IMPACT OF FINANCIAL LEVERAGE ON THE FIRM PERFORMANCE IN MALAYSIA COMPANY

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IMPACT OF FINANCIAL LEVERAGE ON THE FIRM PERFORMANCE IN MALAYSIA COMPANY

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This project is submitted in partial fulfillment of the requirements for the degree of Bachelor of Finance with Honours (Finance)

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Statement of Originality

The work described in this Final Year Project, entitled “The impact of financial leverage on the firm performance in Malaysia Company” is to the best of author’s knowledge that of the author except where due to reference is made.

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Saya mengakui bahawa Projek Tahun Akhir bertajuk “KE giám Leverage KEWANGAN PADA PRESTASI FIRMA DI SYARIKAT MALAYSIA” ini adalah hasil kerja saya sendiri kecuali nukilan, petikan, huraian dan ringkasan yang tiap-tiap satunya telah saya nyatakan sumbernya.

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(Tarikh Serahan)   (Tandatangan Pelajar)

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ABSTRACT

THE IMPACT OF FINANCIAL LEVERAGE ON THE FIRM PERFORMANCE IN MALAYSIA COMPANY

By

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Financial leverage can be defined where the company apply fixed income securities such as preferred equity and debt. It involves the raising of funds through financial activities. The use of financial leverage will help to boost and enhance the financial performance of the firm. This study aims to study the impact of financial leverage towards the firm performance in Malaysia Company. In addition this study also meant to investigate the relationship between debt ratio, debt-equity ratio and net working capital on return on asset. A sample of time series data on one firm for the period of 2006 first quarter until 2014 second quarter is conducted for this study. It is about 34 observations. For the purpose of this study, ARCH Heteroskedasticity Test, CUSUM-of-Squares test, Jarque-Bera Normality test (JB), Breusch-Godfrey Serial Correlation LM Test, Ramsey RESET test, and Granger Causality Test is applied for further analysis. The results claim that there is a significant negative relationship found between debt ratio (DR) and return on asset (ROA). The results also indicate that there is a significant negative impact on debt-equity ratio (DER) on return on asset (ROA). In contrast, a significant positive relationship is found between net working capital (NWC) and return on asset (ROA).
ABSTRAK

KESAN LEVERAGE KEWANGAN PADA PRESTASI FIRMA DI SYARIKAT MALAYSIA

By

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# TABLE OF CONTENTS

## CHAPTER 1 INTRODUCTION

1.0 Introduction .................................................................................................................. 1  
1.1 Research Background .................................................................................................. 1  
  1.1.1 History of Financial Leverage ............................................................................... 2  
  1.1.2 Impact of Financial Leverage .............................................................................. 3  
  1.1.3 Limitation of Financial Leverage ......................................................................... 3  
1.2 Theoretical Framework ............................................................................................... 4  
  1.2.1 Pecking Order Theory ......................................................................................... 5  
  1.2.2 Leverage Irrelevance Theory ................................................................................ 5  
  1.2.3 Target Leverage Model ....................................................................................... 6  
  1.2.4 Static Trade-off Framework ................................................................................... 7  
1.3 Problem Statement ....................................................................................................... 10  
1.4 Research Objective ..................................................................................................... 10  
  1.4.1 General Objective ............................................................................................... 10  
  1.4.2 Specific Objective ............................................................................................... 11  
1.5 Research Question ...................................................................................................... 11  
1.6 The Significance of Study ......................................................................................... 12  
1.7 Conclusion .................................................................................................................. 13

## CHAPTER 2 LITERATURE REVIEW

2.0 Introduction .................................................................................................................. 15  
2.1 Theoretical Literature ............................................................................................... 17  
2.2 Reviews on Relationship between Variables ........................................................... 17
CHAPTER 3 DATA AND METHODOLOGY

