

# Correlation between Cost of Capital, Book Values and Shares Prices: Evidence from Qatar Stock Exchange

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Ibrahim Tahat  <https://orcid.org/0000-0002-4013-9045>

Department of Business and Economic, University of Pecs, Pecs Hungary

*Email:* [ibrahim.tahat@gmail.com](mailto:ibrahim.tahat@gmail.com)

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**Abstract.** *This study investigates the link between the cost of capital, and both share book values and market prices on Qatari Stock Exchange. The rationale of this test suggested that their relationship between the published financial data and decision making as result of complying with transparent disclosure, in capital markets which suggested that this data has lost its value relevance to shareholders. Ohlson (1995) basic equity valuation model applied in this research, which linked to the firm's equity market value to book values adjusted for abnormal returns. Data used in this study represent all listed firms on Qatari Stock Exchange, to test this assumption for the period from 2010 to 2019. The result indicated a negative correlation among cost of capital and both firms book values and share market prices. Firms bearing higher risks are predicted to earn higher returns. According to the study's findings, statistical evidence supports the claim that raising the amount of leverage raises the risk for equity shareholders. Because of an increase in leverage results in a higher expected return on investment to compensate equity shareholders for the increased risk.*

**Keyword:** Book Values, Market Prices, Cost of Capital, Value Relevance, Qatar.

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**Introduction.** The study of financial markets has devoted significant time and energy to examining the connections between financial information and stock prices. When financial markets become more aware of financial information, one of the keys focuses of the study of finance is determining whether or if stock prices fluctuate in response to and alongside reported earnings and book value of equity (Lim and Park, 2011). The level of information within financial statements is called value relevance (Lam et al., 2013). The investigation of value relevance seeks to discover the factors that influence stock prices and how they are related to a group of independent financial metrics. It is based on the research done by Alfraih (2016) and considers the institutional characteristics of the Qatari stock market. The concept of this research project is that when market participants make modifications, stock values in marketplaces quickly shift in response, provided that valuable information is supplied (Alfraih, 2017). The term "value relevant" refers to the accounting variables strongly connected with the predictor variables (Beaver et al., 2011). We presume that the extent of value relevancy of the data enclosed in a financial report will determine the extent to which it can be utilised in the process of making investment choices and the proximity of the connection that will exist between an income statement and the price increases of shares or the returns that a company will generate (Lam et al., 2013). According to Barth et al. (2001), one of the most important goals of the research of book value is to extend our knowledge of the relevance and dependability of accounting quantities as reflected in equitable values (Barth et al., 2001).

Following several events that hit the global economy, such as 2008, the Arabic spring and the Gulf crisis against Qatar, a clear line has been drawn to estimate the fair value of listed firms and their actual value in their financial statements (Almujamed, 2018). Therefore, examining this new reality in the Qatari listed firms, the study objective is to test to what extent there is a link between the cost of capital, and both book and market value, which means the impact of the cost of capital on the firm value using the basic equity valuation model of Ohlson (1995). The outcome of this research will help to understand better and gain more insight into the feasibility of the stock price to firms' operations echoed by the value of leverage on the balance sheet, moreover, to verify for any market response to the financial result of firms after entering the market. This study used a sample of firms listed on the Qatar Stock Exchange (QSE) for the year between 2010 and 2019, making all economic sectors in Qatar a total of 34 firms (Almujamed & Alfraih, 2019).

This study reveals three primary conclusions in its findings section. First, the cost of capital and book values of shares were discovered to be important in cross-sectional, grouped, and year-on-year multiple regression analysis for clarifying the Qatari Stock Exchange share prices in 2012–2016. Thus, it suggests that Qatar stock exchange participants rely significantly on such information when making investment decisions. Second, contrary to a study hypothesis, the findings of this study imply that the joint value significance of cost of capital and book values has become much less important throughout the sample period. Third, decreases in value relevance have been reported for income but not for book values; such a finding leads us to conclude that changes in share prices favour book values, which exhibit increases with time. Therefore, although the overall findings from studies of earnings quality recommend that both book values and share market prices are relevant in a mature market, the importance of these metrics has decreased, at least in markets such as the United States. Studies have shown an increasing trend in industrialised countries to study these changes (Chamisa et al., 2012).

