Faculty of Economics and Business

IMPACT OF CAPITAL STRUCTURE ON FIRM PERFORMANCE: EVIDENCE FROM MALAYSIA PLANTATION FIRMS

Yong Hooi Ying

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YONG HOOI YING

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Statement of Originality

The work described in this Final Year Project, entitled **"Impact of capital structure on firm performance: Evidence from Malaysia plantation firms"** is to the best of the author's knowledge that of the author except where due reference is made.

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Yong Hooi Ying

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ABSTRACT

IMPACT OF CAPITAL STRUCTURE ON FIRM PERFORMANCE: EVIDENCE FROM MALAYSIA PLANTATION FIRMS

By

YONG HOOI YING

The objective of the study is to examine the impact of the capital structure of firm performance in Malaysia. The investigation has been performed using panel data procedure for a sample of 10 Malaysian listed plantation firms on the Bursa Malaysia Stock exchange during 2008-2014. . The data is focusing in one sector which is plantation sector. The study is conducted with two performance measures which are included Return on Equity (ROE) and Return on Assets (ROA) as dependent variables. There have three capital structure measures which included Short Term Debt (STD), Long Term Debt (LTD) and Total Debt (TTD) as independent variable in this study The results indicate that firm performance, which is measured by Return on Asset (ROA) and Return on Equity (ROE). Both dependent variables have a significant positive relationship with Short Term Debt (STD) and Long Term Debt (LTD), but having significant negative relationship with Total Debt (TTD) throughout of this study.

ABSTRAK

KESAN STRUKTUR MODAL KE ATAS PRESTASI FIRMA : BUKTI DARIPADA SYARIKAT PERLADANGAN MALAYSIA

Oleh

YONG HOOI YING

Objektif kajian ini adalah untuk mengkaji kesan struktur modal prestasi firma di Malaysia. Siasatan telah dijalankan menggunakan prosedur panel data bagi sampel 10 syarikat perladangan tersenarai di Laman Web Bursa Malaysia dari tahun 2008 ke 2014. Data ini memberi tumpuan dalam satu sektor iaitu sektor perladangan. Kajian ini telah menggunakan dua langkah prestasi termasuk pulangan ke atas ekuiti (ROE) dan pulangan ke atas aset (ROA) sebagai pemboleh ubah bersandar. Terdapat tiga langkah struktur modal iaitu hutang jangka pendek (STD), hutang jangka panjang (LTD) dan jumlah nisbah hutang (TTD) sebagai pembolehubah bebas dalam kajian ini. Keputusan menunjukkan bahawa prestasi firma yang diukur dengan pulangan ke atas aset (ROA) dan pulangan ke atas ekuiti (ROE). Kedua-dua pemboleh ubah bersandar mempunyai hubungan positif yang signifikan dengan hutang jangka pendek (STD) dan hutang jangka panjang (LTD), tetapi mempunyai hubungan negatif yang signifikan dengan jumlah hutang (TTD) dalam kajian ini.

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CHAPTER ONE

INTRODUCTION

1.0 Introduction

Nowadays, global business has changed dramatically. Capital structure is considered as one of the popular topics within the finance field. Capital structure has involved the firm or company's financial framework which it included debt and equity. Those debt and equity is used to finance the firm or company. As far as capital structure is concerned due to capital structure is categorized as one of the most widely researched topics in applied finance. Firm performance and capital structure has succeeded in attracting a good deal of public interest because it is a tool for socio-economic development. As capital structure is mainly based on two sources of finances that is debt and equity. The use of each source of financing indicates mixed and inconsistent results on the firm performance. Modigliani and Miller (1963), who are father of modern finance studied capital structure and they tried to answer the question how the mix of debt and equity in capital structure affects the firm value. Modigliani-Miller (MM) theorem is the structure theory which had been used by many researchers and generally accepted capital structure theory because it is the origin theory of capital. Based on the MM Theorem, these capital structure theories function under perfect market. Due to the tax deductibility of interest payment, firm value is considered as an increasing function of leverage at the corporate level. Therefore, they has demonstrated and to conclude that "capital structure is irrelevance" in a perfect financial market.

