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Capital Structure and the Post Performance Factors of Malaysian PN 17 Firms

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ABSTRACT : *The theory of capital structure and its effect on the value of the firm had been discussed extensively in the finance literature since its inception in the 1958. However little work had been done in the area of capital structure and financially distressed firms. This conceptual paper is trying to open a discussion on the effects of reorganized financially distressed firms with regards to the value of the firm.*

Keywords: *Capital Structure, Financial Distressed, Regulatory Framework, Value of the Firm.*

I. INTRODUCTION

Malaysia was hard hit by the Asian economic crisis that impacted on the region in 1997. Corporate sector vulnerabilities and poor corporate governance were considered important causes of the crisis (Khatri, Leruth&Piesse, 2002). The Kuala Lumpur stock market index fell to 876 points in December 2008 with "net financial and capital outflow ballooned from RM-37.7 billion in 2007 to RM-118.5 billion in 2008" (Hui, 2010). Corporations, including GLCs, suffered heavy losses and liquidity problems. Firms were unable to obtain business loans and export credits manufacturing activities contracted and the country suffered a negative GDP growth rate of 3.0% in 2009 (Malaysian Economic Report 2009/2010).

Malaysian companies were also affected by the crisis and several were in financial distress. They had to seek protection under a bankruptcy protection plan known as Practice Note 17 (PN 17) which is similar to Chapter 11 in the United States, and undertake a capital restructuring exercise. Despite the significance of the issue, a preliminary literature review revealed scarce prior research on the adequacy and effectiveness of the PN 17 and its relation to capital structure. Literatures were also silent on the post factor performance of PN 17 firms.

II. THE MALAYSIAN AND GLOBAL CONTEXT

In early 2008, the world experienced another financial crisis which stemmed from the mortgage crisis in the US. This crisis, widely acknowledged as the most severe crisis after the great depression of 1929, threatened to plunge the world economy into a severe depression. In (2012), four years after the worldwide economic recession, the effects are still evident. Japan, the second largest economy in Asia is still in a deflationary state while European countries have yet to overcome their debt problem that emerged from the crisis. The US is still in a weak growth trajectory even after two quantitative easing exercises amounting to USD 3 trillion (Kok, 2011).

The 2008 global financial crisis started from the collapsed of the United States sub-prime mortgage industry, which than spread into the world financial and banking sector. The cumulative effect of the financial crisis had both diminished the consumer confidence and investment opportunities worldwide (Krugman, 2009). With the world's largest economy effectively in recession, the global economy contracted and with it, severely affected the heavily export dependent Asian economies.

Almost all countries posted negative growth in that year. Malaysia, the world 17th.largest trading nation (Damodaran, 2012) which was largely insulated from the "financial and banking" effects of the crisis was also affected through the contraction of "aggregate demand" and the decline in exports. By 2009, the Malaysian GDP registered a negative growth of 6.2% and 3.9% respectively in her first two quarters and posted an overall negative growth for the year 2009. However, due to the country's strong economic fundamentals, it recovered in 2010. This was due to two economic stimulus packages by the government amounting to RM 67 billion which was specifically designed to "absorb retrenchment" and accelerate development expenditure" in order to "offset the fall in aggregate demand due to significantly reduced exports" (Rasiah, 2009).

Due to the effect of the 2008 financial crisis, many Malaysian companies suffered financially from their exposure to the fluctuations of the business cycle. Companies that are strong financially will be able to weather the downturn economic storms but for those who do not have the resilience, will suffer financially and for some, may even go out of business. The latter are companies which are known in the financial literature as financially distressed firms. In general, there are three characteristics that followed any severe financial crisis (Rogof, 2008);

- i. **The collapsed of the "assets market".**
- ii. **Declines in "output and employment".**
- iii. **The increased of public debt.**

Interestingly, all three characteristics were evident in the Malaysia setting after both the financial crisis of 1997 and 2008.