On the other hand, not much consideration has been given to emerging markets, which are characterised by uncertain compliance with accounting rules. This research aims to address this knowledge gap by examining the subject in Qatar's developing market context. Compared to mature markets, those that have not yet reached their full potential have a lower value relevance for financial accounting (Hellstrom, 2006). The contrary may be true in Qatar, thanks to the notable number of knowledgeable investors trading on the Qatar stock exchange. On the other hand, the fact that trustworthy sources of valuable information are hard to come by in Qatar may give the impression that financial statements have a greater impact on the stock market there than they do in industrialised countries. It is possible that the large expansion in the number of listed firms and participants in the Qatar stock exchange from 2012 to 2016 helped improve the environment for information, which led to the Qatar stock exchange being better able to meet the requirements of investors.

Consequently, cost of capital, book values and share prices were enacted to bridge the gap between the Qatar stock exchange and financial markets. The issuance of these decrees aims to improve the financial statements' consistency and accountability, boost the trust of both domestic and international investors in the credibility of Qatar stock exchange annual reports, and lure a higher level of investment to the Qatar economy. Despite this, several research studies on the existing financial statements in Qatar have shown that there are still several integration weaknesses, which could lead to a failure to comply with the cost of capital, book values and share prices (Almujamed, 2018). The lack of recommendations, the poor practitioner training, and the poor implementation procedures by the regulatory agencies are all examples of these implementation problems. Because of this, there was a strong impetus for the current study, which aimed to investigate the potential influence that how the cost of capital, book values and share prices are inter-connected with each and how each determinant depends on each other in the Qatar stock markets that could have on the cost of equity and debt financing for those companies. This study aims to estimate the impact of valuable information on published and market data. Book value and market value are more important to the investor to measure the fair value than those influenced by unusual earnings or operating cash flow because the market approach is the most used method of valuation among professionals (Pinto, Robinson, and Stowe, 2019).

## Literature review

**2.1 Qatar Stock Exchange and Financial statements.** As a result of the higher production of oil and gas and the diversification of Qatar's revenue streams, the Qatari economy experienced tremendous growth, which in turn affected the country's GDP. Earnings from oil and natural gas exports have helped propel Qatar to a position as having one of the greatest per capita income levels in the world (Almujamed, 2018).

Because of this prosperity, the country has seen an influx of investments and money from other countries (Qatar National Vision, 2008). The Qatar stock exchange was established in 1995, but it wasn't until 1997 that it began functioning formally (Ghaida et al., 2016). Over the past twenty years, it has been subjected to major alterations in its operations and regulations (Almujamed, 2018). 2009 was the year that the Qatar stock exchange was given its current name. The number of firms listed on the Qatar stock exchange expanded from 18 to 45 between 1997 and 2016, thanks in large part to the restructuring and development efforts carried out in collaboration with stock exchanges (Qatar Stock Exchange, 2017). The Queensland Stock Exchange is subject to oversight from an impartial authority, the QFMA (2017), to ensure that all investors in the stock market enjoy an equitable and secure environment in which to make investments. Because of the differences in their ownership structures, the stock prices of Qatari companies that are listed on the Qatar stock exchange and companies that are listed on the Kuwaiti financial markets are the same agencies.

In contrast to the stocks listed on developed stock markets, the ownership of stocks in Qatar and Kuwait, which are the focus of this article – is extremely concentrated (Abdallah and Ismail, 2017). For example, Abdallah and Ismail (2017) brought attention to the fact that the Qatar Stock Exchange is plagued by extremely concentrated ownership. According to the study's findings, most of the companies are held by the five investors that own the most shares, with their ownership ranging from 24 to 47 per cent. Almutairi (2011) came to the same conclusion on Kuwait. As an illustration, he indicated that the government of Kuwait controls a significant amount of shares in most industrial companies listed on the Kuwaiti stock market. In addition, Morgan Stanley Capital worldwide has proposed that to entice foreign investors, Qatar, along with the other GCC nations, should aim to reveal further information, promote transparency, provide better protection to investors, and adhere to international rules (QFMA, 2017). Certain companies must have at least 51 per cent Qatari management on the Qatari share market.