3.0 Introduction .................................................................................................................. 28
3.1 Conceptual Framework .................................................................................................. 29
3.2 Research Hypotheses .................................................................................................... 30
3.3 Variables of Study .......................................................................................................... 31
   3.3.1 Dependent Variable Measurement ......................................................................... 31
   3.3.2 Independent Variable Measurement ...................................................................... 34
3.4 Sample and Data Collection .......................................................................................... 35
3.5 Model Specification ....................................................................................................... 37
3.6 Research Design ............................................................................................................ 38
3.7 Data Analysis ................................................................................................................ 39
3.8 Diagnostic Checking ...................................................................................................... 40
   3.8.1 ARCH Heteroskedasticity Test ............................................................................. 40
   3.8.2 Cusum / Cusum-of-Squares Test ........................................................................ 41
   3.8.3 Jarque-Bera Normality Test ................................................................................. 41
   3.8.4 Breusch-Godfrey Serial Correlation LM Test ...................................................... 42
CHAPTER 4 RESULTS AND DISCUSSION

4.0 Introduction .................................................................................................................. 44
4.1 Data Analysis .................................................................................................................. 46
4.2 Interpretation on Estimated Model .................................................................................. 51
4.3 Diagnostic Checking ...................................................................................................... 52
  4.3.1 Arch Heteroskedasticity Test .................................................................................... 53
  4.3.2 Cusum Test ............................................................................................................... 54
  4.3.3 Jarque-Bera Normality Test ...................................................................................... 55
  4.3.4 Breusch – Godfrey Serial Correlation Test ............................................................... 56
  4.3.5 Ramsey Reset Test ................................................................................................... 57
  4.3.6 Granger Causality Test ............................................................................................. 64
4.4 Discussion ....................................................................................................................... 65
  4.4.1 Debt Ratio is negatively and significantly Impacts on Financial Performance ........... 66
  4.4.2 Debt Equity Ratio is negatively and significantly Impacts on Financial Performance ......................................................... 66
  4.4.3 Net Working Capital is positively and significantly Impacts on Financial Performance ........................................................................................................... 67
CHAPTER 5 CONCLUSION AND RECOMMENDATION

5.0 Introduction ............................................................................................................. 68
5.1 Summary.................................................................................................................. 70
5.2 Limitation of Study ............................................................................................... 71
5.3 Recommendation of Future Study ....................................................................... 72
5.4 Conclusion ............................................................................................................. 73

REFERENCES .............................................................................................................. 80
APPENDICES .............................................................................................................. 92
LIST OF TABLE

Table 1: The summary of Theoretical Framework ........................................ 8-9

Table 2: Summary of Literature Review on Research Variables .................... 26-27

Table 3. Coefficient of variation, Akaike Info Criterion and Schwarz Criterion for each model .......................................................... 46

Table 4: Result of Ordinary Least Square (OLS) ........................................... 47

Table 5: t-statistics for variables in log-log regression model ......................... 48

Table 6: Heteroskedasticity Test: Breusch-Pagan-Godfrey ........................... 52

Table 7: Cusum Test .................................................................................... 54

Table 8: Jarque-Bera Normality Test ......................................................... 55

Table 9: Breusch-Godfrey Serial Correlation LM Test ................................. 56

Table 10: Ramsey RESET Test .................................................................... 57

Table 11: Granger Causality Test .................................................................. 58
LIST OF FIGURE

Figure 1: Summary of Theoretical Framework ......................................................... 8-9
Figure 2: Relationship between debt ratio, debt-equity ratio, net working capital ......
and return on asset. ................................................................................................. 29
Figure 3: Cusum Test................................................................................................ 54
Figure 4: Jarque-Bera Normality Test ...................................................................... 55
CHAPTER 1

INTRODUCTION

1.0 INTRODUCTION

This chapter defines the background of financial leverage across the worldwide ranges as in Malaysia too, the impact caused by the financial leverage towards the company in terms of few aspects. Next, we will evaluate further on the theoretical framework, problem statement, our general and specific study of our objectives, significance of study at last but not least is the organization of the study. In the end of the research, the researcher will provide an entire research about the chapter layout following by the conclusion of the whole chapter.

