CAPITAL STRUCTURE DETERMINANTS OF FINANCIALLY DISTRESSED FIRMS AT THE BURSA MALAYSIA

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ABSTRACT

This study provides an insight to the state of determinants of capital structure on financially distressed firms of the Bursa Malaysia, under the classification of Practice Note No. 17 (PN17). This is a quantitative research employing the Partial Least Squares (PLS), a more robust of the Structural Equation Modelling (SEM) variant as its main tools of data analysis. Central to this analysis is the adoption of Central Limit Theorem as its main parameters. The findings of this study concluded that significant determinants for the pre-reorganised capital structure of the PN17 firms are tangibility and size while for the post-reorganized capital structure was growth. In line with conventional wisdom, the relationship between pre-reorganized capital structures and its determinants was only reliable one year prior to the date of reorganization. The study also found that there are no association between the pattern of pre and post reorganized capital structure indicating independence capital structure reorganization process of the PN17 firms. In terms of capital structure models, the pre-reorganized PN17 firms exhibit a preference towards the Total Loan Model which indicated leaning towards financial structure while the post reorganized firms gravitate towards Total Debt Model, indicating the notion of capital structure. This study concluded that the present PN17 classification is effective in fulfilling its duty as intended by Bursa Malaysia in identifying and restructuring financially distress public firms.

APPROVAL

I certify that I have supervised / read this study and that in my opinion it conforms to acceptable standards of scholarly presentation and is fully adequate, in quality and scope, as a thesis for the fulfillment of the requirements for the degree of Doctor of Philosophy.

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DECLARATION

I hereby declare that the thesis submitted in fulfillment 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.

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LIST OF ABBREVIATIONS

ABS	Asset Based Securities
ADB	Asian Development Bank
AFC 1997	Asian Financial Crisis 1997
AIG	American Insurance Group
ASEAN	Association of Southeast Asian Nations
APN 17	Amended Practice Note No. 17
BNM	Bank Negara Malaysia
BoJ	Bank of Japan
BSKL	Bursa Malaysia
ECB	The European Central Bank
FDI	Foreign Direct Investments
TRAP	Treasury Assistance Programme
TBTF	Too Big To Fail
GMC	General Motors Corporation
GDP	Gross National Product
GFC	Global Financial Crisis
KLCI	Kuala Lumpur Composite Index
MM Theory	Modigliani-Miller Theory
PLS	Partial Least Square
PN 17	Practice Note No. 17
PN 4	Practice Note No. 4
QE	Quantitative Easing
SEM	Structural Equation Modeling
SPSS	Statistical Package for Social Science

CHAPTER 1

INTRODUCTION

1.1 Background of Study

The Global Financial Crisis of 2008 had proven that the world conventional economic and financial wisdom which was dominant for the last fifty years, ever since Milton Friedman promotes his famous mantra “the business of business is doing business” and Eugene Fama “Efficient Market Hypothesis”, was “a huge slap in the face for the free market fundamentalist” (Krugman, 2012). The housing bubble that erupted in the United States in the late 2007 and later became the worst ever global financial crisis in post-World War II history was mainly due to the cumulative effect of financial deregulation that swept the advanced economies since 1980’s (Sherman, 2009), which by 2012 had cost the United States economy by an estimated USD12.8 trillion (Weise, 2012). The aftermath effect of the 2008 financial crisis was disastrous. In the United States the number of businesses that field for bankruptcy in 2008 and 2009 was almost double and triple respectively, from 2007 and the situation is no different for Malaysia (please refer to Table 1.1). Analyst pointed out that there are many causes which led to the Great Recession 2008, which started from the policy mismanagement by Freddie Mac and Fannie May to the derivatives trading’s of mortgage backed securities and the collapsed of the credit swap market. However the researcher concluded that the final blow to the crisis was stemmed from the “mistrust within the banking community” (Amadeo, 2017) that originated from the “greed is good” behaviour of the industry participants.

Table 1.1: Bankruptcy Statistics 2007-2012*

Year end: December	Companies Filed for Bankruptcy	
	Private	Public
2007	2554	35
2008	2752	32
2009	2988	40
2010	2758	50
2011	2662	39
2012	2820	49
2013	2921	41
2014	2861	33
2015	3144	33
2016	3054	38

*Statistics from Securities Commission Malaysia (SSM, 2019)

Malaysia, as the world 17th largest trading nation (Damodaran, 2012) and 23rd largest exporting countries in the world (Mahmud, 2016) understandably was affected by the world financial crisis and posted negative growth in 2009. This situation however is not unique to Malaysia alone since almost all countries posted negative growth in that year. Malaysia however was lucky in the sense that her economic fundamentals was strong enough to withstand the brewing world recession that she recovered quite beautifully by 2010, albeit thanks to two economic stimulus package by the government that cost around RM67 billion (Khuen, 2016).