Qatar doesn't have its chart of accounts; in 1999, like some other GCC countries, it embraced the Financial Reporting Standards (IFRS), which has become compulsory for all firms mentioned on the Qatar Stock Exchange. As a result, there has been an improvement in the promptness and accessibility of financial data to investors due to this change. On the other hand, the legislative structure governing financial reporting in Qatar dates back to the 1980s. Certain standards were mandated by the country's Commercial Company statute and the stock market in the 1980s and 1990s. These regulations came into effect. In addition, this law required all businesses to keep records of their financial activity and a general ledger, inventory records, and a communication register. These new advances in the legal framework that underpins financial statements may suggest a better media environment, serving the needs of current investors and attracting more investors, which, in turn, increases the book value of earnings and share values.

**2.2 Cost of capital, books value and share price.** The literature on capital structure provided examples of how capital gearing ratios affect weighted average cost of capital (WAAC), corporate value, and shareholder wealth. According to conventional wisdom, businesses should borrow money in order to lower their WACC because at low gearing levels, the additional cost of equity is not significant. When gearing is high, both lenders and shareholders expect larger returns, which raises WACC. However, shareholders' wealth is maximized just before shareholders' and lenders' returns start to increase, and this is the point at which WACC is at its smallest (McLaney, 2017). According to Modigliani and Miller (MM), when debt is introduced, shareholders would want a bigger return. The high expectation of shareholder returns is offset by the low cost of debt, hence there is no effect on WACC. MM is predicated on the idea that a company's ability to issue debt, pay corporation taxes, and avoid bankruptcy won't have any impact on the firm (Scott, 1976). Tax was later removed as an assumption from the MM theory because it was thought to be unreasonable. The trade-off hypothesis, which is based on the MM theory, contends that the tax shield (benefits of interest payments) and the costs of bankruptcy should be balanced (Graham and Leary, 2011). This theory contends that a company's worth is maximized when it is structured so that the advantages of tax relief cancel out or significantly reduce the potential costs of bankruptcy.

According to the pecking order theory, the ideal debt ratio is thought to be second best (Sunder, and Myers, 1999). Particularly, businesses prefer internal funds due to significant adverse selection costs. The high issue costs, the fact that shares are offered at a discount during the share issue period, and the uncertainty surrounding the subscription of shares during an IPO and rights issue are the reasons why managers are hesitant to issue shares (Chamisa, Mangena & Ye, 2012). Due to the low information costs involved with debt issues, businesses choose them when there is a financial gap (Frank and Goyal, 2003). Nirmala (2011)

asserts that as a firm's capital structure becomes less debt-heavy, its stock price rises and vice versa. Given that a firm's higher use of loan reduces the earnings accessible to common stockholders and causes investors to worry for their returns, this suggests that investors favour firms with lower borrowing content. Corporate financing practices in developing nations may be significantly impacted by price controls on the securities markets and government-directed credit programs to selected sectors (Booth et al., 2001).

Following the innovative research by Modigliani and Miller (1963), numerous ideas were developed to attempt to explain what influences whether firms employ equity capital or debt capital. The pecking order and trade-off hypotheses shine out among these. Myers (2001) affirms that the trade-off theory places a strong emphasis on taxes and foresees those businesses will target for debt levels that will enable them to strike a balance between the tax advantages and financing costs, which are represented by the costs of bankruptcy (or reorganization) and agency costs. The key empirical relationship anticipated is that because debt financing offers tax advantages, more lucrative businesses would seek to rely on it more frequently (QFMA, 2017). Conversely, corporations prioritize different types of funding in accordance with the pecking order theory outlined by Myers and Majluf (1984) and Myers (1984), starting with internal resources, moving on to debt financing, and concluding with the issuance of shares. This ranking is derived from the information that each sort of finance mechanism conveys, with those that are less sensitive to the information being relayed being given preference. This hypothesis states that when internal resources are insufficient to cover capital expenditures, companies will choose debt over equity.

