CROSS-INDUSTRY DETERMINANTS OF CAPITAL STRUCTURE: EVIDENCE FROM MALAYSIA PUBLIC-LISTED COMPANIES

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ASIA e UNIVERSITY
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ABSTRACT

The main objective of this thesis is to investigate the determinants of capital structure of the firms in the Malaysian capital market for seven sectors; this paper aims to study how capital structure differs across the industry in Malaysian public listed companies. New evidence from sector-specific panel models; and the conclusions in this study; firstly, the firms' profitability is the most important determinant, followed by firm size and GDP, and the determinants of capital structure differ between industries, according to new sector-specific models. These findings add to the stylized facts of sector-specific capital structure factors. Secondly, the paper investigates whether capital structure differs between large and small firms. Evidence from Malaysian Public Listed Companies; the study aimed to examine the capital structure and the leverage used in Malaysian public listed firms. This study examines firms' capital structure in the Malaysian stock market. Based on 265 non-financial firms from the seven sectors between 2010–2018, our sample firms are further divided into small and large firms. Our results show that, on average, small firms recorded more leverage than large firms, except for the plantation and property sectors. Second, the Fixed Effect Model with a robust standard error, Quantile regression, and system GMM model show that profitability and size are significant for large and small firms. Lastly, sector-specific models show that the most important determinants are profitability, followed by firm size and GDP growth. These new sector-specific models show that the determinants of capital structure differ across different industries. These findings contribute to the stylized facts of sector-specific determinants of capital structure concerning large and small firms. Thirdly, the paper studies the nexus between financial leverage and board independence of public-listed firms: is there any stylized fact? This study examines the relationship between financial leverage and board independence for firms listed in the Malaysian stock market. Based on a sample of 265 non-financial firms listed on Bursa Malaysia from 2014 to 2018. These results indicate the importance of independent directors for old, large, or low-profitability firms in reducing their financial leverage. These findings highlight the relevance of independent directors in decreasing financial leverage for old, large, or low-profit companies. These findings support the stylized facts of the link between financial leverage and board independence. This study makes several significant contributions to existing capital structure studies. This work contributed to the development of a model of determinants of the capital structure by combining factors relevant to the businesses, culture, shareholders, policymakers, and manager behavior. This research also offers insight into shareholder and managers' financing preferences with appropriate implementations for researchers, investors, financial providers, and policy makers. The research results will assist shareholders and managers in making optimal capital structure decisions, and policymakers will make effective financing policies.

Keywords: Trade-Off Theory, Pecking Order Theory, Agency Theory

APPROVAL

This is to certify that this thesis conforms to acceptable standards of scholarly presentation and is fully adequate, in quality and scope, for the fulfilment of the requirements for the degree of Doctor of Philosophy.

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Professor Dr. Siow Heng Loke
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[17 April 2023]

DECLARATION

I hereby declare that the thesis submitted in fulfilment of the PhD degree is my own work and that all contributions from any other persons or sources are properly and duly cited. I further declare that the material has not been submitted either in whole or in part, for a degree at this or any other university. In making this declaration, I understand and acknowledge any breaches in this declaration constitute academic misconduct, which may result in my expulsion from the programme and/or exclusion from the award of the degree.

Name: Kok Wai Cheng

Signature of Candidate: **Date**: 17 April 2023

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CHAPTER 1

INTRODUCTION

1.1 Background of the Study

This chapter introduced capital markets in Malaysia, especially considering the cross-industry's Malaysia-listed companies' capital structure. Capital structure is crucial for companies to choose between different equity and debt financing sources. The final results of the company's financial decision operations were financial liquidation, bankruptcy, and financial distress. A high-leverage business would gradually lower its costs and effectively allocate capital mix; this is a firm method for reducing weighted capital costs. This would ultimately increase the value of the company by maximizing net returns. The company's management must decide to maximize the value of its business in the uncertain environment in particular.

The determinant of capital structure was first proposed by Modigliani and Miller in 1958; from thereon, many researchers conducted research in financial theory to direct the financial manager to select the correct strategy for the capital structure. Three contradictory theories have been established regarding capital structure. They are the pecking order theory, static trade-off theory, and agency theory.

However, a definite goal of selecting the best with a correct strategy and effective financial leverage remains an unpredictable decision made by the manager. In today's ambiguous world, there is a lot of empirical evidence and hypotheses to provide the best framework for capital, but without effective guidance to assist management with the optimum debt and equity mixture level. The decision was based on a certain interpretation of financial theories and the manager's measured decision

to integrate into the financial mixture decision. This would be a probable method that a manager can choose and affect the stock and valuation of the company.

