DETERMINANTS OF CONSTRUCTION INDUSTRY PROFITABILITY IN MALAYSIA

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CHAPTER 1: INTRODUCTION

1.0 Construction Industry in Malaysia

In most of the countries, the construction sector contribution in the national income is said to be significant has contributed to 40% to 60% towards the Gross Fixed Capital formation as well in developing countries (Wibowo, 2009).

The Malaysia construction sector is divided into two part (Report from Market Watch 2012). One part is consisted of engineering works for instance civil engineering and other construction works such as construction for residential areas and commercial buildings as well. Apart from this, special commercial and works such as metal works, electrical works, plumbing, sewerage and sanitary works and others will be the another part in construction sector.

In Malaysia, the construction sector has a place as the 3rd biggest provider to country income and has contributed to GDP (Gross Domestic Product) of the country (Bakar, Awang, Yusof & Adamy, 2011). Researches and economist have stated that the construction industry is a one of the productive sector which contributes to the Gross Domestic Product (GDP) of the country and has held market size about RM 43 billion based on gross output (Fong, 2005).

Apart from this, research that performed by Dlamini (2012), has argue that the construction industry plays main role in economic growth. The study has proved that the industry is positively responsive towards the development of the country. Apart from this, the construction output has brought significant impact towards Gross Domestic Product (GDP) of a country.
In Malaysia, construction sector plays important roles in producing infrastructure, utilities and creation of job opportunities as well. Khan (2008) mentioned that this sector has an estimation of US$4.5 billion for the annual global construction output contributes to the worldwide market. In additions, major roles of construction industry towards the socio-economic development in a country are such as providing infrastructure, employment and sanctuary. Through the productive activities of construction sectors, buildings, schools, houses, road, port, sewerage and so on can be provided.

Thus, construction industry is said to be crucial towards the development of a country due to the major roles provided by the sector such as:

1) Creation of job opportunities.

2) Provided of infrastructure towards the socio-economic.

3) Attracting foreign direct investment to the country.

4) Main contributor towards national income of a country.

However, construction industry has been affected and influence much by the economic environment such and unpredictable situations and future expectations. Sundaraj (2006) has mentioned that the construction industry is very much depend on other sectors whether from public or private sector. Besides, during the peaks and troughs period, the construction sector is extreme in the 4 phases of business cycle in an economic and has been affected negatively during both financial crisis 1997 and 2008.
1.1 Financial Crisis and Construction Industry

Sundaraj (2006) stated the construction industry rate has kept declining and even met contraction of -1.5% in year 2004 in Malaysia economic during the financial crisis.

Apart from this, the financial crisis which occurred in year 1997 and 2008 has brought negative towards the construction industry around the world. The production of construction sector has decreased dramatically in year 2008 during the Global Financial crisis especially in the European market. The great impact has been felt especially towards the physical volume of construction works and the investment volume as well (Nistorescu & Ploscaru, 2010).

During the financial crisis in 1997 and 2008, lots of government projects have been forced to reduce in order to reduce the government spending. Besides, government tenders and projects have been postponed and withdraw during the crucial period. Hence, the sector has experienced a great break down and downturn during the period. Moreover, lots of construction firms have been shut down and fight for survival in the tough period.

The fallen of the Thai baht during 1997 has marked the emerged of the Asian Financial Crisis 1997 which then bring to a crisis in currency, a financial crisis and the downturn in economy in most of countries especially Asian including Malaysia. Asian Financial crisis in 1997 has brought big impact towards Malaysia which goes through constantly growth in economy and development in social.

Lots of local multiple firms' business and operations have been shut down during the financial crisis 1997 and there was a contraction of Gross Domestic Product.
Product (GDP) in which Real GDP has declined from 7.3% in 1997 to -7.4% in 1994 and it is the worst downturn for Malaysia since her independence. The negative shock has also lead to the collapsed of share market and current market for the country as well.

According to International Monetary Fund (IMF), the unstable current situations such as poor management, poor corporate governance of firms and corruptions were the main factors which lead to the financial crisis. Such recession has contributed to the contraction of foreign direct investment from other countries as well and affected the international trade badly. For some years, Foreign Direct Investment is considered as one of the most important income resources for the Malaysia economy to hasten the growth of economy (Liew, 2009).