Nevertheless, using data on corporate financial behaviour, Myers (1984) noted that when a company's stock price is high, it tends to issue shares instead of using debt financing, a behaviour that has previously been supported by Taggart (1977), Marsh (1982), and numerous other academics. This finding, according to Myers (1984), disproves both the trade-off and pecking order theories. The theory of equity market timing arose in this situation as a different way to comprehend business financing decisions. As a result, the capital structure should represent the sum of prior attempts to issue shares at opportune times. According to this method, examining the market-to-book (M/B) ratio can help determine when it would be ideal to issue bonds or shares.

Regression assessments were carried out by Baker and Wurgler (2002) using debt as the dependent variable and a measure of the historical average M/B ratio weighted by the issuance of new stock and debt as the independent variable. They discovered a consistent negative correlation between these factors, suggesting that the usage of debt financing will decrease as the firm's market value increases since issuing shares is more advantageous.

Scholars significantly contribution to corporate finance literature related to share price and cost of capital, Ohlson 1995, illustrated in his research the relationship of the firm equity value and market value. Ohlson model endorsed by several scholars, (Dechow, Hutton and Sloan, 1999; Lim & Park, 2011) articulating that Ohlson model very important empirical study contribution and regarded as outstanding research in financial accounting field with profound impact, and information adynamic one of its key features (Lo and Lys, 2000). While Lundholm (1995) suggested that Ohlson and Feltham model provide us with very weak but descriptive depiction of the financial accounting valuation procured. In addition, (Bernard, 1995), suggested that Ohlson model in overtake other methods such discounted cash flow or dividends methods because its support us with superior share price. Moreover, Abdallah & Ismail (2017) and Ohlson and Feltham (1995) research one of the most significant result of new development in capital markets studies lasted several years and regarded as first step toward redesigning the suitable objective of valuation studies (Atyeh and Al-Rashed, 2015).

Prior research by Brief and Zarowin (1999) used Ohlson (1995) model indicated that the value relevance in New York Stock Exchange has declined during the time between 1978 and 1997. The purpose of this research was to investigate the link between firm book value and dividends as well as book value and earning per share. After 2000, Ohlson model appear to be attractive topic to a lot of academics for instance (Choi et al, 2001; Callen Segal 2005; Gode and Mohanram, 2003; Silvestri and Veltri 2012). These studies collect sample from the European stock market and the USA, using cross-sectional data, auto regression the later time serious accordingly. All these studies' results indicated that the Ohlson model is appropriate and efficient.

An empirical study using 12 years' data from Johannesburg Security Exchange for approx. 130 firms to validate the relationship between share price and accrual accounting information, finding no significant relationship. On the other hand, the research result indicated a significant and positive relationship between



the share price and abnormal earnings, cash dividends and book value of the assets. Another study sample from the Tehran Stock Exchange covering over 10 years of data adopting linear information found that the Ohlson model (1995) received a higher rank among other models used in unusual earning forecasting (Khodadi et al., 2005). Further, significant studies by Vazquez et al. 1997, suggested that the Ohlson model illustrates the firm's market value as a linear regression of its book value as well as unusual return in addition to other variables information. While Dahmash and Qabajeh's (2012) research result using the Ohlson model 1995 criticized the use of a market-based approach and recommended the use of the historical price model in value relevance research.

Several studies used the (Ohlson 1995) model valuation approach, which investigated the firm earnings and book value. According to Vazquez et al. (2007), a study testing the correlation between financial variables and the underlying share price in the Mexican market found that earning and book value are positively correlated. In addition, (Graham and King, 2000), using a data sample of firms from six Asian Markets, namely Indonesia, Korea, Malaysia, the Philippines, Taiwan and Thailand, the research examined the relationship between earning and book values and the market share prices suggested that this type of exercise could be beneficial for settling the international accounting standards. Moreover, research by (Collins, Maydew and Weiss, 1997) testing the changes in relevance of book values and earnings for the period between 1953 and 1993 found an increase in the combined value of earnings and book values during the research period.

