



UNIVERSITI PUTRA MALAYSIA

***IMPACT OF FINANCIAL FLEXIBILITY ON DEBT MATURITY,
INVESTMENT DECISIONS AND PERFORMANCE OF FIRMS IN
MALAYSIA AND AUSTRALIA***

NG HUEY CHYI

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By

NG HUEY CHYI

Thesis Submitted to Graduate School of Management, Universiti Putra Malaysia in
Fulfillment of the Requirements for the Degree of Doctor of Philosophy

June 2018



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DEDICATION

To
my parents,
Ng Seng Eng and Lim Sor Ngor
my husband,
Wong Lih Wern
No one has ever been given more loving and unconditional support than I have been
given by you all.
I love you all.



Abstract of thesis presented to the Senate of Universiti Putra Malaysia in fulfillment of the requirements for the degree of Doctor of Philosophy

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June 2018

Chairman: Associate Professor Cheng Fan Fah, PhD
Faculty: Graduate School of Management, UPM

Financial flexibility was defined as a firm's ability to respond in a timely manner to unanticipated shocks or changes in firms' cash flows and investment opportunity. Financially flexible firm reserves some borrowing power to avoid any financial distress, which enable firm to issue new debts or adjusting capital structure at low cost. Firm's financial flexibility, debt maturity structure and investment opportunities have been linked together with strong potential interactions. During financial crisis, firms that had over borrowed or have optimum debt-equity choice have been subjected to mismatched asset liability. Those saddled with more short term debts are facing higher default risk and interest rate risk during such times. Subsequently, many firms have had to stop operations and slash employments; some opted for liquidation. Thus, firm sustainability is also highly reliant on their financial flexibility and debt maturity structure. Research of firm's financial flexibility is lacking despite financial flexibility being able to reduce company risk and respond effectively to any investment opportunity or financial constraint. There are also lack of research on the impact of firm's financial flexibility on debt maturity structure, investment decisions and firm's performance. The objectives of this thesis including determination of factors affecting firm's capital structure and to identify the firm's financial flexibility status; examine the relationship between firm's financial flexibility and the firm's debt maturity structure; study the impact of firm's financial flexibility and debt maturity structure on their investment decision; and lastly examine the impact of firm's financial flexibility towards firm's performance and value.

This paper study on listed companies in Malaysia and Australia due to their location in Asia Pacific region with different economy development structure and status. Study period starting from year 2000 to year 2014, yielding 10,633 observations. Panel regression has been employed for all hypotheses. The preliminary result of this

study to meet the first research objective has suggested that Malaysian firms follow the pecking order theory, whereas Australian firms follow the trade-off theory. Firm's financial flexibility has been identified by comparing targeted debt ratio and actual debt ratio. In meeting the second research objective, financially flexible firms found to have less long term debts in both Malaysia and Australia. This financially flexible firm has lower default risk and debts roll over risk due to the ability to restructure their financial policy during uncertainty or shock. Thus, they prefer short term debts rather than long term debts.

Subsequently, for research objective three, mixed results being found where financial flexibility has shown no impact on firm's investment decision in Malaysia, but Australian firms are positively impacted. Debt maturity shows positive significant impact on firm's investment in both countries. In additional study, financial flexibility has shown negative impact on low investment firms in Malaysia, indicates that firms forgo investment opportunity to maintain financial flexibility. In Australia, financial flexibility shows strong positive impact towards the high investment activities firms only, signaling the importance of financial flexibility in high investment firms. For the last research objective, no significant result found in both countries on the impact of financial flexibility towards performance. Details investigation shows negative impact on firm's performance in low profitability and smaller firms, whereas positive impact on high profitability and large firms. The financial flexibility helps in restructuring firm's financial position at a lower cost, proving the important role financial flexibility plays in increasing firm's performance and value in both countries. This study has substantiated the importance of financial flexibility and debt maturity structure in a firm's capital structure, investment decisions and performance. The research findings provide an overview of financial flexibility and serve as a good guide for firm's managers, regulators as well as investors. It was recommended study on the opportunity cost of maintaining financial flexibility and adding more countries for future study.

Abstrak tesis yang dikemukakan kepada Senat Universiti Putra Malaysia sebagai memenuhi keperluan untuk ijazah Doktor Falsafah

**KESAN FLEKSIBILITI KEWANGAN PADA STRUKTUR MATANG
HUTANG, KEPUTUSAN PELABURAN DAN PRESTASI FIRMA.**

Oleh

NG HUEY CHYI

Jun 2018

Pengerusi: Prof. Madya Cheng Fan Fah, PhD
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Fleksibiliti kewangan ditakrifkan sebagai keupayaan firma untuk bertindak balas dengan cepat pada kejutan yang tidak dijangkakan atau perubahan dalam aliran tunai firma dan peluang pelaburan. Firma yang mempunyai fleksibel kewangan memegang kuasa pinjaman untuk mengelakkan sebarang masalah kewangan. Fleksibiliti kewangan, struktur kematangan hutang dan peluang pelaburan telah dikaitkan bersama dengan interaksi yang kuat. Semasa krisis kewangan, firma yang telah meminjam atau mempunyai pilihan ekuiti optimum telah mengakibatkan nisbah liability dan aset yang tidak sesuai. Mereka yang dibebani dengan banyak hutang jangka pendek berhadapan dengan risiko tidak bayar balik dan kadar faedah yang tinggi, sedangkan firma yang mempunyai hutang yang lebih rendah dan kematangan hutang yang lebih lama sama ada akan kurang terganggu atau masih boleh tahan. Seterusnya, banyak firma terpaksa menghentikan operasi dan mengurangkan pekerjaan; ada juga yang berjaya, manakala yang lain memilih untuk pembubaran. Oleh itu, adalah jelas bahawa kelestarian firma juga sangat bergantung kepada fleksibiliti kewangan dan struktur kematangan hutangnya. Penyelidikan fleksibiliti kewangan syarikat masih kurang walaupun fleksibiliti kewangan dapat mengurangkan risiko syarikat dan bertindak balas dengan berkesan kepada sebarang peluang pelaburan atau masalah kekurangan kewangan. Terdapat juga kekurangan penyelidikan mengenai kesan fleksibiliti kewangan syarikat terhadap struktur kematangan hutang, keputusan pelaburan, prestasi dan nilai firma. Objektif tesis ini termasuk penentuan faktor-faktor yang mempengaruhi struktur modal firma dan untuk mengenal pasti status fleksibiliti kewangan firma; mengkaji hubungan antara fleksibiliti kewangan firma dan struktur kematangan hutang firma; mengkaji kesan fleksibiliti kewangan syarikat dan struktur kematangan hutang ke atas keputusan pelaburan mereka; dan akhirnya mengkaji kesan fleksibiliti kewangan firma terhadap prestasi dan nilai firma.

