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**POLITICAL CONNECTION AND CORPORATE
FINANCING DECISION: EVIDENCE FROM MALAYSIA**



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UUM
Universiti Utara Malaysia

MASTER OF SCIENCE (FINANCE)

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POLITICAL CONNECTION AND CORPORATE FINANCING DECISION:
EVIDENCE FROM MALAYSIA

BY

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(College of Business)
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ABSTRACT

This study investigates the impact of political connection on corporate financing decision of 292 firms listed in Bursa Malaysia from 2006-2015. Existing studies document that firms with political connection tend to have more debt because they have close relationship with the government, which enable them to have easier access to loans. Employing a sample of trading & service sector and industrial products sector, the result of this study concludes that politically connected firms in Malaysia prefer debt to finance their operations. This study also employs firm size (SIZE), firm growth (GROWTH), profitability (PROFIT), liquidity (LIQUID) and asset tangibility (TANG) to determine the other factors that influence corporate financing decision. The results show that SIZE, PROFIT and LIQUID have a negative relationship with total debt ratio (LEV). This implies that larger firms and more profitable firms less prefer debt as their sources of financing. Firms with high liquidity also tend to use their equity as internal sources of finance instead of debt. Meanwhile, TANG has a positive relationship with LEV, indicating that Malaysian firms with greater amount of tangible assets prefer debt as their sources of financing.

Keywords: Political Connection, Debt, Financing, Malaysia.

ABSTRAK

Kajian ini mengkaji kesan hubungan politik ke atas keputusan pembiayaan korporat terhadap 292 buah syarikat yang tersenarai di Bursa Malaysia dari tahun 2006 hingga 2015. Kajian-kajian terdahulu telah mendokumentasikan syarikat-syarikat yang mempunyai hubungan politik cenderung mempunyai banyak hutang kerana hubungan rapat mereka dengan kerajaan yang memudahkan mereka untuk memohon pinjaman. Dengan menggunakan sampel sektor perdagangan & perkhidmatan dan sektor barangan industri, hasil kajian ini menyimpulkan bahawa syarikat yang mempunyai hubungan politik di Malaysia lebih memilih hutang sebagai sumber pembiayaan operasi syarikat mereka. Kajian ini juga menggunakan saiz firma (SIZE), pertumbuhan firma (GROWTH), keuntungan (PROFIT), kecairan (LIQUID) dan aset ketara (TANG) untuk menentukan faktor-faktor lain yang mempengaruhi keputusan pembiayaan korporat. Hasil menunjukkan bahawa SAIZ, PROFIT dan LIQUID mempunyai hubungan yang negatif dengan nisbah jumlah hutang (LEV). Ini menunjukkan bahawa syarikat yang lebih besar dan syarikat yang lebih menguntungkan kurang memilih hutang sebagai sumber pembiayaan. Syarikat yang mempunyai kecairan yang tinggi juga cenderung menggunakan ekuiti berbanding hutang sebagai sumber kewangan. Sementara itu, TANG mempunyai hubungan yang positif dengan LEV, menunjukkan bahawa syarikat Malaysia dengan jumlah aset ketara yang lebih besar memilih hutang sebagai sumber pembiayaan.

Kata Kunci: Hubungan Politik, Hutang, Pembiayaan, Malaysia

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CHAPTER I

INTRODUCTION

1.1 Background of study

What determines corporate capital structure? Despite a huge numbers of researches have been conducted on this question, there are still uncovered issues within capital structure including corporate financing. Financing decision is essential for the firm's long run performance as it may lead to financial distress and even bankruptcy if any flawed decision is taken. One of the important aspects that should be considered in every decision is to maximize the firm's value (Suhaila and Wan Mahmood, 2008; and Alipour, Mohammadi and Derakhshan, 2015). Basically, capital structure is an approach a firm uses to finance its overall operations and growth by using varieties sources of funds. Capital structure generally comprises of debt, common stock, and preferred stock that are used to finance the various long-term projects of the firm (Chadha and Sharma, 2015).

