ISSN: 2308-5096(P) ISSN 2311-620X (O)
[International Journal of Ethics in Social Sciences
Vol. 7, No. 1, June 2019]

Moderating Role of Growth Opportunities on the Relationship between Corporate Financing Decisions and Firm Value: A Conceptual Paper

Chaleeda[1], Md. Aminul Islam, Tunku Salha Tunku Ahmad

Abstract

Growth is expected to bring positive returns for the firm as it increases the attractive opportunities to invest in the firm. As investments are projected to bring in positive returns in the future, firms' growth is seen as a favourable prospect for investors. Growth opportunities likewise can be named as investment opportunities and defined as options for firms to invest in projects that returns positive net present value (NPV). Corporate financing decisions can act as a dual role in a firm's value and are dependent on the availability of growth opportunities, which can be discussed in two dimensions; the underinvestment theory and the overinvestment theory. Corporate financing decisions can positively affect the firm value without growth opportunities (i.e., overinvestment theory) while negatively affects the firm value with growth opportunities (i.e., underinvestment theory). This paper proposes the models to study the impact of corporate financing decisions on firm value, and the potential moderating effect of growth opportunities to the relations of Malaysian companies listed on Bursa Malaysia.

Key Words: Moderating Role, Growth Opportunities, Corporate Financing Decision, Firm Value

1.0 Introduction

According to Eckert & Engelhard (1999)**,** corporate financing decisions revolve around how a company finances its investments by using different sources of funds which form the capital

[1] School of Business Innovation and Technopreneurship, Universiti Malaysia Perlis, Malaysia, Tel: +6 010-2266 706, E-mail: chaleeda.s@gmail.com

structure. Managers need to choose a suitable financing structure for the company that contributes to maximising its value, and thus maximising the wealth of the owners of the company (Ramadan & Ramadan, 2015). Financing decisions are indeed one of the most complex areas of financial decision making due to their interrelationships with other financial decision variables (Nimalathasan & Brabete, 2010).

Corporate financing decisions can act as a dual role in a firm's value and are dependent on the availability of growth opportunities, which can be discussed in two dimensions; the underinvestment theory and the overinvestment theory. For companies with high growth opportunities, underinvestment will negatively impact the firm value. On the contrary, the overinvestment perspective is when the firm has no growth opportunities, and there is a high amount of free cash flow. This theory accentuates the negative consequences of having excess cash flow under the manager's discretionary command. Hence, debt issuance will not only discipline inefficient managers to limit their access to free cash flow but also protects the firm value. Conforming to this, when the firm has no growth opportunities, debt positively affects the value of the firm, but when firms have positive growth opportunities, debt has a negative influence on market value. Therefore, disciplinary tools are more crucial especially when growth opportunities are absent, lest dividends and debt are interdependent mechanisms to deal appropriately at the managers' discretion (Alonso, Iturriaga, & Sanz, 2005).

2.0 Literature Review

The earliest capital structure theory was initiated by Durand (1952) with the proposition that capital structure is relevant to firm value (Chen, Jiang, & Lin, 2014). Then, a series of debates started soon after, since Modigliani and Miller (MM) presented the capital structure irrelevance theorem, dividend irrelevance theorem, and investment separation principle in their papers (Modigliani & Miller, 1958; Miller & Modigliani, 1961), relating to a firm's three primary financial decisions, namely; financing decisions, distribution, or pay-out, decisions and investing decisions.

Modigliani & Miller (1958) proposes that the firm's market value is independent of its capital structure in a world of frictionless capital markets, commonly known as the "capital structure irrelevance theorem". In essence, the capital structure irrelevance theorem highlights that there is no difference between internal and external financing costs in a firm's investment policy, which implies that there is no relationship between investment and financing. Any investment choice will generate the same stream of cash flow regardless of the way the collection of projects is financed.

