



Does Financing Decision Influence Corporate Performance in Malaysia?

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ABSTRACT

This paper examined the impact of financing decision on performance among Malaysian public listed firms in Bursa Malaysia. Previous studies did not examine the relationship between selection of capital structure and performance in the perspective of firms that implement industrial diversification strategy. This research comprised of 76 firms and covering balanced panel data series for the period of 1994-2007. The study observed that capitals structure has insignificant relationship with performance. However, it is recommended that firms should wary in using debt financing to finance business operation as it could lead to performance discount. Finding of the research contributed in explaining the capital structure decision made in the firms that implement industrial diversifications. Future research should investigate the option of firms that implement international diversification and its impact on corporate performance.

Keywords: Financing decision, industrial diversification, Performance

JEL Classifications: G30, G32

1. INTRODUCTION

Financing decision was always an important decision made by firms. Finance manager needed to optimize the best financing method either using debt or equity in order to maximize their firm performance. Maximization of performance by utilizing combination of debt and equity had been discussed in a number of literature among them (Masulis, 1983; Myers, 1984; Kjellman and Hansen, 1995; Kovenock and Philips, 1995; Rajan and Zingales, 1995; Majumdar and Chibber, 1999; Vicente-Lorente, 2001), recently by (Tudose, 2012; Kajananthan and Nimalthasan, 2013; Akeem et al., 2014; Younus et al., 2014; Muhammad et al., 2014; Mwangi et al., 2014; Zhang and Yu, 2016). It was also being studied in South East Asian countries such as in Malaysia (San and Heng, 2011; Salim and Yadav, 2012; Ramezanalivaloujerdi et al., 2015) and in Indonesia (Sagara, 2015).

Capital structure issue has yet to be comprehended in literature (Myers, 1984) in which the author suggested that non-financial

variable to be included to understand how financial manager choose either debt or equity to support their business operation. This suggestion had lead Barton and Gordon (1988) to conduct their research by introducing diversification strategy as the non-financial variable to explain choice of financing made by firms. Nevertheless, this issue is far from over as indicated recently by Junior and Funcal (2013) who demonstrated that there was an insignificant relationship between diversification strategy and capital structure. Furthermore, there were conflicts of evidence on the impact of capital structure on performance as indicated by Salim and Yadav (2012). They revealed multiple proxies of performance that highlighted different empirical results which indicated inconsistency of evidence in Malaysia. Therefore, this issue is still puzzling researchers as well as practitioners on what the actual impact of financing decision on performance. As this issue has yet to be resolved, this study provided some contributions in understanding the impact of capital structure decision on performance by observing firms that implemented industrial diversification strategy particularly in Malaysia.

The next section of this paper highlighted some theoretical framework and empirical evidence relating to selection of capital structure and its impact on performance. The following section explained the methodology and estimation model used in this study. Finally, discussion of the empirical evidence follow by conclusion derived from the results was presented.

2. LITERATURE REVIEW

The arguments over which financial structure either debt or equity could enhance firm value commence with seminal work of Modigliani and Miller (1958). They proposed that firm value would not be affected by any form of financing whether using debt, equity or combination of both in perfect market condition. This stance has been rebuked by a number of literature (Myers, 1984; Kovenock and Philips, 1995; Rajan and Zingales, 1995; Tudose, 2012; Kajanathan and Nimalthasan, 2013; Akeem et al., 2014; Younus et al., 2014; Muhammad et al., 2014; Mwangi et al., 2014; Zhang and Yu, 2016) as there is no existence of perfect market condition due to existing of market distortion such as transaction cost, coinsurance effect and taxation cost. Modigliani and Miller (1963) also changed their stand due to existing of taxation cost imposed to the firms that could affect performance.

