A TEST OF STATIC TRADE-OFF THEORY AND PECKING ORDER THEORY ON MALAYSIA FIRMS’ GROWTH OPPORTUNITIES AND FINANCIAL DECISION POLICY

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Bachelor of Finance with Honours
2011
A TEST OF STATIC TRADE-OFF THEORY AND PECKING ORDER THEORY ON MALAYSIA FIRMS' GROWTH OPPORTUNITIES AND FINANCIAL DECISION POLICY

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

Faculty of Economics and Business
UNIVERSITI MALAYSIA SARAWAK
2010/2011
Statement of Originality

The work described in this Final Year Project, entitled “A Test of Static Trade-Off Theory and Pecking Order Theory on Malaysia Firms’ Growth Opportunities and Financial Decision Policy” is the best of the author’s knowledge that of the author except where due reference is made.

13th April 2011

Date

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ACKNOWLEDGEMENTS

First and foremost, I would like to thank my supervisor, Madam Josephine Yau Tan Hwang for her never ended support, encouragement, motivation, guidance, and suggestion. Her keen mind and immense knowledge made this work possible especially at the crucial stages. Words cannot express my appreciation to her.

Also thanks to my family because of their constant support and encouragement, physically and emotionally for me to finish this final year project. The good deeds are appreciated.

Finally, I wish to thank all the other lecturers and friends who contributed and involve, both direct and indirectly, to the realisation of this final year project.
# TABLE OF CONTENTS

LIST OF TABLES ........................................................................................................... xi

LIST OF FIGURES ........................................................................................................... xii

CHAPTER 1: INTRODUCTION 1-13

1.0 Introduction .......................................................... .................................................. 1

1.1 Theoretical Framework .......................................................... .................................. 2

1.2 Background of the Study .......................................................... .................................. 6

1.3 Problem Statement .......................................................... ......................................... 9

1.4 Research Objectives .......................................................... ..................................... 11

1.4.1 General Objective .......................................................... ..................................... 11

1.4.2 Specific Objectives .......................................................... .................................... 12

1.5 Rationale of Research .......................................................... ................................... 12

1.6 Scope of Research .......................................................... ....................................... 13

1.7 Conclusion .......................................................... .................................................. 13

CHAPTER 2 : LITERATURE REVIEW 14-26

2.0 Introduction .......................................................... .................................................. 14

2.1 The Development of Capital Structure .......................................................... .... 14

2.2 The Theory of Capital Structure .......................................................... ............. 15

2.2.1 Static Trade-Off Theory .......................................................... ....................... 16

2.2.2 Pecking-Order Theory .......................................................... ......................... 17
2.2.3 Signaling Theory .................................................................18
2.2.4 Agency Cost Theory ............................................................18

2.3 Growth Opportunities and Financial Decision Policy on Capital Structure.............................................................20
2.3.1 Evidence from Developed Countries .........................................................20
2.3.2 Evidence from Developing Countries .......................................................23
2.3.3 Evidence from Malaysia .................................................................25

2.4 Conclusion .................................................................................26

CHAPTER 3 : RESEARCH METHODOLOGY 27-42

3.0 Introduction.....................................................................................27
3.1 Conceptual Framework .................................................................28
3.2 Sample .........................................................................................29
3.3 Hypothesis.....................................................................................31
3.4 Data Description..........................................................................34
  3.4.1 Leverage Ratio .........................................................................35
  3.4.2 Tangibility .................................................................................35
  3.4.3 Firm Size ...................................................................................36
  3.4.4 Profitability ...............................................................................36
  3.4.5 Investment Opportunities..........................................................37
  3.4.6 Liquidity ....................................................................................37
  3.4.7 Dividend Policy .........................................................................38
<table>
<thead>
<tr>
<th>Section</th>
<th>Title</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>3.5</td>
<td>Data Analysis</td>
<td>39</td>
</tr>
<tr>
<td>3.5.1</td>
<td>Descriptive Statistic</td>
<td>39</td>
</tr>
<tr>
<td>3.5.2</td>
<td>Correlation Coefficient</td>
<td>39</td>
</tr>
<tr>
<td>3.5.3</td>
<td>Multiple Ordinary Least Square (OLS) regression</td>
<td>40</td>
</tr>
<tr>
<td>3.6</td>
<td>Conclusion</td>
<td>42</td>
</tr>
</tbody>
</table>