Following Myers (1977), growth opportunities are considered regarding the proportion of the firm value accounted for by assets-in-place (plant, equipment, and other tangible assets); the lower the fraction of firm value represented by assets-in-place, the more the firm's growth opportunities or investment opportunity set (IOS). Growth opportunities include virtually any kind of further discretionary expenditure like the production of existing assets, new product

lines and maintenance and capacity expansion projects (Mason & Merton, 1985). Hence, firms with more growth options are known to have high investment opportunities. Growth opportunities moreover indicate the company's ability to make a future investment positive NPV project (Ghalandari, 2013). Debt obligations may discourage firms from adopting growth opportunities with positive NPV, thereby aggravating the under-investment problem (Myers, 1977). Managers should avoid such risk by following the interests of their current shareholders and increasing the firm value. Zeitun and Tian (2007) discuss evidence to support further Myers (1977)'s research that firms with high short-term debt to total assets have a high growth rate and high performance. Their research showed evidence that a firm's capital structure significantly and negatively affects the firm's performance measures in both the market and accounting measures. Aggarwal and Zhao (2007) had the same point and view and proved that leverage has a negative relationship with value for both high and low growth US firms.

Hermuningsih (2013) and Cuong (2014) justifies that growth opportunities have a significant and positive direct influence and are significant toward the value of the firm. However, recent research by Lee, Shin, and Stulz (2016) discovered that since the middle of the 1990s, high-value industry firms increase the share repurchases instead of raising more funding from the capital markets, hence industries with the best growth opportunities do not need further cash inflow. Thus, no matter how the growth opportunities are financed, the end result which is the higher firm value is what is anticipated.

Corporate financing decisions can act as a dual role in a firm's value and are dependent on the availability of growth opportunities, which can be discussed in two dimensions; the underinvestment theory and the overinvestment theory. According to Myers (1977), firms with high leverage might not take up positive NPV projects even though these are positive NPV projects due to the shortcoming of excessive debt financing. Since debtholders are the preceding claim holders, managers find it unworthwhile undertaking investment projects where cash flows will be perceived by creditors and not by company owners. This motivates managers to forego profitable investment projects. Hence, for companies with high growth opportunities, underinvestment will negatively impact the firm value. The study also suggests firms minimise the underinvestment problem by using short-term debt or limiting total debt.

Mustapha et al. (2011) added that the significant and positive relationship between growth opportunities and capital structure of Malaysian companies gives support to the pecking order theory. The theory hypothesises that the firm's shares will be undervalued if information asymmetry exists between the managers and investors (Myers, 1984). According to Myers and Majluf (1984), asymmetric information between managers and outside investors affects the firm's choice of new capital because of the pecking order theory. Firms favour internal funding, but when the need for external funds exists, the debt will be taken into account first prior to equity. The financing pecking order rationally inhibits a target debt ratio, meaning that companies following the pecking order should be fluid. In a simple definition, in pecking order theory, firms prefer debt compared to equity, up to the debt limits. Moreover, after or

above the existing target limits, equity will be raised as a final alternative. Reversely, when firms have an excess flow of surplus funds, the priority will be given to retiring debt first rather than through equity buyback (Myers, 2001).

Iturriaga and Crisóstomo (2010) assesses a sample of 213 Brazilian firms listed between 1995 and 2004 to investigate the impact of the absence or presence of growth opportunities on the subsequent effect of ownership concentration, dividend payout and leverage on the value of the firm. The research found that leverage positively affects the firm value without growth opportunities (i.e., overinvestment theory) while negatively affects the firm value with growth opportunities (i.e., underinvestment theory), showing stark evidence of having a dual role.

Teguh and Ardianto (2015) prove that growth opportunities moderate and act as a quasi-moderator on the association between financing decisions toward firm value in their research on firms listed on the IDX for the years 2010 to 2012. Serrasqueiro and Nunes (2010) discovered that the leverage has a dual effect on the firm value. Further, growth opportunities impact debt positively only among Portuguese firms with less growth opportunities. The evidence shows that leverage is one of the effective tools to discipline the actions of managers. However, the research found growth opportunities is negatively related to debts when the growth opportunities are average probably due to the underinvestment problem. But, the relationship between growth opportunities and debt is again positive when the firms have high growth opportunities. The positive association is again found because firms can finance their financial needs for growth opportunities through debt financing, which is very much supported by creditors who are confident with the high growth opportunities that the firms will reap. In addition, recent research by Lee, Shin, and Stulz (2016) discovered that since the middle of the 1990s, high-value industry firms increase the share repurchases instead of raising more funding from the capital markets, hence industries with the best growth opportunities do not need further cash inflow. Thus, no matter how the growth opportunities are financed, the end result which is the higher firm value is what is anticipated.