Additionally, Malaysia national income has been badly affected due to the global financial crisis as well even though the United State has started the crisis due to the weaknesses in the financial industry of the country (Khoon & Lim, 2010).

Apart from this, the impact of the financial crisis 2008 has spread to Malaysia even though the originated crisis is not from Asia countries, but the country has experienced it during the fourth quarter of 2008. During the fourth quarter of 2008, the income of the country (Gross Domestic Product) has shown contraction that the GDP growth has drastically decrease at 0.1% compare with the average percentage of 5.9% compare with the first nine month of the year (Khoon & Lim, 2010).
During the crisis, a direct influence towards the country Gross Domestic Product (GDP) and economy can be felt in which there is a contraction in external demand in Malaysia economy. Moreover, according to a report from University Malaya and ISIS Malaysia (2009), the high export percentage to other countries and its high contribution towards the country income was the main factor which leads to the contraction in GDP of Malaysia and burdening the economy during the crisis.

Khoon & Lim (2010) have stated Malaysia economic have faced few negative impacts during the financial crisis 2008 such as towards the financial sector, international trade and real economy as well. The contraction of foreign investment is one of the symptoms and Ringgit Malaysia (RM) currency value has declined in the currency market as well. The decreasing value of RM is due to the factor of less export demand and investment capital outflows.

Besides this, the declining demand of export to United State and other countries which have suffered the financial crisis has occurred during the financial crisis 2008 and imbalance trade has happened. Apart from this, Malaysia also depends much on the import of intermediate goods from other countries. Therefore, the activity of import also decline during the crisis and by greater amount when export decrease. Due to this, Malaysia is still can maintain a positive trade balance throughout the crisis.

For Malaysia, the labour market has been badly affected during the financial crisis 2008 and such situations have contributed to high unemployment rate to the country as well. Khoon & Lim (2010) mentioned that lots of the firms
have closed down and there was a high retrenched rate in the country as well during the crisis. According to the statistics given by Malaysia Ministry of Human Resource, 40,000 workers have been retrenched. The government has frozen to hiring of foreign workers and most of the foreign workers have been affected. The unemployment rate has increased during the crisis as well.

The serious crash which lead by the financial crisis 1997 and 2008 have bring negative shock towards many different industries of the countries especially in the construction industry. Thus, precaution action need to be taken and alert by the government, business owners, stakeholders and shareholders in order to survive through the future coming financial crisis.

1.2 Challenges For Construction Industry in Malaysia

Since year 1786-1957, construction activities in Malaysia have been emerged especially during the British administration period. The explored demand and market of alluvial tin has brought in engineers and other workers and follow by labours from China and India to the country.

During the early years, the terms “contractors” would be referring to a small groups or individual which provide services and products under the instruction of engineers and architect in the employment of customers. Until now, the construction sector is largely depends on the traditional and labour intensive methods in their production process. The over dependence on foreign workers in the sectors can be considered as not a healthy trend. Apart from this, globalization has also brought local contractors to be more competitive in order to meet the expectation in the global market. Moreover, the competitive edge in the construction industry is expected in order to make
the sector become more productive, competitive and can contribute to the sustainable economic growth of the country.

Due to the important roles and functions played by the construction industry, the Malaysia government has much emphasized on the growth of the industry in which organizations such as Construction Industry Master Plan (CIMP) was developed to monitor the construction industry and solve the weaknesses. Performance of construction firms have been taking care and monitoring as well in order to continuously contribute to the national income.

1.3 Problem Statement

The construction sector is the main contributor of Malaysia’s nation income and at the same time, play crucial functions and roles in contributing to the country development and growth especially in the socio-economic sectors. The financial crisis 1997 and 2008 have proved that the failure to monitor the performance of firms may cause the contraction of economic due to issues such as lacking of monitoring firm’s performance and corporate governance issues as well.