Basically, capital structure is important to indicate on how a firm finances its general operations and growth by using different sources of funds. There has two traditional theories of capital structure which are the trade-off theory and pecking order theory is developed based on the Modigliani-Miller theorem. The trade-off theory is clarified about the circumstance that companies usually are financed by partially with debt and partially with equity. According to Jensen and Meckling (1976), trade-off theory indicates that firms regulate their capital structure in response to the temporary shocks which it causes the firms leverage to diverge from the target. On the others hands, the pecking order theory implies on asymmetric information while a manager is making any financial decisions by external funds which investors would perceive this behaviour as the firm is overvalued (Myers, 1984).

According to (Seetanah, Seetah, Appadu & Padachi, 2014), the firm's performance is measured by return on assets (ROA) and return on equity (ROE). ROA reflects the overall performance of the firm and the total profits gained by a firm which is relative to the total assets of a firm whereas ROE reflects the performance of a firm's profitability by revealing the profit does a firm generates with the money that the shareholders have invested. In this study, both ROA and ROE has been chosen as dependent variables in order to measure the firm performance.

In short, capital structure is a combination of a company's debts whether is in long-term or short-term, common equity and preferred equity. Capital structure is essential on how a firm finances its overall operations and growth by using different sources of funds. However, in reality, capital structure of a firm is hard to determine.

This will cause financial managers are facing problem to determine the capital structure. A firm has to concern various securities in an uncountable mixture to come across particular combinations that can maximum its overall value which means optimal capital structure. Although optimal capital structure is a topic that had commonly done in many researches, there are quite many of researchers still cannot find any formula or theory that conclusively provides optimal capital structure for a firm. If irrelevant of capital structure to firm value in perfect market, then imperfections that exist in reality may cause of its relevancy.

Based on the above discussion, there is one important thing which is basic drive of all the theories of capital structure is to examine whether the capital structure has any impact on firm's performance or not. However, this study aims to examine the relationship between capital structure leverage and firm's performance employing a sample of 10 firms in plantation sectors among the main sectors which are listed in Kuala Lumpur Stock Exchange (KLSE) for the period 2008-2014.

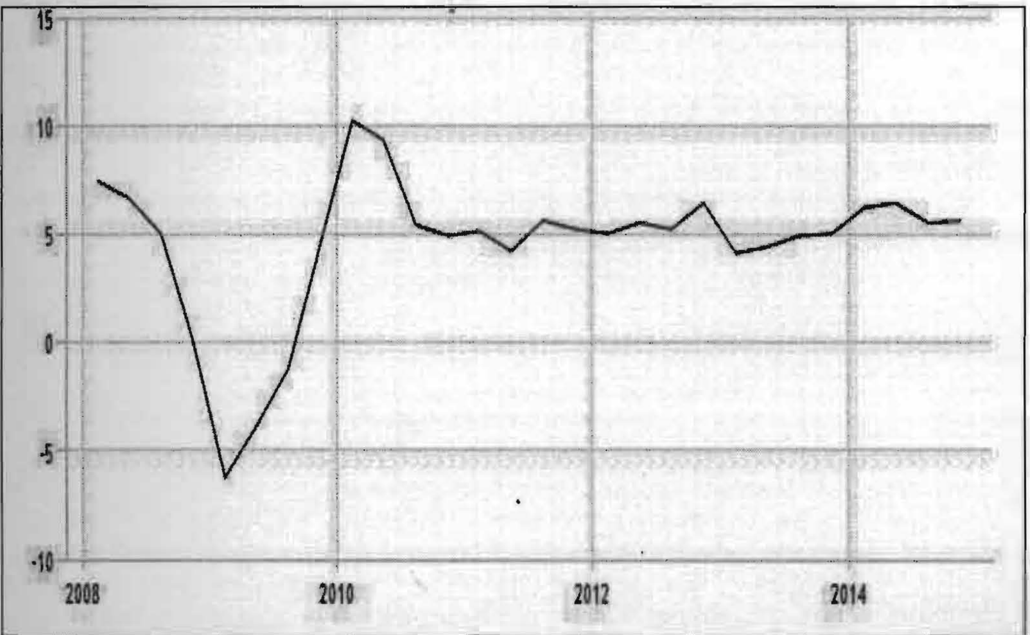
1.1 Background of Study

There is no doubt that capital structure is one of the popular topics among the scholars in finance field which aims to resource allocation. The capital structure of a firm is very significant since it is related to the ability of the firm to meet the needs of its stakeholders. The theory of the capital structure is an important reference theory in enterprise's financing policy.