Debt defines as source of fund that firm has to borrow from various provider of capital. Debt is different from equity due to it has borrowing costs, typically through payment of interest. Debt also has fixed term at the end of which debt will mature where the borrowed amount or also known as principle must be repaid at maturity.

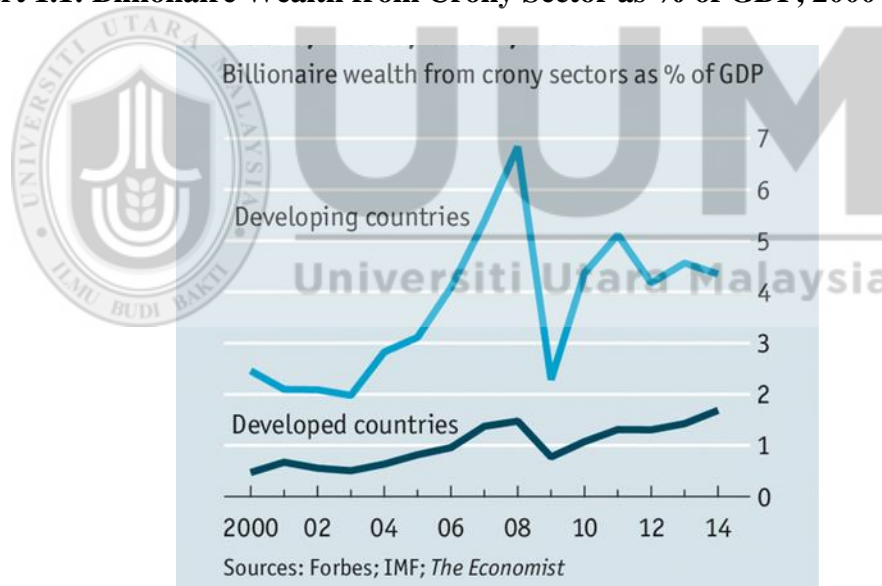
Debt generally consists of long term debt and short term debt. Long term debt is debt that has terms exceeding a year. The examples of long term debt are bonds, debenture, notes issued to the public, term loans and long-term notes. While, short term debt is exercised when the firms need quick financing in order to finance working capital needs and other liquidity demands. Short-term debt can be in term of revolvers, discounted bills and commercial paper (Subramanyam, 2014).

Harris and Raviv (1990) outline the benefits of debt such as tax advantages, reduce agency cost, a signal of firm quality, restricting managerial discretion, as a discipline and informational instrument and also an antitakeover. Existing studies on corporate financing decisions focus on the tax advantages of debt. Debt has an ability to increase the firm's value because debt is benefits through tax since interest payments can be subtracted from the taxable corporate income (Miller, 1977). The deduction of tax allowing tax shield for the firms which able the firms to pay lower taxes than they should, as the used of debt increases (Eriotos, Vasiliou and Ventoura-Neokosmidi, 2007). This tax benefit of debt is firstly introduced by Modigliani and Miller (1963).

The agency cost of debt also is considers in corporate financing decisions. As managers act as the agents of shareholders, they are responsible in managing the business for the benefits of the shareholders. This agency relation between managers and shareholders can cause agency problem (Jensen and Meckling, 1976). This problem arises when managers are interested in securing their own interest such as high salaries, job security, and enjoy other essentials (Nazir, Saita and Nawaz, 2012). Thus, debt can be utilized as a device to control agency conflicts between managers and shareholders.

Lately, there is also growing literature associating political connection with capital structure, particularly financing decision (Lim et al., 2012). Political connections have always provided benefits to business. For the past 20 years, from Malaysia to Mexico, crony capitalist defined as individuals who gain their wealth credit to their intimate relationship with government have had a prosperous period. Worldwide, the value of billionaires in crony industries increased by 385% between 2004 and 2014, to \$2 trillion (*The Economist*, 2016). In the developing countries, their wealth doubled relative to the size of the economy and is equivalent to over 4% of GDP in 2014 compared with 2% in 2000 as shown as Chart 1.1.

