Faculty of Economics and Business

THE CAPITAL STRUCTURE AND FINANCIAL PERFORMANCE IN MALAYSIAN COMPANIES

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Bachelor of Finance (Honours)
2014

UNIVERSITI MALAYSIA SARAWAK

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Final Year Project Report	√
Masters	
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THE CAPITAL STRUCTURE AND FINANCIAL PERFORMANCE IN MALAYSIAN COMPANIES

YONG SIEW MEI

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

Faculty of Economics and Business
UNIVERSITI MALAYSIA SARAWAK
2014

Statement of Originality

The work described in this Final Year Project, entitled
"The capital structure and financial performance in Malaysian companies"
is to the best of the author's knowledge that of the author except
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(Date Submitted)

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ABSTRACT

THE CAPITAL STRUCTURE AND FINANCIAL PERFORMANCE IN MALAYSIAN COMPANIES

By

Yong Siew Mei

Capital structure is defined as the financial tool that helps the firm to determine the source of finance. The optimal capital structure has being the focus of attention in many academic and financial institutions long time ago because the guidance might be helpful for those operators in selecting the right capital structure which can add value to the firm. This study aims to examine the impact of capital structure on financial performance in Malaysian companies. Besides, this study also attempts to identify the relationship between capital structure and financial performance. A sample size of 40 listed companies for the period of 2007 to 2011 is used in this study. For the purpose of this study, correlation coefficient, Granger causality, panel data analysis, Breusch and Pagan Lagrangian Multiplier test and Hausman test are used for the analysis. The results reveal that there is significant positive relationship between long-term debt ratio (LTDR) and return on equity (ROE). Short-term debt ratio (STDR) is found insignificant positive impacts the financial performance. Moreover, a significant negative relationship exist between debt-to-equity ratio (DTER) and ROE.

ABSTRAK

STRUKTUR MODAL DAN PRESTASI KEWANGAN DI SYARIKAT MALAYSIA

Oleh

Yong Siew Mei

Struktur modal ditakrifkan sebagai alat kewangan yang membantu syarikat dalam menentukan sumber kewangan. Struktur modal yang optimum telah menjadi fokus perhatian dalam kebanyakan bidang akademik dan institusi kewangan sejak dahulu kerana panduan ini mungkin dapat menbantu pengendali dalam memilih struktur modal yang betul lalu dapat menambah nilai kepada syarikat. Kajian ini bertujuan untuk mengkaji kesan struktur modal atas prestasi kewangan di syarikat Malaysia. Selain itu, kajian ini juga bertujuan mengkaji hubungan antara struktur modal dan prestasi kewangan. Saiz sampel yang mengandungi 40 syarikat tersenarai dari 2007 hingga 2011 telah digunakan dalam kajian ini. Untuk mencapai tujuan kajian ini, *correlation coefficient*, *Granger causality*, analisis *panel data*, ujian *Breusch* dan *Pagan Lagrangian Multiplier* dan ujian *Hausman* telah digunakan dalam analisis. Kajian ini mendapati bahawa nisbah hutang jangka panjang (LTDR) mempunyai hubungan positif yang ketara terhadap pulangan atas equity (ROE). Nisbah hutang jangka pendek (STDR) didapati mempunyai kesan positif yang tidak ketara atas prestasi kewangan. Selain itu, hubungan negative yang ketara wujud antara nisbah hutang kepada ekuiti (DTER) dan ROE.

AKNOWLEDGEMENT

First of all, I wish to express great and external thanks to my final year project supervisor, Mr. Shaharudin Jakpar, who always gives constructive advises, valuable comments and steady support throughout the period of this study. Without his supervision and guidance, my project would not have completed as desired.

Special thanks to my friends who always share their views and opinions with me during the process of this study. Their valuable views had helped and taught me a lot in the completion of this project.

Foremost, I would like to express my gratitude to my family and my loved one who always show their encouragement, caring and love during the period of this study. Deeply thanks to them for being with me at all difficult time.

Finally, I thank those have not be referred above, but have contributed in one way or another to the successful completion of my project.