A number of studies extensively researched in this area in various developed and developing countries ((Masulis, 1983; Myers, 1984; Kjellman and Hansen, 1995; Kovenock and Philips, 1995; Rajan and Zingales, 1995; Majumdar and Chibber, 1999; Vincente-Lorente, 2001; San and Heng, 2011; Tudose, 2012; Salim and Yadav, 2012; Kajanathan and Nimalthasan, 2013; Akeem, et al., 2014; Younus, et al., 2014; Muhammad, et al., 2014; Mwangi, et al., 2014; Sagara, 2015; Ramezanalivaloujerdi, et al., 2015; Zhang and Yu, 2016) in order to comprehend the position of financial structure in the firm in enhancing performance of the firms.

Capital structure is an important element in determining the success of the firms by using combinations of debt and equity (Abor, 2005). Any erroneous decision in optimizing financial structure would cause financial distress to the firms and lead to bankruptcy (Eriotis, 2007). The reason being that usage of debt would create financial risk to the firms. Therefore, selection of capital structure which reflects financial resources is a very crucial factor in determining the performance of the firm. Firms may raise capital through the issuance of equity in good economic time but reluctant to issue undervalue shares to avoid from depress in share price. In the meantime, firms were looking at financial flexibility in managing their organization, which lead them to choose debt financing. However, it depends on interest rate as well as market value of equity as main determinant factors regardless of economic situation (Bancel and Mittoo, 2002). In this case, market timing was used as the main criteria in selecting capital structure of the firms.

In the other hand, Kjellman and Hansen (1995) and Abor (2005) stated that country's characteristics have significant role on how firms used financial resources for business activities. Kjellman and Hansen (1995) reported that there are contrasted system in

Finland and the United States of America whereby Finnish's financial institutions are allowed to hold equity in non-financial firms which is a different practice compare to American's financial institutions. This situation resulted in the Finnish firms had large debt in capital structure as compared to the American firms. Finnish policy possibly followed trade off theory in setting optimizing level of capital structure. In contrast, American firms followed pecking order approach in which they positioned internal financing as main source of capital to fund the business operation followed by debt financing and later used equity financing as the last option. Similarly, Abor (2005) indicated that firms were using short term debt to raise most of their fund due to undeveloped capital market in Ghana. Moreover, long term debt was hard to get from any financial institutions. Parallel with India, Majumdar and Chhbibber (1999) revealed that financial institutions supported by government financial played a key role in offering debt financing to the firms. They usually adopted tolerant approach in collecting debt thereby cared less for unpaid firms. This is consistent with Pandey (2001) who demonstrated Malaysian firms raised capital by using debt financing due to contribution from development in capital market. Therefore, capital structure was the key aspect that needed to be seriously considered by firms' management in ensuring performance of the firms.

Extensive research in this area showed that there are four major streams of empirical evidence in literature. The first stream suggested that there were positive relationships between usages of debt over equity in enhancing performance (Abor, 2005; Sagara, 2015). The second stream of literature proposed debt financing lead to performance destruction (Akeem, et al., 2014; Mwangi, et al., 2014; Muhammad, et al., 2014; Ramezanalivaloujerdi, et al., 2015). In the other hand, the third stream indicated no relationship between debt financing and performance of the firms (Younus, et al., 2014; Kajanathan and Nimalthasan, 2013). The last stream implied that the relationship was mixed based upon proxies used in the study either debt proxies or proxies of performance (Abor, 2005; San and Heng, 2011; Salim and Yadav, 2012; Tudose, 2012).

Abor (2005) used three proxies of debt ratio which are short-term, long-term and total debt in examining the impact on performance. The results showed that short-term debt and total debt have a positive relationship with performance. In contrast, it was negatively related to long-term debt. The reason for such relationship could be more short-term debt is used to finance business expansion compared to long-term due to undeveloped capital market of the country concerned. It is consistent with Chang et al. (2005) who indicated that multiple proxies of debt could have divergent effect on performance. In spite of indecisive result, Abor (2005) stated that more debt should be used in capital structure to bring upwards performance of the firms. According to him, capital structure could bring improvement of performance as it would discipline firms' managers from acting for their own benefit.

Masulis (1983) and Kjellman and Hansen (1995) shared those views in which they proposed that firms should use more debts in their capital structure to improve performance. Profitable firms would have the ability to serve its debt obligation by using their income generating business which could deter them from default

of payment and consequently bankruptcy. Su and Vo (2010) threw in similar idea that performance would be improved if firms emphasized on financial strategy as it has significant impact on performance.