Chart 1.1: Billionaire Wealth from Crony Sector as % of GDP, 2000-2014

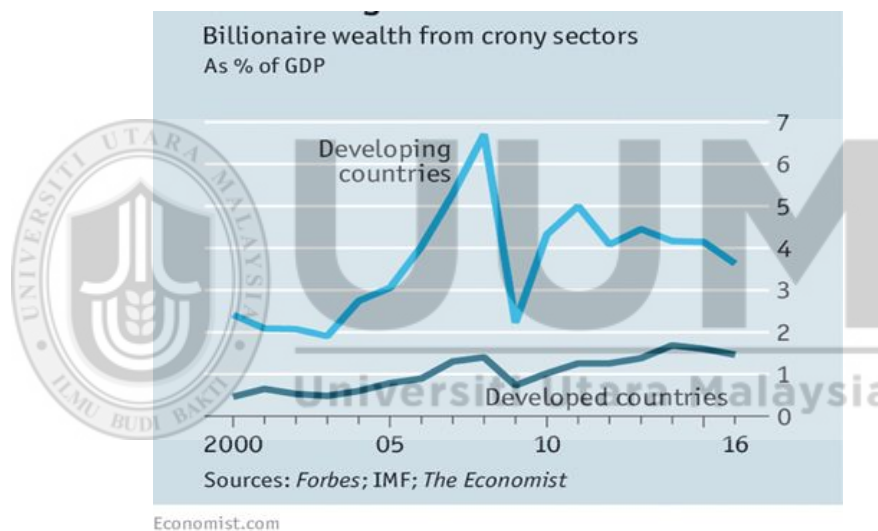


Sources: *The Economist* (2014)

However, it may seem that this prosperous era of crony capitalism is coming to a slummy end. *The Economist* (2016) reports a steady decreasing of crony billionaire wealth to \$ 1.75 trillion in 2016, a fall of 16% since 2014. According to Chart 1.2, in developed countries, the crony wealth remains stable at about 1.5% of GDP.

Meanwhile, in the developing countries, the crony wealth has drop to 4% of GDP in 2016, from a peak of 7% in 2008. Few reasons behind this fall are including commodity crash and also a backlash from the middle class. More, the corruption scandals involve governments in Brazil and Malaysia. Elsewhere, pressure is coming from the top down. India's reforming Prime Minister, Narendra Modi, is trying to subject his partly closed economy to a blast of competition. Meanwhile, Xi Jinping, China's autocrat, thinks grafts is the big threat to one-party rule, and is trying to root it out.