Kajian kertas ini mengenai syarikat-syarikat tersenarai di Malaysia dan Australia disebabkan lokasi dalam Asia Pacific dengan kedudukan ekonomi yang berlainan. Kajian ini menggunakan data dari tahun 2000 hingga tahun 2014 dan menghasilkan 10,633 pemerhatian. Regresi panel telah digunakan untuk semua hipotesis yang diuji dalam kajian ini. Hasil kajian ini mencadangkan bahawa firma-firma Malaysia mengikuti teori “pecking order”; sebaliknya, firma-firma Australia mengikuti teori “trade-off”. Fleksibiliti kewangan firma telah dikenal pasti selepas memperoleh nisbah hutang yang disasarkan dari kajian model regresi tahap hutang, kerana firma dengan nisbah hutang sebenar yang lebih rendah dibandingkan dengan nisbah hutang yang disasarkan akan dikelaskan sebagai firma yang mempunyai fleksibiliti kewangan. Keputusan menunjukkan bahawa firma kewangan yang fleksibel kurang mempunyai hutang jangka panjang dalam Malaysia dan Australia. Firma yang mempunyai kewangan yang fleksibel ini mempunyai risiko tidak bayar balik hutang yang lebih rendah kerana firma ini mempunyai keupayaan untuk mengubahsuikan dasar kewangan mereka semasa ketidakpastian atau kejutan. Oleh itu, mereka lebih suka memegang hutang jangka pendek berbanding dengan hutang jangka panjang. Untuk kajian objektif ketiga, keputusan yang berlainan ditemui di mana fleksibiliti kewangan tidak memberi kesan kepada keputusan pelaburan firma di Malaysia, tetapi firma Australia menunjukkan kesan positif. Kematangan hutang menunjukkan kesan positif terhadap pelaburan firma di kedua-dua negara. Dalam kajian tambahan, fleksibiliti kewangan telah menunjukkan kesan negatif terhadap firma yang mempunyai pelaburan yang rendah dan tidak memberi kesan kepada firma yang mempunyai pelaburan tinggi di Malaysia. Ini menunjukkan bahawa syarikat-syarikat melepaskan peluang pelaburan mereka untuk mengekalkan nisbah perhutangan mereka pada tahap fleksibiliti kewangan. Di Australia, fleksibiliti kewangan telah menunjukkan kesan positif yang kuat terhadap firma yang mempunyai aktiviti pelaburan yang tinggi, ini menandakan kepentingan fleksibiliti kewangan dalam syarikat berpelaburan tinggi.

Untuk objektif terakhir, keputusan menunjukkan sebaran kesan-kesan fleksibiliti kewangan di dalam kedua-dua negara ini. Walau bagaimanapun, kajian tambahan mengenai objektif kajian ini mendapati kesan negatif terhadap prestasi firma dalam firma yang mempunyai keuntungan rendah dan firma yang bersaiz kecil. Sementara itu, fleksibiliti kewangan telah menunjukkan kesan positif yang signifikan terhadap firma yang mempunyai keuntungan yang tinggi dan saiz besar untuk Malaysia dan Australia. Fleksibiliti kewangan membantu dalam pengubahsuaian semula kedudukan kewangan firma dengan kos yang lebih rendah, membuktikan peranan fleksibiliti kewangan adalah sangat penting dalam meningkatkan prestasi dan nilai firma di kedua-dua negara. Keseluruhannya, kajian ini telah membuktikan kepentingan fleksibiliti kewangan dan struktur kematangan hutang dalam struktur modal syarikat, keputusan pelaburan dan prestasi syarikat. Penemuan penyelidikan ini menyumbangkan gambaran keseluruhan fleksibiliti kewangan dan menjadi panduan yang baik untuk pengurus firma, pengawal undang-undang serta pelabur. Kajian ini mencadangkan bahawa kos memegang fleksibiliti kewangan dalam firma perlu dikaji. Selain itu, kajian boleh dijalankan dengan menggunakan banyak negara-negara dalam kajian.

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APPROVAL

I certify that a Thesis Examination Committee has met on 1st June 2018 to conduct the final examination of Ng Huey Chyi on her thesis entitled “Impact of Financial Flexibility on Debt Maturity, Investment Decisions and Performance of Firms in Malaysia and Australia” in accordance with the Universities and University College Act 1971 and the Constitution of the Universiti Putra Malaysia [P. U. (A) 106] 15 March 1998. The Committee recommends that the student be awarded the Doctor of Philosophy.

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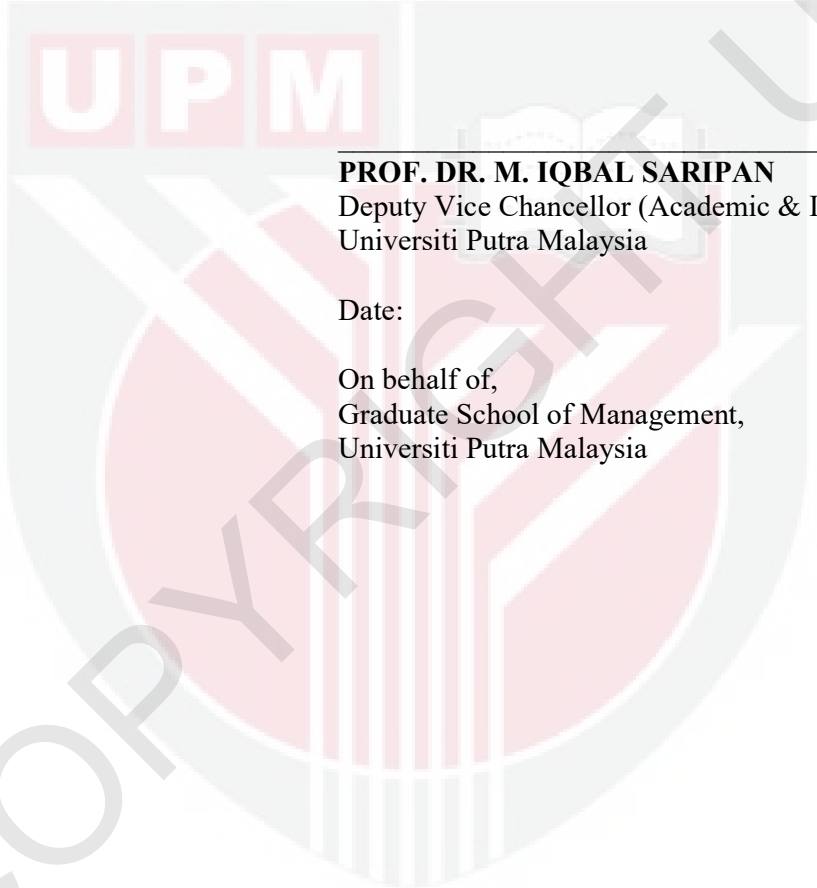
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LIST OF ABBREVIATIONS