When a company faces a loss that affects the company's financial condition, the decision to undertake a capital restructuring requires expertise to make the right choice with a structure of the corporate equity and debt capital structure level. Retained earnings, equity, and debt are sources of funds. Therefore, retained earnings are the cheapest sources of financing and are not directly included in the expense in line with external sources.

A firm seeks an alternative source of finance to fund higher debt will occur during financial distress when a company default on its payments to the creditor and fails to meet its financial obligation; the costs of financial distress may include bankruptcy incurred costs such as legal expenses, court fees, direct and indirect costs consider expenses incurred by a company undergoing liquidation and reorganization. If there is too much debt in a company, this may jeopardize the company's future, resulting in bankruptcy.

There is an impact on costs arising in debt to finance its investment; the company must prioritize debt structure, maturity date, mixed debt decision to parties involved, and different forms of debt arrangements in the business sector. (Barclay et al., 2003, Pierson et al., 2002).

1.2 An Overview of the Malaysian Capital Market

1.2.1 Introduction

The stock market of Malaysia plays an important role in the country's economy since it serves two roles simultaneously. First, the capital market acts as an alternative method for a company's stock. For the growth of the company and its expansion,

the capital obtained from the public offer will be used. Second, the stock market operates as a public investment option. Investors can invest their money according to each instrument's level of risk tolerance.

1.2.2 Development of the Malaysian Capital Market

Bursa Malaysia has 90 years of history in Malaysia first began trading in Malaysia when it was renamed the "Singapore Stockbrokers' Association" in 1930. At that time, the stock was not solely traded publicly within the Malaysian security stock market. In 1937, the capital exchange association was called the "Malayan Stockbrokers Association."

The Malaysian stock market first traded publicly in 1960 and was called the "Malayan Stock Exchange." In the global market, which reflected the new security structure. Malaysia's stock market is an influential participant worldwide; it was later renamed "Malayan stock exchange" in 1964 and then changed the name to " Stock Exchange of Malaysia."

The "Malaysian stock exchange" was re-established in 1965. In 1965, as a result of Malaysia's secession from Singapore, Malaysia was shifted to the "Stock Exchange of Malaysia and Singapore." In 1973, the stock market was split into the "Singapore Stock Exchange"; in 1973, the "Kuala Lumpur Stock Exchange Board" (KLSEB) was subsequently removed from Malaysia, and the Singapore currency was separated. KLSEB was accepted as a limited by-guarantee company in 1996 by the Kuala Lumpur Stock Exchange (KLSE).

In 2004, KLSE incorporated Bursa Malaysia transforming the market from a limited company with a guarantee into a limited company with shares. In 2005 Bursa Malaysia was listed on the main board. Bursa Malaysia was able to adapt to consumer needs and resolve fluctuations in market forces in a globally competitive market to be

customer-driven and market-oriented. The goal is to increase the quality of products and services to achieve a better economy and size of their operation.

All Bursa Malaysia-listed companies must comply with regulations regulated by the Acts of Parliament. Companies listed on bursa Malaysia will be traded on the main or second board. However, Bursa Malaysia came into existence in 1997 to trade the MESDAQ (Malaysian Exchange of Securities Dealing and Automated Quotation) market to deal with futures and options contracts. There is also an offshore firm trading on the Bursa Derivatives. MESDAQ aims to ensure that the highly competitive sector and technological innovation simultaneously collect funds, helping technology-intensive businesses. This market seeks to become the NASDAQ equivalent emerging market in the US. Bursa Malaysia operates in real-time and online; during trading hours, investors can access the perfect market information to make their investment decisions.

Companies that meet the requirements are eligible for listing on the Bursa Malaysia. However, companies with limited resources can apply to be listed on the second board, especially for small and medium-sized businesses with growth potential in the future to seed on the stock market listing.

In 2009, Bursa Malaysia's main and second board businesses were combined with a set of standardized listing criteria, the main and second board comprises the stock market of Bursa Malaysia, and MESDAQ combined the two boards. The ACE Market replaces the formerly known MESDAQ market.

a) Phase 1: Malaysian First Crisis

The capital structure is essential for corporate managers and affects the firm's valuation. Malaysia's capital market began in the 1960s and 1970s, with a limited

number of companies, mainly from the banking sector, offering financial instruments to finance economic activities.

The main socio-economic problems in the early 1970s faced the nation due to heavy dependence upon two export products, rubber and oil prices, whose world prices are falling steadily, the known reserves of which are speedily being exhausted. A high rate of a growing population poses a complex and challenging shortage of work opportunities for each year's new entrants into the labor force and enforces a social cost increase.

