CAPITAL STRUCTURE AND PERFORMANCE OF MANUFACTURING COMPANIES ON BURSA MALAYSIA

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Abstract

The study is carried out to examine the impact of capital structure on the performance of Malaysian manufacturing listed corporations. Specifically, the study attempts to investigate the relationship between short-term debt (STD), long-term debt (LTD), total assets (TA) and debt to equity (DE) on the return on equity (ROE) of manufacturing companies listed on Bursa Malaysia. To achieve this objective, the data is collected from the annual data of 30 Malaysian manufacturing companies listed on Bursa Malaysia from 2010 to 2017. The annual reports of the selected companies are available on the Bursa Malaysia webpage. In this study, the data is analyzed using Eviews 9 software. The findings of the study show that total assets (TA) and debt to equity (DE) have negative significant effect on the return on equity (ROE) whereas short-term debt (STD) and long-term debt (LTD) have positive significant relationship with firm financial performance. The study thus contributes towards better understanding on the relationship between the capital structure and performance of the manufacturing companies in Malaysia.

Keywords: *capital structure, manufacturing companies, Malaysia*

INTRODUCTION

Economic calamity has given a tremendous effect on the firms in Malaysia. One of the most affected sectors in Malaysia is manufacturing industry. Due to this reason, Malaysian exports have dropped dramatically after 1997 with a net export consistent for about 20% which makes Malaysia one of the most open economies that is dependent on international trade. This has been recorded as the greatest decrease in the Malaysian history after the year 1982. Manufacturing as a dynamic sector is considered as a central to the economic development of Malaysia right after service sector and therefore plays a critical role in the Malaysian economy.

Share values are devalued and numerous firms have lost their assets because of this financial crisis that Malaysia experienced. This situation results in a few firms experiencing capital restructuring and some of the other firms even into bankruptcy. Hence, it is crucial for a company to plan a strategic capital structure that is flexible to any kind of changes in the surrounding condition (Adeniyi et al., 2020). Capital structure is an important element for any organization to achieve an improved monetary state.

Capital structure decision plays an important role for a firm to operate successfully in any type of business organization. Manager or upper management tend to decide a right proportion of debt and equity securities by making sure the various cost and benefit gets along with these securities in order to maximize the wealth of its shareholder. Firms normally have face difficulties in developing an appropriate capital structure model resulting a wrong financing decision being made that affects the value of the firm or leads the firm into confronting its financial delinquent which can end up in bankruptcy. The combination of equity and debt have been identified by researchers such as Abor (2005), Zeitun and Tian (2007) and San (2011) to affect the operations of the firms.

Malaysia encountered a financial crisis at the time of 1998. Malaysia endured a withdrawal in Gross Domestic Product (GDP) because of the Asian financial crisis which started from Thailand. This crisis does not begin in Asia but rather because of the United State financial industry which swelled into harsh global monetary tragedy and profound decline in worldwide market by the end of 2008. In light of all these, a large portion of the determinants of capital structure on financial performance are extremely difficult to be referred as unclear.

The financial performance of the Ringgit Malaysia currency was plugged due to this crisis. Henceforth, this resulted in affected stock prices, share prices and also a high percentage of leverage of firms in Malaysia reflected a higher amount of the former's investment in machinery and other assets in the manufacturing sector as well. Other than that, the export and industrial output were also affected where it deteriorated, and investments were declined. Due to the importance of capital structure on firm performance, therefore, this research is conducted to examine the impact of capital structure on the corporate financial performance in the context of manufacturing sector in Malaysia.

LITERATURE REVIEW

Theories on Capital Structure

Modigliani & Miller

Modigliani and Millers (1958) was the very first theory that have been established from the capital structure in which the research found that the capital structure does not bring any effect on firm's market value and also on the average cost of capital. M&M 1958 theory is a theory that was made based on the inference on the presumption of perfect capital market with risk free debt, no tax, and no transaction cost (Modigliani & Miller, 1958). In the condition of a perfect market, shareholders can sell their asset with no disadvantage for themselves, should be a temporary in earnings to leave them for a short of fund. But in the year of 1963, a new research paper on irrelevance of capital structure by Modigliani and Miller has been published in order to correct or rebate their past error and it was indicated that debt finance gives tax advantage to the firm (Modigliani & Miller, 1963). Due to the tax advantages, the firms can eventually reduce their tax bills as it results in more debt. When debt to equity ratio escalates, the market worth of the firms rises as well. Based on the finding by a study done by Sabin and Miras in year 2015, it refers that the firm esteem is significant to the capital structure. Other than that, it declares that the firm worth can be amplified by raising up the debt level in that certain capital structure that belongs to them.

Trade off Theory

Kraus and Litzenberger (1973) who originated the trade-off theory presented the interest tax shield related to the obligation and the cost of financial distress into a state preference display. Trade-off theory is referred to decisions encompassing several perspectives which include exposure of firm on bankruptcy and agency cost that against the tax benefit associated with the obligation that is being utilized. Trade-off theory is also known as the part for its characterization on how a firm can deal with their power on either short or long-term debts. It also helps to characterize a firm's capital structure that is ought to be used in their trading transactions by stabilizing the benefits and costs. According to a framework of trade-off theory, an organization is alluded to be focusing on the obligation of equity ratio and continuously moving towards its objectives.

Pecking Order Theory

This pecking order theory is positively related to asymmetric data unlike trade-off theory. Asymmetric data often occur amongst manager along with shareholder, where manager is able to distinguish more data compared to external depositor regarding firm performance (Nirajini & Priya, 2013). According to Luigi and Sorin (2009) pecking-off theory has no deliberation on the prime capital structure. The decision made on source of financing depends on the preference order or financial hierarchy where it begins with in-house resources supported by liability and impartiality or more commonly known as equity. Firms maximize their value by choosing to finance new investment with the cheapest available sources (Luigi & Sorin, 2009). Pecking order theory urges the firm to maintain their business so that they stick to financing sources of hierarchy. Based on the finding of a study done by Acaravci (2015), small and large company can both practice the pecking theory.