In the other hand, Kochhar (1996) and Korajczyk and Levy (2003) suggested that firms with niche assets should use equity financing and lowering debt in financing their business. However, Korajczyk and Levy (2003) expressed that firms with large size and significant tangible assets should use more debt as these types of firms have a strong financial fundamental. Hence, the firms would have sufficient financial resources to meet debt obligation. In contrast, firms with niche assets such as technology firms do not have such flexibility, as rapid change in technology creates a short product life cycle. Therefore, more debt in such firms would endanger firms' survival due to capital intensive industry without any guarantee of product success.

In contrast, Akhtar (2005) and Allen (1991) showed that debt was negatively related to performance in Australia which consistent with pecking order theory. Booth et al. (2001) supported those contentions whereby high performer firms used less external financing which clearly against trade off theory. The theory stated that more debts are used in profitable firms to avoid lower tax charges. This situation resulted in negative association between capital structure and performance.

Similar situation was highlighted by Claessens et al. (2000) that massive financial crisis in 1997/1998 resulted from extreme used of debt by the firms. This was done to catalyst economic growth (Nachum, 1999). Various countries in developing markets also demonstrated negative relationship such as Sri Lanka, Jordan, Vietnam and India in which their capital structure was inversely related to performance (Pratheepkanth, 2011; Su and Vo, 2010; Zeitun and Tian, 2007; Majumdar and Chhibber, 1999).

Similar view had been shared by Kajanathan and Nimalthasan (2013) who demonstrated insignificant relationship between capital structure and performance when it was proxied by return on assets. Their view supported the above argument, therefore, managers need to be tactful in utilizing debt in capital structure. They recommended that managers should give priority in using retained earnings instead of debt to implement their business projects. Apart from that, they proposed several approaches for firms to improve performance such as prudent in making financing decision, induce investors to assist in increasing performance, find out crucial areas that can be improved and should have mix combination of instruments in capital structure. In the other hand, Younus, et al (2014) indicated that debt has insignificant impact on performance in sugar industry in Pakistan. Sugar is basic necessity in daily life and in making consumer products, hence, the firms that involved in this industry possibly do not need huge capital spending as internal generated income is more than sufficient to support business operation compared to automotive firms. Therefore, sugar firms in Pakistan do not need huge financial resources, thus, the relationship between capital structure and performance insignificant.

3. DATA AND EMPIRICAL MODELING

Various sources of secondary data were used for collecting information gathering such as from World scope, Thomson Financial Banker, Data Stream databases and Bursa Malaysia's library. The period of study covers from 1994 to 2007. This coverage of study is considered unique in Malaysia as Malaysian economy experienced robust economy growth from 1994 to 1996 but it confronted the worst financial crisis in 1997/1998. Then, the economy strongly rebound in 1999 until 2007. Even though, there was a global financial crisis in 2008/2009, Malaysia was less affected due to less exposure in international market. Therefore, a study is needed to understand how firms, at least in this sample, survived from financial distress in 1997/1998.

The firms were then classified into related and unrelated categories. Dummy variable was employed to differentiate between those two categories of diversification strategy (related = 0; unrelated = 1). Only 76 firms left in the sample due to the inability of some firms to meet the criteria set in this research.

This study used a model suggested by Gujarati and Porter (2008) to find the links between each strategy; related and unrelated by incorporating dummy variables. The regression model below showed the relationship between capital structure and performance:

$$ROA_{it} = \alpha_{0i} + \beta_1 size_{it} + \beta_2 cf_{it} + \beta_3 liq_{it} + \beta_4 ce_{it} + \beta_5 TDA_{it} + \bar{\epsilon}_{it}$$