An unequal income distribution features significant gaps between people who live in rural areas and those who live in cities, between people who live in the states of Malaya and Borneo, and between people who belong to different social groups. Because of the relatively low level of human resource development, there is a shortage of many skills necessary to achieve growth.

In Malaysia's context, after independence, Malaysia suffered four major crises, with the first crisis in the oil crisis of 1971-1973, when Malaysia's economic growth was at its early stage. Oil prices dropped after the world oil crisis affected Malaysia's exports, thereby slowing down the country's growth.

b) Phase 2: Post-Mid-1980s Recession: 1988-90

From 1980 to 1981, during the commodity or second oil crisis, the US policy of high-interest rates led to a significant decline in the world commodity exchange. Malaysia's overall export price index decreased by 30 percent as tin and palm oil prices fell sharply. The country suffered from high domestic and external debts, government deficits created a short-term financial imbalance, and fiscal policy limited the country until 1983 and 1984; Malaysia's economy began showing signs of recovery; the crisis happened again in the 1985-86 electronic crisis due to the weakening demand for

electrical products affected the world economic growth; therefore recession occurred in Malaysia in 1985 due to the weak demand for electronic products

Another crisis occurred from 1989 to 1996; Malaysia's economy reported an average growth rate; during this time, the capital market relied more heavily on the finance sectors to encourage trade activities and provide the private and public sectors with a source of funds for their investment needs. At the beginning of the 1990s, initiatives to liberalize the capital market in Malaysia occurred at the same time that hedge funds and other institutional investors became increasingly interested in emerging market economies. Consequently, there was a sizeable increase in the money brought in through net portfolio investments. By the middle of the 1990s, the amount of volatile capital, which is short-term borrowings and portfolio capital, had grown to a significant level. Since it was over 150 percent at the beginning of the 1990s, the amount of reserve capital used for liquidity has gone down, making it harder for the government to protect the ringgit from a speculative attack (Prema 1990).

According to Prema (1990), Malaysia reported a significant accumulation of outstanding domestic credits in the banking system during the first half of the decade of the 1990s. These were mainly due to domestic credit's heavy exposure to the property sector, broadly defined as share trading and the real estate sector. The annual bank credit expansion rate to the private sector increased to 15 percent from 12 percent from 1990 to 1994. Unclassified loans to conglomerates, typically utilized to finance property purchases, were appropriately considered in this assessment. The banks' already precarious financial position was further eroded due to their increased exposure to the real estate market, which resulted in an oversupply of residential real estate on the market.

c) Phase 3: The Asian Crisis of 1997-98

However, from 1997 to 1998, the Asian financial crisis occurred, and many companies where losses could not pay back their loans which increased non-performing (NPL) loans. The banking industries were also affected by their loans; to gain the confidence of all investors, in March 2000, the Malaysian government announced the Malaysian Corporate Governance Code and issued the first code. The code was therefore reviewed to make public listed companies more effective by implementing the management qualification standard and reinforcing the audit committees. The revision of the Corporate Governance Code for Malaysia, including an internal audit feature, was held in 2007.

The recession's effect would lead to higher unemployment and lower living standards. In comparison, the recovery from the crisis was swift. A fair growth rate was recorded in 1999 when most of the economy had stabilized. Global capital has migrated to the country again.

With its strong critics, Malaysia has stabilized the currency, binding the Ringgit Malaysia's exchange rate to the US dollar at RM 3.80/USD. The short-term capital outflow had to be managed and monitored for seven years of the fixed currency regime.

In the decision on the capital structure, political patronage plays a significant role; Byers et al., (2005) shows that, through the size and profitability of the business, there is evidence that political patronage and the firm’s capital structure have an indirect correlation. According to Faccio et al. (2001) and Gomez and Jomo (1997) and the business and corporate-policy relationship is well known; it suggested that through listing restrictions, the Malaysian government exerts control on selected firms over the private sector, regulation of the banking sector, ownership of direct equity

listed firms and government links institutional investment, this means that Malaysia is an important political patron for some sectors (Gomez and Jomo, 1997).

In developing economies like Malaysia, where many public listed companies are privately owned, Graham, Litan, and Sukhtankar (2002) argue that minority shareholders are proportionally responsible for the costs associated with poor corporate governance. Several Malaysian companies have failed because of issues related to executive compensation, board member selection, investor relations, information disclosure by companies trading on the Bursa Malaysia, and the inability of regulatory agencies to enforce legislation by punishing offenders and protecting minority shareholders (Mohamad, 2002). These issues regularly arise in discussions about corporate governance. These problems remain unaddressed, proving that a rule-based conformance approach did not work and led to corporate governance failure.