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CHAPTER 1

INTRODUCTION

1.1 Introduction

There are several ways that firms normally use to raise their capital which including new equity issue, internally generated fund or various types of debt. In finance, capital structure is defined as the financial tool that helps the firm to determine the source of finance. Niragini and Priya (2013) defined the term capital structure as the proportionate between debt and equity. In short, it is also refers to the mixture of securities which the firms issue in order to finance its operations.

The objective of corporate financial management is to assist managers in making a valuable decision framework (Lindbergh, 2003). Therefore, the decision on capital structure is important because capital structure also implies the risk level bear by the company. This decision not only affects the firm's financial performance, it also determines the ability of firms in dealing with the competitive environments. The optimal capital structure has being the focus of attention in many academic and financial institutions long time ago because the guidance might be helpful for those operators in selecting the right capital structure which can add value to the firm. According to Zeitun and Tian (2007), the cost to finance a firm could be reduced and the firm's revenue could be raised if the managers are able to determine the optimal capital structure.

Moreover, some company specific factors such as the bankruptcy probability, profitability, structure and quality of firm’s assets will largely shape a company’s capital structure. Other than that, the company’s industry affiliation and country characteristics will also affect its capital structure decision. Hence, seeking the optimal capital structure will impact on the trade-off between the tax benefits of debt and associated bankruptcy and agency costs.

A variety of financial liberalization measures has been widely implemented by lots of developing countries recently which significant improved their financial structures. This is to make sure the implication of capital structure can lead to better performance of the firm and to enable it to compete in the complex and competitive business environment. Chung, Na, & Smith (2013) mentioned that firms with higher opportunities to growth or presenting imperfect operating performance reduces equity value or compels borrowing appear to increase their firm’s leverage. Therefore, this study aims on debt financing structure to identify how it affects the firm’s financial structure in Malaysian companies.

1.2 Background of study

Debt and equity are the common sources of funds that company finances their business. The combination of equity and debt will influence the cost of capital and the market value of the company because the mixture of debt and equity had an overall implication toward the shareholders earnings and risk (David and Olorunfemi, 2010). Thus, the link between capital structure and financial performance is one of the most complex issues in corporate finance. The alternative capital structures of a firm included the use of warrants, issues of convertible bonds, bond swaps trade and arranging the lease financing (Gill, Biger, Pai & Bhutani, 2009). Risk management, debt or equity repurchases, debt or equity issuance, acquisitions and new investment is one of the ways that can be used by companies in order to manage their capital structure (Shivdasani & Zenner, 2005).

Debt financing is defined as borrowing money from any financial institution that is to be repaid with interest over a period of time. There are two types of debt financing; one is short term debt that is the repayment due in less than 12 month; second is long term debt that is the repayment due in more than one year. On the other hand, equity financing is the selling of company interest in the business in exchange for capital. It allows the company to obtain funds without incurring debt. Equity financing can be in the form of ordinary share capital and preference share capital. However, the disadvantage of equity financing is that there is a dilute of ownership interest and a possible loss of control due to the sharing of ownership (Entebang, 2002).

Both debt and equity financing do have different enticement characteristics, therefore, it have different effects on firm's financial performance. Company that access to public bond market tends to have higher leverage level compared to the company that access to bank lending. It is hard in determine the precise combination of debt and equity. Therefore, firm should establish a target capital structure which is most favourable. The optimal capital structure of a company is when its weighted cost of capital (WACC) is at the lowest. The analysis of firm's financial performance based on capital structure is crucial as it helps the management to review their company performance and thereby enable them to take suitable measure.

Malaysia has developed a considerable economic progress in recent years where its financial market becomes essential to accelerate economic growth. The study in Malaysia companies make it unique as the public traded companies in Malaysia provide a number of characteristics that make it suited to the firm value investigation (Chu, 2007). Hence, this study focus on single nation so that the corporate capital structure can be identify at a level of detail.