1.1 RESEARCH BACKGROUND

1.1.1 HISTORY OF FINANCIAL LEVERAGE

“Leverage” is known as one kind of interesting but till quite a difficult concept that grasped in the field of finance. An individual need to know what is the real meaning of leverage before borrowing. In mid-late 1980s, a buyout king named Mike Miken indicates the function of debt for those companies that eager to grow rapidly.
According to Smith (2002), leverage can be known as the process of borrowing money for investment purpose and return on the particular assignment. However still, a company is in high risk if the ratio of financial leverage is high. In other words, financial leverage is also defined as the degree where the company will apply the fixed-income securities for such as preferred equity and debt as well. The higher the degree of financial leverage, the higher it is for the interest payments. From that, we can deduce that the bottom-line earning per share will be inversely proportional to the interest payments. Modigliani and Miller (1958) say that the relationship between financial leverage and firm value is unimportant and it only exist when the capital structure is affected at the time when those who operate in taxable environment call or tax payments. Debt can affect the returns to shareholders in good condition but in other hand it will also influence them in bad condition. This is how financial leverage is created. In this study, we are going to study and evaluate further on how the financial leverage affect the financial condition of a company.

1.1.2 IMPACT OF FINANCIAL LEVERAGE

For financial leverage, the associated risk will have a vary effect depends on whether the value is added from the financial leveraging. If it is added from the financial leverage, automatically the associated risk will not facing a negative effect. We will develop further on the application of return of equity (ROA) which commonly used in
measuring profitability in a business deals. ROA provide a comparison within the profit that produced during a fiscal year and the amount that invested by the shareholders. It also indicate that the leverage bring risks, which will then lead to the occurrence of takeovers and liquidation. Thereafter, the firm may need sufficient profitability to pay off the debts. There is a general perception that the increased of risk and leverage will lead to an increment of the probability of default as well as the cost of financial distress and bankruptcy costs.

1.1.3 LIMITATION OF FINANCIAL LEVERAGE

For the limitations, as known the uses financial leverage is also another way of borrowing funds. Borrowing money is a troublesome stuff as it always causes a thunderstorm or either a little shade to us. A company may incur in a high level of risk if they often involve in borrowing cases. Following it, it might lead to an increase of interest rates too. The higher the debt level found in the capital structure of the firm, the higher the risk in terms of financial to the particular lender. End up, borrower required to pay a big sum of interest rate payment. The restrictions of the corporation will be mainly affected lead to the downturn of the stock price. Financial leverage might function well only when the interest rates of the corporations is in a low condition. Therefore, it is extremely crucial for us to use the financial leverage in a right medium so that to avoid those occurrence of limitations.
1.2 THEORETICAL FRAMEWORK

Theoretical Framework commonly represents a structure that used to support the evidences of theories in the research study. In the study, it describe thoroughly on the theory which clarify why the research problem occurs and how it happens. It guide us in our research, what we are going to measure later on, and type of statistical relationship we are looking for actually in our further study. We has discover some major findings that involve the theoretical frameworks that we need on for our study for such as pecking order theory, leverage irrelevance, static trade off and lastly is asymmetric information signaling framework. All these frameworks is leading us a way in understanding more on the underlying factors that truly describe on the firm’s financial leverage.

1.2.1 PECKING ORDER THEORY

Myers (1984) purposed pecking order theory. In this theory, adverse selection indicate that among retained earnings, debt and equity, retained earning rank the first follow by debt and next is equity. The pecking order hypothesis say that normally a firm will use internal equity for further growth development. But in the case for external finance, a firm will prefer to raise debts for it. Frank and Goyal (2003) say that when we view
from the aspects of testing pecking order, since tangible assets assist together with collateral, hence we can say that it is related with the increased of leverage. There is an indication of negative relationship between leverage and profit of firm. As to say, when a firm gains earnings or profits, debts will be paid off automatically and the leverage will falls dramatically.