The 2008 global financial was considered as the most severe financial crisis that the world had ever encounter since the great depression but what puzzled many experts is the reason behind its happenings and the speed that it spread throughout the world from its epicenter. One main reason however, which was shared by many as the main contributor to the financial crisis was the "great financial liberalization and prosperity that preceded the crisis" and "powerful banking oligarchy" that took uncalculated risk for the sake of huge profits which in the end not only endangered themselves but also the mass majority (Reavis, 2012). On a larger scale Koltz (2009) proposed that the financial crisis was due to the "systemic crisis of a particular form of capitalism, namely neoliberal capitalism". Schwartz (2009) on the other hand listed three factors that she described as the main contributor to the 2008 financial crisis which are;

- i. **Expensive monetary policy.**
- ii. **Flawed financial innovations.**
- iii. **The collapsed of trading.**

The reasons behind the 2008 financial crisis are many and the effects of the crisis are still simmering. In order to avoid the world economy to slide again into another recession, by the third quarter of 2012, the Federal Reserves, the European Central Bank and the Bank of Japan had pooled their effort in an exercised dubbed as the "Quantitative Easing Infinity" to provide their economies with cheap credit to stimulate growth (See-Yan, 2112). In a nutshell, the 2008 global financial crisis is mainly due to the role of "greed, fear and oligarchs" (Reavis, 2012).

III. REGULATORY FRAMEWORK

Regulatory framework is defined by QFinance as "a system of regulations and the means to enforce them, usually established by a government to regulate a specific activity" (http://www.qfinance.com/dictionary/regulatory-framework). Since the nature of this subsection is more on the regulatory framework that governs financially distressed firms that are publicly traded, the review on the literature in this section will mostly limited to the areas of the relevant stock exchange regulatory framework.

Financially distressed firms are firms that are experiencing financial difficulties in maintaining their normal operations and in most severe conditions are potential candidates to the bankruptcy proceedings. In most advanced countries such as the Unites States, companies that are experiencing bankruptcy proceedings are allowed to file for the bankruptcy protection plan which is known as the Chapter 11 (Altman & Hotchkiss, 2006). Under the Chapter 11 exercise, financially distressed firms are given time to reorganized their turnaround plan so much so that, if the plans are agreed upon by the creditors and the court, the company can exit the Chapter 11 and resume trading as a normal company.

The situation is however quite different in the emerging markets. Public companies in countries such as Malaysia, Thailand and Sri Langka do not have the same protection accorded to them as per Chapter 11. What they do have however is the kind of Chapter 11 protection for financially distressed firms, prior to the bankruptcy proceedings.

In Sri Langka, the financially distressed firms are known as the Non Performing Listed Companies (NPLC) and once classified, are taken out from the Main Board and transferred to the Default Board. Upon the transfer, the NPLC's are given two years to revive their business and get back to the Main Board, failing which they will be delisted from the stock exchange. In Thailand, public firms which are classified as non-performing are normally suspended up to two years from trading in the Stock Exchange of Thailand. During the suspension period, the NPLC's are expected to formulate and execute a rehabilitation plan to normalize its operations before the trading suspension are lifted (Langka, 2011).

A similar bankruptcy protection plan which is known as PN 17 was introduced in Malaysia which was a successor to another category known as the practice note no 4 or PN 4. However only certain company that fulfill the specific criteria of PN 17 are classified under this category and will be given a stipulated time to remain as a listed company while undergoing its restructuring exercise.

When a company is listed as a PN17 company, they have to undergo certain requirements by the Bursa Malaysia, failing which; they will be suspended from trading and face delisting procedures. In order to graduate from the PN17 status, a company has to first complete the implementation of the approved regularizing plan and to prove to the authorities that they should not be listed as a PN17 company anymore by submitting proper documentations.

In Malaysia, the stock market regulator is Bursa Malaysia. To deal with financial distress companies, Bursa Malaysia had introduced Practice Note No. 4/2001 or PN4 on 15 February 2001 and Practice Note No. 17/2005 or PN17 on 30 November 2004. PN17 was further amended on 5 May 2006 (APN17) to improve the ways Bursa Malaysia deals with listed financially distress companies. The main objective of PN4, PN17 and later APN17 are basically to make sure listed companies which are facing financial distress are given time to restructure both financially and operationally in order to nurture them back into sound financial footing.