1.3 Theoretical Framework

1.3.1 Modigliani and Miller Theory

Modigliani and Miller theory (1958) known as the roots of capital structure theory for more than fifty decades. According to this theory, the cost of capital does not influence capital structure under restrictive assumptions that there is no tax and transaction cost involves (Soumadi & Hayajneh, 2012). Consider there are two firms named Firm X and Firm Y. Firm X is an unlevered firm that is only financed by equity while Firm Y on the other hand, is a levered firm that is partly financed by both equity and debt. Follow the Modigliani and Miller theorem, the value of Firm X and Firm Y is the same. In short, the value of levered firm is equal to the value of unlevered firm. Therefore, Modigliani and Miller theorem is often refers to capital structure irrelevant principle. The theory further argued that at all capital structure level, a firm should have the same market value and the same weighted average cost of capital (WACC) because the value of firm should depend on the risks and return of its operation and not the way it finances those operations (O. P. Ogebe, J. O. Ogebe, and Alewi, 2013).

1.3.2 Trade-off Theory

Trade-off theory supports the relevance of capital structure. This theory implies that there is a positive relationship between leverage and profitability. The cost of bankruptcy and challenge of tax benefit that are associated with debt financing is considered in this theory. Nirajini and Priya (2013) stated that the objective of trade off theory is to explain the strategy of the firms to finance their investments by debt. Under trade off theory, firms that have high growth opportunities are most likely to lose value in financial distress. Thus, it will arise risks accompanying with debt of which firm abandon the profitable investment opportunities. This theory expected that firms with higher profitability should mean more debt serving capacity and taxable income to shield (O. P. Ogebe, J. O. Ogebe, and Alewi, 2013).

1.3.3 Pecking Order Theory

Pecking order theory is considered as one of the most convincing theories of capital structure (Amjed, 2011, p. 4). This theory implies that when internal cash flow is not sufficient to fund capital expenditures, the firm will rather borrow than issuing equity. Afrasiabishani, Ahmadinia and Hesami (2012) claimed that unlike the trade-off theory, pecking order theory suggests the firm to use internal finance over external finance but does not take an optimal capital structure as an initial point. However, if the firms choose to use the external funds, they need to choose the appropriate fund that suit with the company in order to minimize the additional costs of asymmetric information.

1.3.4 Agency Cost Theory

Soumadi & Hayajneh (2012) identified agency cost theory as the potential conflict between the shareholders and managers, and between the shareholders and debtors. On the other hand, Nirajini and Priya (2013) explained the agency cost theory by classified it into three types; asset substitution effect, underinvestment problem, and free cash flow. Firstly, asset substitution effect indicated that when the debt to equity ratio increases, the management has an increased incentive to undertake risky project. Secondly, underinvestment problem implies that, profits from the project will accrue to debt holders instead of shareholders if the debt is risky. Lastly, free cash flow indicates that management has an incentive to reduce firm value, unless free cash flow is given back to the investors.