ROA denotes return on asset which was derived from net income after tax over total assets. It reflects dependent variable varying across section and time. Previous studies such as Bettis (1981) and recently by Salim and Yadav (2012) used this proxy as measurement of performance. Meanwhile, SIZE, cash flow (CF), liquidity (LIQ), capital expenditure (CE) and TDA are the size of the firm, its CF, LIQ, CE and total debt with β_1 , β_2 , β_3 , β_4 and β_5 as its coefficients that were to be estimated. α_{0i} and $\bar{\epsilon}_{it}$ represented unknown intercepts for each entity and error terms respectively. Size is proxied by the logarithm of total assets, CF is proxied by net income, depreciation and amortization over total assets, LIQ is proxied by current assets over current liabilities, CE is proxied by investment in fixed assets over total assets, and total debt used total debt over total assets to indicate level of indebtedness of the firms. The total liabilities over total assets measured the dependent variable, debt ratio (Abor, 2005). This ratio reflected capital structure in the firms, which represented the choice of debt over equity. The total debt represents short-term or long-term debts used by the firms to finance business activities. Implicit dummy were used to determine the association between capital structure and performance in industrial diversification firms as what had been done by Barton and Gordon (1988).

4. FINDINGS

This section presents the results obtained by estimating the model using static panel data with fixed effects and the random effects estimation method. Table 1 shows the results of this study. Several tests, such as normality, multicollinearity, heterocedasticity and Hausman test were performed before the results were shown in

Table 1: Determinants of financing decisions using three estimation methods

Variables	POLS	FE	RE
Constant	-0.0287*** (0.0033)	-0.0439*** (0.0046)	0.0287*** (0.0033)
CE _{it}	-0.0003* (0.0002)	9.45E-05 (9.16E-05)	0.0003 (0.0002)
LIQ _{it}	-0.0006** (0.0016)	-0.0005 (0.0004)	-0.0006** (0.0016)
CF _{it}	-0.9031*** (0.0071)	-0.9791*** (0.0036)	0.9031*** (0.0070)
SIZE _{it}	0.0021*** (0.0005)	0.0027*** (0.0006)	0.0021*** (0.0005)
TDA _{it}	-0.0146*** (0.0032)	-0.0016 (0.0026)	-0.0146** (0.0031)
Durbin watson test	0.2387	1.6470	0.2387
Prob >F	0.0000	0.0000	0.0000
F-statistics	3393.27	3950.46	3393.27
Adjusted R ²	94.53%	98.57%	94.50%
No observed	988	988	988

Figure in parenthesis is the standard error. **Significant at 5% level, ***Significant at 1% level, *Significant at 10% level

Table 1. After using Hausman test, the fixed effects indicated that there was a more robust estimation method for explaining the impact of debt on performance. All three estimation results were presented.

Table 1 demonstrated the results on the impact of debt on performance. As explained earlier there are four streams of evidence pertaining to relationship between these variables; positive relationship advocated by Masulis (1983), Kjellman and Hansen (1995) and Sagara (2015), negative association supported by Akeem et al. (2014), Mwangi et al. (2014), Muhammad et al. (2014) and Ramezanalivaloujerdi et al. (2015), no relationship upheld by Younus et al. (2014) and Kajanathan and Nimalthasan (2013), and mixed results affirmed by Abor (2005), San and Heng (2011), Salim and Yadav (2012) and Tudose (2012).

In this model, return on assets was used as the observed variable while debt was used as the explanatory variable. In the other hand, other variables were utilized as the control variables. The results showed for panel data ordinary least square, fixed effect estimation output using seemingly unrelated regression and random effect estimation. All three models produced high explanatory independent variables to explain dependent variable at more than 94% for adjusted R². However, two models suffered from autocorrelation, leaving only fixed effect estimation results to explain the association between debt and performance.

Even though this result appeared to be consistent with the findings of several other studies such as Younus et al. (2014), and Kajanathan and Nimalthasan, (2013), they showed that there was no significant impact of debt on performance. One potential justification for such outcome could be the sufficient internally generated funds to support their business activities. Therefore, there is no need for the firms to employ debt for business operation.

A second possible clarification was due to low level of indebtedness of Malaysian firms in this sample. Firms used in this study were those firms which survived financial crisis that occurred in 1997/1998. Among the reason for their survival was due to level of debt at manageable level during Asian financial crisis. Hence, the impact of debt on performance was not significant even though, the coefficient of debt was pointing towards negative relationship.