**CHAPTER 4: EMPIRICAL RESULTS AND FINDINGS**

<table>
<thead>
<tr>
<th>Section</th>
<th>Title</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>4.0</td>
<td>Introduction</td>
<td>43</td>
</tr>
<tr>
<td>4.1</td>
<td>Evolution of Capital Structure in Malaysia</td>
<td>43</td>
</tr>
<tr>
<td>4.2</td>
<td>Correlation Coefficient Test</td>
<td>45</td>
</tr>
<tr>
<td>4.3</td>
<td>Summary of Descriptive Statistic</td>
<td>48</td>
</tr>
<tr>
<td>4.4</td>
<td>Regression Result for Total Debt Ratio</td>
<td>51</td>
</tr>
<tr>
<td>4.5</td>
<td>Regression Result for Short Term Debt Ratio</td>
<td>54</td>
</tr>
<tr>
<td>4.5</td>
<td>Regression Result for Long Term Debt Ratio</td>
<td>57</td>
</tr>
</tbody>
</table>

**CHAPTER 5: DISCUSSION, CONCLUSION & RECOMMENDATION**

<table>
<thead>
<tr>
<th>Section</th>
<th>Title</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>5.0</td>
<td>Introduction</td>
<td>60</td>
</tr>
<tr>
<td>5.1</td>
<td>Discussion of the Hypothesis and Findings</td>
<td>60</td>
</tr>
<tr>
<td>5.2</td>
<td>Summary of Research Study and Theoretical Implication</td>
<td>66</td>
</tr>
<tr>
<td>5.3</td>
<td>Conclusion</td>
<td>68</td>
</tr>
<tr>
<td>5.4</td>
<td>Limitation of the Study</td>
<td>69</td>
</tr>
<tr>
<td>5.5</td>
<td>Recommendation</td>
<td>70</td>
</tr>
</tbody>
</table>
5.6 Further Research Directions ........................................................................71

REFERENCES ........................................................................................................73
LIST OF TABLES

Table 3.1  Public listed companies for different industrial sector in Malaysia ......29
Table 3.2  The expected relationship between the Leverage with firms’ Growth
            Opportunities and Financial Decision Policy based on the theories......38
Table 3.3  Interpretation of the Correlation Coefficient, r ..........................40
Table 4.1  Evolution of Capital Structure in Malaysia .................................43
Table 4.2  Correlation Matrix .......................................................................47
Table 4.3.1 Summary of Descriptive Statistic .................................................48
Table 4.3.2 Descriptive Statistic for all Year by Year Average .........................49
Table 4.4  Regression Result for Total Debt Ratio .........................................51
Table 4.5  Regression Result for Short Term Debt Ratio ................................54
Table 4.6  Regression Result for Long Term Debt Ratio .................................57
Table 5.1  Summary of Results .....................................................................66
LIST OF FIGURES

Figure 1       Summarize of Theoretical Framework ......................................5
Figure 2       Conceptual Framework of the study .............................................28
Figure 3       Evolution of Capital Structure in Malaysia .................................44
CHAPTER ONE

INTRODUCTION

1.0 Introduction

Capital is defined as an important and critical resource for all companies in all countries and the capital can be divided into two categories which are equity and debt. When companies finance its operation and investing activities with the funds obtained from the selling of ownership rights and assets, it’s called equity financing. On the contrary, debt financing happened when companies borrow an amount of money from others and repay it together with the principle and interest within a stipulated time frame.

There are many definitions has been given to capital structure of companies. From the definitions given by many previous researchers, capital structure can be defined as the mix of the diverse funds obtained by the firm. It is summarized that an appropriate and accurate capital structure is an important decision for any business organization to avoid the losses happens to shareholder and also at the same time to maximum the return and minimum the risk (Meyers, 1984; Fraser, Zhang, & Derashid, 2006; Bevan & Danbolt, 2002).