Chart 1.2: Billionaire Wealth from Crony Sectors as % of GDP, 2000-2016

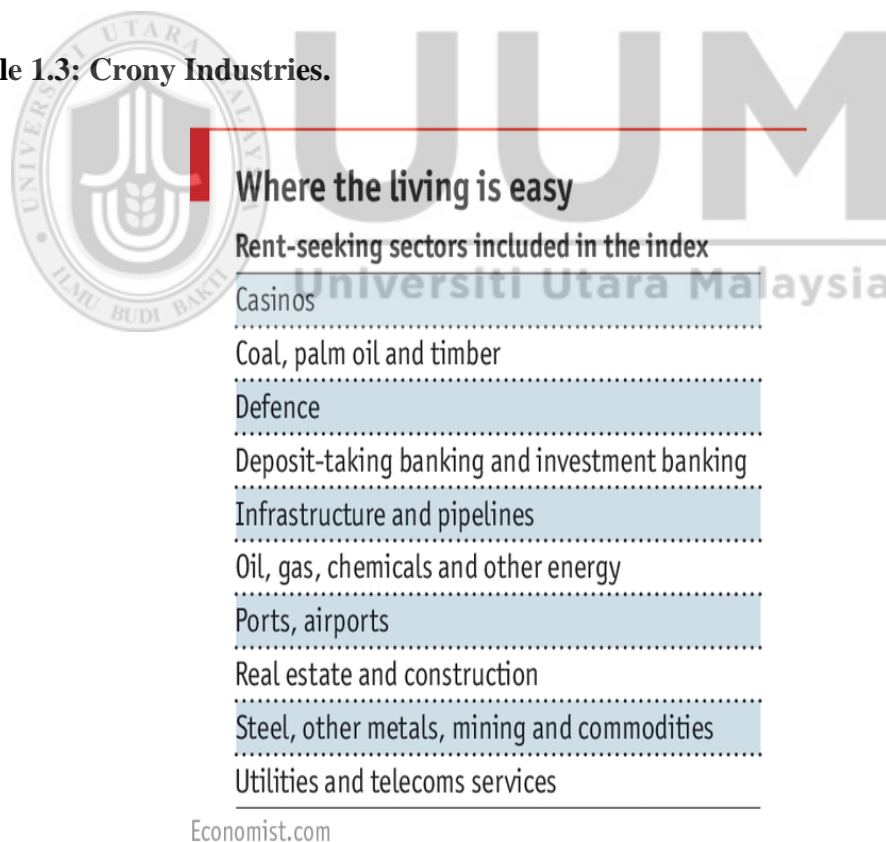


Source: *The Economist* (2016)

Despite this slowdown, it is too soon to say that the period of cronyism is over. This is supported by the crony capitalist index created by Ruchir Sharma of Morgan Stanley Investment Management and Aditi Gandhi and Michael Walton of Delhi's Centre for Policy Research and others. This index tests the claim that the crony capitalists are on the rampage. It uses data on billionaires' wealth from rankings by Forbes.

The billionaire labelled as a crony or not based on the industry in which he is most active and then, the countries' total crony wealth are compared to their GDP to get a sense of its scale. The industries included are vulnerable to monopoly or that involved licensing or heavy state involvement, for example defense, construction, real estate, natural resources, and telecoms. The other industries involved are as listed in Table 1.3. According to Chart 1.4, the index shows results for 22 countries which are the five largest developed countries, the ten largest developing countries for which reliable data are available and a selection of other countries where cronyism is believed to be a big problem. The larger the ratio, the more likely the economy suffers from a serious case of crony capitalism.

Table 1.3: Crony Industries.



Where the living is easy

Rent-seeking sectors included in the index

Casinos
Coal, palm oil and timber
Defence
Deposit-taking banking and investment banking
Infrastructure and pipelines
Oil, gas, chemicals and other energy
Ports, airports
Real estate and construction
Steel, other metals, mining and commodities
Utilities and telecoms services

Economist.com

Source: *The Economist* (2016)

Chart 1.4: The Crony-capitalism Index



Sources: *The Economist* (2016)

Based on Chart 1.4, The Economist outlines that Russia scores badly, considering its corruption and dependence on natural resources. Both its crony fortunes and GDP had dropped in dollar terms in the past two years, reviewing the ruble's collapse. Furthermore, Malaysia and Ukraine also continue to score worst on the index. This implies that cronyism has led to political instability for both cases. Singapore also ranked poorly in the crony index because of its role as an entrepot for racier neighbors, and its property and banking clans. From the index, it shows that the cronyism or political connection still has strong existence in the business world for few countries.

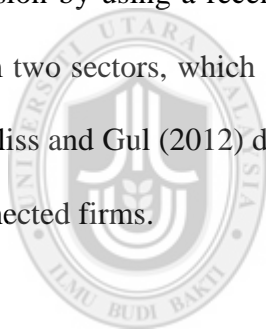
Many empirical studies agree that the linkage between firms and political provides enormously advantages toward politically connected firms. Faccio, Masulis and McConnell (2006) suggest that, firms with political connection have special access to debt financing. Other prior studies support the findings by suggesting that firms with political connections have higher debt than the firms without political connections (Faccio, 2003; Johnson and Mitton, 2003; Fraser, Zhang and Derashid, 2006; Khwaja and Mian, 2005; and Wei and Hooi, 2011).