In Malaysia, the issue of monitoring the construction industry profitability performance still need to be paid more attention and there is much more need to be analyzed due to the issue is still relative new in the country. Construction industry needs to be emphasized more compare to other sector because this sector is expected to increase to 11.2% in Budget 2013 of Malaysia and in future outlook as well. Thus, the determinants of the profitability of public listed construction industry in KLSE during before and after the Global Financial Crisis 2008 need to be study in order to create the
maximum the profit for the business owners create extra value to the shareholders, investors and contribute to a country economic growth.

In the competitive environment and unpredictable business cycle, to determine the factors affecting the profitability of construction industry is crucial and is the main reason since the result will act as a suggestion and guideline for the management and the business owners of firms to monitor and increase the firm’s profitability in the long run. Moreover, the owner of business can gain benefits through the identifying of determinants of firm’s profitability because this may allow the owner of business and other stakeholders to manage and adjusts their operations performance and company profit can be maximize as well and provide value added to the shareholders of company. Besides, regulators such as government of country may have strategic planning and implementation towards the construction sector in which will assist in the contribution of economic growth in future.

1.4 Research Objectives

To identifying the determinants of the profitability of local main public listed construction firms in KLSE or currently known as Bursa Malaysia from year 2005 to 2009 is the general objective of this research. Secondary data has been applied in order to identifying the determinants of the profitability performance of local main market listed public construction firms in Kuala Lumpur Stock Exchange (KLSE) from year 2005 to 2009.

The study is conducted in order to discover which variables that was significant and can have influence towards the firm’s profitability in the country during before and after the financial crisis in year 2008. The
resources to support the study are the retrieved from the secondary data for total of 5 years which is 2005 until 2009 with the sample of construction firms listed in KLSE or Bursa Malaysia which symbolize the main market listing construction industry in Malaysia. From those variables that have been selected, we analyze the significant the relationship between the variables and will study the determinants for the dependent variables as well. Furthermore, the improvement of the current study and literature is expected to be obtained due to the performed of this study.

Few financial ratios which are the Return on Assets (ROA) and Return on Equity (ROE) have been selected by previous academicians as dependent variables in order to measure the profitability of firms. However, in this study, the dependent variable will be mostly focused on ROA which is the most familiar used financial ratio to measure the firm’s profitability. Thus, the specific objectives are:

1) To determine whether the size of firms will affect the profitability of main market listing construction industry in KLSE in year 2005 until 2009.

2) To evaluate whether the leverage of firms will influence the profitability of main market listing construction industry in KLSE in year 2005 until 2009.

3) To examine whether the net sales of firms affects the profitability of main market listing construction industry in KLSE in year 2005 until 2009.

4) To identify the determinants of construction industry profitability performance in Malaysia during before and after of Global Financial Crisis 2008.
1.5 Significance of Study

The performing of this research is expected to provide the experiential and practical proof on identifying the determinants of profitability of the main market listing constructions firms in KLSE in year 2005 until 2009. The current literature can be improve through the outcome of this research and can contribute towards the business owners as well in order to increase the firm’s profitability by monitoring the determinants variables. The profit and revenue can be maximized and value added can be created to the shareholders as well by determine the significant of the variables and improve the factors in future.

In addition, stakeholders and shareholders can gain benefits through the study because it can provide future guideline and allow them to monitor the firm performance through the determinants variables in future.

Besides, this study is important towards the growth of an economy in the country due to the construction sector is the contributor of country income in Malaysia. Apart from this, socio-economy of Malaysia also has been influence by the development of this sector example such as the production of infrastructure and job opportunities creations. The sustainable of a growth in a country can also indirectly attract more foreign direct investment towards the country which may lead to injection in the economy of Malaysia as well.

A productive sector such as the construction industry in Malaysia has begun to develop its construction industry since independence and this statement has been stated in the Budget Malaysia 2013. In 2013, the country the Gross Domestic Product is expected to have expansion which exceeding RM 1
Trillion with the expected increment percentage in construction industry to 11.2% in 2013.

During the financial crisis especially the Global Financial Crisis 2008, lots of firms have been shut down, downsizing and negative impact towards productive sectors such as the construction sectors have been felt. Thus, the factors which affecting the construction industry’s profitability performance need to be determined and studied especially during the pre-period and after-period (from years 2005 until 2009) of the crisis in order to bring sustainable growth to the country as well as contributing more towards the socio-economic sectors in Malaysia. Besides, precautions ways can be planned, implemented and analysis in order to face the future challenges which is unpredictable.