In order to investigate how varying the firms’ growth opportunities and financial decision policy bring their implications on capital structure for companies at different countries, there are several theories have been built up. All the theories have evolved along many directions and it suggest that firms is depend on the features that influence the costs and benefits associated with debt and equity financing, by selecting a
appropriate capital structure. There are four basic theories that explain the capital structure of the companies; Trade-off Theory, Pecking Order Theory, Agency Cost Theory and Signaling Theory.

1.1 Theoretical Framework

Capital structure theories developed since the original Modigliani and Miller propositions and these theories were widely developed in the field of corporate finance. In complete and perfect capital markets, numerous researches has shown that total firm value is independent of its capital structure which mean that when capital structure are perfect, an optimal capital structure does not exist (Frydenberg, 2004). Thus, the study paper of Modigliani and Miller that published in 1958 has supported the perfect market assumptions namely:

- Capital structure markets are assumed to be without transaction costs and there are no bankruptcy costs.
- All firms are in the same risk class.
- Corporate taxes are not the only government burden.
- No growth is allowed since all cash flows are perpetuities.
- Information is symmetric across insider and outsider investors (Frydenberg, 2004).

Later, others researchers have removed the assumption in the study of Miller and Modigliani (1958). Turning the irrelevance proposition around, the proposition also tells us what factors may be the causes of corporate capital structure (Frydenberg, 2004).
Myers (1984) said that lifting these restrictions, one at a time, start possible causes for the capital structure puzzle. Thus, there are several other theories relevant to capital structure have developed following the Modigliani and Miller study.

First theory has developed following Modigliani and Miller’s theory is the Static Trade-Off Theory. Jensen and Meckling (1976) suggest that the firm’s optimal capital structure will involve the tradeoff among the effects of corporate and personal taxes, bankruptcy costs, agency costs and etc. According to the Static Trade-Off Theory hypothesis, the performance of a particular firm affects its target debt ratio and this theory also states that optimal capital structure is obtained when the tax advantage of debt financing and leverage related costs such as financial distress and bankruptcy is been balanced by holding firm’s assets and investment constant.

Other than that, the differences in institutional setting that lead to the different levels of information asymmetry and recapitalization cost will cause the different implication on the capital structure theories in a firm.

The second theory is Agency Costs Theory. Agency costs Theory is an important, yet controversial theory (Eisenhardt, 1989). According to Eisenhardt (1989), the Agency Costs Theory is concerned with resolving two problems that occur in agency relationships which is the agency problem that arises when the desires or goals of the principal and agent conflict. The second problem is the problem of risk sharing that occurs when the principal and agent have different attitudes toward the risk.

The Agency Costs Theory becomes more complicated when debt holders’ interest is considered (Zhang & Li, 2008). Normally, the agency costs associated with debt consist of the opportunity wealth loss, which is caused by the impact of debt on
investment decisions of the firm, bankruptcy costs and monitoring and bonding expenditures (Jensen & Meckling, 1976). In addition, there have been great strides made in demonstrating empirically the role of agency costs in financial decisions such as in explaining the choices of capital structure, maturity structure, dividend policy and so on (Ang, Cole & Lin, 2000).

The third theory is Pecking Order Theory. According to the Pecking Order Theory, the firms will prefer internal financing to external financing, and debt to equity if the firm issues securities (Frydenberg, 2004). The Pecking Order Theory is constructed from the asymmetric information theory. Myers and Majluf (1984) have developed a model in which the capital structure choice is caused by informational asymmetries and states that the private information about the firm whether its operation or investment opportunities are known by outsider investors. However, the adverse selection problem will arise from asymmetric information. Therefore, in order to overcome the problem, firms prefer to use internal funds and when internal funds are not enough to be used, firms turn to use debt and finally equity, which is at the top of the pecking order. Thus, the Pecking Order Hypothesis implies the existence of a financing hierarchy: internal funds first, debt second, and equity last.