Furthermore, other benefits of having political connections in the firms are including higher stock return (Faccio, 2006; Claessens, Feijen and Laeven, 2008) and boost firm's value (Faccio, 2006; Goldman, Rocholl and So, 2009; Yang, Lian and Liu, 2012; Li and Xia, 2013). Politically connected firms also have the ability to obtain subsidies and recover faster than non-connected firms after crisis and after the imposition of capital control (Johnson and Mitton, 2003).

Moreover, firms with political connections are also able to be bailed out if their financial is worse than firms without such connection (Faccio, Masulis and McConnell, 2006). Chan, Tang and Yan (2012) also recommend firms with politically linked CEO or Chairman tend to be clear from funding restriction. In other words, politically connected firms possess a higher level of preferential access to credit (Khwaja and Mian, 2005; Dinc, 2005; Faccio, 2007; Yang et al., 2012; Yeh, Shu and Chiu, 2013).

Additionally, politically connected firms also able to secure favorable regulatory conditions (Agrawal and Knoeber, 2001) and benefits of cut rate credit and import licenses (Mobarak and Purbasari, 2006). Moreover, politically connected firms also enjoy lower taxation and stronger market power (Faccio, 2007). It seems like by having political alliances between firms and government or even influential politicians, the firms will gain some remarkable advantages.

It is interesting to examine the influence of political connection on corporate financing decision in Malaysia. Thus, this study will add to the existing literature on capital structure by exploring the impact of political connection on Malaysian firm financing decision by using a recent time period, 2006 to 2015. The sample is derived mainly from two sectors, which are trading and service sector and industrial products sector, as Bliss and Gul (2012) document that these 2 sectors have large number of politically connected firms.



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1.2 Overview of Malaysian Capital Market

Capital markets are markets for buying and selling financial instrument. The financial instruments in capital market generally involves in two categories which are equity securities (stocks) and debt securities (bonds). Capital markets consist of primary markets where new stock and bond issues are sold to investors, and secondary markets which trade existing securities.

Capital markets play an important role by ensuring that growth is not about maximization, but optimization of an economy (Securities Commission Malaysia, 2015). In Malaysia, capital market is supervised by Securities Commission Malaysia (SC) which, has direct authorities in overseeing and monitoring the activities of market institutions and regulating all persons licensed under the Capital Markets and Services Act 2007.

Generally, in Malaysia, there are two types of capital markets which are conventional and Islamic capital markets. Islamic capital market is divided into Islamic debt market and Islamic equity market. All the securities provided by Islamic capital market are based on Shariah principles. Shariah is the Islamic ethical value or laws derived mainly by Al Quran and Sunnah.

Moreover, capital market in Malaysia has grown over the years from a capital market composing mostly equities and government debt securities in 2000 to the successfully developed of private debt securities and investment management, together with the expansion of a comprehensive and innovative Islamic capital market. This solid growth was gained via rapid industry development and strong regulatory oversight that support investor confidence in the capital market (SC, 2011). Furthermore, as the Malaysian bond market has remarkable growth, it has supplied crucial long term financing for many large scaled and catalytic profitability projects, causing in Malaysia owning one of the top infrastructures in the division. The infrastructures cover from international airports and highways to power plants and telecommunications.

The bond market also has been source of financing aid for banks and firms and provided liquidity to balance sheets via the securitization of mortgages and other receivables (SC, 2011).

In 2013, according to Capital Market Malaysia (CMM) which established by SC, Malaysia obtained recognition as an Advanced Emerging market, with leading positions in regional bonds and global Islamic capital market. It has one of the largest of the largest unit trust industries in ASEAN, the third largest bond market in ASIA as a percentage of GDP and the largest *sukuk* market in the world. As at 31 December 2014, the Malaysian bond market including *Shariah*-compliant bonds such as *sukuk* accounted for 40.2% of total corporate financing.