Parienté's (2003) model of empirical research suggested that this research could not justify Ohlson's 1995 model to replace the discounted cash flow approach; he suggested that based on (Dechow, Hutton, and Sloan's 1999) research, Ohlson's model resulted in limited improvements to the previous efforts to use the dividend discount approach by a capitalization of short-term earnings forecasts in perpetuity. Most recently, in 2015, research by (Atyah and Al-Rashed 2015) results using the (Ohlson 1995) model using the sample from the Kuwait Stock Exchange for the period between 2005 and 2011, testing the degree of correlation between the cost of capital and share book and market values found negative correlation suggesting that listed firms be liquidated or exit the market in short time horizon. Myers (1999) ran the test on the Ohlson (1995) model to find out the impact of other information and suggested that, in a general sense, other information backed up the effectiveness of the Ohlson (1995) model. Therefore, based on the literature mentioned above, we can rely on the Ohlson model to investigate the correlation between Qatari Stock Exchange firms between the share price book and market values, and cost of capital and earnings per share.

## Methodology

This study's objective is to test the effect of the cost of capital on the share values of Qatari-listed firms. The model adopted the capital and book value cost and adjusted abnormal earning impact. Hence, this research paper used the Ohlson (1995) basic equity valuation approach to examine the degree of correlation as indicated below.

$$P_t = b v_t + a_1 \chi_{at} + a_2 v_t \quad (1)$$

Where  $P_t$  is the market price of the firm stock, time  $t$ , but are the book value of the firm stock, time  $t$ .  $\chi_{at}$  are the abnormal earnings per share during the year time  $t$ . it is non-accounting information or relevant, time  $t$ .  $a_1$  and  $a_2$  are coefficients applying the values that are a function of the linear information dynamics model and the risk-free rate for the firm. To estimate the discount rate and cost of capital in the weighted average cost of capital (WACC) format. My experience as an investment professional found that most analysts used a rate that was between 10% to 12%. However, the widely recognised and used approach Capital Assets Pricing Model (CAPM) as a model to estimate the discount rate which can be solved in the following formula format:

$$DR = R_{fr} + (\beta \times R_p) \quad (2)$$

Where, DR discount rate,  $R_{fr}$  risk free rate,  $\beta$  firm specific risk,  $R_p$  risk premium of the country, therefor the weighted average cost of capital formulated by the following:

$$WACC = DR \times E / (D + E) + I \times D / (D + E) \quad (3)$$

Where DR discount rate, D is the leverage percentage (Debt) of each firm, E is the equity percentage, and I the cost of debt (interest rate). For the tax rate, Qatar is tax-free; therefore, we assume no tax.

**Data and Sample.** This research uses a sample of all firms listed on the Qatari Stock Exchange (QSE).

Thirty-four firms were listed on (QSE) representing seven different sectors, according to table (1) below. The data collected from 2010 to 2019 share book values derived from the firm annual audited financial statements. All firms selected for the study have positive book value from 2010 to 2019. The market share price of all firms in the study was taken last day of trading at the yearends from Thomson data sources which were also used for the risk-free rate based on the average return on long-term of the T-Bonds for the year from 2010 to 2019. Damodaran database derived the equity risk premium and country risk profile for each year of the study periods.

Table 1. Sample Firms Industry Classification

<i>Sectors Profile</i>	<i>No of Firms</i>
Banking	11
Consumer Goods and Services	8
Insurance	6
Industries	10
Real Estate	3
Telecommunications	2
Transportation	3
<b>Total</b>	<b>43</b>

Source: Qatar Stock Exchange 2019.

Table 2. Sample Data Descriptive Statistics

<i>Variable</i>	<i>Number of Observation</i>	<i>Mean</i>	<i>Std. dev.</i>	<i>Min</i>	<i>Max</i>
<i>MVPS</i>	430	5.086	4.692	0.000	22.900
<i>BVPS</i>	430	21.044	25.082	0.000	133.900
<i>EPS</i>	430	0.108	0.113	-0.150	0.430
<i>Cost of Equity</i>	430	0.049	0.057	0.000	0.180
<i>Cost of Debt</i>	430	0.014	0.018	0.000	0.090
<i>WACC</i>	430	0.088	0.096	-0.085	0.544

Source: Compiled by the author.