A firm is classified under the PN4 classification if it exhibits either one or more of the following criteria (Bursa, 2001);

i. Deficit in the adjusted shareholder’s equity of the listed issuer on a consolidated basis.
ii. Receivers and/or managers have been appointed over the property of the listed issuer, or over the property of its major subsidiary or major associated company which account for at least 70% of the total assets employed of the listed issuer on a consolidated basis.
iii. The auditor have expressed adverse or disclaimer opinion in respect of the listed issuer going concern in its latest audited accounts, or
iv. Special administrators have been appointed over the listed issuer or the major subsidiary or major associated company of the listed issuer pursuant to the provisions of the PengurusanDanaharta National Berhad Act 1998.

Under the PN4, affected issuer are required to make a first announcement informing the market about their PN4 status within 7 market days of them failing within any of the PN4 criteria. Subsequently, affected issuers are generally given;

i. Six months from the date of the first announcement to make requisite announcement regarding their plans to regularize their financial conditions.
ii. Two months to subsequently make their submissions to all relevant authorities for approval, and
iii. Four months to obtain all necessary approvals for the implementation of their plan.

However, due to a long and complex de-listing process, PN4 firms have managed to maintain its listing status on the pretext of the firm is in the midst of formulating a comprehensive restructuring plan. Consequently, PN17 was introduced with the aim of expediting the time taken by distress firms to regularize its financial conditions and level of operations.

A firm is classified under PN17 if its exhibit one or more of the following criteria’s (Bursa, 2005);

i. Deficit in the adjusted shareholders’ equity of the listed issuer on a consolidated basis.
ii. Appointment of receivers and/or managers over the property of the listed issuer or its major subsidiary or major associated company which property accounts for at least 70% of the total asset employed of the listed issuer on a consolidated basis.
iii. Auditors have expressed adverse or disclaimer opinion in respect of the listed issuer’s going concern, in its latest audited accounts.
iv. Listed issuer has suspended or ceased all of its business or its majority business or its entire or major operations for any reason whatsoever.
v. Listed issuer had an insignificant business operation.

Under the PN17, listed firms with unsatisfactory financial conditions and level of operations;

i. Will have 8 months to submit their regulation plans to the relevant authorities for approval.
ii. In the event that the effected issuers fail to do so, their listing status will be automatically suspended on the 5th market day after expiry of the 8th month period, and
iii. Delisting procedures undertaken against such firms.

To further strengthen investor protection and promote investor confidence, PN 17 was amended on 5 May 2006 with the objectives of enhancing the quality of listed firms. A firm is classified under the Amended Practice Note No. 17 (APN71) if it exhibits one or more of the following criteria;

i. Shareholder's equity of the listed firm on a consolidated basis is equal to or less than 25% of the issued and the paid up capital of the listed firm and such shareholder's equity is less than the minimum issued and the paid up capital as required under paragraph 8.16A(1) of the listing requirements.
ii. Appointment of receivers and/or managers over the asset of the listed firm, its subsidiary or associated company which asset accounts for at least 50% of the total asset employed on the listed firm on a consolidated basis.
iii. A winding up order of the listed firm subsidiary or associated company which accounts for at least 50% of the total assets employed on the listed issuer on a consolidated basis.
iv. Auditor have expressed adverse or disclaimer opinion in the listed firm latest audited accounts.
v. The auditors have expressed a modified opinion with emphasis on the listed firm latest audited accounts and the shareholders equity of the listed firm on a consolidated basis is equal to or less than 50% of the issued and paid up capital of the listed firm.
vi. A default in any payment by listed firm, its major subsidiary or major associated firm, as the case may be and the listed issuer is unable to provide a solvency declaration.
vii. Listed issuer has suspended or ceased all of its business or its majority business or its entire or major operations for any reason whatsoever.
viii. Listed issuer had an insignificant business operation.

The latest criteria and obligation of PN17 companies issued by the Bursa on August 3, 2009 had consolidated the criteria's of PN17 and APN17 firms and grouped them together under the PN17 heading.