According to the chairman of SC, Ranjit Ajit Singh and as shown in Chart 1.5, Malaysian capital market in 2015 continues to grow by 2.2% to reach RM2.82 trillion in size compared to RM2.76 trillion in 2014. This shows that despite a volatile global environment, the Malaysian capital market continues to grow and play a major role in financing the domestic economy. The growth was driven by the equity market, which increased by RM 44 billion from RM 1,651 billion in 2014 to RM 1,695 billion by end-2015, and the bond market which also increased by RM15 billion to reach RM1,125 billion in 2015 in contrast to RM1,110 billion in 2014. As the bond market continues to grow, Malaysia also continues to maintain its position as the third substantial local currency bond market as a percentage of GDP in Asia, after Japan and South Korea as shown in Chart 1.6.

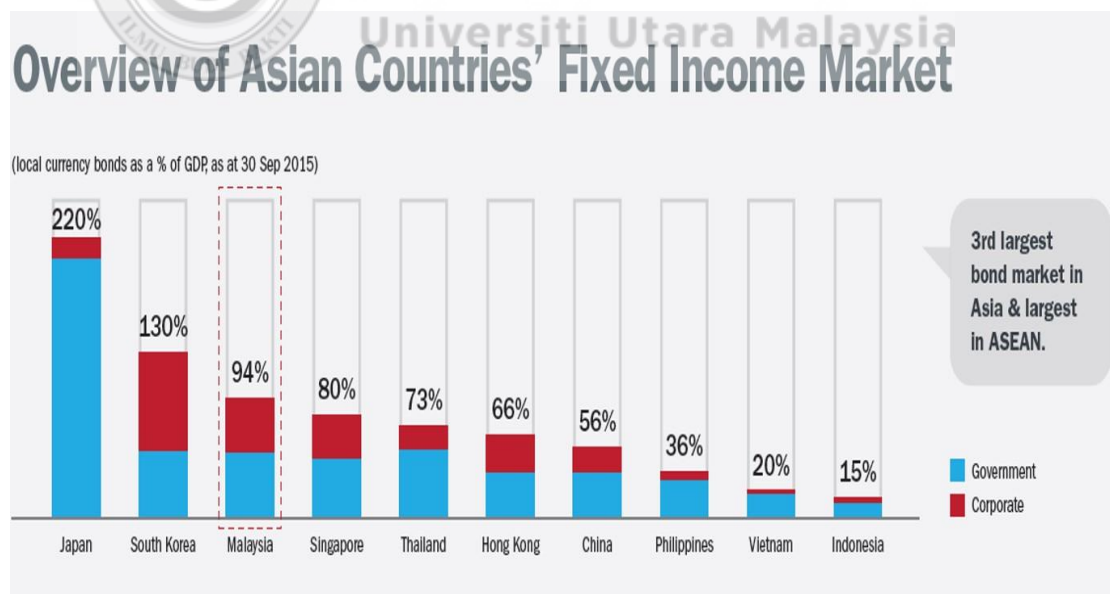
Chart 1.5: Malaysian Capital Market



Source: SC, BNM

(Extracted from SC annual report 2015)

Chart 1.6: Overview of Asian Countries' Bond Market.



Source: Capital Market Malaysia (2015).

1.3 Research problem

Over the past decades, political patronage has been an interesting topic widely debated in academia. Faccio et al., (2006) define political connection as direct connection and indirect connection. The direct connection is recognized when the firm's top officers or a large shareholder are the politicians themselves. While indirect connection is identified via three ways including relatives, perceived friendship and also from prior studies. Qin (2013) suggests four mechanisms that probably the reasons why government favors politically connected firms; social networking, information view, reputation building, and bribery view.

Furthermore, it is also well-known that political connection provides significant advantages to firms including special access to debt financing (Faccio et al., 2006; Johnson and Mitton, 2003; Fraser et al., 2006; Khwaja and Mian, 2005). Politically connected firms can obtain their financing via various ways such as through bank debt, long-term debt, debt with preferential terms and also government bailouts (Bunkanwanicha and Wiwattanakantang 2009).

