

# CHAPTER 1

## RESEARCH OVERVIEW

### 1.1 Background

When a firm starts operation, it needs capital; and when it expands, it needs capital also. The capital can be raised from equity; from one, a few or many people or through debt. The relationship between debt and equity is termed as capital structure or sometimes as leverage or gearing. The capital structure tells the extent of financing a company or project via debt and equity.

Debt has two advantages. First, interest paid is tax deductible, which lowers debt's effective cost. Second, debt holders get a fixed return, so stockholders do not have to share their profits if the business is extremely successful. On the other hand, it has also its disadvantages. The higher the debt ratio, the riskier is the business, hence the higher is the interest rates it will have to pay. Then, if a company fails and operating income is not sufficient to cover interest charges, its stockholders will have to make the shortfall, and if they cannot, bankruptcy will result.

An appropriate capital structure is a critical decision for any business organization. The decision is important not only because of the need to maximize returns to various organizational constituencies, but also because of the impact such a decision has on an organization's ability to deal with its competitive environment. The prevailing argument, originally developed by Modigliani and Miller (1958) is that an optimal capital structure exists which balances the risk of bankruptcy with the tax savings of debt. Once established, this capital structure should provide greater returns to stockholders than they would receive from an all-equity firm.

When these firms discover that the net benefit of debt is positive, they will move toward their optimal capital structure by issuing additional debt and/or reducing their equity. The implicit assumption has been that a firm's leverage is completely a function of the firm's

demand. In other words, the supply of capital is infinitely elastic at the correct price and the cost of capital depends only upon the risk of the firm's projects.

Although the empirical literature has been successful, in the sense that many of the proposed proxies are correlated with firms' actual capital structure choices, there are certain firms that appear to be significantly under-levered. For example, based on estimated tax benefits of debt, Graham (2000) argues that firms appear to be missing the opportunity to create significant value by increasing their leverage and thus reducing their tax payments, assuming that the other costs of debt have been measured correctly. This interpretation assumes that firms have the opportunity to increase their leverage and are choosing to 'leave money on the table'. An alternative explanation is that firms may not be able to issue additional debt.

There are a few factors that influence the capital structure decisions in maximizing the company's performance. First, the *business risks*; which is the degree of riskiness in using debt. The higher the company's business risks, the lower its optimal debt ratio. Then, the company's *financial flexibility* plays an important role. It refers to the ability to raise capital on reasonable terms under adverse conditions. A steady supply of capital is necessary for stable operation. Thirdly, *managerial aggressiveness*. The more aggressive managers are inclined to use debt in the capital structure decision to boost profits and vice versa for more conservative managers. Then, the firm's *tax position* also influences the capital structure decision. If using more debt will not be advantageous where interest is deductible due to the firm's income already sheltered from taxes by depreciation tax shields or whatsoever reason, then financing via debt is not preferred.

## **1.2 An Overview on Construction Sector in Malaysia**

The construction industry in Malaysia consists of general construction, which comprises residential construction, non-residential construction, industrial construction, infrastructure and civil engineering construction. The main reason construction sector is

being analyzed in this research is because it constitutes an important element of the Malaysian economy. Although it accounts for less than 5% of Malaysia's Gross Domestic Product (GDP), this industry is a strong growth push because of its extensive linkages with the rest of the economy e.g. construction related manufacturing industries such as basic metal products and electrical machinery. Indirectly, the characteristic of the construction sector is of much importance to the economy of Malaysia because of its effect on other sectors. The changes in the construction industry can potentially affect the economy of Malaysia as a whole. Therefore, it is worthwhile investigating the effect of capital structure decision on construction companies' performance in Malaysia.

In year 1999, the construction sector experienced a contraction with a negative growth of 5.6%. In the civil engineering sub-sector, several privatized projects which is supposed to take-off, was delayed, such as the New Pantai Expressway, Express Rail Link and the Kuala Lumpur Monorail System. In the non-residential sub-sector, there was still an excess supply of office and retail space. However, there was a slight growth in the residential sub-sector with the increase in new approvals for private housing projects and increased in the number and value of residential property transactions.

The construction sector turned around in year 2000 to record a growth of 1.1%, due primarily to government spending under the fiscal stimulus program. It also emanated from the revival of several privatized infrastructure projects that were shelved in 1999 as well as the commencement of new privatized projects during 2000 including TNB Janamanjung power plant and Kajang Seremban Expressway. Growth in the residential housing development was supported by strong underlying demand, particularly for affordable housing, arising from low interest rates, rising income and improved sentiment. In contrast, construction activity in the non-residential sub-sector remained subdued, constrained by excess capacity given the large overhang of office and retail space.

The fiscal stimulus program, privatization of infrastructure projects and housing development contributed to a stronger growth of 2.3% in the construction sector for the

year 2001. New infrastructure projects included Kajang Ring Road, Ipoh-Lumut Highway, Guthrie Corridor Expressway, Butterworth Outer Ring Road, Technology Tenaga independent power plant and ongoing works related to airports, rail, ports, waste disposal, water and sewerage projects. Growth in the residential sub-sector was supported by strong underlying demand for residential units, particularly affordable and conventional housing in choice locations with good accessibility, low interest rates, competitive housing loan packages offered by financial institutions, withdrawals of EPF funds for purchase of second house and exemption of stamp duties. Construction activity in the non-residential sub-sector consolidated further due to the large overhang of office and retail space.