Even though there was no impact of debt on performance in this study, firms need to seriously consider the effect of debt as pointed out by its coefficient. The reason is that firms might choose to purchase more strategic assets or non-strategic assets by utilizing debt financing. An excessive use of debt would potentially lead to default in payment and subsequent bankruptcy. Thereby, monitoring debt level is important in avoiding bankruptcy possibility. The reason being that firms' growth might be affected due to an excessive debt, hence, it would have difficulty to plan their business strategy such as in obtaining new fund for a new acquisition or implementation of a new project. Without a proper business strategy, firms could not expand their business, thus, it may have negative impact on performance as their performance target could not be reached (Daud, 2014).

A third possible explanation for insignificant relationship was due to environmental effect that could have major effect on the influence of capital structure on performance. After financial shock in 1997/1998, Malaysian firms had better access to capital market as the government enforces merger among financial institutions, strengthen the function of capital market and introduce more systematic instruments for the firms to raise the capital for business funding. Therefore, firms with better access to capital market would rely less to debt financing which result in insignificant relationship between capital structure and performance. The trend showed that corporate borrowing from capital markets grew significantly after a crisis. Capital markets may provide a cheaper cost of financing to firms to encourage them to raise more capital through borrowing (Daud, 2014).

In imperfect market conditions such as in developing markets, obtaining funds from external party would incur higher costs. Therefore, the internal capital market provided unrelated firms with low cost of capital that could be used for capital investment to enhance performance. Apart from that, situations such as underutilization of resources and capabilities, earnings stability, response to a dynamic environment, lower business risk and pressure from the board of directors to attain their target profits leads firms to diversify from their current businesses.

Finally, industry nature also could play a factor on insignificant effect of capital structure on performance. Syed and Rao (2004) indicated that high level of CF resulted in low level of debt as there was less need for the firms to use more debt to support their

business operation. They provided examples of firms in electronics that may have a low level of debt due to cyclical earnings. In contrast, firms in the food industry that usually received a high level of CF would pay less attention to the level of debt. These firms in the food industry can lower or increase their use of debt, depending on the condition of their business.

Grant et al. (1988) supported the scenario of having low level of debt in high level of CF and LIQ industry. There was no need for external funding if internal funding was sufficient to support the business activities. Similar claim were made by Peyrefitte and Brice (2004) that firms should rely on LIQ in the products development, thus, less emphasize on external funding for their operation.

In the other hand, size seemed to have major impact on performance of the firms. The empirical evidence proposed that large firms possibly with large resources and capabilities at their disposal that could be used anytime to maneuver business direction to improve performance. They also could afford to employ more debt in their capital structure without risking their financial position. Daves et al. (2000) and Eriotis (2007) claimed that size had a significant impact on financing decisions. The evidence is consistent with the results of Lim et al. (2009) who stated that firms in the United States induced debt more than Singaporean firms. The difference between Singaporean and American firms could be the former is smaller than the latter which reflect the availability of huge resources available for enhancement of business operation.

4.1. Robustness Test

This section presented the robustness check on the sample. The data was separated due to the crisis occurred in 1997/1998. For pre-crisis, the data started from 1994 to 1996 while post crisis data started from 1999 to 2007. Elimination of financial crisis year was to avoid outlier where a number of firms were affected during the crisis. The test was done to provide robustness check on the impact of financing decision on performance. Table 2 presented the result of the robustness check. Similar with earlier evidence using the whole sample, there was an insignificant relationship between capital structure and performance for both period pre and post crisis. Other results also remain consistent with the whole

sample except for positive and negative relationships of CF on performance.

5. CONCLUSION

As discussed earlier, this study demonstrated that there was no significant impact of capital structure on performance. Several reasons were discussed on the cause of insignificant relationship. Several earlier studies were quoted to support the current outcome on the association between capital and performance such as by Younus et al. (2014) and Kajanathan and Nimalthasan, (2013). Nevertheless, it should be noted that the coefficient of debt was negative even though not significant. In addition, after separating two periods of study into pre and post crisis, negative coefficients still prevail. Therefore, the firms should wary when utilizing debt as part of financing requirement as further research on the issue is required to comprehend the said relationship.

