CHAPTER ONE

INTRODUCTION

1.1 Theoretical Background

1.1.1 Types of Funds

A public limited company can finance its assets and daily operation using either debt or equity capital. Debt capital refers to funds that are raised from external parties such as trade creditors, advances from customers, financial institutions or bondholders. Examples of debt capital are accounts payable, bank overdrafts, term loans and bonds. The repayment period of debt capital can be either short or long. On the other hand, equity capital refers to funds that are obtained from the firm's existing or new shareholders and are only long-term in nature. Equity fund comprises ordinary share capital and retained earnings.

Debt capital is cheaper than equity capital as interest payment is tax-deductible. The presence of debt provides a tax shield as it reduces the tax liability of the firm.

1.1.2 Financial Structure

Financial structure refers to the proportion of the various types of liabilities inclusive of both current and long term funds employed within a firm. There are many ways to measure financial structure. Most finance writers seem to include only long-term funds which are raised by issuing securities. This is too narrow a definition as it excludes current liabilities such as account payables, overdrafts and insurance loans. In its arbitrary distinction, it implies that long-term funds are much riskier than current liabilities.

This broader definition allows us to concentrate on what is recognised as the best measure of gross risk - the ratio of total debt (including current liabilities) to equity. In other words, financial structure is simply a choice between debt or equity capital irrespective of the maturity of the funds.

1.1.3 Financial Leverage

The presence of debt and hence fixed financial charges in the income stream creates financial leverage. These fixed financial charges do not vary with the firm's earning before interest and tax (EBIT) and must be paid regardless of the amount of EBIT. The most common type of fixed financial charges are interests on term loans, bonds and dividends on preference share. These two expenses are prior claim charges that have to be paid before the ordinary shareholders get their earnings.

Financial leverage is defined as the firm's ability to use fixed financial charges to magnify the effect of a change in EBIT on return on equity (ROE) and earnings per share.

The degree of financial leverage is measured by the percentage change in earnings per share divided into percentage change in EBIT.

The higher the degree of financial leverage, the higher is the financial risk. Financial risk is the probability of not being able to service fixed financial charges. In short, a high level of fixed financial charges will increase the financial leverage and financial risk. This is because the firm has to maintain a higher level of EBIT in order to stay in business. Hence, the trade-off between the use of cheaper debt and the risk of bankruptcy due to an increase in financial risk.

Expected return on equity would increase with an increase in the degree of financial leverage. This is in line with the concept of high risk, high return. A higher return on equity is needed to compensate shareholders for taking on a higher level of financial risk. Therefore, the use of debt would magnify or leverage expected return on equity when the firm is profitable. Similarly, when the firm suffers from a loss in bad times, financial leverage will increase the risk of shareholders by magnifying the loss.

1.1.4 Operating Leverage

Operating leverage, on the other hand results from the existence of fixed costs in the firm's production scheme but is generally associated with the use of fixed assets such as plants and machinery. These fixed costs such as rental and interest payments on loans to purchase machinery do not vary with units of output. Hence, fixed costs have to be borne regardless of sales revenue. The higher the component of fixed costs, the higher the degree of operating leverage and also the level of business risk.

Business risk is the probability of being unable to cover fixed costs. It can also be defined as the risk that is faced by a firm that is solely financed with equity capital. Business risk increases as the volume of sales that is necessary to cover all fixed operating costs increases. The sales volume to break even increases with the amount of fixed costs.

1.1.5 Role of Beta

Beta measures the market or systematic risk that arises from the relationship between return on a share and return on the market. It reflects the volatility of a share relative to the Composite Index. If beta is greater than one, then the share is more volatile than the Composite Index and if beta is less than one, then the share is less volatile than the Composite Index. A beta of one indicates a share with average market risk. Such share rises and falls by the same percentage as the market Composite Index. Similarly, return on the share will increase or decrease by 25 percent more than the return on the Composite Index for a share with beta of 1.25.

1.2 Objective of The Study

The objective of this study is to determine whether there is a significant relationship between financial structure and return on equity, operating leverage and beta.

1.3 Significance of The Study

This study supplements other similar research findings that were conducted overseas. This is to determine if Malaysian companies funding decisions are influenced by the same sets of attributes as shown overseas. Secondly, this findings will provide practising finance managers some guidelines when deciding on the amount of debt given their sets of attributes. For instance, if it is found that the majority of firms with high operating leverage, tend to have gearing ratio of only between 15 to 20 percent, then financial managers in companies of high operating leverage can use this rule of thumb to decide on the amount of debt capital to raise in relation to equity capital. Thirdly, it allows financial manager to determine the right mix of debt to equity capital without having to resort to sophisticated financial model.

1.4 Organisation of Study

This study is organised into 5 chapters. This chapter discusses the two broad categories of funds that are available to firms, financial structure, financial leverage, operating leverage and beta as a measure of market risk. Chapter two provides the literature review of past studies while chapter three describes the research methodology. The research findings are presented in chapter four. The last chapter summarises the study, highlights the major shortcomings and gives suggestions for future research.