ASIC	Australian Securities and Investments Commission
ASX	Australian Securities Exchange
CAPM	Capital Asset Pricing Model
CFO	Chief financial officer
DFI	Development Financial Institution
DM	Debt maturity
FDI	foreign direct investment
FF	Financial flexibility
GDP	Gross Domestic Product
GLS	Generalised least squared
GST	Goods and Services Tax
HOC	high ownership concentration
IMF	International Monetary Fund
INV	Investment activities
KLCI	Kuala Lumpur Composite Index
LOC	low ownership concentration
MIFC	Malaysia International Islamic Financial Centre
OC	ownership concentration
OLS	ordinary least square
US	United States
R&D	research and development
RBA	Reserve Bank of Australia
ROA	Return on assets
SC	Securities Commission Malaysia
SME	Small and Medium Enterprise

CHAPTER 1

INTRODUCTION

1.1 Background of the Study

Profit maximization for shareholders has long since been acknowledged as a firm's primary objective by striving for an optimal capital structure combining debt and equity proportionately. Modigliani and Miller (1958) have previously postulated the independent nature of the firm's financing and investment decisions, as the market is frictionless. However, the process is saddled with various issues and factors, especially the methods of obtaining, achieving and maintaining the optimum capital structure. These concerns are attributable to the changing landscape of the market and the presence of many internal and external factors affecting debt and equity allocation. By considering these different factors, managers will be able to construct a target optimal capital structure utilizable as a guide to raise funds in the future.¹ Optimal capital structure will play a big role in maximizing the value of the firm while minimizing the risk and cost of capital.

When firms are in need of funds for business investment, the first step to be taken is to look into free cash flow availability in the business. If none are available for such purposes, funds must be raised from other resources; managers are responsible of deciding the method of obtaining them. They have to decide the source and collection method, look into any associated costs, and factor in any elements correlating with their decisions. They should also be clear on the amount of funds they are supposed to obtain from different types of resources and maintaining a certain debt to equity ratio.

Major resources of fund can be classified into two: equity and debt. Managers may either opt in issuing new equity to the market or issue additional debt in the form of long term or short term loan, corporate bond or debentures instrument, and others so as to obtain funds. The decision between issuing debt, equity or both combined to achieve this purpose can be influenced by various factors. For example, when it is decided that a firm will utilize debt finance, some of the expected future cash flow will be reallocated away from the shareholders in exchange for current cash inflow. The firm's objectives remain the same: maximizing firm's value and creating wealth for the shareholders in the future. However, shareholders demand for a higher rate of return as risk increases while firm increases their investment activities. Thus, the optimum capital structure (i.e. debt and equity) is an issue always deemed as important and meriting discussion by researchers; many has focused their attention on the topic but it remains an interesting area for research. Furthermore, the bond market in Malaysia has undergone rapid development and showing increased

¹ Target might change over time as conditions vary in different time period. Named as the static tradeoff framework by Myers (1984), the work has described firms setting the target debt-to-value ratio and gradually moving towards it.

activities. The conventional and Islamic bonds issued both have increased from year to year, revealing external financing to be flexible and easily available. This is evidenced by the statistics displaying improved figures from RM 263,370 million in year 2000 towards RM 763,368 million in year 2010 (Bank Negara Malaysia). This showed that external financing easily available and flexible in the market.

Denis (2011) defined that financial flexibility represent the ability of a firm to respond in a timely and value-maximizing manner to unanticipated shocks or changes in the firm's cash flows or investment opportunity. According to Marchica and Mura (2010), the positive gap between firm's actual debt and optimum debt is known as spare debt capacity which represent firm's financial flexibility. Myers (1984) and Froot et al. (1993) both have also suggested that firms reserve some borrowing power to avoid any financial distress, which allows them the flexibility to issue new debts at low cost when in need of funds for any investment activities and avoiding underinvestment. Rapp et al. (2014) have argued further regarding the significance of financial flexibility towards a firm's financial policy. A survey conducted by Graham and Harvey (2001) among top United States (US) corporations has also reinforced firm's financial flexibility status as the most important factor in leverage policy, followed by credit rating, earnings volatility, cash flow volatility, and internal funds constraint. Conversely, Takami (2016) reported maintaining good relationship with banks is more important than attaining financial flexibility in Japanese firms. Therefore, they do not raise external funds during financial crisis using their internal financial flexibility.

In addition, debt maturity structure has also been deemed as an important player in determining corporate capital structure and firm's investment decisions (Myers, 1977; Diamond's, 1991; Mitcheel, 1991; Stohs & Mauer, 1996). Without a proper decision on the debt maturity structure, a firms may face liquidation due to unable to payback their short term debts. Myers (2003) has stated that: "... There is no universal theory of capital structure, and no reason to expect one. There are useful conditional theories, however.... Each factor could be dominant for some firms or in some circumstances, yet unimportant elsewhere". Different countries have different country characteristics; thus, previous empirical research results may not be applicable to all countries around the world, as it may implicate differently. This may cause improper financial management in the Malaysian firms and Australian firms, consequently these corporations unable to perform or survive and declare bankruptcy. It is important to study on Malaysia and Australia to gain a better understanding on the firms in both countries rather than applying the finding from others countries in these two countries. With the results from this study as the guideline, a proper financial management can help the firms to perform better in future or sustain better during crisis.

Regardless, firm's leverage, debt maturity structure and investment opportunities have been linked together to strong potential interactions. Firms that are already tied up with debts of longer maturity will always opt for a reduced amount of new debt to be issued, especially if they have a high level of leverage. In fact, they are oftentimes charged with higher interest rates in case of new debt issuance, due to increased

default risk and resulting in increased cost of debt. Growing businesses burdened with long-term outstanding debts may find themselves resorting to underinvestment sometime later as they are unable to issue new debts. New debts may only be issued if the debt maturity structure is adjusted or debt level is reduced, for the purpose of funding new investment projects. Diamond (1991) and Johnson's (2003) both argued that there is a positive relationship between firm's debt maturity and firm's leverage level, as firms with short-term debt and in risk of liquidity will be motivated to reduce their debt level. A smaller amount of debt will result in a reduced cost of debt and allow a firm to experience value growth. Thus, it is reasonable to predict that lowering the leverage level and opting for a short term debt will generate positive growth opportunities on investment, reinforcing the importance of financial flexibility in a firm. On the other hand, Dang (2010) who studied on UK firms had reported high growth firms control underinvestment problems by reducing leverage level but not shortening firm's debt maturity.

Tradeoff theory by Modigliani and Miller (1963) described that firm prefer to issues debts up to the maximum level. The cost of debts is tax-deductible this levered firm would enjoy higher firm value with tax shield compared to unlevered firm. In contrast, many researchers have found negative relationship between profitability and firm leverage level (Titman & Wessels, 1988; Hovakimian et al., 2001; Raheman & Nasr, 2007; Nadeem & Zongjun, 2011). Such finding is consistent with the pecking order theory by Myers (1984), which has described how managers fund new investments by using their firm's retained earnings. According to the pecking order theory, firm will actively accumulate their retained earnings when the business is profitable. However, non-profitable businesses that lack of the accumulated retained earnings require managers to issue new debts so as to fund for firm's investment activities. However, this does not align with the tradeoff theory described by Modigliani and Miller (1963). This has therefore sparked the argument that the pecking order theory yields better empirical explanation of the capital structures compared to the traditional tradeoff theory (Shyam-Sunder & Myers, 1999).

