

Corporate Investment, Financing and Dividend Decisions, and Firm Value: A Conceptual Paper

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Abstract

The primary objective of shareholders and financial managers is generally stated to be the maximisation of shareholders' wealth. There are three forms of financial decisions which will influence the firm value which are investment decisions, financing decisions, and dividend decisions. The Modigliani and Miller (MM) theorem posit that investment, financing and dividend decisions are irrelevant to firm value. However, many recent papers have proved otherwise. The investment decisions made by a firm will determine the future potential dividends and future earnings, whereas dividend decisions influence the amount of equity capital in a firm's capital structure, thus, influences the cost of capital which is the financing decision. This paper develops the hypothesis and conceptual framework on this basis to explore the effect of corporate investment, financing and dividend decisions on firm value.

Key Words: Corporate Investment, Financing, Dividend Decision, Firm Value

1.0 Introduction

Maximizing the shareholder's wealth is the ultimate goal of every financial managers and shareholders. The wealth of shareholders will be maximised by maximising the value of capital gains (increases in the value of their shares) and dividends that shareholders receive over time as shareholders receive their wealth through dividends and capital gains (Watson & Head, 2007). The clear goal of long-term increase in firm value is fundamental in creating value for all company stakeholders. With the intensity of competition reaching new heights, this is crucial for a firm's success. Companies profess devotion to shareholder value but rarely follow the practices

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that maximise it (Rappaport, 2006). Further, maximising shareholder value has been embraced as the “politically correct” stance of corporate members and the top management of companies globally. The reality is that the shareholder value principle has not failed management; but rather, it is management that has betrayed the principle. Indeed, this is because when executives damage the value that they are supposed to be creating, they regularly claim that the stock market pressure made them do it. Eriotis, Vasiliou, & Ventoura-Neokosmidi (2007) highlighted that due to the wrong decision making, it might inevitably lead the firm to financial strain and finally bankruptcy.

There are three forms of financial decisions which will influence the firm value which are investment decisions, financing decisions, and dividend decisions. Investment decisions are involved with the acquisition of real assets, whereas financing decisions are about how these assets are to be financed. Dividend decisions arise when firms begin to generate profits, and whether the firm should distribute a proportion or all of the retained earnings to the shareholders or put them back into the business for investment opportunities. Therefore, company value will be determined by these three primary financial decisions; financing, investment, and dividends which could likewise be interdependent in a number of ways.

The Modigliani and Miller (MM) theorem posit that investment, financing and dividend decisions are irrelevant to firm value. Although some research has found evidence for the proposition to be true, there is also much research that proves otherwise. Because research undertaken in different countries might produce different outcomes, the applicability of the MM theorems in the Malaysian context is questionable. Previous works have given greater focus on the practical contribution of it, but less research has been carried out to examine its theoretical contribution.

2.0 Literature Review

The clear goal of long-term increase in firm value is fundamental in creating value for all company stakeholders. With the intensity of competition reaching new heights, this is crucial for a firm’s success. Rappaport (2006), who provided the idea of firm value, identified seven drivers within a business that can be managed to create value: which include a reduction in the weighted average cost of capital, a reduction in fixed asset investment, a reduction in working capital investment, a reduction in the cash tax rate, an increase in the operating profit margin, growth in sales, and an increase in the competitive advantage period. According to this shareholder value theory, the improvements in these value drivers will lead to a gain in shareholder value.

Managers must have a criterion for evaluating performance and deciding between alternative courses of actions, and it should be to maximise the firm market value. Rashid (2008) defined the term value as the utility or the benefit derived from a good or an object. Specifically, in finance or economics, the term value refers to the price for which a good or object can be exchanged (exchange value or market value). On the other hand, firm value is a long-term measure of performance (Samiloglu & Demirgunes, 2008). Notwithstanding, it is of the utmost importance to increase the firm value as it does not only reflect the present intrinsic value but also includes the

expectation of the company's ability to increase the value of its future prospects (Sudiyatno, Puspitasari, & Kartika, 2012).

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 presented the capital structure irrelevance theorem, dividend irrelevance theorem, and investment separation principle in their papers Miller & Modigliani (1961) and Modigliani & Miller (1958), relating to a firm's three primary financial decisions, namely; financing decisions, distribution, or pay-out, decisions and investing decisions. The first ground-breaking paper by Nobel laureates 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.

Then, Miller and Modigliani (1961) suggested the circumstances under which the dividend policy does not affect the firm value. This paper demonstrates that in a world of complete and perfect capital markets, a firm's value is also independent of the firm's dividend decision; a result known as the "dividend irrelevance theorem". Furthermore, in this theorem, the dividend payout policy is not unrelated to firm value. This is because, firstly, only investments, which generate cash flows and future earnings affect firm value, and secondly, investments are independent of dividends. This basic premise of Miller and Modigliani's argument is that firm value is very much driven by selecting optimal investments. The final payout is merely a residual, which is the difference between earnings and investment. On account of the net pay-out, it comprises of issuances, shares repurchase and dividends, of which a firm can alter its pay-out to any level with an offsetting change in shares outstanding, which is, by financing the pay-out. Tellingly, the dividend irrelevance theorem implies that the dividend policy should not affect investment decisions and the firm value.