Capital investments decisions are considered as important among these decisions where the decisions are vital at two levels for the future operability of the individual firm making the investment. At the firm level, capital investment decisions have implications for many aspects of operations, and often exert a crucial impact on survival, profitability and growth. At the national level, the suitable planning and allocation of capital investment are essential to an efficient utilization of other resources, poorly placed investment diminishes the productivity of labour and materials and sets a lower ceiling on the economy's potential output.

After more than fifty years of studies, researchers and economist have not reached a compromise on how and to what extent the mixture of capital structure take effect on the value of firms and accordingly it did affected the shareholders wealth, performance and also governance. However, the studies and empirical findings of the last decades have at least demonstrated that capital structure has more importance than in the simple Modigliani-Miller model. This is due to we are far from reaching a compromise on the perfect combination between equity and debt, but the efforts of fifty years of studies have provided the evidence that capital structure does affect firm value, does affect executives behaviour, and as well as it does affect future performance of the company.

Therefore, this study will provide empirical evidence on the effect of capital structure on firms' performance. The analysis is conducted on a sample of 10 plantation firms from plantation sector which are listed on the Kuala Lumpur Stock Exchange (KLSE) in Bursa Malaysia. After the event of Global Financial Crisis in 2008 that triggered by bankruptcy of Lehman Brothers, it takes time for the plantation firms to recover from the shock as Malaysia which is one of the developing countries around the world, Malaysia GDP annual growth rate in 2008 till 2009 has a gradually drop and recover back in year 2011. The figure below has shown the trend for the Malaysia GDP annual growth rate from year 2008 to 2014.



Source: Trading Economics, 2015.

Figure 1: Malaysia GDP Annual Growth Rate from year 2008-2014

According to Modigliani and Miller (1963), under perfect capital markets assumption, the capital structure has no impact on firm's value. However, this theory is criticized by many researchers objecting due to there are no perfect capital markets in real world, although later they revised their earlier theory by incorporating tax benefit and argued that under market imperfection where interest payments are tax deductible (Modigliani & Miller, 1963). Besides, the trade-off theory argues that firms trade off the benefits and costs of debt and equity financing and reach to an optimal capital structure even with the market imperfections such as taxes, bankruptcy costs and agency costs. Profitable firms can borrow more up to a certain level, because after that the profitability and the value of the firm will decrease due to interaction of bankruptcy costs and agency costs. However, to magnify the MM theory, Jensen and Meckling (1976) developed agency costs theory. Based on the agency costs theory, the agency problem is caused by a conflict of interest between shareholders and managers or between shareholders and debt holders.

In contrast to trade-off theory, Myers and Majluf (1984) has presented the pecking order theory which the theory states that optimal capital structure does not exist. Based on the theory, they argued that to minimize the problem of asymmetric information between firms' managers and investors, financial pecking order. For instance, a hierarchy of financing that begins with retained earnings, which is followed by debt, and finally new stock issues are takes place. Lately, Baker and Wurgler (2002) have recommended a new theory of capital structure which is known as "market timing theory of capital structure". The theory recommends that managers can increase shareholder's wealth by scheduling the issue of securities. Consequently, firms schedule their equity issues by marketing new stocks when the stock price is perceived to be overvalued, and buy their own shares right after they become undervalued.

1.1.1 Firm Performance in Malaysia

There are many researches have studied about the influence to capital structure and firm performance by many aspects (He, 2013). Opening new markets for listed firms in Malaysia as one of the developing countries in Asia is more frequent recently. This issue show how significant to recognize the capital structure in Malaysia listed firms in order to identify what kind of capital structure will improve to their performance. In this study will present the problems which are existing in this research. Also, and tries to explore how the capital structure leverages effect firm performance in Malaysia.