Even though the 2008 financial crisis had to a certain extend damaged the Malaysian economy, it has not made much impact of its public listed firms. According to media release by Bursa Securities, there are a total of 22 companies under Practice Note 17 which represent 2.3% of the total number of 962 companies listed on Bursa Securities as at May 2011 (Bursa Malaysia, 2013). The small number of financially distressed firms in Malaysia however does not eliminate the need for a proper research on the post restructuring performance of these firms.

The purpose of Chapter 11 is to give a financially distressed firm an adequate time to reorganize itself into a new and viable business entity. The newly emerged firms normally will have "the opportunity to establish a new capital structure" that supposedly, maximized its value and "unrelated to the pre-reorganization capital structure" (Randall at al., 2009). The new, post-reorganization capital structure however had demonstrated a higher debt ratio than the industry average upon completion of the Chapter 11 exercise which even though somewhat puzzling, can be explain by the dynamic theory of liquidation (Kahl, 2002).

The dynamic theory of liquidation postulates that creditors will support the Chapter 11 plan rather than the business liquidation plan of Chapter 7 in order to maximize their proceeds from claims. However to ensure that the managers (under Chapter 11) will not "reorganize the firms to their own benefit (as per the issues in agency theory)", a high post-reorganization debt is favorable by the creditors to act as a "circuit breaker" in the event that the Chapter 11 exercise failed to meet the expectation of the creditors (Randall et. al, 2009). This will then automatically lead to the process of Chapter 7.

IV. FINANCIALLY DISTRESSED FIRMS

Financially distressed firms generally can be classified into four main categories which are failure, insolvency, bankruptcy or default (Altman & Hotchkiss, 2006). Companies that consistently generate lower realized rate of return compared to the market rate for similar investments, having average return that is lower than the cost of capital or do not have enough revenue to meet their cost can be classified as experiencing business failures.

Insolvency is the situation when a company is unable to meet its current obligation, thus indicating liquidity problems. Firms which are categorized under (technical) insolvency are normally associated as having "temporary" distress problem. Bankruptcy, on the other hand, is a situation where a firm's total assets are lower than its total liabilities thus indicating a negative net worth. At this stage, firms are categorized as facing chronic financial distress and in one way or another must initiate restructuring exercises in order to avoid formal bankruptcy proceedings. Last but not least, default is a situation when a firm is not able to pay its creditors on time. This of course is a ground of legal action which could lead to either insolvency or in a more serious situation, bankruptcy proceedings.

However, since there had been no research of this nature conducted in Malaysia and the PN 17 classification is relatively new, having been introduced only in 2005, we had chosen to review literatures in other country which have similar characteristics with the PN 17 and had chosen the Chapter 11 statute under the US Bankruptcy Act as proxy.

Chapter 11 is a situation where financially distressed firms are allowed to reorganize their operations while negotiating with their creditors on the future of their business. While in Chapter 11, the debtor is granted an "automatic stay" from the "enforcement actions of the creditors" and allowed to continue the operations of the business (Kunkel et. al., 2009). Even though Chapter 11 is designed to optimally facilitate the reorganization of financially distressed firms, lately its "effectiveness" had been severely questioned (Hotchkiss, 1995). The proponents of the Chapter 11 suggested that Chapter 11 process "facilitates a complete capital restructuring" that is "consistent with the static tradeoff theory" in where "the debt ratios of the firms emerging from Chapter 11 are negatively related to the liquidation cost" (Alderson &Bekter, 1995). In another study, Gilson (1997) reported that "leverage remains high after out of court restructurings than after Chapter 11 bankruptcy reorganizations, and that post event leverage is positively related to pre-event leverage only for firms that restructure out of court".

The opponents of the existing Chapter 11 framework such as Roe (1983) and Bebchuck (1988) however pointed out that in the present Chapter 11 form, ambiguity in the reorganization valuation process resulted in attempts of different class of creditors trying to maximize their own claims. This normally led to two negative consequences for the post reorganization capital structure that;

i. deviate significantly from the maximization of the total value of the reorganized firm.
ii. tied the post reorganization capital structure to the pre reorganization capital structure.

The two consequences, in general, had rendered the Chapter 11 process as ineffective to the reorganized firms.