After the seminal work of Miller & Modigliani (1961) and Modigliani & Miller (1958) that assumed the market to be frictionless, much research has tested the outcome of both the capital structure and dividend decisions when imperfections are brought into the capital markets. Notwithstanding, these imperfections comprise of a vast range of situations, like agency costs, asymmetric information, transaction costs and taxes. This theory has been criticised as there is no perfect market with no impact of inflation, transactional costs and tax. Therefore, this instigated Modigliani & Miller (1963) to publish amendments to their earlier papers. Although MM still asserted that any change to the debt to equity ratio will have no impact on the value of the firm, with the consideration of taxes and other transaction costs. Therefore, two factors need to be recognised in this instance: Firstly, a firm's weighted average cost of capital decreases as it

increases its debt. Secondly, a firm's cost of equity also rises as it raises its debt since shareholders endure more business risk because of the higher probability of default.

The MM theorems propose that external and internal funds of a firm are exact substitutes in a frictionless market environment, and therefore the optimal level of a firm's investment will be driven entirely by its actual considerations and entirely separated from its financial decisions. Both the dividend payout and capital structure choices, therefore, do not affect firm value, and are insignificant to shareholders' wealth, indicating that the set of corporate decisions have no interdependencies inside a perfect market environment.

The two irrelevance propositions put forth by Miller and Modigliani imply that a firm's financing, investment, and dividend decisions are independent in perfect and complete capital markets. Fama & Miller (1972) labelled these results as the "separation principle." In summary, the separation principle has two implications which are that investment decisions should never be influenced by the firm's financing decisions, and similarly, the firm's investment decisions should never be influenced by the firm's dividend decisions. In a perfect capital market, the value of the firm is independent of the way in which the productive assets are financed. With this condition, regardless of how it is financed, firms basically decide the optimal level of investment or other words, the dividend payout of a firm is independent of its investment decisions. In behavioural terms, investment decisions precede dividend decisions in the investment-dividend-financing triad. Indeed, together these papers started a revolution in the domain of corporate financial management which continues even to this day. Accordingly, the theorems have built the foundation of modern corporate finance theory (DeAngelo & DeAngelo, 2006). Delfouf (2016) accentuated that before making any financial decisions, finance managers should first realise its impact on the firm value.

3.0 Research Methodology

The research methodology includes the research hypothesis, research variables and proposed conceptual framework.

3.1 Research Hypothesis

Research carried out by Rahim, Yaacob, Alias, & Nor (2010) on the non-financial firms that are consistently listed on the Main Board of Bursa Malaysia for the years 2002 to 2007 suggests that there is a positive insignificant relationship between investment and firm value. Furthermore, they also noted that there is no optimal investment level for Malaysian firms. Making the correct investment decisions like investing in projects with positive NPV will increase the value of the firm (Hsiao, Hsu, Li, & Hsu, 2011).

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

Leverage can provide tax benefits of debts, hence improving firm value (Tahir & Razali, 2011; Zou, 2010). Free cash flow may increase the strength of positive influence of leverage on value of the firm because through committing to the interest payment and avoid overinvestment, leverage

is effective to reduce the agency problem of free cash flow (Cheng & Tzeng, 2011). This positive effect of leverage on firm value will then be reflected in the stock price increase.

H2: There is a positive and significant relationship between corporate financing decisions and firm value of Malaysian companies listed on Bursa Malaysia.

According to the signalling theory, dividends have a positive effect on value of the firm because it conveys positive signals to the investors of the current income position and that the value of the company is improving. Shareholders have imperfect information about firm profitability, and therefore, dividends function to convey signals to investors about the firm's future profitability as a signal of expected cash flows.

H3: There is a positive and significant relationship between corporate dividend decisions and firm value of Malaysian companies listed on Bursa Malaysia.

3.2 Proposed Conceptual Framework

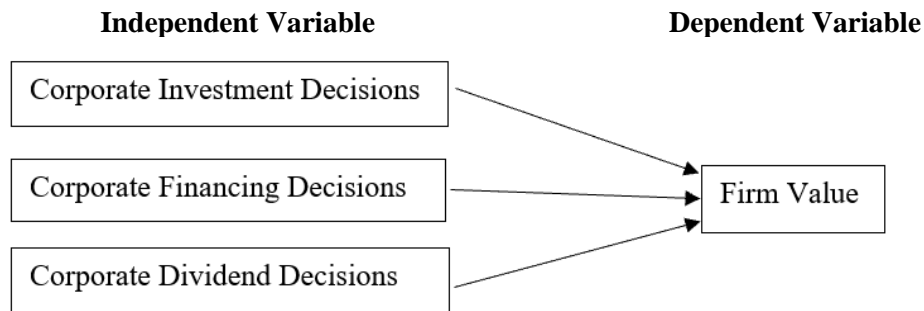


Figure – 1: Proposed Conceptual Framework

The proposed conceptual framework is shown in the figure. It illustrates the independent variables and dependent variable. The independent variables to be examined are corporate investment decisions, corporate financing decisions and corporate dividend decisions whereas firm value will be the dependent variable.

4.0 Conclusion

Corporate decisions are undeniably crucial to increase the firm value. Investment decisions made by a firm will determine the future potential dividends and future earnings, whereas dividend decisions influence the amount of equity capital in a firm's capital structure, thus, influences the cost of capital which is the financing decision. Every decision made in the firm has its own financial implications, and any decisions that involve the use of money are considered a financial

decision. This trilogy of corporate financial decisions has always been in the limelight of finance research as it is regarded to somewhat affect corporate performance (Wang, 2010).

Although corporate decisions are an upcoming management force for the emerging economic benefits, the overall functioning of synergistic benefits and opportunities to work together are still lacking and unclear as to which is the optimal solution to operate most effectively (Viederyte, 2016). This research will examine the basic three corporate decisions that firms' top managers make in managing their firms. These decisions are made together, thus examining them simultaneously gives more meaning to the research.

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