Nevertheless, Jong et al. (2011) has focused on the differences in prediction between the two theories before concluding that the pecking order can explain the American firm's practice of issuing debts better. However, they have obtained contradicting results regarding share repurchase decisions, finding the tradeoff theory more suitable to explain debt-equity choice. Regardless, arguments made using pecking order theory has afforded new insight in market timing theory, which is a consequent derivative of the traditional pecking order theory. According to this, firms tend to issue equity when the share price increases and repurchase shares while share price decreases (Baker & Wurgler, 2002). Therefore, the important role played by stock returns and debt market conditions in a firm's capital structure decisions can thus be reaffirmed. Furthermore, the market timing theory describes managers issuing new shares if the issuing cost is irrationally low and repurchases shares in the contrasting circumstances (Baker & Wurgler, 2002).

Firms that need to pay interest on debt can enjoy tax shield or tax deductibility. In other word, firms can increase debt level in their capital structure to reduce tax

payment. Factoring in this aspect, the value of a levered firm is equivalent to those of an unlevered firm, but extensive reliance on debt poses a higher risk especially in cases of uncertain earnings. Despite its ability to increase interest tax shield, debts can also inflate other borrowing costs like financial distress and agency costs. Harris and Raviv (1991) had empirically investigated on firm capital structure, finding the significant positive relationship between leverage and fixed assets, non-debt tax shield, growth opportunities and firm size. In contrast, firm's leverage also displays a significant negative relationship with volatility, advertising expenditures, research and development expenditures, bankruptcy probability, profitability and uniqueness of a product. However, Titman and Wessels (1988) have disagreed regarding the impact of non-debt tax shield, volatility and collateral value or future growth towards the firm debt ratio.

Empirical evidence justifying the commonly acknowledged debt and equity choice to be affected by firm's characteristics are largely mixed and unclear. Studies done are limited in number and are generally done in countries like USA or major developed countries, with only few papers analyzing international data by developing countries (Rajan & Zingales, 1995; Deesosak et al., 2004). Furthermore, the work by Clark, Francis and Hassan (2009) on the speed of target capital adjustment in selected develop and developing countries has yielded significant differences between developed and developing countries. Legal, institutional and other country level factors have been highlighted subsequently, with developing countries showing higher expected bankruptcy costs, managerial agency costs, tax rates and other elements. Therefore, they are associated with adjustment speed and the need for financial flexibility, whereby strong shareholder and creditor rights have been shown to be allied with faster adjustment speed in developing countries. Nevertheless, Francis and Hassan (2009) have highlighted the negative impact of financial market development and tax rates in developed countries, while the same factors positively affect the adjustment speed in developing countries.

The puzzling capital structure remains a complex issue with the different results found, with the high likeliness of its patterns to have changed over the years and decades. Nevertheless, explanation on financial flexibility in the traditional capital structure theories (trade-off theory and pecking order theory) are either limited or unclear, whereas research of firm's financial flexibility is practically negligible (de Jong et al., 2012; Rapp et al., 2014). Empirical study conducted on the topic is even more lacking (K. Yung et al., 2015). This is despite financial flexibility being able to contribute towards a better capital structure decision, reduced company risk and solving bankruptcy problem. It allows firms to respond effectively to any investment opportunity or financial constraint, enables obtainment of long term debts while avoiding interest rate risk.

Raja and Zingales (1995) have highlighted the importance of past findings obtained from works in developed countries towards studies being done in other countries as well. As identifying the fundamental determinants of capital structure requires good understanding and sufficient literature on relevant issues, an examination on any changes over time is crucial. Therefore, this necessitates a study on the national environment factors affecting debt-equity choice of firms in Malaysia and Australia.

This can provide a clearer picture on how the firms' capital structure and the impact of financial flexibility to the firms. These countries in particular are highlighted due to their location in Asia Pacific region, having sparse literature on the determinants of capital structure, financial flexibility, debt maturity and the impact on firm's investment and performance. Furthermore, they also have different institutional set-ups, such as financial markets, legal traditions, bankruptcy codes, the economy development and corporate ownership structure. Their respective status also differs: Malaysia is an emerging market, while Australia has established their market and landscape. Thus, this study will be able to emphasize differences or similarities between firm's capital structure, financial flexibility, investment decisions and firm's performance among the two countries.

1.1.1 Countries Background

1.1.1.1 Malaysia

Malaysia is a developing country with a newly industrialised market economy. As a middle income country with a services and manufacturing-based multi-sector economy, its Gross Domestic Product (GDP) has been steadily increasing since year 2000 from US\$ 93.79 billion to US\$ 338.069 billion in year 2014. However, it has encountered a small decrease of GDP value in year 2008 due to global crisis, while year 2015, the decreased value has been documented to be at US\$ 296.283 billion (The World Bank, 2016).

The Asian financial crisis in year 1997 has delivered a hard hit on the country's economy. Massive governmental expenditure has been made to rejuvenate it; subsequent recovery has been led by strong growth in exports, particularly of electronics and electrical products to USA and other principle trade and investment partners. The national central bank, Bank Negara Malaysia has also reduced the interest rate, resulting in a speedier recovery from the crisis compared to neighboring countries.

Other than that, Malaysia is also an exporter of natural and agricultural resources, such as petroleum, rubber, palm oil, pepper and others, with palm oil specifically being a major foreign exchange generator. However, the country is evolving from an economy reliant on agriculture and primary commodities to a manufacturing-based, export driven economy, utilizing high technology, knowledge-based and capital-intensive industries.

In year 2008, Malaysia has received RM46.1 billion FDI and ranked 10th out of all the countries, with an FDI Confidence Index of 1.41 in year 2012 (The World Bank, 2016). Meanwhile, Australia has ranked at 6th place, with an index of 1.52. The index specifically assesses the impact of political, economic and regulatory changes on FDI intentions and preferences of the leaders from top companies around the world.

Moreover, the national financial system consists of the conventional financial system and Islamic financial system concomitantly. The Central Bank of Malaysia, Bank Negara Malaysia is in charge of controlling the country's monetary and financial stability so as to sustain economy growth. This is reflected in their primary roles in formulating national monetary policy, regulating and supervising financial institutions, overseeing money and foreign exchange markets, promoting progressive financial system and more. Furthermore, Malaysian banking system is comprised of commercial banks, Islamic banks and investment banks; they are the main sources of fund provision in supporting national economic activities. Additionally, non-bank financial institutions like insurance companies, Development Financial Institution (DFI) and Takaful operators also cooperate with conventional banking institutions to organize savings and meet the country's financial needs accordingly.