1.2 Problem Statement

The relationship between capital structure and firm performance is a topic that one firm should be concerned due to it might be influenced by economic growth since it would change dramatically nowadays. However, the problem in financial management have not found by the researchers regarding to the optimal capital structure of the firm. The best that academics and specialists have been able to achieve are prescriptions that satisfy short-term goals also stated that over fifty years of studies, researchers have not reached an effect of capital structure on profitability of listed plantation firms in Malaysia on how and to which extent the capital structure of firms' impact on the firm's value, performance and governance. The management of the Malaysia plantation sector cannot be exempted from these facts. This problem compounded with lack of financial resources to lack of skilled labour to economic and political issues have cause the Malaysian plantation sector to decline. From the analysis being developed, it becomes imperative that the profitability of the plantation sector could not be undermined. The aim of this study was to determine the effect of capital structure on the profitability of listed plantation firms in Malaysia.

1.3 Research Question

Most of the researchers have conducted this kind of study in developed countries. There are some research questions dealing with the study of relationship between capital structures and firm performance. The main question in this study is, is there any positive or negative relationship between capital structure and firm performance?

Below show some specific research questions,

1. Is there any relationship between short term debt and firm's performance in Malaysia?
2. Is there effect of long term debt on firm's performance in Malaysia?
3. Is there any relationship between total debt ratio and firm's performance in Malaysia?

1.4 Research Objective

1.4.1 General Objective

The general objectives of this study attempts to investigate the relationship between capital structure and firm performance in Malaysia whether it belongs to positively relationship or negatively relationship between independent variables and dependent variables.

1.4.2 Specific Objective

Consequently, in order to make the objectives to be more specify, therefore, below show the specific objectives to ensure the objectives is more clearer in this study.

1. To determine whether there is a relationship between short term debt and firm's performance in Malaysia.
2. To examine whether there is a relationship between long term debt and firm's performance in Malaysia.
3. To examine whether there is relationship between total debt ratio and firm's performance in Malaysia.

1.5 Significance of Study

The study of relationship between capital structures intends to provide a better understanding about the impact of capital structure influence the firm performance. There is a lack of similar research done on Malaysian companies especially on examination of lagged values towards the firm performance. Hence, this research will explore the extent to which debt which are differentiate into short term, long term and total debt which will influence firm performance. In addition, it is interesting to differentiate short- term debt, long- term debt and total debt ratio since they have different risk and return profiles. Besides, if the relationship between capital structure and firm performance can be determined, management of a firm is able to come out with a better solution in order to minimize the negative impact for capital structure to a firm so that to help a company to performance better in their own sectors. This study will encourage plantation firms with problems in raising funds to implement our findings so as to make better financing decisions, and to put mechanisms in place to limit problems associated with it as well as help to further investigate whether theories about the relationship between firm value and capital structure by Modigliani and Miller are applicable to Malaysian situations or not in order to know the best combination of debt and equity to use. Furthermore, this study helps to address issues of capital structure from the Malaysian perspective in order to boost investor and other stakeholders' confidence in the plantation sector and to encourage investing in this sector. Last but not least, it helps to find out on the statement that firms in developing countries rely more on debt financing than equity financing in order to reveal due diligence and confidence to their stakeholders, by putting in place appropriate controls in policy making and implementation.

1.6 Scope of Study

This study intends to examine the causality between capital structure and firm performance in Malaysia. The scope is on 10 listed firms but specifically on plantation firms chosen from the plantation sector on the Kuala Lumpur Stock Exchange (KLSE). The study made use of financial statements from of manufacturing firms for the past ten years which are from 2008 until 2014.

1.7 Organization of Study

This study is organized and presented into several sections as discussed below. Chapter one introduces the research's structure and overview of this study which includes background of study, problem statement, objective of study, significance of study, scope of study and last but not least organization of study.

The following chapter reviews the relevant research paper on the debate of capital structure and firm performance. In this chapter, a brief discussion is carried out. It is divided into several subsections which include theoretical framework, empirical testing, and empirical evidence.

In chapter three, however, the methodology used is further described. Similar to the previous chapters, it is divided into few subsections such as conceptual framework, data description as well as data sources, empirical models and hypothesis testing.

Data result and analysis of finding are discussed in chapter four. Last but not least, chapter five covers the summary, conclusions and presents suggestions and recommendation for the further studies in the future research.