The last theory is Signaling Theory. Other than the above theories, the Signaling Theory also takes into account for the capital structure of firms. The basic idea of this theory is signal outside investors the information of the insiders to make the wise choice of capital structure with the implications of the relevance features and aspects. In finance, the Signaling Theory and the Pecking Order Theory both concern the relationship between a firm’s financial leverage and cash flow under asymmetric
information (Zhao, Katchove, & Barry, 2004). The positive relationship between financial leverage and cash flow is suggested by signaling theory whereas pecking order theory implies a negative relationship.

**Figure 1: Summarize of Theoretical Framework**

Theoretical Framework for four main capital structure theories, Static Trade-Off Theory, Agency Costs Theory, Pecking Order Theory and Signaling Theory.

- **Static Trade-Off Theory**
  - Corporate and personal taxes
  - Bankruptcy costs
  - Agency costs

- **Pecking Order Theory**
  - Firms will prefer internal financing to external financing, and debt to equity (Frydenberg, 2004).

- **Agency Costs Theory**
  - Concern with two problems (Eisenhardt, 1989)
    - Agency conflict
    - Problem of risk sharing

- **Signaling Theory**
  - Signal outside investors the information of the insiders to make the choice of capital structure
  - concern the relationship between a firm’s financial leverage and cash flow under asymmetric information (Zhao, Katchove, & Barry, 2004)
1.2 Background of the Study

This study is conducted to examine the Static Trade-Off Theory and the Pecking Order Theory on Malaysia firms and to investigate the implication of growth opportunities and financial decision policy on the capital structure decision for the public listed companies in Bursa Malaysia (KLSE) for all the industry sectors in Malaysia. In this study, the independent variables are group in two which are financial decision policy and growth opportunities. Researcher chooses the liquidity and dividend policy which also known as the dividend payout ratio stands for the financial decision policy. Besides, the researcher is also choosing the firm size, profitability, tangibility, and investment opportunities as the proxy for firms’ growth opportunities. The dependent variables in this study are the leverage or debt ratios which include the short-term debt ratio, long-term debt ratio and total debt ratio. The relationship between all the independent and dependent variables also examine in this study. Leverage is the result and consequence from the amount of debt that a firm uses to finance its assets. However, it is a challenging task to achieve the objectives in order to maintain and to support the growth of a country especially for a developing nation like Malaysia.

Malaysia has gone through many times of the economic crisis and these causes the capital structures of the companies at Malaysia remained uncertain and keep drifting (Pandey, 2001). Hence, from the past few decades, many theories of capital structure have been built to explain a firm’s financing behavior. Thus, in this study, the researcher would like to examine which corporate finance theories are adopted by the firms in Malaysia.
In 1958, Modigliani and Miller have developed the modern capital structure theory to supports the perfect market assumption of no taxes, no bankruptcy costs, and perfect contracting assumption. Following the assumption of Modigliani and Miller, the value and the overall costs of capital was independent of its choice of capital structure. Soon thereafter, Modigliani and Miller (1963) concluded that the market value of a firm is increased and the overall cost of capital is reduced to the point of interest being tax deductible by incorporating corporate tax.

Besides Modigliani and Miller, there are many other financial economists who have also have studied some of the relevant theories to explain the determinants of the capital structure. Some of them have also used the theories to explain the variation in debt ratios across firms. The trade-off theory is one of the new generated theories after Modigliani and Miller. It explains the relation of taxes and bankruptcy costs with debt. The static trade-off theory, which focuses on the benefits and costs of issuing debt, predicts that an optimal target financial debt ratio exists, which maximizes the value of the firm (Swinnen, Voordeckers & Vandemaele, 2005).

Myers (1984) has developed the second type of theory for capital structure known as Pecking Order theory. It is also an important theory that explains the relevance of the debt and optimum capital structure. From Myer’s study, it was demonstrate firms prefer retained earnings as their main source of funds for their investment and operation activities followed by debt. Firms will only consider external funding when they have insufficient internal funds.