In Malaysia, political connection plays huge role in the Malaysian business world. It reflects from Malaysia's ranks in the crony capitalism index provides by *The Economist*. According to the 2016 index, Malaysia was ranked as having the second-highest percentage of billionaires' fortunes coming from political connection behind the Russia. While Malaysia's neighbors the Philippines, Singapore, Indonesia and Thailand were third, fourth, seventh and twelfth respectively. Critics link the political connections in Malaysia to the pro-Bumiputera New Economic Policy (NEP) that

officially ended in 1990, but affirmative action continues in various economic policies in the present period.

However, the existing empirical studies in Malaysia report mixed evidences regarding the relationship between political connection and debt. Johnson and Mitton (2003) is the first study to report the association between political connection and debt in Malaysia. The study indicates that Malaysian firms have more debt during pre-crisis. However, the focus of Johnson and Mitton (2003) study is on the effects of capital controls and not on the political connection and debt capacity. The study also reports the results based on one year for only one element of political connection. While, a later study by Fraser et al. (2006) builds on Johnson and Mitton (2003), focuses on the connection between political patronage and leverage in Malaysia by using three different proxies within 10 years period from 1990 to 1999. The study confirms that political connection is associated with the capability of the firms to carry more debt. The study by Bliss and Gul (2012) which focus on the sample period of 2001-2004, also suggests a positive and significant correlation between leverage and political connection. Wei and Hooi (2011) also state that the Malaysian politically connected firms tend to carry more debt because they have strong government backing to grant easier access to loans compared to non-connected firms.

On the contrary, Ebrahim, Girma and Shah (2011) explore the connection of political connection of Malaysian firms' capital structure within pre and post crisis. The study argues that the politically connected firms carry more debt before crisis but irrelevant after crisis period. Ebrahim et al. (2014) also report the effect of political connection on firms' capital structure following an exogenous shock caused by 1997 Asian crisis.

However, the study rejects the claims that politically connected firms hold significantly higher level of debt. Besides that, Johansson (2014) also finds a significant and negative connection between political connection and change in leverage. The study investigates the effect of the political connection on the change in leverage after 2008 Malaysian election.

Furthermore, the empirical studies from other countries also indicate that political connection has a significant relation with debt. Faccio et al., (2006) suggest that firms with political connection enjoy the benefit of debt financing because their ability to gain future bailout and the lenders bias toward politically connected firms. Fu, Shinamoto and Todo (2015) conclude that political connection portrays a significant role on the ability to access bank loans in Indonesia. This finding is supported by Li et al., (2008), the study from China which suggests that having politician membership helps a firm to borrow from banks and other state institution which also contribute positively to current borrowing. Khwaja and Mian (2005) report that government banks support Pakistani politically linked firms by granting greater access to credit. However, a study by Bunkanwanicha and Wiwattanakantang (2009) find that there is no positive effect of political connection on the corporate debt financing in Thailand.

Despite various findings on political connections suggest they may influence firm financing, however, there are still some studies that have opposite findings. Fraser et al., (2006) propose that there are still unexplored issues regarding the potential link between political connection and capital structure. Prior empirical studies in Malaysia provide some insight into the association of political connection and debt, but these evidences are either during the period of pre-crisis, post-crisis or both (Johnson and

Mitton, 2003; Fraser et al., 2006; Ebrahim, Girma and Shah, 2011; Ebrahim et al. 2014). Thus, this study aims to fill the gap by providing new evidence on the effects of political connection on corporate financing by using a recent period of analysis which covers period from 2006 to 2015.

Besides that, this study differs from Johnson and Mitton (2003) and Bliss and Gul (2012) by using political connections proxy based on direct and indirect connection as suggested by Faccio et al., (2006). Previous empirical studies (Johnson and Mitton, 2003; and Bliss and Gul, 2012) use the proxy for Malaysian political connection in the form of informal links to politicians.