3.0 Research Methodology

3.1 Sampling Design

This paper suggests a quantitative research method by using secondary financial data extracted from the DataStream by Thomson Reuters. Companies from all sectors on the Main Board (2000-2008) and Main Market (2009-2018) of Bursa Malaysia, having complete data from 2000 to 2018 should be considered, except for the finance and utility companies due to the different regulations and face strict capital structure requirements.

3.2 Research Hypothesis

Tahir and Razali (2011) proved that corporate financing affects the firm value positively in their study of Malaysian public listed companies. The reason was because through leverage, firms are able to source the investment opportunities in their business without raising its equity. Hence, when the investment is profitable, shareholder's value will then be increased.

Salim and Yadav (2012) also discovered a positive relationship between Tobin's Q and capital structure when conducting a study in Malaysia.

H1: There is a positive and significant relationship between corporate financing decisions and firm value of Malaysian companies listed on Bursa Malaysia.

Iturriaga & Crisóstomo (2010) and Ghalandari (2013) also discovered a dual effect, but different findings; the relationship is positive for firms without growth opportunities and negative for firms with growth opportunities. Hermuningsih (2013) and Cuong (2014) justifies that growth opportunities have a significant and positive direct influence and are significant toward the value of the firm.

H2: Growth opportunities will moderate the relationship between corporate financing decisions and firm value of Malaysian companies listed on Bursa Malaysia.

3.3 Research Variables

Most research studying on correlation involving capital structure will proxy using the three ratios of short-term debt to total assets (STDA), the ratio of long-term debt to total asset (LTDA) and total debt to total asset (TDA) (Abor, 2005; Ebaid, 2009; Handoo and Sharma, 2014). As cited in Ahmad and Aris (2015), Bevan and Danbolt (2002) and Sheikh and Wang (2013), they argued that a more precise view is obtained when these three proxies are used.

STDA= (Short term debt)/ (Total assets)

LTDA= (Long term debt)/ (Total assets)

TDA= (Total debt)/ (Total assets)

This study uses profitability, asset tangibility, liquidity, firm age, firm risk and ownership structure as the control variables. Hence, this research will use the following model.

$$Q_{it} = \beta_0 + +\beta_1 \mathrm{STDA}_{it} + \beta_2 \mathrm{LTDA}_{it} + \beta_3 \mathrm{TDA}_{it} + \beta_4 \mathrm{TANG}_{it} + \beta_5 \mathrm{LIQ}_{it} + \beta_6 \mathrm{SIZE}_{it} + \beta_7 \mathrm{AGE}_{it} + \beta_8 \mathrm{RISK}_{it} + \varepsilon_{it}$$

Growth opportunities (GROWTH) will be proxied by the market-to-book value of equity ratio (MBE). MBE measures the present value of all future cash flows to equity holders from assets in place and future investment opportunities. The book value is the original sale price of the stock plus the value of its debt whereas the market value includes the firm's outstanding stock measured at market prices and the value of its debt. The reason MBE ratio is chosen to proxy

for growth opportunities is because the stock price of the firms includes the shareholders' valuation of future investments (Berlin, 2006). The MBE ratio is a combination of cash flow from both assets in place and future investment opportunities and does not require information on the estimation of replacement values and the market value of debt

In summary, the MBE ratio is chosen in this study to proxy for GROWTH, and the formula will be: -

$$\boldsymbol{GROWTH} = \frac{\boldsymbol{Market\,Value\,of\,Equity}}{\boldsymbol{Book\,Value\,of\,Equity}}$$

$$Q_{it} = \beta_0 + \beta_1 \mathrm{STDA}_{it} + \beta_2 \mathrm{LTDA}_{it} + \beta_3 \mathrm{TDA}_{it} + \beta_4 STDA * GO_{it} + \beta_5 LTDA * GO_{it} + \beta_6 TDA * GO_{it} + \beta_7 \mathrm{TANG}_{it} + \beta_8 \mathrm{LIQ}_{it} + \beta_9 \mathrm{SIZE}_{it} + \beta_{10} \mathrm{AGE}_{it} + \beta_{11} \mathrm{RISK}_{it} + \varepsilon_{it}$$