In the case of Malaysia, The Global Financial Crisis of 2008 is considered as muted compared to the Asian Financial Crisis of 1997. “It was neither a currency crisis, nor a financial crisis” to Malaysia but more sort of an export crisis (Khoon & Mah-Hui, 2010). However, unlike the 1997 crisis where Malaysia was able to “export out” her recovery, the 2008 crisis was dealt mostly by domestic demand, which is small in size (Nambiar, 2017) and marred with high level of household debt (Shaffer, 2015), which is about 88% of national GDP in 2015.

1.2 Financial Distress

In sync with the economic boom or bust, companies are severely exposed to the fluctuations of the business cycle. Generally, companies that are strong financially will be able to weather the economic downturn but for those who do not have the resilience, will suffer financially, and for some company, will be forced to even go out of business.

One of the main issues that had consistently lingers on the minds of the investing public and the policies of governments have been financial distress of public companies. Researchers had paid a lot of attention to the issues of financial distress in public firms because of its importance to the overall economy. The study by Habib (Habib, Bhuiyan, & Islam, 2013) and Weise (Weise, 2012) **concluded that there are strong correlation between economic conditions and corporate performance** which leads to the importance of financial distress issues.

Financial distress may occur as a significant and persistent reduction in a company’s financial performance, making investors and creditors suffered dramatic financial losses. Companies that suffer financial distress normally can be classified into either four main conditions which are **failure, insolvency, bankruptcy or**

default (Altman & Hotchkiss, 2006). *Companies that consistently generate lower realized rate of return compared to the market rate of similar investments, having an average return that is lower than the cost of capital or do not have enough revenue to meet their operating cost can be classified as experiencing business failures.*

Insolvency however is the situation when company is unable to meet its current obligation, thus indicating a negative net worth. At this stage, firms are categorized as facing chronic financial distress and in one way or another must initiate restructuring exercises in order to avoid formal bankruptcy proceedings. Last but not least, *default is a situation when a firm is not able to pay its creditors on time. This would normally necessitate legal actions which could lead to either insolvency or in a more serious situation, bankruptcy proceedings where a company is no longer able to fulfill its financial obligations.*

In the United States, when companies are suffering severe financial distress, they will normally filed for bankruptcy protection under Chapter 11 that gives them time to reorganize their turnaround plan so much so that, if the restructuring plans are agreed upon by the creditors and the court, the company can exit the Chapter 11 protection and resume trading as a normal company. In Malaysia, the existing Company Law (2012) does not provide for any bankruptcy protection similar to Chapter 11. However, since 2001, Bursa Malaysia had introduced a special category specifically for financially distress companies known as Practice Note No.4 (PN4). Public companies that are experiencing financial difficulties that fulfill the specific criteria of PN4 are classified under this category and will be given a stipulated time by the Bursa to remain as a listed company while undergoing restructuring exercise.

In 2005 the Bursa made some changes to the criteria of Practice Note No. 4 and is currently known as Practice Note No. 17 (PN17).

1.2.1 Development of PN4 and PN17 of Bursa Malaysia

PN4 was introduced on 15 February 2001 to provide a comprehensive plan for listed firms with financial condition that does not justify continued trading and /or listing on the exchange. It was introduced to ensure that sufficient discloser was made about listed companies that were financially distressed or had inadequate level of operations and to ensure that those companies took steps to expeditiously restructure in order to address their unsatisfactory conditions.

However, the 1997 Asian Financial Crisis had proven that the PN4 classification was unable to meet its objectives. PN4 covers listed companies that are in poor financial conditions and were required by the stock exchange to provide proposals to restructure or revive the companies. However, some companies that had been listed as PN4 and subsequently graduated from the list after solving their financial problems apparently were back in financial difficulties later within a short period. This practice note has since 2005 been replaced by requirements under PN17 but rules for PN4 companies continue to apply to those who had been classified as such.

PN17 was introduced on 3 January 2005 by amending the requirements of PN4. The amendments were made by Bursa Malaysia to further improved and strengthen the qualities of companies that are listed on the exchange. *The amendments were also aimed to expedite the time taken by listed companies with unsatisfactory financial condition and level of operations to regularize their condition.* Lastly, the amendments were expected to directly enhance the capital market and securities industry, in order to further promote the integrity and credibility of companies listed on the exchange.