The Islamic financial system implemented by Malaysia is in support of the regulatory, legal and Shariah governance framework present, which is made up of four main components. They are: Islamic banking, Takaful and Retakaful, Islamic interbank money market and Islamic capital market. Therefore, various financial instruments and products offered are compliant with global Shariah principles and can be promoted in global market, which has attracted international investors. For example, sukuk has been issued in different currencies like US Dollar, Renmimbi and Singapore Dollar, allowing Malaysia to evolve into becoming a multi-currency sukuk market. Increased issuance in the country has thereby positioned Malaysia as the second largest market in terms of US Dollar- denominated sukuk in the world, accounting for 14.5% of the market share (Abhinav,2013).

As of December 2016, the amount of total Islamic banking assets in Malaysia has reached a staggering RM742 billion and a market share of 28%, compare to RM685 billion and 26.8% in year 2015 (Mushtak, 2017). The Islamic banking asset growth has recording an average annual growth rate of 16.07% for the period between year 2002 to year 2011. Meanwhile, the Takaful industry may boast of total assets reaching RM17 billion, 8.89% market share and average annual growth rate of 20.1%. The Malaysian capital market has also recorded total outstanding sukuk amounting to RM200 billion as of September 2011, surpassing the outstanding conventional bond with 58% of market share (Abhinav, 2013). Furthermore, year 2006 has seen Malaysia to be positioned as an international hub for Islamic Finance, which strengthens its role as an intellectual epicenter for field. It has therefore spurred the setting up of the Malaysia International Islamic Financial Centre (MIFC).

On the other hand, the Development Financial Institutions (DFI) have been established by the Malaysian Government in their pursuit of developing and promoting key industries throughout the country's economic development. The industries are inclusive of the agricultural, Small and Medium Enterprise (SME), infrastructure, maritime and export oriented industry, capital-intensive and high technology industries. DFI as a whole is committed to providing services and various financial products in the industries to achieve economic development.

Other than that, the Malaysian Capital Market is an efficient resource for long term funds in financing the country's economic state. Malaysian equities market has been acknowledged as the 5th fastest growing landscape among their Asian counterparts, whereby market capitalization has displayed triple growth within the last decade and is projected to double in the next decade (The World Bank, 2016).

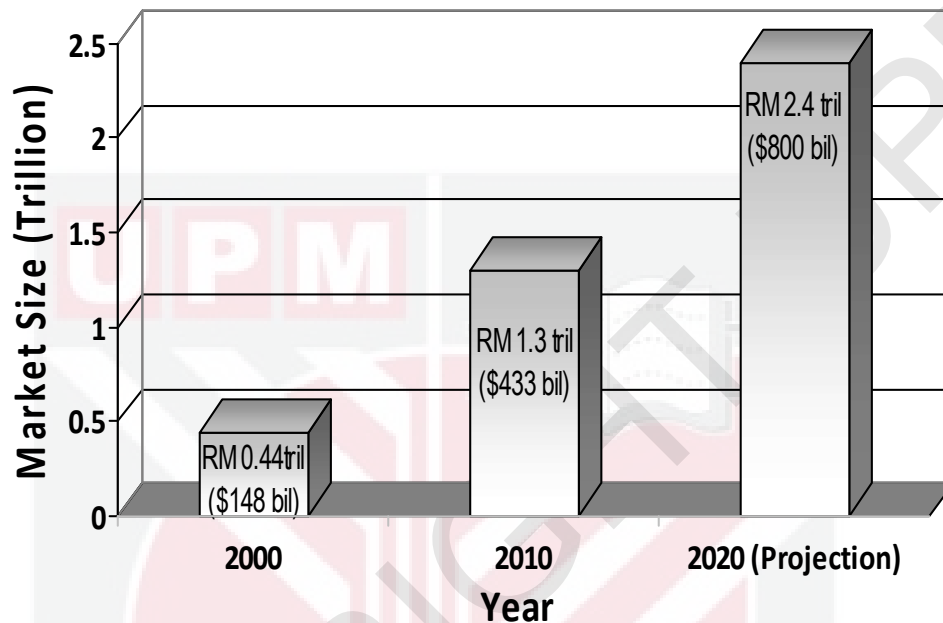


Figure 2.1: Malaysia's Market Capitalization
Source: Securities Commission (SC) Malaysia

Securities Commission Malaysia (SC) is a self-funding statutory body with investigative and enforcement powers, primarily tasked with regulating and developing the capital market and reports to the Minister of Finance. Its roles include: handling authority registration for prospectuses of corporations, supervising the exchange clearing house and central depositories, approving authority for corporate bond issues, regulating matters regarding to securities, futures contracts and unit trust, regulating company mergers and take-overs, ensuring ethical conduct of market institutions and licensed personnel, and more. SC is also in close cooperation with the accounting boards to integrate accounting principles, committed towards full convergence with international accounting standards by year 2012. These steps have been taken to protect investors in the capital market and promote the domestic security and futures markets.

Meanwhile, Bursa Malaysia is an approved exchange holding company, fully integrated and serves to regulate the exchange market, offering equities, derivatives, offshore, bonds as well as Islamic products among the wide range of investment choices. Besides also operating the securities trading activities in Malaysia with approximately 1,000 listed companies, it can be grouped into either the Main Market

for large-capitalization established companies or ACE Market for emerging companies. Furthermore, FTSE Bursa Malaysia Kuala Lumpur Composite Index's (KLCI) value is generally accepted as the main index measurement, consisting of 30 stocks index calculated according to global index standards. As the institution is responsible of promoting the Malaysian's capital market in local and global market and to investors, Bursa Malaysia must ensure a high standard of code of conduct by players within a fair market and assure for investor's protection.

Generally, participants of the capital market consist of stockbroking companies and trading participants. The stock broking companies are mainly investment banks offering services that deal with the exchange listing and other financial services, such as corporate finance, debt securities trading and dealing in securities. Meanwhile, trading participants is a company owning at least one preference share of the Bursa Malaysia Derivatives to conduct business as futures broker, which licensed by SC.

Due to the governmental support and insightful long term planning, the domestic capital market has grown from a market size of RM717.5 billion in year 2000 to RM2.0 trillion in year 2010. Similarly, the bond market has also exhibited growth of 10.8% annually, amassing RM273.1 billion in year 2000 towards RM758.6 billion in year 2010 and emerging as the third largest bond market in Asia (Abhinav, 2013). Despite the size of its economy, the domestic equity and debt market are relatively large, accounting to 165% and 97% respectively of the nominal GDP in year 2010 (Securities Commission Malaysia). Nevertheless, as the bond market is expected to grow up to RM2.053 trillion by year 2020, bond market players are eligible for various tax incentives. For example, institutional investors may enjoy tax exemption and withholding tax exemption on interests or profits received by non-resident investors, profit from investments in Islamic securities in any currency other than convertible loan stock, which has to be approved by SC. Individual investors may also enjoy tax exemption on interest or profits paid to individuals, applicable for investments in securities issued by government, bond issued by Central Bank Malaysia, and some others instruments approved by SC.