## Results and Discussion

The sample data used in the research study includes firms from various Qatari economic sectors list on its stock exchange with total average market value approx. 143 billion USD, during the period of the study, representing the whole market capitalization. The test result indicated a weak negative relationship between the book values Qatari listed firm and the weighted average cost of capital (WACC). In the second test of this research the relationship between the share market value and (WACC) also appear to be negative and weaker in contrast to book values. as show in below table 3.

Table 3. Book Values correlation with WACC

	<b>BVPS</b>	<b>MVPS</b>	<b>WACC</b>
<b>BVPS</b>	1.000		
<b>MVPS</b>	0.3807	1.000	
<b>WACC</b>	-0.1656	-0.150	1.000

Source: Compiled by the author.

## Conclusion

This research investigated the extent of correlation and relationship of the Qatari stock exchange based on the Ohlson (1995) basic equity valuation model. Accordingly, two tests were used. The first test used between the cost of capital and the book value considered the adjustment of abnormal earnings. On the other hand, the second test was between the market share prices and the weighted average cost of capital for each company covering the period from 2010 to 2019. The outcome indicated a weak negative correlation for both book values and share prices and tested with a weighted average cost of capital of all listed firms in the Qatari stock exchange used in this study. Therefore, it is rational to expect some of the listed firms on Qatar stock exchange to be liquidated in the near future or exit the Qatar stock exchange market because of the gap between the cost of capital and both book values and market values. The reason for that lead to adequate capital structure between equity and debt, which must be optimized or relocated in terms of the portion of debt-to-equity ratio before it is too late, and these firms may find themselves out of the market. Moreover,

Ohlson's (1995) model is regarded as an advanced and enhanced method because it's linked the stock price to the book values with the cost of capital. Hence, it illustrates a strong perspective on the firm's financial health and position to continue trading in the stock market based on the current performance and capital structure. Finally, it is also interpreted to advise if there is a need to re-engineer its capital structure to provide the expectable return to its shareholders.

**5.1 Managerial implications.** The Qatari-listed firms will understand the significance of disclosing information about their market variations and how doing so might positively affect the market prices of those companies. The investors and shareholders will utilize this knowledge in determining the company's market worth. Third, the results have implications for government policy for the institutions to assure the realization of the conversion to a market value by the enterprises and the capital market. As a result of the transition to market values, knowledge has emerged as a primary factor in driving economic expansion and has surpassed the significance of capital, land, and manpower. Because of this transformation, the cost of capital is necessary for businesses to generate income and value and obtain competitive advantages. Because of this, companies have been pressured to rely more heavily on the cost of capital and share values. The study results indicate that publicly traded companies in Qatar have begun to rely increasingly on share prices, which is consistent with the trend toward a share price and is one of the study's findings.

**1.2 Limitations and Future directions.** It is highly suggested that future researchers conduct an additional study to unearth those indigeneity problems, which could affect the measuring system of the cost of capital in Qatar (for example, institutional ownership, stock market discrepancies, variability as a way of measuring market volatility, beta as a firm's way of measuring of risk premium, and the book-to-market ratio). This additional research should be carried out to find more information about that unobserved heterogeneity. Another useful way to extend the scope of this study is to investigate whether or not the earnings quality in Qatar's setting affects the way the link between book values and the cost of capital is shaped. In this respect, Francis et al. (2008) state that there is experimental evidence of a favourable association between the number of book values, share prices and the quality of earnings. They say this because they believe the two have a positive correlation. It has been discovered that there is a negative relationship between book values and the quality of earnings over time. Therefore, Francis et al. (2008) contend that the presumed significant negative relationship between the cost of capital and book values is primarily based on the amount of earnings quality. They say this because they believe that the level of profitability is the primary factor. In light of the information presented above, the input of our article untruths not only in the fact that it sheds light on the impacts of the level of reporting in a country such as Qatar but also in the fact that it opens up new establishments for future studies in Qatar or any other developing markets that have qualities that are comparable to those of the Qatar context. In other words, the paper sheds light on the consequences of the book values, share values and cost of capital in Qatar by shedding some light on the implications of the Qatar stock exchange.

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