PN17 was amended again on 5 May 2006 by Bursa Malaysia as Amended Practice Note No. 17 (APN17). *The key objectives of the amendments were to further enhance the quality of listed issuers, to strengthen investor protection and to promote investor confidence.* With the amendments, the criteria for classification as a PN17 company, i.e. a listed issuer that is subjected to the obligations under APN17 have been made more stringent. The classification as a PN17 company means that they must submit a restructuring plan to the Securities Commission (SC) within a period of **eight months.** They must also implement their restructuring plans within the timeframe stipulated by the relevant authority. In addition, to ensure the quality of the restructuring exercise, the APN17 now require all restructuring plans undertaken by the PN17 companies to fall within Section 32 of the Securities Commission Act 1993. This means that it requires Securities Commissions approval for the restructuring exercise to proceed.

1.2.2 Restructuring Exercise

When a company is listed as a PN17 company, they must undergo certain requirements by Bursa Malaysia. If they failed to comply, they will be suspended from trading and face delisting procedures. In order to graduate from PN17 classifications, financially distressed firms must first have completed the implementation of the approved regularizing plan and proved to the Bursa that is it no longer in financially distressed condition. With the Global Financial Crisis that occurred in 2008, it has made it tougher for financially troubled PN17 companies to tap on public funds in order to regularize their condition back to usual. In fact, there may be more companies added on to the list of PN17 firms given the situation of the financially distress environment during the crisis. According to the statistics provided by Bursa Malaysia as at 10 August 2016 there are a total of 188 companies that had been classified under the PN17 from 2005 to 2015 which represent 20.8% of the total number of 903 companies listed on Bursa Malaysia as at 31 December 2015 Bursa Malaysia (Malaysia Bursa, 2015).

1.2.3 Bursa Malaysia

The history of Bursa Malaysia can be traced back to 1930 when the Singapore Stockbrokers' Association was established and later renamed as Malayan Share Brokers' Association in 1937. In 1960 the Malayan Stock Exchange was set up with exchange rooms linked between Malaysia and Singapore via telephone lines and was renamed as the Malaysian Stock Exchange in 1964. By 1965, due to the cessation of Singapore from Malaysia, the stock exchange was again renamed as the Stock Exchange of Malaysia and Singapore. However, the stock exchange of both nations function as a single entity (Chong, 2011).

The Stock Exchange of Malaysia and Singapore then was split into the Kuala Lumpur Stock Exchange and Stock Exchange of Singapore in 1973 due to the decoupling of Malaysia and Singapore currencies. The Kuala Lumpur Stock Exchange then became a limited company in 1976. In 2004, due to the demutualization process, the exchange was renamed as Bursa Malaysia Berhad as was traded in its own Main Board on 18 March 2005 (Malaysia Bursa, 2016).

As at end March 2016, the market capitalization of Bursa Malaysia stands at RM1.7 trillion with 907 companies listed in its board (Amirsham, 2016). Currently, public companies in Bursa Malaysia are classified under four categories which are;

i. Main Market

ii. ACE Market

iii. PN 17 Companies, and

iv. GN3 Companies

1.3 Problem Statement

The issue of financial distress firms among Bursa Malaysia public listed companies was an old but neglected one. Prior to Asian Financial Crisis in 1997 (AFC 1997), Bursa Malaysia did not have any mechanism on identifying and segregating between financial distressed and non-financial distressed firms. Even the Company Act 1965, which was later amended in 2012, was silent on this matter. As such it can safely said that until the AFC 1997, the Malaysian capital market regulators were not focusing in developing a mechanism to support and strengthen financially distressed, public companies listed in Bursa Malaysia.

Public perception towards financially distressed firms changed after the AFC 1997 because many investors were "burned" during that crisis. There was also growing interest from the regulators on the need ~~on~~ of having a mechanism to identify and separate the listing status of financially distressed entities against the good ones, facilitating the birth of the PN4 status in 2001. The classification was later refined and morphed into a more stable classification and the scope of this study, is PN17 in 2004.

The operational objective of the PN4 and later PN17 status were to provide a clear criterion for the identification of financially distressed companies and set conditions for the restructuring of their businesses for a stipulated timeframe, to return to normalcy, failing which their listing status will be revoke. The intended outcome of this process is very noble, which is to ensure a healthy and robust financial market for the public to invest. As such, it is very important to ensure that