In addition to that, many previous researches have studied on the determinants of capital structure. From these researches, it were investigated that the growth
opportunities of a firm are involved firms’ size, investment opportunities, profitability and also the assets structure which also known as tangibility. However, the others factors such as non-debt tax shields, earning volatility, industry classification and many other also tested on others researches to see how they affect the firm’s debt-equity choice. Some study has tested the relationship for firm’s size, tangibility, profitability and market-to-book with the level of gearing in UK companies (Bevan & Danbolt, 2002). Other than that, Psillaki and Daskalakis (2009) study on the capital structure in the developed countries such as France, Greece, Italy and Portugal. From their analysis, firm size is positively related to leverage while the relationship between leverage and asset structure, profitability and risk is negative. The results show that the market-to-book is not statistically significant for any of the four countries. Chen (2004) also has studied the capital structure of Chinese-listed companies. Besides, Ghosh, Giambona, Harding, and Sirmans (2010) have studied the influence of managerial incentives, traditional managerial monitoring mechanisms and managerial entrenchment on the capital structure of Real Estate Investment Trusts (REITs).

Based on the previous studies, the influence of growth opportunities and financial decision policy on capital structure for different country and company are not similarly. In this study, researcher would like to study how the growth opportunities and financial decision policy bring influences on the capital structure for the listed company in Malaysia and examine how the trend of the use of debt for Malaysia before the period of financial and economic crisis and after financial and economic crisis. Other than that, researcher would like to examine between the Static Trade-Off Theory and Pecking
Order Theory, which capital structure theories are mostly adopted by the public listed companies in Malaysia.

1.3 Problem Statement

Despite many researches has done the topic related to capital structure, there are still a very contentious issue in the corporate finance field and topic which is how do firms choose their capital structure. The answer is remaining unclear. It means that there are no a specific answer on how the growth opportunities and the financial decision policy bring impact on the capital structure of one company.

Since independence in 1957, Malaysia has undergone four major economic crises: the first two crises were the oil crises of year 1973-1974 and 1980-1981, the third crisis was the commodity crisis of 1985-1986, and the recent was the financial and currency crisis of 1997-1998 (Ismail, 2006). According to Ismail (2006), from these four major crises, most of the impact on decision making for capital structure in Malaysia is derived from the financial and currency crisis for year 1997-1998. According to Kumar (2009), this crisis lead to the happening of high interest rates added to the corporate and banking crisis. Thus, it will lead to the happened of currency depreciation. In addition to that, the financial crisis will lead to the freedom of capital mobility and allow funds to flow out. Lastly, the deregulation of foreign ownership will happen and will leads to the foreign takeover of many local assets. All of these will cause the capital structure of the companies become not stable and remain uncertain.

To conclude, it is very important for Malaysia to realize the important of sustaining future growth and development. These crises lead to the difficultly of the
company at Malaysia to make their capital structure decision because those crises is bringing much negative effects on the performance of the listed companies as well as their financial status. Due to the problems, the listed company at Malaysia is forced to make some adjustment other from their debt, equity, assets or sales in order to improve the company’s performance. The trend of the use of debt is remain unstable and uncertainty for that moment. In this study, researcher would like to examine the trend of the use of debt at present for all the companies that listed in Bursa Malaysia in Malaysia. The researcher would like to know whether the implication of the growth opportunities on the debt ratios and the relationship among the variables will be the same as the previous researches.

Although there are a number of researches are done on capital structure in the developed nations and developing nations for the past few decades, few studies have focused on Malaysia. Besides, there is less empirical evidence to answer the question like:

I. What is the capital structure adopted by companies in Malaysia?

II. How the growth opportunities and the financial decision policy influence the capital structure choices and the corporate finance theories that adopted by these firms?

III. How was the employment of the debt financing by the companies in Malaysia?

There issues in growth opportunities for a firm are tangibility, profitability; firms’ size and investment opportunities. However, many studies had been carried out testing the above features on different countries with different measurements for leverage. In
other hand, there are still inconsistencies in the evidence. Thus, it was making an important problem to be tackled in Malaysia.