1.1.1.2 Australia

Australia is a developed country, boasting one of the largest economies in the world. Its mining industry has generated substantial contribution towards the economic growth in the past decade, with various minerals and resources present, such as zircon, nickel, zinc, iron, coal, copper, silver and so on. These resources are highly sought-after, especially by China due to their fast progression in the manufacturing industry. Furthermore, Australia has ranked second in terms of highest average wealth per adult in year 2013 after Switzerland, whereas it is also recognized as the nation with the highest median wealth in the world by Credit Suisse Research Institute. A strong economy growth, low inflation and low unemployment rates have been documented since early the 1980s, with the country's mineral and energy resources being in high demand from Asia. In terms of its GDP, it has also seen considerable increase from US\$ 414.952 billion in year 2000 to US\$ 1.455 trillion in

year 2014, but Australia has also been a victim of the financial crisis in year 2008 (The World Bank). The fallen commodity prices has slowed the economy down and recorded a US\$ 926.564 billion GDP in year 2009, compared to US\$1.055 trillion in year 2008. Additionally, the domestic economy has displayed level of growth rate that is below average, decreased trade and reduced household expenditure as residents are focused on saving instead of spending.

From year 2012 to 2013, despite the national economic growth, some non-mining states and non-mining economy sectors have experienced a recession. Prior to that, a major change constituted by indirect tax system in year 2000 has been implemented, with an introduction of 10% Goods and Services Tax (GST) (Wikipedia). Therefore, the main sources of government revenue have been generated from personal and corporate income taxes, with inflation rates typically around 2% to 3% and base interest rate around 5% - 6%. Otherwise, the service industry made up of tourism, education and financial services have contributed to about 70% of Australia's GDP. Furthermore, the country is rich in natural resources and agricultural products, rendering it a major exporter of agricultural products that trades with Japan, China, US, Korea and New Zealand. As of August 2013, the unemployment rate was 5.8%. Nevertheless, the IMF has forecasted Australia to be the best performing major and advanced economy in the world over the subsequent two years. With its stable and modern institutional and regulatory structures, Australia has ranked 3rd after Hong Kong and Singapore in the Economic Freedom Index in year 2011, 4th out of 188 countries in terms of ease in starting business in the country, and 10th in terms of ease in doing business (The World Bank).

The setting has benefited from the role played by Australian Securities Exchange (ASX); as the market operator, it clears the house and facilitates the payment system. It also oversees compliance with the operating rules, promotes standards for corporate governance among listed companies and helps to educate retail investors. This has ensured an in-depth and transparent market with informed investors and clear, efficient regulation procedures. In fact, ASX is the largest stock exchange in the South Pacific region, ranking at 9th in the world in terms of market capitalization (Wikipedia).

Moreover, regulating the domestic capital market has been upheld by Australian Securities and Investments Commission (ASIC) and the Reserve Bank of Australia (RBA) both. While ASX is responsible of monitoring and enforcing compliance with its operating rules, ASIC will monitor and enforce compliance for the ASX Group's own listing. ASIC is also responsible of supervising real-time trading in the domestic markets, including those operated by ASX Group, imposing laws against misconduct on the Australian financial market and supervising the Australian Financial Services license holders. In contrast, the RBA is tasked with ensuring the licensed clearing and settlement facilities are in compliance with the Financial Stability Standards and working on reducing any systematic risk.

Due to Australia's innovativeness, good development and high quality financial services industry and capital market, it has ranked 5th out of 57 world-leading financial systems and capital markets by the World Economic Forum in year 2010. In year 2012 – 2013 alone, the financial markets have generated a turnover of more than \$135 trillion.

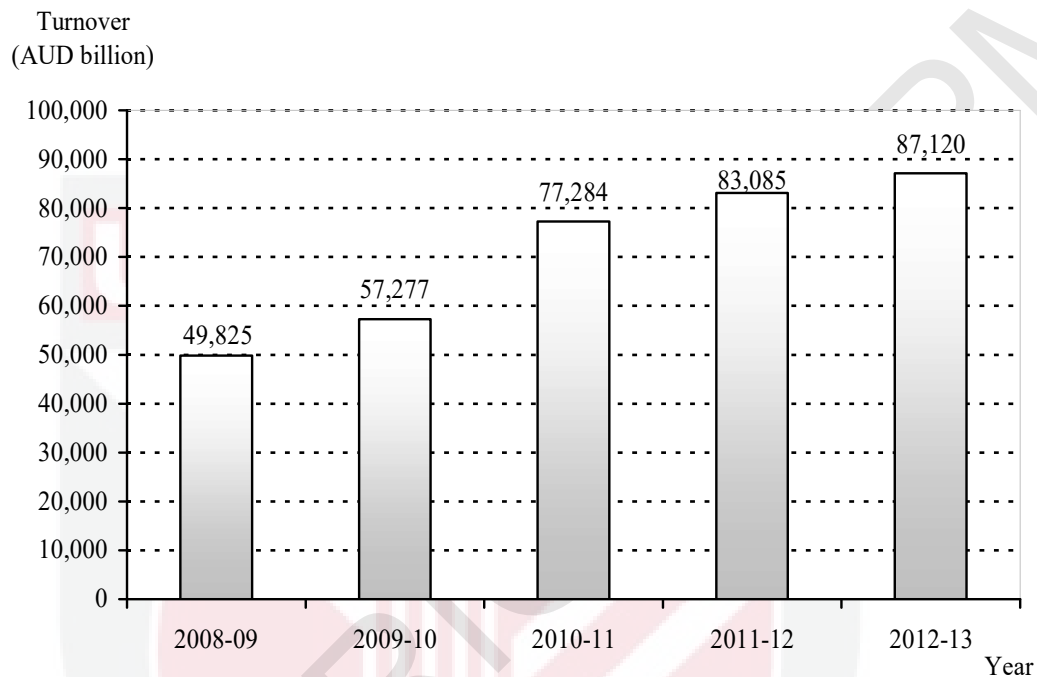


Figure 2.2 Australia debt market turnover.

Despite the Federal Reserve's announcement to taper the Quantitative Easing (bond-buying program), Australia's primary debt markets have shown distinct progression over the financial year of 2013. Different industries have yielded increased number of new bonds and volume of issuance, generating higher turnover from the debt market, especially the corporate bond. The corporate debt securities annual turnover in the financial year of 2013 alone has had a 34.5% increment compared to the previous financial year. Additionally, the Australian equity market's investors are almost evenly spread, comprising of 40% domestic institutional investors, 40% foreign investors and 20% retail investors (The World Bank). Therefore, strong economy and stable political standing have resulted in Australia becoming an attractive investment destination for global investors.

In February 2013, the ASX has launched ASX Net Global, a high-speed and cost effective network for global customers to connect to the Australia's financial markets (Wikipedia). This network has successfully linked financial communities from Singapore, London and Chicago to Australian financial markets and created high liquidity for the market.