1.6 Scope of study

To identify the determinants of the profitability of construction industry in KLSE in year 2005 until 2009 which is the pre-period and after-period the Global Financial Crisis 2008 is the purpose of this research. In the study, we included 38 construction companies that has listed in the main market of KLSE (Kuala Lumpur Stock Exchange) for 5 years where we include firm size (total assets), leverage (debt structure) and net sales of firms as the independent variables whereas Return on Asset (ROA) as dependent variable.

1.7 Chapter layout

The layout for the chapter in this study is as follow:-

The first Chapter will start on with the introduction and history of the construction sector in Malaysia, the statement of problem and the purpose of
study. Scope of study and chapter layout will be included in the first chapter as well in the chapter final part.

The second chapter continues with the review of theories and previous academician studies which is related to identify the determinants of firm’s profitability of construction industry in KLSE, 2005 until 2009. Previous studies from researchers have been mentioned in this chapter and act as motivation in order to perform the current study of the determinants of firms in construction industry. Theories and findings from previous academicians will be included in this chapter to support the future argument as well.

The third chapter will mention the methodology that has been used in which it describes the resources of data, the usage of panel data techniques, the framework developed and the hypothesis set up as well. Besides, this chapter will explain the determination of independent variables and dependent variables as well.

The forth chapter will explain and discuss the findings and analysis results towards the determinants of the variables. Different type of analysis and technique models have been used to test the significant of variables and result towards the analysis has been discussed.

Finally, Chapter 5 mentioned the study outcome which explained the constraints and guideline for future research can be provided.
CHAPTER 2: LITERATURE REVIEW

2.0 Introduction

In around the world, the contribution of construction industry cannot be denied because it plays important roles towards the growth of socio-economic in the country. The construction sector is said to be the 3rd biggest provider towards national income of Malaysia and has played an important role in contributing to GDP of the country (Bakar et al., 2011).

In the country, the construction industry is a productive industry which contributes to the Gross Domestic Product (GDP) of the country and has held market size about RM 43 billion based on gross output (Fong, 2005). Thus, the importance of determinants towards the profitability performance of construction firms need to be study and identify in order to create a sustainable economic growth of a country and at the same time bring benefits to other stakeholders as well.

2.1 Firms Profitability and Financial Ratios

Nagy (2009) has employed the Return on Asset (ROA) and other financial statement variables such as net sales and debt to assess the determinants of profitability performance of firms. The employ of ROA is because this financial ratio provides investors an idea of how much the firm’s asset can be converted into income.

Besides, the using of debt structure (leverage) to measure Return on Asset is because the economy of the United Stated has been influence by debt factor over the past 15 years before the study. Net Sales has been used as one of the
independent variable to measure the profitability of firms because it represents the figures of sales created by a firm after the deduction of returns, allowances for missing goods and other discounts allowed. Apart from this, a company may consider have obtained revenue once the products and services have been delivered to customers and is an obvious variable that would bring impact towards firm’s profitability.

Nagy (2009) has employed panel data analysis which is one and two ways Fixed Effects Model to predict the hypothesis and found out both sales and debt are significant towards Return on Asset (ROA) at the level of 1%. Besides, net sales has positive relationship towards firm’s profitability and the significant result of debt shows that firms will benefit more with less debt structure and higher debt structure may lead to bankruptcy of firms.

Akhtar, Javed, Maryam & Sadia (2012) has employed financial leverage (debt structure) of 20 listed public limited firms in Karachi Stock Exchange (KSE) to measure the performance of firms. The indicator of performance that has been used is the financial ratio Return on Asset (ROA) and the period of study is for 5 years (year 2000 until 2005). The finding of the study has suggested that leverage has a positive relationship with the financial performance (ROA) of firms and null hypothesis has been rejected as well.