In addition to this, there are less research had been done on others issues in a firm’s financial decision policy such as return on assets ratio, firm’s age, dividend policy ratio, non-debt taxes shield and others on the capital structure in Malaysia. This attracts the researcher interest and attention to do the research on it. On this reason, researcher takes into account of the growth opportunities and financial decision policy of firms to examine the relationship among them with the three leverage ratios.

Besides, there are no many studies and researches had done on examine which capital structure theories is adopted in Malaysia. It remains an uncertain issue and this creates the researcher’s interest to examine which capital structure theory is adopted by the public listed companies in Malaysia in this study.

1.4 Research Objectives

1.4.1 General Objective

The general objective of this study is to examine which corporate finance theory between the Static Trade-Off Theory and the Pecking Order Theory is adopted on the capital structure for the public listed company in Malaysia.
1.4.2 Specific Objectives

I. This study is investigating the relationship between the growth opportunities of a firm with the three types of the debt ratio which is long-term debt, short-term debt and the total debt for the public listed companies in Malaysia.

II. This study is investigating the implication of firms’ financial decision policy on the capital structure decision for the public listed companies in Malaysia.

III. This study is investigating and comparing the deployment of the debt financing for the public listed companies in Malaysia.

1.5 Rationale of Research

This study aims to examine the capital structure for public listed companies in Malaysia by studying the relationship between the independent variables with three types of leverage which are short-term debt, long-term debt and the total debt. Therefore, this study is useful for marketers and government bodies to know which capital structure adopted by the public listed companies in Malaysia so that they can make further decisions and actions to change the current status that face by the any of the companies.

This study would also contribute to the corporate finance field in Malaysia to help analyze the capital structure that adopted by the public listed companies in Malaysia as this study is less conducted by most of the market researchers. Other than that, this study also useful for the companies that has being chosen in this study for them to understand which capital structure and corporate finance theory that actually should adopt by them.
Last but not least, it is hope that this research would be a platform for other researchers to conduct more in-depth studies and contribute more to the corporate finance field in Malaysia.

1.6 Scope of Research

The scope of research is public listed companies in Malaysia. The result would be applicable in Malaysia only and might not relevant in other countries. The researcher is using 5 years data that from year 2005 to 2009 and the data is related which the companies’ performance which normally getting from their financial statement such as balance sheet, income statement and cash flow statement. This research is focused on the types of leverage the companies are using such as long-term debt ratio, short-term debt ratio and total debt ratio.

1.7 Conclusion

This study consists of 5 chapters which arrange as follow. Introduction is in the chapter 1 which has an introduction of the company’s capital structure background, problem statement, objectives, rational of study and the scope. Chapter 2 presents the literature review that related with the capital structure of companies in different countries and the theories that related with the capital structure of companies. In chapter 3, the researches on methodology and data are discussed. It also demonstrates the sample, data description and data analysis. Chapter 4 would present the findings and results from the data getting in chapter 3. Lastly, conclusion and recommendations for future study is in the final chapter of the study.
CHAPTER TWO

LITERATURE REVIEW

2.0 Introduction

This chapter reviews some concepts relating to the topic of this research based on previous researches and studies. It includes the development of capital structure, the theories of capital structure and the implication of growth opportunities and the financial decision policy on the capital structure of the firms of developed market and developing market. This section also reviews how varying the growth opportunities and the financial decision policy on the capital structure in Malaysia from previous researches and studies.

2.1 The Development of Capital Structure

The “classic” proposition made by Modigliani and Miller (1958) posits that the firm’s value is independent of its capital structure (Zurigat, 2009). The Modigliani-Miller proposition is based on the assumptions of a prefect capital market that are no transaction costs, no information asymmetry, no bankruptcy costs, no taxes and therefore investors can borrow at the same rate as corporations.

Capital structure means how a company finances its operation. How firms make their capital structure decisions had been one of the most extensively researched areas in corporate finance (Bancel & Mittoo, 2002). Normally, it is financing its operations through three basic ways which are debt, equity and personal saving. In other word, the