, corporate strategy affects the performance of multinational banks. The two strategy constructs: geographical diversification, and equity financing positively relate to bank profitability in terms of ROA while debt financing strategy exposes a reversed effect. Therefore, investors and corporate manager should design their strategic plans from which the best strategies for implementation can be selected. Particularly,corporate decisions on questions about the bank's where to go, and the source of funds for investment should keenly be addressed during strategic planning.

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Appendices

Table 1: Summary list of variables and their measurement.

	Variable label	Variable name	Measurement
Performance	ROA	Return on assets	Percentage (total income/total assets)
	Lag1_ROA	One year lag for profitability	ROA_{t-1}
Corporate strategy	Diversf	Diversification	No. of countries a bank has operation in.
	Debt	Debt financing	%Debt/capital
	Equity	Equity financing	%Equity/capital
Bank assets	Log_Assets	Bank assets	Natural log of total bank assets
Country size	Log_YPC	Country size	Natural log of per capita income

Table 2: A two-step system GMM estimates-effect of diversification, and debt and equity financing on profitability of multinational banks in sub-Saharan Africa

Variable	Model I	Model II
Lag1_ROA	0.0205** (0.0410)	0.0260** (0.0391)
Diversf	0.0140** (0.0121)	0.0324** (0.0110)
Debt	-0.0631** (0.0002)	-0.0651** (0.0001)
Equity	0.0371** (0.0007)	0.0362** (0.0003)
Log_Assets	-	1.0104** (0.0001)
Log_YPC	-	0.0072** (0.0004)
Constant	1.3250** (0.0021)	1.3173** (0.0098)
Group banks	10	10
Number of banks	126	126
Observations	1386	1386
Number of instruments=j	98	104
AR(1)p	0.0013	0.0010
AR(2)p	0.0464	0.0566
Hansen p>ch2	*0.3124*	0.3116
Diff-in-Hansen testP	0.4441	0.4128

Source: Researcher's output from sub-Saharan Africa multinational banks Panel data (2007-2017)

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