In year 2002, growth in the construction sector was maintained at 2.3%. As in the past few years, growth was supported mainly by government expenditure on infrastructure projects and household demand for residential property. One of the major ongoing public projects is the Rawang-Ipoh electrified double tracking railway project and other ongoing projects initiated in the past two years. In the non-residential sub-sector, construction activity remained focused on existing projects given the prevailing large overhang of office and retail space.

In year 2003, the construction sector expanded at a more moderate pace of 1.9% due mainly to a slowdown in the civil engineering sub-sector following the completion of several privatized projects. However, several new infrastructure projects supported the civil engineering activity including the Penchala Link of the SPRINT Expressway, the SMART Intelligent Tunnel for Flood Mitigation and the Kuala Lumpur Convention Center. In view of the experience acquired in the domestic civil engineering sub-sector, Malaysian construction companies have diversified their earnings base and expanded overseas, particularly in the construction of highway projects and other infrastructure projects mainly in India and Middle East. Growth was mainly supported by the residential sub-sector, while activity in the non-residential sub-sector remained subdued amidst the continued overhang of office and retail space, although the excess supply was reduced during the year.

The Government of Malaysia has consistently allocated sufficient budget for construction of infrastructure projects such as roads, bridges, railways, ports, airports and road maintenance and construction-related projects such as new hospitals and clinics, low-cost housing and government servant quarters, training institutes, new schools and universities. The construction industry will continue to be boosted by the government's pump-priming package, an effort to mitigate the adverse impact of the slowdown in the global economy.

## **1.2 Statement Of The Problem**

There are many researches done on capital structures in developed countries like United States and United Kingdom. Simerley and Li (2002) have examined the economic performance of over 700 firms across 31 industries. Those firms in industries characterized as exhibiting high levels of dynamism were more successful if they had relatively low levels of debt. In other words, debt was negatively related to profit in these industries. In more dynamic environment, debt-holders are less likely to appreciate the need to invest in long-term projects with questionable pay-off.

Following the financial crisis that hit Asia in July 1997, the share market collapsed, cost of borrowing was higher due to high interest rates and also devaluation of Malaysian Ringgit. It is obvious that the capital structure of most Malaysian companies fail to withstand the onslaught of the financial crisis. During this period, companies often need extra fund for liquidity and emergency purposes in order to continue its operation. Companies were more inclined to source for funds by acquiring debt rather than issuing equity because of higher rate of return required by shareholder and to compensate for the risk bear by shareholder in the highly volatile stock market.

The collapsed of share market had registered a huge negative return on common stocks and many companies were very risky. Firms with large amount of debt face higher bankruptcy risk and thus a significant fall in the company performance.

This study has focused on the effect of capital structure decisions on company performance of construction companies in Malaysia. The capital structure decision is one of the most important strategic management decision in this industry. The revenue of this companies comes from new construction projects, either housing, infrastructure, industrial or other type of projects. The way of funding the projects; which may worth hundreds of millions of Malaysian Ringgit, is of importance to the company. Therefore, it will be useful to study the effect of such decisions on the company performance. In addition, it looks into the effect of firm size on company performance of the construction sector in Malaysia.

The essence of this study is to attain more understanding of the capital structure decision and the relationship with the company performance in Malaysia. It is worthwhile investigating the effect of capital structure decision on company performance, especially in developing country like Malaysia.

### **1.3 Objectives Of The Study**

The main objective of this study is to examine the effect of capital structure decision on the performance of construction companies in Malaysia. Throughout the paper, we measure the firm's long term debt ratio as the representative of capital structure ratio. Debt consists of long term debt measured on a book value basis. Company performance is measured by ratio of net profit to total equity.

In the linear regression analysis, firm size approximated by company revenue, will also be included as a control variable. The influence of firm size is being evaluated in the study of the effect of capital structure decisions on company performance. The main focus of this study is to examine the effect of capital structure decision on the performance of construction companies in Malaysia.

#### **1.4 Significance Of The Study**

This study would be of value for academics and practitioners in Malaysia. From the academic perspective, this study is expected to contribute to the generalizability of the existing body of research. Since the major focus of this study is to examine the influence of capital structure decision on the performance of construction companies, it is hoped that the findings of this study will contribute to the literature of the construction industry in Malaysia.

It is anticipated that this study will also stimulate others to conduct further research on capital structure used by Malaysian organizations and other factors that will influence the company performance besides capital structure decisions. In practice, the findings of the present study might provide Financial Officers and Managers of the construction industry with valuable information in capital structure decisions.

It is hoped that the result of this study will make clear to organization that capital structure decision is important and may influence company performance. This is especially true for Malaysia, a country that is trying to rise to a developed and industrialized nation status.

#### **1.5 Organization Of The Thesis**

This research will be organized into six different chapters:

Chapter 1 states the introduction and overview of the research project.

Chapter 2 discusses the literature of capital structure, operating leverage and company performance. Then, some other issues and related theories e.g. Bankruptcy costs, Tax shield effect, Agency theory, Static Tradeoff theory and Pecking Order theory is also being discussed.

Chapter 3, meanwhile, discusses the research methodology. It looks at the research design, data collection, hypothesis and data analysis.

Chapter 4 on the other hand, is on findings and analysis. It looks at the testing of hypothesis and the results of regression between ROE and long term debt ratio, ROE and revenue and finally ROE and both Long term debt ratio and Revenue.

Chapter 5 is the discussion and conclusion section.

Chapter 6 looks at the limitations of the study and suggestion for future research.