1.1.1.3 Comparing Malaysia and Australia

The importance of ease of obtaining credit is influential towards a country's financial market and a company's capital structure. A Getting Credit (June 2012) report from the World Bank Group has iterated that getting credit is inclusive of credit information registries and effective collateral and bankruptcy laws to facilitate lending. The ease of the process can be measured by: 1) the legal rights of borrowers and lenders in secure transactions and bankruptcy laws, and 2) credit information registries or bureaus. Malaysia has ranked first place together with South Africa and United Kingdom, whereas Australia is 4th. The report has also displayed the strength of legal rights index for borrower and lenders, which measures the degree to which collateral and bankruptcy laws protect the rights of borrowers and lenders and thus facilitate lending. In this context, Australia and Malaysia both have scored highly, earning the title of having one of the most legal rights. Moreover, the depth of credit information index serves as a measurement for rules and practices that affect its coverage, scope and accessibility available through either a public credit registry or a private credit bureau. Scoring 6 out of 6, Malaysia has obtained the most credit information, whereas Australia has scored a score of 5. Meanwhile, in the resolving insolvency ranking, Australia and Malaysia have ranked 18th and 49th respectively (The World Bank).

In terms of the economic size, Australia has ranked 14th in the world GDP with 1.21% in year 2014, which is four times more than Malaysia, which has ranked 39th with 0.27% (Nation Master). Another important factor in terms of attracting new investors is the aspect of investor's protection against corporate assets misuse. Therefore, in terms of transparency in business transactions, Australia has scored 8 out of 10 to rank at 68th place, whereas Malaysia is ranked 4th with a score of 10 (The World Bank).

In some countries like the USA, double taxation on dividend is commonly practiced, with high amounts being paid by the company and received by shareholders despite the enforcement of tax adjustment after year 2008. Australia implements a dividend imputation system, whereby the tax paid by the company is not the final amount as shareholders will be taxed again upon receiving their gross dividend. Malaysia has previously executed the same system prior to year 2008, but has been allocated a transitional period of five years to switch to a single tier system that quotes the tax paid by the company as the final amount. Thus, the taxation policy in a country may either directly or indirectly affect firm's capital structure and financial policy. Finally, the total tax rate is a measure of the amount of taxes and mandatory contributions payable by the business in the second year of operation, which is expressed as a share of commercial profits. Australia pays a total tax rate of 47% and Malaysia 36.3% respectively, comparable to the amount that developed countries pay, such as US (46%), UK (34%), New Zealand (34.6%) and Netherlands (39.3%) (The World Bank).

1.2 Problem Statement

The financial crises occurred in year 1997 and 2007 respectively have been a hard hit for most of the countries in South East Asia and Asia Pacific. The booming economic growth present prior to the crises has been a period when firms were actively getting loans for good investment projects and business expansions. However, once the trying times commenced, overinvestments have been rife and implicated with poor cash flow and more high default risk loans. Firms had gotten loans from the local financial market, whereas financial institutions in the developing countries had went as far as obtaining foreign direct investment in short term structure. In turn, the foreign resources have been handed out to local corporations as long term loans, causing a mismatch between the two different settings across two different types of institutions (Andrew, 1999).

The developing countries in particular have experienced sharp depreciation of their currencies during the 1997 financial crisis (Corsetti, Paolo, & Nouriel, 1999). When the crisis resulted in foreign exchange losses, foreign direct investments have called back but financial institutions have found it difficult to pay their investment funds back as the corporation loans have been given out in a long term structure instead. Moreover, the depreciated domestic currency has also inflated the payback amount. Firms that had over borrowed or have optimum debt-equity choice have consequently been subjected to mismatched asset liability (Ayaydin et al., 2014). They also have no borrowing power anymore due to the over leveraging, as they are saddled with optimum capital structure or high default risk. Therefore, their inability to sustain may result in either merging, buy overs or declaration of bankruptcy; this leads to high retrenchment and unemployment rate in the country.

The equity markets in countries like Malaysia, Indonesia, and the Philippines have tumbled as their currency plunged (Bhagwan & Amit, 2000). Many financial institutions have been rendered non-sustainable and caused for many mergers and financial structure restructuring to happen. Similarly, the credit crises occurred in year 2007 and 2008 both have also spiked the loan default rate and firm's assets value, making it harder for funds to be obtained. Subsequently, many firms have had to stop operations and slash employments; some coped well, while others opted for liquidation. Therefore, it is clear that firm sustainability is also highly reliant on their capital structure and financial flexibility. However, Takami's (2016) empirical research has concluded that for Japanese firms, maintaining good relationship with banks is more important than attaining financial flexibility. Therefore, they do not raise external funds during financial crisis using their internal financial flexibility.

Corporate failure during financial crisis is an evidence of possible ineffectiveness of optimum capital structure due to a highly uncertain market, whereas a firm's financial flexibility and debt maturity structure is crucial for survival. Furthermore, Iwan et al. (2013) has found that firms with high leverage prior to a crisis will find their firm value to be negatively impacted further during such trying times. This may be due to their inability to pay back their debts due to assets and liability mismatch,

endangering their survival. Moreover, they also cannot roll over their debts for longer maturity due to high default risk (He & Xiong, 2012). Nevertheless, a short term debt is riskier and can create a larger debt overhanging problems compared to a long term debt, especially as rolling over the debt maturity is very sensitive for a firm's value and market condition (Lutkebohmert, Oeltz, & Xiao, 2017). In fact, those saddled with more short term debts are faced with higher default risk and interest rate risk during such times, whereas those with lower debt levels and longer debt maturity may either be less affected or survive. Therefore, this is an indicator of the importance of firm's financial flexibility so as to remain sustainable during crisis-stricken times.

Recent studies have also substantiated the significance of firm's financial flexibility in capital structure decision making (Graham & Harvey, 2001; Bancel & Mittoo, 2011; Brounen et al., 2006; Gamba & Triantis, 2008). According to Denis (2011), financial flexibility represents a firm's ability to respond in a timely and value-maximizing manner to unanticipated shocks or changes in its cash flows or investment opportunity. Such capability allows firms with additional borrowing power in case new debts are necessary, as being recognized to have lower default risk allows them to obtain lower interest rate and longer debt maturity. In contrast, firms with high short term debts are synonymous with higher default risk, and despite allowance of debt roll overs, they are still exposed to high interest risk.

Rapid developments in the financial market, seen in the equity market, bond market and derivatives market can be attributed to the economic growth (Chien & Chun, 2009). Firms are starting to be actively issuing debts to raise funds for investment activities, but it will be risky if they over leveraged or are unable to hedge their exposure (Gatev & Strahan, 2006). When a crisis occurs, they will struggle or find it difficult to pay back the bond, affecting investors' confidence with the firms. The market will lose confidence due to high default risk, increasing the firm's failure rate. Such scenario is avoidable if financial flexibility is practiced and firms opt to maintain their spare debt capacity.