V. CAPITAL STRUCTURE

The main underlying theory of this study is deep rooted within the capital structure theory of Modigliani-Miller, which is also known as the MM Theory, first published in 1958. The theory, which was under some very restrictive assumptions, was the first ever theory in finance that linked the use of debt in capital structure with the value of the firm (Al-Najjar&Hussainey, 2011) due mainly to the tradeoff between the firm's tax shield and its bankruptcy cost (MM, 1963). Over the years, the capital structure theory had grown into many other variant that branched into other discipline such as the static tradeoff theory, asymmetric information theory and many others. For the purpose of this study, we will only discuss the spinoff theories of capital structure that relates with the topic of this study.

The theory of capital structure is arguably one of the most important theories in finance as it deals directly with the question on how to maximize the value of a firm, which is the main objective of financial management, via the maximization of shareholder wealth (Weston & Brigham, 1990). Prior to the introduction of the MM theory, the traditional view of capital structure was always that the higher the value of debt used in the capital structure, the higher the value of the firm should be (Aliahmed, 2011, p. 70). In 1958, Modigliani and Miller published their first paper which postulates that capital structure is irrelevant to the value of the firm. Their conclusion however was derived under some very unrealistic assumptions such as;

i. There are no taxes (corporate and individual).
ii. Personal investor can borrow at the same rate as corporation.
iii. There are no brokerage costs.
iv. No risk are attached to debt regardless on the amount used.
v. EBIT is not affected by the use of debt.

In 1963, Modigliani and Miller published another paper on capital structure, only this time they incorporate the effect of corporate income tax in their model. They found that due to the tradeoff between the tax shield and financial distress of a firm, the value of a leveraged firm will always be higher than unleveraged firms by the amount of tax savings on interest on debt. This implies that firms should maximize the usage of debt in their capital structure.

The findings of Modigliani-Miller have two major implications. First, it directly linked the value of a firm with the used of debt as part of its capital structure and promotes debt as a viable source of growth (quite similar to the Keynesian theory in economics that promotes increased government spending in order to stimulate growth in GDP). Second, it gives birth to the static tradeoff theory which predict that the used of debt is positively related to profitability (Randall et. al, 2009). The MM Theory, which later won the Nobel prize was so powerful and widely used in the area of corporate finance that it had been credited as the impetus to the growth of many hybrid financial instrument such the leverage buyouts and merger and acquisitions (Weston & Brigham, 1990).

There are many variant of capital structure theories, but two of the most famous are the static tradeoff theory and the pecking order theory, which is also known as the asymmetric information theory (Forgathy, 1988). The static tradeoff theory posits that “the optimal debt level balances the benefits of debt, such as the tax deductibility of interest payments and the reduction of free cash flows, against the cost of debt including bankruptcy cost, loss of non-tax shields and under investment due to debt overhang” (Randall et. al, 2009). The pecking order theory however suggested that, in order to capitalize investment opportunities, firms will first look at their internal generated funds, then the debt financing and lastly the issuance of new equity (Myers, 1984).

The static tradeoff theory and the pecking order theory however are not mutually exclusive in a capital structure setting (Bradley et. al., 1984). Cross-sectional regression study on the static tradeoff theory often yield a negative correlation between profitability and debt ratios (Titman &Wessels, 1988; Rajan&Zingales, 1995), findings which is inconsistent with the prediction of the theory and mostly are due to the entanglement of the pecking order theory in the capital structure preference (Hovakimian et. al., 2004). Other studies such as by Methotra (2003) however found that there are positive correlations between “differences in profitability and debt ratios” which are attributed to the pecking order effect. Ditmar (2004) on the other hand “does not find any significant relationship between profitability and leverage in her sample”. However it should be noted that Barens and Cuny (1995, p.1185) found that “debt ratios provide an inappropriate framework for empirically examining the trade off theory of capital structure”.

VI. CONCLUSION

The literature reviewed in this paper showed that until today, there are hardly any literatures that linked the capital structure theory and the reorganization performance of financially distressed firms. The idea to investigate the relationship of capital structure, post reorganization performance and financially distressed firms in Malaysia maybe the first of its kind and clearly provides a research gap that is worthy of an in-depth study.

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