CHAPTER 1: INTRODUCTION

Capital structure is defined as the mix of debt, equity and hybrid securities issued by a firm to finance its operations (Annuar and Shamsher 1993). Another definition is given by Brealey and Myers (2000) who define capital structure as the mix of different securities. They say that a firm can issue distinct securities in countless combinations. The choice of capital structure is, in fact, an attempt by a firm to find the particular combination that maximizes its overall value. Capital structure is also referred to as financial structure by some authors.

1.1 PURPOSE AND SIGNIFICANCE OF THE STUDY

Pomerleano (1998) and Claessens et al. (2000) found that the total debt to equity ratios of companies in Malaysia increased during the few years before the 1997/98 economic crisis (henceforth known as “the crisis”) which caused Malaysia to suffer a 6.7 per cent decrease in GDP growth rate in 1997 (Asian Development Bank, 1999).

Borrowings have a leverage effect that can increase a firm’s expected return on equity provided that the expected return on invested capital exceeds the after-tax interest rate (Brigham et al. 1999). However, financial leverage also increases shareholders’ risk and when a leveraged company is not performing well, it not only incurs losses but has to pay interests on its borrowings as well.

This study looks at the capital structure of Malaysian companies during the 1990s and its effect on company financial performance before and during the crisis as well as during the recovery in 1999 because this will not only update us on the extent of debt usage among Malaysian companies but also enlighten us on whether it is better to have high or low levels of leverage.
This study also looks into the extent of long-term debt usage as well as the financing of fixed assets by long-term debt and long-term capital (long-term debt and equity). An ideal financial management practice is to finance fixed assets with either long-term debt or long-term capital. Financing fixed assets with short-term debt may be cheaper in the short-run but it may also increase a firm’s financial distress if the economy takes a downturn because interest rates can rise sharply like what happened during the crisis before the imposition of capital controls in September 1998 and this can expose the firm to loan renewal problems.

1.2 RESEARCH OBJECTIVES

The objectives of the study can be summarized as follows:
1) To examine how the capital structure of public listed companies in Malaysia differ across time and industry.
2) To examine whether the financing of fixed assets is matched by long-term debt or covered by long-term capital.
3) To examine the effect of leverage on the performance of public listed companies in Malaysia over the past 10 years.

1.3 SCOPE OF THE STUDY

This study covers both the KLSE Main Board and Second Board companies that were continuously listed from 1990 to 1999. Data up to March for a particular year is used as data for the previous year. For instance, data for the period April 1999 to March 2000 are taken as data for 1999.

The study does not take into account the finance sector because financial institutions have high levels of debt. For example, Annuar and Shamsher (1993) found that the average debt-equity ratio from 1975 to
1989 for the finance sector was 16.29 but was only 1.04 for the industrial\(^1\) sector which had the second highest average debt-equity ratio. The finance sector has a high level of debt because banks and finance companies receive deposits from customers and borrow through the money market. Banks and finance companies may also indicate a bias in favour of an optimal capital structure that is stable over time because of existing regulation on this sector by Bank Negara Malaysia especially with regard to capital adequacy requirements (Ang 1994, Annuar and Shamsher 1993, Tho 1993).

The hotel sector is not included because it only had 3 counters in December 1990 and only 2 of them still remained in this sector in December 1999. Also excluded are the infrastructure project company (IPC) sector which was not in existence in 1990 and the technology sector which was only established on 15 May 2000.

1.4 LIMITATIONS OF THE STUDY

Actual data could not be used for all companies in some of the years studied because financial year-ends were sometimes changed. Consequently, some companies had financial periods exceeding 12 months with no financial year-end in a particular year or had financial periods which were less than 12 months. When such a situation occurred, profit and loss data had to be estimated by extrapolating the data over 12 months.

The economic value added (EVA) formula has been simplified in this study. Actual interest expense is used instead of arbitrarily estimating cost of debt from company annual reports. Furthermore, cash-flow adjustments, like eliminating deferred tax, are not done because the results may not be materially different after such adjustments are made.

\(^{1}\) The industrial sector was subdivided into the consumer products, industrial products, construction and trade/services sectors in 1993.
Another limitation is that some companies actually became insolvent during the crisis and had negative shareholders' equity which resulted in negative or larger than normal ratio values for the study.

1.5 ORGANIZATION OF THE STUDY

Besides this introductory chapter, this paper is organized into another four chapters. Chapter 2 discusses previous studies in the literature. Chapter 3 describes the methodology employed and the sample data for this study. Chapter 4 presents the empirical findings and Chapter 5 concludes the results of the study.