4.0 Conclusion

Growth is anticipated to bring favourable aspects for the firm through expanding the demanded opportunities to invest in the firm. Accordingly, the firm's growth is a positive prospect for investors because the investment is expected to provide a high return in the future. As investments are projected to bring in positive returns in the future, firms' growth is seen as a favourable prospect for investors. If the firm has no existing debt, existing stockholders would evaluate the growth opportunities separately from the investment in place and would support exercising the growth opportunities because it is profitable. However, if the firm has debt outstanding, stockholders will have to share future profits with the bondholders who provided the funds to finance the investment in place. When the outstanding debt is large enough to affect a firm's investment decisions, it is often referred to as the debt overhang. If the debt overhang is large, the bondholders will capture a relatively large share of the projected revenues from the new profits, and the firm might forgo the profitable growth opportunities. Thus, the situation is called the underinvestment problem.

Hence, there is a need for studies that will examine how growth opportunities will change or moderate the relationship between corporate financing decisions and firm value. This paper proposes the models to study the impact of corporate financing decisions on firm value, and the potential moderating effect of growth opportunities to the relations of Malaysian companies listed on Bursa Malaysia.

References

Aggarwal, R. and X. Zhao (2007). "The leverage–value relationship puzzle: An industry effects resolution." *Journal of Economics and Business* **59**(4): 286-297.

Alonso, P. d. A., et al. (2005). "Financial decisions and growth opportunities: a Spanish firm's panel data analysis." *Applied Financial Economics* **15**(6): 391-407.

Brabete, B. and B. Nimalathasan (2010). "CAPITAL STRUCTURE AND ITS IMPACT ON PROFITABILITY: A STUDY OF LISTED MANUFACTURING COMPANIES IN SRI LANKA."

Chen, J., et al. (2014). "What determine firms' capital structure in China?" *Managerial Finance* **40**(10): 1024-1039.

Cuong, N. T. (2014). "Threshold effect of capital structure on firm value: Evidence from seafood processing enterprises in the South Central region of Vietnam." *International Journal of Finance & Banking Studies* **3**(3): 14.

Durand, D. (1952). Costs of debt and equity funds for business: trends and problems of measurement. *Conference on research in business finance*, NBER.

Eckert, S. and J. Engelhard (1999). "Towards a capital structure theory for the multinational company." *MIR: Management International Review*: 105-136.

Ghalandari, K. (2013). "The Moderating Effects of Growth Opportunities on the Relationship between Capital Structure and Dividend Policy and Ownership Structure with Firm Value in Iran: Case Study of Tehran Securities Exchange." *Research Journal of Applied Sciences, Engineering and Technology* **5**(4): 1424-1431.

Hermuningsih, S. (2013). "Pengaruh profitabilitas, growth opportunity, struktur modal terhadap nilai perusahaan pada perusahaan publik di Indonesia." *Buletin ekonomi moneter dan perbankan* **16**(2): 127-148.

Iturriaga, F. J. L. and V. L. Crisóstomo (2010). "Do leverage, dividend payout, and ownership concentration influence firms' value creation? An analysis of Brazilian firms." *Emerging Markets Finance and Trade* **46**(3): 80-94.

Lee, D., et al. (2016). Why does capital no longer flow more to the industries with the best growth opportunities?, *National Bureau of Economic Research*.

Mustapha, M., et al. (2011). Determinants of debt structure: Empirical evidence from Malaysia. *2nd International Conference on Business and Economic Research 2nd ICBER proceeding*.

Ramadan, Z. S. and I. Z. Ramadan (2015). "Capital structure and firm's performance of Jordanian manufacturing sector." *International Journal of Economics and Finance* **7**(6): 279-284.

Tahir, I. M. and A. R. Razali (2011). "The Relationship between enterprise risk management (ERM) and firm value: Evidence From Malaysian public listed companies." *International journal of economics and management sciences* **1**(2): 32-41.

Zeitun, R. and G. Gang Tian (2007). "Does ownership affect a firm's performance and default risk in Jordan?" Corporate Governance: *The international journal of business in society* **7**(1): 66-82.