Furthermore, it is necessary for a firm to have sufficient cash so as to maintain the combination of debt-equity structure and financial flexibility (Byoun, 2011). Highly credit-worthy firms (i.e. according to traditional financial ratios) making investment decisions are extremely sensitive to the availability of internal funds, whereas less creditworthy firms are the opposite are less sensitive to internal fund availability (Alfonsina, Leone, & Aydin, 2006). By maintaining financial flexibility, firms will find it easy to get funds necessary for their investment activities, but doing so requires them to be limited from obtaining new debts or using internal cash for new investment activities. Therefore, they may face underinvestment problem or cash under-utilization instead (Boyle & Guthrie, 2003). Such issues are not profitable to the firm; it decreases their value and causes shareholders to be displeased as they will not receive dividends due to cash being held for financial flexibility. Thus, agency problem incurred.

The case of Lehman Brothers' bankruptcy is due to their inability to meet their obligatory debts due to too-high leverage. Their debts are made up of short term debts, while assets held are long term and decreasing in value. In contrast, the Dubai debacle is a different example of financial distress due to inability to meet debt obligations during the financial crisis of year 2007. In a nutshell, financial flexibility can influence the firms' capital structure and debt maturity structure due to the borrowing power and liquidity risk of the firms. This lead to changes in firms' investment activities since investment funding resolve the ability of taking up new investment opportunity. Meanwhile, underinvestment might happen when the firms are trying to maintain financial flexibility in the firms and forgo any investment opportunity. Subsequently, firms' performance and sustainability depending very much on the firms' financial flexibility, borrowing power and investment decisions.

As mentioned by Myers (2003), there is no universal theory of capital structure to apply in all countries around the world. Different countries have different country characteristics; thus, previous empirical research results may not be applicable to all countries around the world, as it may implicate differently. Thus this paper will start with the investigation of factors affecting firms' capital structure. In addition, this study examines the impact of financial flexibility in two countries, namely Malaysia and Australia, which has different market structure and national characteristics for better understanding. The average firms' debt ratio in Malaysia and Australia are 54.25% and 27.05% respectively. These shows that the Malaysian firms are generally exposing to higher debts compare to Australian firms. The average debt maturity and profitability recorded 26.44% and 3.51% in Malaysia, where else Australia recorded 24.64% and -8.36% correspondingly. The Australian firms are generally having lesser long term debts compare to the Malaysian firms. In average, the Australian firms are making a loss within the study time period, while Malaysia firms are still able to record a 3.51% profitability in average. These shows that some of the firms' characteristics in both countries are quite different from one another. Hence, this study is essential to have a better knowledge on the impact of financial flexibility in both countries.

1.3 Research Questions

The problems discussed have raised the following questions:

- i) What are the factors affecting firm's capital structure?
- ii) What is the impact of financial flexibility on the firm's debt maturity structure?
- iii) How does the firm's investment decision be affected by firm's financial flexibility and debt maturity structure?
- iv) Does the firm's financial flexibility increases its performance?

1.4 Research Objectives

Optimum capital structure is always an important research area due to the constantly contradictory results obtained by different researchers. Furthermore, different geographical locations and countries having different financial and economic levels have always yielded different findings. However, financial flexibility is an aspect lacking research, in developed countries and even lesser for the developing countries (K.Yung et al., 2015). Therefore, this work is crucial as it will look into capital structure and financial flexibility of the listed companies in the sample countries and the subsequent impact of financial flexibility towards firm's performance. In-depth investigation will also be conducted regarding firm's financial flexibility its influence towards debt maturity structure and investment decisions. Moreover, the study will also focus on the preferred debt maturity structure by the participating companies and its impact to the firm's investment decision.

The above-mentioned aspects are key to maximizing their value as they have to invest in projects having positive net present value, but the investment financing by debts is a risky step towards the process. Such investment decisions may be affected by liquidity, financial flexibility and debt maturity structure. As it is believed that financial flexibility plays a crucial role, this present work will also investigate its impact to a firm's performance and value. Thus, this study embarks on the following objectives:

- i) To determine the factors affecting firm's capital structure and to identify the firm's financial flexibility status.
- ii) To study the relationship between firm's financial flexibility and the firm's debt maturity structure.
- iii) To study the impact of firm's financial flexibility and debt maturity structure on their investment decision.
- iv) To examine the impact of firm's financial flexibility towards firm's performance.

1.5 Significance of the Study

The past has seen many firms failing and falling bankrupt due to mismatched firm's asset and liability structure, debt maturity structure and their inability to obtain a new loan when fund is required. Therefore, by utilizing listed companies in Malaysian and Australian Stock Market as the sample, this thesis will focus on firm's capital structure, financial flexibility, debt maturity structure and the subsequent impact on their investment decisions and performance. It will substantiate the importance of financial flexibility and debt maturity structure in a firm's capital structure and reduce possibilities for bankruptcy problem. The research findings will also benefit towards improved firm sustainability and performance, alongside maximizing its value. Moreover, focus will also be placed on firm's investment decisions based on their financial flexibility and debt maturity to avoid underinvestment and

overinvestment problems both. Therefore, this study will be able to shed more light on firm's investment decision and prevent any agency problem.

Furthermore, subsequent findings regarding firm's investment decisions can give the managers, policy makers, investors and even the regulations makers an overview of the debts and equity structure of the countries' listed companies. This will also serve as a good guide for firm managers in comparing themselves with industrial competitors, and allow them to be cautious of their financial management should there be any over debts to equity ratios or overinvestment with long term assets. Moreover, investors can also gain more insight regarding debt structure and its effects on investment decisions in specific industries, while shareholders will find it helpful in understanding managerial actions taken to control agency problem. This will allow additional information for consideration before any investment is made in related industries or firms. For regulation makers / government or any related institutions, this may serve as a guideline for any changes necessary in current regulations with the clearer picture of firms' performance with or without financial flexibility. This will control the debts market and avoid cases of financial distress or high bankruptcy rate in the future, especially in the event of any crisis occurrence.

Financially flexible firms are expected to be well equipped to cope with any financing problems. Due to the important role of financial flexibility towards affecting firm's value, it will be interesting to know the extent to which it affects investment decisions and its impact towards performance. This will undoubtedly be a crucial addition to financial flexibility literature, while also benefit developmental process of the respective countries' financial market, reduce company failure as well as improving their future growth. Finally, the finding from this research can be a valuable addition literature in related studies.

1.6 Organization of this Thesis

This thesis has been organized into six chapters as follows:

Chapter 1 provides the background of the study, importance of financial flexibility in a firm and their sustainability, problem statement, research questions, research objectives and the significance of the study. An overview of the economic and financial markets in Malaysia and Australia is also provided comprehensively.

Chapter 2 discusses the theoretical framework and literature related to this study, explaining firm's capital structure, financial flexibility, debt maturity structure, investment decisions and performance respectively.

Chapter 3 provides the research framework, research hypotheses and research methodology used in this study. Research models for each of the research questions are also presented accordingly.

Chapter 4 discusses the research findings on the Malaysian firm's sample to answer the research questions of this study.

Chapter 5 discusses the research finding on the Australian firm's sample to answer the research questions of this study.

Chapter 6 concludes by comparing the results obtained between Malaysia's and Australia's sample groups accordingly, before being substantiated with the conclusion, implication, limitations and recommendation of this study.



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