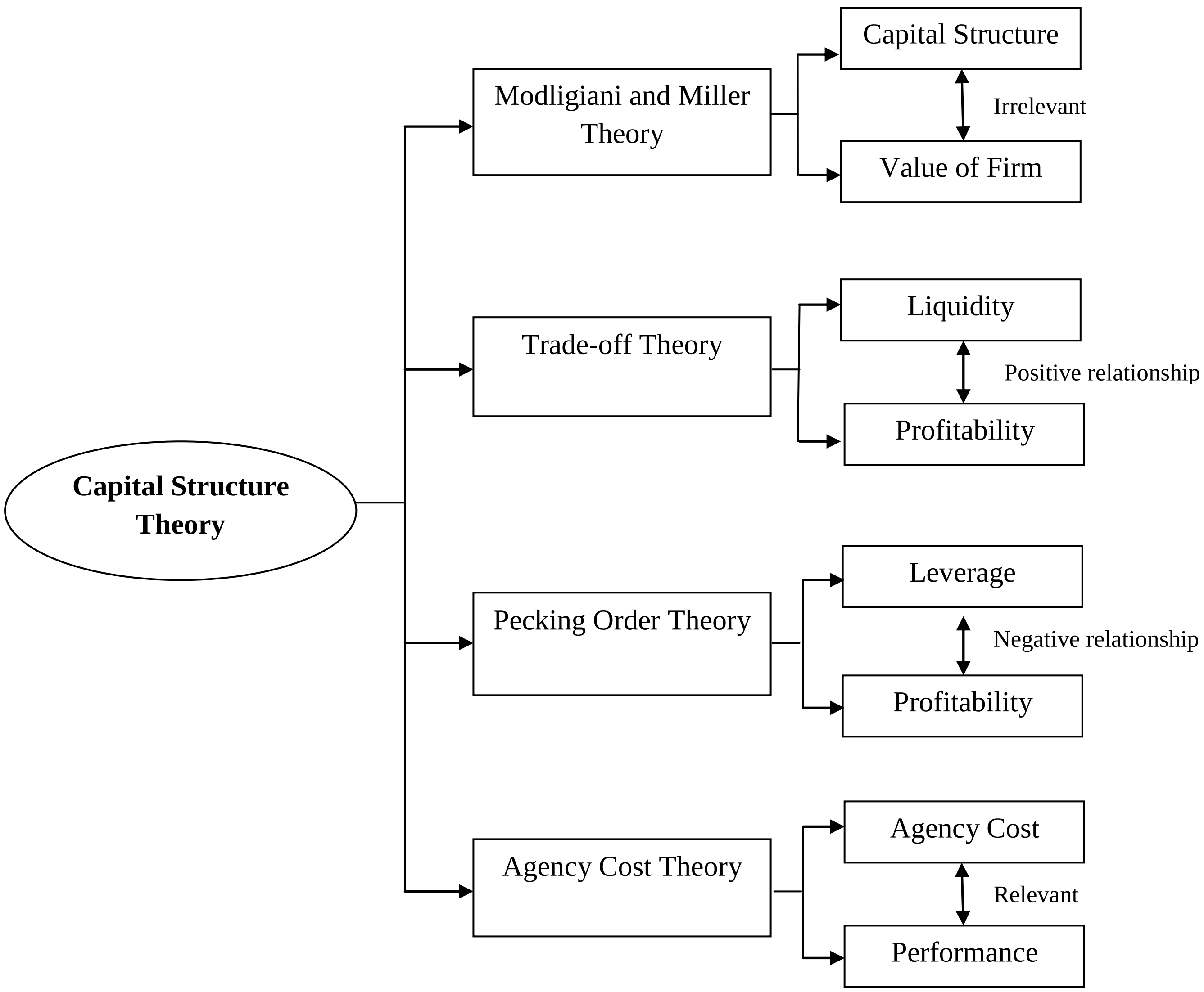

Figure 1: Summary of Theoretical Framework

1.4 Problem Statement

The relationship between capital structure and financial performance is still vague because the relevant studies have obtained many difference results. Previous empirical studies explored whether there is a positive, negative or no significant relationship between capital structure and financial performance. However, some studies produced mixed results which we can see from the literature review. This indicates that there is a deviation among these literatures and therefore, more researches will need to carry out to analyze the relevant issues.

Zeitun and Tian (2007) expressed that empirical evidence about the influence of capital structure on the firm's financial performance in both developing and developed countries is still insufficient. Niragini and Priya (2013) also mentioned that there is still lack of studies in this area conducted in developing countries. In addition, there are not many research conducted in analyzing the association between capital structure and profitability although there are evidence that many research have been analyzed in the field of capital structure. Since the impact of capital structure on financial performance has not been investigated sufficiently for developing countries, therefore this study is conducted to make a significant contribution in this respect.

The difficulty facing by most of the Malaysian companies in financing prospect is the dilemma between to raise debt or equity capital. The issue of finance is very crucial not only because of the need to maximize the business wealth, but also because it has been determined as the main reason that causes most of the business failing in the beginning. Therefore, it is indeed important for Malaysian companies to be able to finance their activities, create value added for the business and to grow over time. Hence, study need to be done to deeply understand how capital structure give impact on financial performance.

1.5 Objective of study

1.5.1 General Objective

The general objective of this study is to examine the impact of capital structure on firm's financial performance in Malaysian companies, that is, to analyze the impact of leverage ratios (long term debt, short term debt, and total debt) and debt to equity ratio on the firm's return on equity.

1.5.2 Specific Objectives

The specific objectives of this study are:

1. To identify the relationship between capital structure and financial performance.
2. To identify whether debt financing contribute to the firm's financial performance.