Even though the term Corporate Governance is understood everywhere, there is no agreed-upon way to define it. It primarily concerns their directors' exercise of authority and control over businesses. Compliance with company regulation law, board authority, structure, best practices, disclosure, reporting practices, and the value both bring to a company's bottom line are all essential to studying corporate governance.

One of the most common strategies for evaluating different corporate governance practices is to read over the previous year's annual reports of companies (Horwath, 2002). Although such a method is not exhaustive in its scope, the analysis may still be able to provide, at least to some extent, the pertinent indicators of actual corporate governance practices. However, the ability to conduct extensive fieldwork to analyze corporate governance practices is severely constrained. This is since the primary sources of data used to evaluate the corporate governance practices of

companies are based on information that is freely accessible to the general public, such as the annual reports of corporations. Actual corporate governance practices extend further than the materials presented in corporate annual reports. Simply the process of complying with regulations gives people a skewed sense of confidence that they are making sound decisions and taking appropriate actions.

Fasterling (2006) found some observations about the significance of truthful and accurate reporting as a foundational principle for the efficiency of disclosure requirements. He argues that if published reporting is not reliable and must instead rely solely on enforcement and verification measures, disclosure rules quickly become inefficient. It is challenging to detect inaccurate disclosures, and even when they are reliable, they may still have invisible impacts that are hard to trace.

Recent developments in finance, such as financial instruments and derivatives, have prompted national accounting authorities to develop new accounting standards to disclose off-balance-sheet exposures. These new standards. Disclosure of the risk exposures associated with financial instruments has received much attention, particularly after the currency crisis that occurred in South East Asia in 1997 and the disasters that occurred with corporate derivatives that were widely publicized (McCarthy, 2000).

The International Financial Reporting Standards (IFRS) were implemented in Malaysia in 2006, the same year that FRS 132 Financial Instruments: Disclosure and Presentation became mandatory. Companies are not prepared to switch from accounting based on historical costs to accounting based on fair value, which the FRS requires. In addition, the global community is continuing to debate and investigate this matter, which is a positive sign. As a result, the new standard that Malaysian

companies have utilized with financial instruments is the one that governs its disclosure and presentation.

d) The Global Financial Crisis, 2008-09

Since its beginnings in 2008, when a speculative bubble burst in the US housing market, the Global Financial Crisis has spread throughout the world via capital and trade flows and commodity price fluctuations. The quality of financial institutions and policies, as well as the extent of each country's financial and trade ties to the rest of the world, have all played a role in how various complex nations have been hit; the 'trade shock' had the most significant impact on Malaysia and other countries in the region. For the year 2009, Malaysia will be undergoing a full-blown economic crisis.

The first factor to consider is how a recession will affect an individual's income. At the regional level, a decrease in income may result from a smaller demand for goods and services, an increase in unemployment, decreased investment, or decreased remittances. At the household level, the crisis is a critical shock to earnings, primarily caused by the depreciation in the value of assets, job losses, lower remittances, and possibly inflation. Second, a decrease in income will inevitably lead to a decline in consumption, which can refer to private or public spending on areas such as education, health care, or even food and other items. Likely, an increase in income poverty, as well as an increase in non-income poverty, will be caused by reductions in both income and spending. Third, and as a consequence, the community would be damaged mainly if starvation results, which could lead to depression, social tensions, ecological degradation, and so on. This would be especially true if poverty were the consequence (Wan & Francisco, 2009).

1.2.3 Capital Market Governance

There is a potential for a wide variety of market performance indicators to be influenced by the regulations governing capital markets and their implementation. In a world economy that is becoming more interconnected, there is a growing awareness of the importance of sound regulation of the financial markets. Although there is a widespread presumption that poor market governance has negative effects, it has been difficult to document direct evidence of those effects on the economy. The inadequate nature of governance is one of the factors that contribute to this issue. It may be difficult to isolate the quality of capital market governance's clear impact on the outcomes of stock markets. This is because the quality of capital market governance is often linked to several other country-level factors.

Capital market governance enforces the laws, rules, and regulations and ensures that it is in place to monitor the operation of financial markets. Insiders of a company have access to information that puts them at an advantage over other investors, which they may choose to use to their advantage. One of the most important predictions made by the body of research on agency theory is that, in equilibrium, outsiders will take into account these agency problems and force insiders to bear the cost.

Each of the governance measures implemented in Malaysia for the capital market is intended to monitor a different facet of the regulatory framework that helps to protect investors against insider activities. The most direct activity of this type of protection is found in laws governing insider trading and the enforcement of these laws. In a similar concept, accounting measure captures the degree to which those with insider knowledge may have an unfair informational advantage over those with outsider knowledge. Finally, the prohibition of short-selling contributes to an increase