

## CHAPTER 2: LITERATURE REVIEW

As mentioned earlier, this research aims to determine the relationships, if any, between shareholder value and the various independent variables, namely corporate performance, growth opportunities, dividend policy and capital structure. Literatures regarding these aspects, although not as abundant than that which exists for shareholder value measurement per se and are examined as follows.

### **2.1 Shareholder Value in relation to Corporate Performance and Growth Opportunities**

Shareholder value has been increasingly seen as the ultimate measure of corporate performance itself (Barfield, 1998). This is in line with view that shareholder value maximization is the firm's main goal, as opposed to that of the stakeholder theory (Mitchell et al., 1997) which takes other stakeholders interests into consideration. However, this research attempts to segregate shareholder value and corporate performance as separate entities, and seek to determine the relationship that exists between them. Instinctively, one would expect a company that is performing well to create value for its shareholders. Johnson et al. (1998) considers profitable revenue growth rate as one of the critical drivers of a company's overall stock value, thus making it an important factor in shareholder value creation. This being the case, significant increases in shareholder value would require a stronger focus on

sales. Interestingly enough, Barfield (1998) discovered that there was a weak correlation between shareholder value and the company's track record in after-tax profit growth. Here, it seems that either profit or asset growth, are means to the end of increasing shareholder value rather than being ends in themselves. Zook et al. (2000) have also found that revenue growth has little or no impact on shareholder value. In the same research, they also determined that size had little bearing on a company's ability to generate either growth or shareholder value.

Existing literature on growth opportunities in Asia has focused on Japan (Gul, 1999), in which growth opportunities were linked to dividend policy and capital structure. Gul found that firms with lower levels of growth opportunities tend to have more debt and higher dividends. There have also been other research done that links the value of a company's investment opportunities to its financial policy decision (Rahman, 1997). With regard to the relationship between shareholder value and growth opportunities, one would instinctively expect a company with higher growth opportunities to be in a better position to create value for the shareholders. Nodine (1999) noted that a reasonably large percentage of a company's stock price is based on expected shareholder value added that comes from future growth. However, there are also views that if no good growth opportunities exist, then equity should be returned to shareholders (Barfield, 1998). If earnings were to be returned to shareholders in the form of dividends rather than being invested in projects that are not profitable, then this would perhaps imply a possibility that shareholder value can still be obtained despite low growth opportunities.

Singhvi (1993) acknowledged the interrelationship in strategic planning between sales growth, growth opportunities and the approach of maximizing shareholder value. Here growth opportunities are needed to achieve a sales growth objective, which would ultimately contribute towards shareholder value. This research will attempt to relate both corporate performance and growth opportunities to shareholder value.

## **2.2 Shareholder Value in relation to Dividend Policy**

There has been considerable debate on how dividend policy affects firm value and subsequently shareholder value, a debate that still continues until today. In perfect and efficient capital markets, dividend policy has been deemed to be irrelevant (Miller and Modigliani, 1961). Miller and Modigliani argued that dividend policy had no effect on the price of a firm's stock. This is the middle-of-the-road approach, which states that the value of any individual company is independent of its choice of dividend policy. However, the argument is based upon five major assumptions: (1) No taxes; (2) No brokerage costs; (3) Investors indifferent to either dividends or capital gains; (4) Firm's capital investment policy is independent of its dividend policy; and (5) Investors and managers have symmetric information regarding future investment opportunities. These assumptions obviously do not hold precisely and may not be valid under real-world conditions.

However, studies on the Malaysian scenario (Kester and Mansor, 1996) show that Malaysian executives believe that share value is affected by dividend policy, and that firms should maintain target pay-out ratios and strive for uninterrupted dividend payments. This is also in line with the classic paper by Lintner (1956) which reported that American firms do maintain long run pay-out ratios, which are based upon earnings and that the year-to-year dividends respond slowly to earnings. The belief by Malaysian executives that dividend policy affects share value would imply that it plays a role in the creation of shareholder value. Another classic research paper by Gordon (1959) also supports the idea that dividend do indeed increase shareholder wealth. Gordon and Lintner constitute the bird-in-the-hand approach, whereby firms set a high dividend pay-out ratio and offer a high dividend yield in order to maximize its stock price. This would contribute positively towards shareholder value.

Yet other researchers have taken the view from the other side of the dividend policy theories spectrum, that is dividends decrease shareholder wealth (Litzenberger and Ramaswamy, 1979). This theory is based on the tax effects on dividends. In Malaysia, dividends are taxable while capital gains are not thus perhaps making dividend policy an unattractive path towards shareholder value creation. This research paper will attempt to identify the relationship between firms' dividend policies and the corresponding level of shareholder value. This will determine if dividend policy is or can be used as a tool to add wealth to the shareholders in the Malaysian scenario.

## 2.3 Shareholder Value in relation to Capital Structure

The theory of capital structure is one area of study on which extensive research has been conducted and it is still very much an ongoing field of research. Harris and Raviv (1991) effectively summarised major research papers on the theory of capital structure right up to the early nineties. It all began when Modigliani and Miller (1958) stated in their famous *proposition I*, that a firm's market value is independent of its capital structure. The prove was however made under a very restrictive set of assumptions, which included the assumption that there were no taxes. These results suggest that it is totally inconsequential as to how a firm finances its operations, as capital structure is irrelevant. In addition to this, Fama (1978) has also shown that under certain assumptions and conditions, the market value of a firm is unaffected by changes in its financing decisions. If capital structure did not have any effect on firm value, then shareholder value would subsequently not be affected by a company's financing policies.