Khandokar, Raul & Rahman (2013) has performed the research towards determinants of the profitability performance of firms of non-banking financial industry in Bangladesh. In the research, the financial variable such as total asset (size of firms) has been employed and result has demonstrated a positive significant relationship towards the profitability of performance of firms.
Martani & Munaiseche (2010) have mentioned in their research paper the size of firms (total asset) has significant impact but negative relationship towards Return on Asset (ROA). In their study, multi-finance companies in Indonesia during period of 2005 until 2007 have been selected as sample. Size of firms which refers to total asset value for the similarity of data measured by the natural logarithm of total assets has been employ to measure ROA. Throughout the research process, panel data analysis such as Fixed Effect Model has been used to test the hypothesis.

In addition, there are also other researchers that have performed the similar research test using the same financial variables to measure the firms’ profitability performance in order to test the relationship and identify the determinants of performance. In Bhagat & Botton (2009) study, Return on Asset (ROA) is financial ratio that acts as a main measure of a firm operating and profitability. Anderson & Campbell (2004) has stated a firm profitability performance can be calculated based on Return on Asset (ROA) as net income of firm divided by their end year assets.

Khatab, Marsood, Zaman, Saleem & Saeed (2011) findings have discovered that financial variable such as leverage has impact of significant towards a corporate profitability. In Khatab et al. (2011) study, the number of 20 listed firms has been randomly selected as samples to support the test. However, the total assets (size of firm) have no relationship to the profitability and are insignificant in the study. Besides, leverage of a firm can influence profitability of the firms as well according to the study also shown that.
In study done by Chaghadari (2011), the research has randomly selected sample listed in Bursa Malaysia and demonstrate the used of Return on Asset Return on Equity to measure profitability of firms. ROA has been selected as dependent variable because it can measure the operating performance of a firm and the management are said to be have direct responsible for the firms’ operation to consume company assets.

In addition, Nam & Lum (2006) argue relationship between the firm’s profitability and the firm sizes is positive. Their findings are concentrated towards the four Asian countries including Malaysia and study performed is based on distribution of questionnaire. The natural log of the firms’ is used to identify the relationship with the bank’s profitability performance.

Said & Tumin (2011) claimed that the there is a positive relationship towards profitability of firms and the independent financial variables. The study has conducted using the internal factor of firms such as size. However, due to some other reasons, for firms that become tremendously large scale, the effect of negative could be felt towards size.

Tam & Tan (2007) in their study has used variables such as debt structure and firms size to measure the profitability of firms and to test the relationship between financial variables and firms’ profitability. However, the finding has stated debt structure is insignificant towards firms’ profitability of firms. In contrast, the size of firms has brought impact towards the ROA of a firm. This is because the expansion of firm’s total asset has been utilized well by experienced management and can obtain economic of scale in long run.
Size of firms has been used as independent variable by many researches to measure performance of firms. Joh (2003) has mentioned in order to measure a size of firm, the log value of assets has been used. This is because a large firm tends to gain benefits from economies of scale and the benefits will decrease as well beyond a certain limit.

In addition, debt structure or leverage is commonly employed in other studies in order to determine the relationship between financial ratios and firm's profitability performance as well. Chaghadari (2011) and Bhagat & Bolton (2009) have highlighted that the relationship between leverage and firms ROE is positive but both variables have negative relationship towards ROA of a firm. Sakai & Asaoka (2003) has found debt asset ratio has a significant relationship towards firm profitability in which it suggested high debt actually increase firm performance.

Apart from this, Khatab et al. (2011) has used sales rate or growth of sales as financial variable to measure profitability performance (ROA) of firms as well and discovered there is a significant impact on Return on Asset (ROA).

Joh (2003) has used ROA to represent profitability of firms because according to the study, ROA is a better evaluation tools to measure firm’s profitability.

As a conclusion, previous researches have demonstrated different theories and support towards the research problem and outcome. Previous researchers have shown how well the independent and dependent variables have been discussed clearly in the literature study. They have mostly applied the financial variables such as size of firms (total asset), leverage (debt structure)
and net sales of firms to represent as independent variables in order to measure and predict the profitability of firms. Besides, Return on Asset (ROA) is widely used by academician as well due to the ratio can explain clearly the profitability of firms.

The current study can refer the previous studies result as guideline and comparison in order to determine the determinants of profitability of the main market listing construction industry in KLSE from year 2005 until 2009.