Firms need financial resources for business operation and expansion, and these resources are reflected under the balance sheet of firms' annual reports. The liability section refers to the external financing obtain by the firms while the equity section can be categorized into two parts in which one part is raising capital using internally generated funds and the second part is through selling of equity to outsider.

The composition of debt and equity is known as capital structure. It also represents financial risk to the firms in which mismanage of composition of financing would deter firms' performance. In certain cases, it causes firms to go into bankruptcy procedure. Therefore, firms' management should be wary on the impact of capital structure on performance. Despite financial risk attach to it, capital structure is needed for the firms to raise the required capital. This is consistent with other studies which investigated the impact of capital structure on performance (Majumdar and Chhibber, 1999; Booth et al., 2001; Graham, 2000; Mitton, 2007). Other emerging countries such as Sri Lanka, Jordan, Vietnam and India reported similar case of the negative impact of capital structure on performance (Pratheepkanth, 2011; Su and Vo, 2010; Zeitun and Tian, 2007; Majumdar and Chhibber, 1999). These countries have something in common in which their capital markets are relatively undeveloped compared to capital market in the United States. Due to those characteristics, firms have to do short term borrowings that are derived from financial institutions instead of long term borrowing. This situation may cause performance distress to the firms.

Difference characteristics among the nation were also highlighted by Hall and Lee (1999) who demonstrated differences between the American firms and Korean firms. These two countries showed dissimilar impact of capital structure on performance whereby it was positively associated with performance in the United States but it was inversely related in Korea. This could result from capital market in both countries whereby it was far more developed in the United States as compared to Korea. The view by Hall and Lee (1999) was supported by Booth et al. (2001) who claimed that a more developed capital market creates more demands for equity financing instead of debt financing. The reason for that was because

Table 2: Pre and post crisis results using fixed effects estimation method

Variables	FE pre-crisis	FE post-crisis
Constant	-0.0382*** (0.0107)	-0.0463*** (0.0058)
CE _{it}	-6.10E-05 (0.0002)	0.0002 (0.0001)
LIQ _{it}	-0.0006 (0.0012)	-0.0011** (0.0005)
CF _{it}	0.9071*** (0.0201)	-0.9808*** (0.0046)
SIZE _{it}	0.0034** (0.0015)	0.0029*** (0.0008)
SD	-0.0009 (0.0078)	-0.0026 (0.0034)
Durbin Watson test	1.7709	1.5425
Prob >F	0.0000	0.0000
F-statistics	368.33	2984.34
Adjusted R ²	93.84%	98.27%
No observed	152	684

Figure in parenthesis is the standard error. **Significant at 5% level, ***Significant at 1% level, *Significant at 10% level

firms have more option to raise capital for financing requirements. Apart from that, in the case of Malaysian firms, Claessens et al. (2000) stated that the crisis occurred due to excessive debt used by South East Asia firms including Malaysia that left many firms to collapse during the crisis period in 1997/1998. Therefore, the reason for insignificant relationship between capital structure and performance in the sample could be because they had low level of debt and high profitability that enable firms to survive the financial crisis. This is consistent with Rajan and Zingales (1995) who stated that high profitable firms would utilize less debt as they possibly have adequate earnings from the past to support the operation. An excessive debt with low profitability could lead to performance destruction to the firms especially during bleak economic condition in 1997/1998. Simerly and Li (2000) also supported the said view whereby they mentioned that debt is positively related to performance only in stable environment but it is inversely related to performance in bleak economic condition. Similar occurrence happened during global financial crisis in 2008/2009 whereby among the reasons cited was excessive debt in the countries affected such as Greece, Ireland, Italy, Spain and Portugal. Thus, excessive debt would eventually lead to performance distress to the firms. Firms have to monitor level of debt so that they can use debt effectively to improve performance. Future research should further examine the relationship in various aspects so that this issue could better understood and bring positive outcome to the firms.

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