However, diverging from these extreme views, it follows that a policy of maximizing the value of the firm through choosing an optimal capital structure is synonymous with what is best for stockholders, that is shareholder value. With this in mind, leverage has been used as a tool to increase shareholder value (Tully, 1993). Lee (1999) also discussed some applications of increased leverage towards shareholder value creation. Some research has shown that leverage is positively correlated with firm value. Masulis (1983) concluded in his research paper that the changes in firm values are positively

related to changes in firm debt level. Myers (1984) presented the static trade-off theory of capital structure, where an optimal debt ratio existed for a firm that maximizes firm value. Maximizing firm value would definitely be in the shareholders interest, in the pursuance of shareholder value. The determination of the optimal debt ratio is viewed as a trade-off between a firm's costs and benefits of borrowing. With respect to the opinions of managers involved in the company's financing procedures, a survey conducted by Pinegar and Wilbricht (1989) showed that the maximization of security prices is indeed considered by some to be an important financial planning principle that governs the financing decisions of the company.

Of the two shareholder value measures used in this research, it would appear that ROE has a direct and positive relationship with leverage based on the fact that ROE can be separated into three components of net profit margin, total asset turnover and leverage. This is however a largely simplified approach as it does not take into account the effect of the other two components (Eisemann, 1997). An increase in leverage usually results in larger interest expenses that in turn causes a decrease in the profit margin and ROE. Thus, the effect of leverage spread itself over two ratios resulting in a not so clear-cut positive relationship as initially expected. With regard to TSR and capital structure, existing research has focused on the announcement of security issues on stock price (Harris and Raviv, 1991), one of the components of TSR. The issue more relevant to this research paper is that of the effect, if any, of a firm's capital structure on shareholder value. According to Myers (1984) a pecking order theory of corporate financing

exists contrasting the earlier trade-off theory of capital structure. In this theory, if external finance were required, companies would prefer debt to equity. Although the reduction in stock price that might result from an equity issuance most probably is due to the "information effect" rather than with financing per se, it is still of concern to companies that have shareholder value maximization in mind. However, the research undertaken in this paper concentrates more on the existing capital structure rather than in any capital structure changes. This research paper will try to determine the link or relationship between firms that maximize shareholder value and their corresponding capital structure.

## **2.4 Existing measures of Shareholder Value**

Shareholder value has been acknowledged as one of the dynamic developments that have occurred to measure value creation in a business. Proxies and measures for shareholder value are by no means limited to just *Return on Equity* (ROE) and *Total Shareholder Return* (TSR), as is utilised in this research project. The existing literature contains many different forms of shareholder value measurements, which include among others *Market Value Added* (MVA), *Economic Value Added* (EVA), *Cash Flow Return on Investment* (CFROI), *Shareholder Value Analysis* (SVA) and many more. These various methods are generally dealt with in the following text.

*Market Value Added* (MVA) has been defined as the change in the market value of capital (debt plus equity) minus the change in the book value of invested capital (Copeland, 1994). This measure of shareholder wealth creation has been attributed as a product of Stern, Stewart & Co. MVA essentially measures the change in the difference between the market and book value of equity over a given period of time. However, MVA by itself is not considered as a useful guide to day-to-day decision making or long-term planning (Al Ehrbar, 1999). Some of its limitations are that changes in the overall stock market level can overwhelm management's contribution in the short run, and that MVA measures are limited to publicly traded companies only at the consolidated level. This meant that there was no clear way in which to manage directly for increases in MVA.

The limitations of MVA led to the development of *Economic Value Added* (EVA), a more internal measure of performance. EVA is defined as the net operating profit before accruals and non-economic charges, less taxes paid on the profit, and less a charge for debt and equity tied up in the business (Finegan, 1991). According to Finegan, empirical evidence shows that EVA is highly correlated with MVA. It has been argued that accounting adjustments can substantially improve on EVA measures (Young, 1999). In comparisons with TSR, it is suggested that if stock markets are efficient and a sufficiently long time horizon is examined, both EVA and TSR will converge (Bacidore et al., 1997). Bacidore et al. also proposed a refinement of EVA called *Refined Economic Value Added* (REVA), which differs from EVA in that REVA assesses its capital charge based on the market value of the firm rather



than the economic book value of the assets in place as in EVA. One major limitation of EVA is that it is of less practical or relevant use in the 'New Economy' businesses of software, media or e-commerce (Wileman, 1999). Sharma and Jones (1999) noted that shareholder value will increase if (i) new capital is invested in a project that earns more than the cost of capital; (ii) capital that does not earn more than the cost of capital is redeployed or sold; and (iii) net operating profit after tax increases without increasing the capital employed. In their case, shareholder value is calculated by deducting the cost of capital from the net operating profit after tax. As mentioned earlier, Stern, Stewart & Co. consulting company had pioneered this concept under the trademark of EVA.

The *Cash Flow Return on Investment* (CFROI) is yet another measure being increasingly employed to measure shareholder value. This method of valuation has been credited to the Boston Consulting Group, as has TSR. The CFROI procedure is based on the conventional relationship that a discount rate or cost of capital converts a firm's forecasted net cash receipt stream to a present value. Its major distinguishing feature is the fact that the discount rate that is used in this valuation model is an integral part of the model itself (Madden, 1998). The discount rate used is not derived independently of the model.

Last but not least, another technique developed to gauge shareholder value is the *shareholder value analysis* (SVA), where value is created as long as competitive advantage is maintained, resulting in returns over its cost of

capital (Barfield, 1991). SVA's fundamental assumption is that in broad terms a business is worth the net present value of its future cash flows discounted at the appropriate cost of capital.

While acknowledging there are many paths towards measuring shareholder value, as mentioned earlier, this research will utilise simple financial measures such as ROE and TSR. The rationale, pros and cons of using these methods are undertaken in the following discussion on research methodology.