

CHAPTER FIVE

CONCLUDING REMARKS AND RECOMMENDATIONS

5.1 Summary

This study analyses the influence of return on equity, operating leverage and systematic risk on the gearing ratios of 60 manufacturing companies that are listed on the Kuala Lumpur Stock Exchange from 1984 to 1993. The two measures of gearing ratio are TD/TA and LTD/TA.

The outcome of the findings are summarised below:

There is a significant inverse relationship between both gearing measures and mean return on equity. This suggests that managers within the manufacturing industries follow the pecking order hypothesis when raising funds.

There is no relationship between TD/TA and operating leverage. However, there is a significant direct relationship between LTD/TA and operating leverage (FA/TA). This is expected as total debts include both current liabilities and long-term debts. Furthermore, firms do not finance fixed assets from current liabilities. As the proportion of fixed assets increases the amount of long-term debt that is used to finance the fixed assets such as plants and machinery also increases.

There is a statistically significant positive relationship between both gearing measures and systematic risk. As

gearing increases, business and financial risk also increases. This is reflected in the stock's measure of systematic risk or beta.

5.2 Shortcomings

In the course of the study, several shortcomings were encountered. First, some of the sample firms are so well diversified that it is difficult to determine the exact nature of their business. The classification of firms by the Kuala Lumpur Stock Exchange also runs into the same problem. This is inspite of the fact that an attempt has been made to include only sample firms whose principal activity is manufacturing. Similarly, holding companies are also excluded.

Secondly, we cannot ignore the influence of foreign parent companies due to joint-venture setup. This is particularly true for some companies like Ajinomoto, Dutch Baby, Nestle, Esso, Shell, Carlsberg and Guinness.

Thirdly, there is a need to update the values of beta for firms in the stock exchange as beta will change over time.

Last but not least is the fact that the Malaysian securities market is a developing market as opposed to a well developed capital market of New York or London. According to Mohamed Ariff and L.W. Johnson (1990), a developing securities market differs from a developed

market in five main aspects. They are economic and institutional differences, size-related variation, liquidity conditions, disclosure requirements and integration of the financial system. These fundamental unique features of a developing market has implications on financial research. One such example is the effect of thinness of trading on the measurement of beta. Thinness of trading refers to the relative frequency in which ordinary share is traded in a given market. Sytematic risk will be under-estimated where securities are thinly traded. See Sinclair (1981) and Ariff (1987).

5.3 Suggestions for Future Research

First, **other factors** that theoretically have an impact on the optimum usage of debt can also be investigated. Examples are factors such as uniqueness, tax shields effect of debt, growth rate and asset structure. Multiple regression can also be used to detect the contributing variances of each factor as it is likely that many factors will influence gearing.

Secondly, **other surrogate measures** of profitability such as the ratio of operating income over sales (OI/S) or operating income over total assets (OI/TA) could also be tested. As for measures of operating leverage, other proxies are also available. They are a) percentage change in earnings before interest and taxes as a proportion of percentage change in sales; degree of operating leverage.

b) the ratio of the average of net fixed assets over a certain period of years to the average of total book assets over the same time period.

Thirdly, as done by Ferri and Jones (1979), **other study methodology** also exist. In this study, only firms from the consumers and industrial products are sampled in order to hold constant the influence of industry classification. Consumers and industrial product are not dissimilar in the sense that both are involved in manufacturing. This is also necessary so as to be able to have enough sample size. As mentioned above, classification of some firms can be problematic. This is so as some firms are well diversified and have different types of business. As an alternative to overcoming these problems, future researcher can group firms based on the similarity of '**leverage classes**'. Firms can then be classified as either highly, moderately, or lowly geared. To quote Ferri and Jones (1979), "thus the similarity of firm's actual financing behaviour... establishes the grouping of firms." This grouping of firms based on different leverage class will then be analysed to detect for common factors such as operating leverage, industrial class, size, and beta.

Finally, this study can also be extended to **include the construction, trading services, properties or hotel sectors** in order to determine if similar results can be found.