1.2.2 LEVERAGE IRRELEVANCE FRAMEWORK

As mentioned previously by Modigliani and Miller (1958), the irrelevance of capital structure which conducted in a perfect capital markets. The earliest part of this theorem started off with the discussion on the corporate valuation, capital structure and also cost of capital. It has been concluded that involving leverage in parts of capital structure is not an effective way in adding on the firm’s value. However still there is also argument on the traditional notion say that debt is also one of the ways of the capital structure. Ghosh (1996) say that the decrement of leverage that causes a negative effect due to the call is mainly related to the change in the composition of assets. There is also an issue related to equity due to the decline in the price of equity and this occurrence confirmed Modigliani and Miller argument.
1.2.3 TARGET LEVERAGE MODEL

Target Leverage Model is also known as Reversion Framework. Fischer et al. (1989) imply that in this target-adjustment theory, it follows the step of dynamic capital structure model. The components of target leverage model mention that the firm will make adjustment on the outstanding debt due to changes of firm value. Mean reverting leverage ratio is been created here. As to say, this model mentions that firms allow their leverage to fluctuate in overtime period but it has to be within an endogenously determined range. A firm will only make an adjustment on their leverage to the target range only when the boundaries of the range are crossed. The exponents of the target leverage model mention that the adjustment or changes to be made on the outstanding debt is vary with the change in the firm value. It generate mean that degenerate the leverage ratio. These frameworks create a stationary leverage ratio. Hovakimian et al. (2001) explain how the debt/equity choice of a firm is affected by the firm characteristics. It found out to be constant with the target leverage ratio. It tells us that the chances of issuing debt compare to equity are in reversely related to the additional amount of leverage.
1.2.4 STATIC TRADE-OFF FRAMEWORK

This framework was introduced by Myers and Majluf (1984). The components of this framework argue that a firm conducts a tradeoff between cost of bankruptcy and the amount of tax shields on interest in order to stabilize their debts and equity positions. This is meant by maintaining other things constant meanwhile rise up the cost of bankruptcy and reduce the amount of debt. We can also increase the maximum marginal rate of tax and the debt level meanwhile preserving other things constant. Graham (2003) proposed that how the taxes affect the capital structure of a firm and search evidences that low tax rate firms has a lower debt level than high tax rate firms. We cannot ignore the possibility that taxes influence leverage. Bhaduri (2002) propose that large firms tend to have the potential to expand and seem to be less vulnerable to financial distress. A positive relationship is meant to be between leverage and firm’s size. While for the firm that are particular with the use of capital they has a lower level of leverage and it protect them from the risk of facing bankruptcy.
Table 1: Summary of Theoretical Framework

In the summary of the theoretical framework, pecking order theory discuss on the relationship between leverage and profitability of the firm which refer to their performance. When a firm earning profits, leverage will decreased after debts are paid. In leverage irrelevance framework, it is mainly on the relationship between leverage and the firm asset. The variation in the structure of assets will lead to the change in the leverage that bought in a negative effect that due to the call. As for target leverage model, it discuss on the relationship among leverage and the value of the firm. Changes in the firm value will affect the adjustment to be applied on the outstanding debt. Lastly for static trade off framework, it determine the relationship between leverage and firm size. There is a positive relationship between leverage towards the size of the firm.

1.3 PROBLEM STATEMENT

Financial leverage is referring to a degree where fixed income securities such as debt and preferred equity in the capital structure of a firm is been apply by the firm. The problem we had today is that the high level of debt financing leads to a high degree of financial leverage as this will slowly lead to a higher level degree of interest payment. Leverage will caused the variation in ROA, ROE, net profit margin, sales growth and earnings per share. It will then leads to the downturn of the financial performance of a firm. Pandey (2008) proposed that financial leverage has causes variability in the
returns of the shareholders and it leads to the add-ons of financial risk to the firms. In this research, we will study on the how the indicator of financial leverage affect the profitability and the performances of the firms. Christie (1982) proposed that there is negative relationship between volatility and stock returns that prompted by financial leverage. Schwert (1989) say that financial leverage does not fully involve in the observed variation in market volatility. The role of financial leverage is extremely crucial in order to boost the performance of the company and leads a company to a higher level of profitability. Financial leverage will affect the position of the company as it will affect the stock value in the future day. It might then affect the decisions of the investors in making investment as well.

1.4 RESEARCH OBJECTIVE

The purpose of this paper is to examine the impact of financial leverage towards the financial performance of a company.

1.4.1 GENERAL OBJECTIVE

The general objectives of this research study are to determine the effect of financial leverage on the firm performance in Malaysian Company.