Moreover, this study will only focus on two sectors in Malaysia which are trading & service sector and industrial products sector, contradicting with prior studies that employ all sectors listed in Malaysia (Johnson and Mitton, 2003; Faccio et al., 2006; Fraser et al., 2006; Bliss and Gul, 2012; Al-dhamari and Ku Ismail, 2015). These two sectors are chosen because as reported by Bliss and Gul (2012), they have large number of politically connected firms. In addition, the Central Bank of Malaysia also states that both sectors are the key drivers of the overall Malaysian economic growth where GDP for service sector in 2015 is 53.5% and 23.0% for industrial product sector. Therefore, it is interesting to examine which financing sources preferably used by the firms in these sectors.

1.4 Research objective

The objectives of this study are as follows:

- i. To investigate the impact of political connection on corporate financing decision of trading & service industry and industrial product industry in Malaysia.
- ii. To examine the impact of firm specific characteristics on corporate financing decisions of trading & service industry and industrial product industry in Malaysia.

1.5 Significance of study

This study intends to fill the gap by analyzing the tendency of politically connected firms in relation to debt. Previous studies have shown that political connection is one of the important factors for firms to secure easier access to loans. Besides that, in order to obtain more accurate findings, this study adopts few firm specific variables such as tangible assets, liquidity, profitability, firm size and firm growth and sees their impact on firm financing decision. These variables are employed to provide a broader range of understanding on how firms in Malaysia determine their corporate financing as well as the factors that influence the financing decision. Thus, the result of this study is expected to give a general insight on the association between political connection and firms' specific variables with corporate financing.

Moreover, most of the researches that study on political connection focus on the sample period around the financial crisis which is either pre-crisis or post-crisis or even both (Johnson and Mitton, 2003; Ebrahim, Girma and Shah 2011; Ebrahim et al., 2014). This study on the other hand, examines whether the linkage between political connection and corporate financing is still effective in the sample period of 2006-2015.

Furthermore, this study will also help the reader to grasp the general ideas of political connection, corporate financing decision, capital structure, capital market and also the factors that drive the firms financing decisions in Malaysia. This study also could be beneficial for investors, lenders or businesses who wish to set up business in Malaysia or wish to provide sources of funds to the Malaysian business.

This study may also assist firm managers in Malaysia in making a decision on the proportion of their capital structure. They will also be able to determine the best financing structure such as long term debt or short term debt that can maximize the shareholders' value.

Therefore, it is hoped that this study will complement the existing knowledge regarding political connection and corporate financing decision both theoretically and empirically.

1.6 Scope of study

This study investigates the impact of political connection and firms specific characteristics on corporate financing decision of trading and service sector and industrial products sector in Malaysia. The period covers from 2006 to 2015 and the sample is firms that are listed in the trading & service sector and industrial products sector excluding firms with missing data. Fixed effect model is used to analyze the data.



CHAPTER II

LITERATURE REVIEW

2.1 Introduction

This study investigates the effect of political connection on the choice of corporate financing. As such the aim of this chapter is to provide a review of empirical findings from previous studies and discussion on the variables and different types of models used.

2.2 History of Malaysian political

In Malaysia, political connection has been applied in three ways. First, the government established a firm which managed through a sovereign wealth fund, for example Khazanah Nasional Berhad. These Government-Linked Companies (GLCs) are key institutions in the economy. Second, patronage is given to firms owned by government-sponsored institutional investors. Lastly, political connection involves informal link with politician. The political connected firms are identified which either owned by relatives and/or friends of politicians or by politicians themselves via proxy (Ebrahim et al., 2014).

Most of the prior studies (Johnson and Mitton, 2003; Bliss and Gul, 2012; Johansson, 2014) agree that main factor that leads to the Malaysian government's involvement in the corporate sector is the government's new economic policy (NEP) that began in late 1969 following divisive racial riots (Gul, 2006). Although ethnic Malay also known as Bumiputera which is precisely, "sons of the soil", stand as the dominant population with 60% of Malaysian, but the business sector are historically been controlled by ethnic Chinese (Johnson and Mitton, 2003). Due to this inequality, the NEP is established by the government to boost the involvement of native Malays in the economy to balance the then existing condition where the economy was primarily controlled by the Chinese to the exclusion of the Bumiputera (Gul, 2006; Al-dhamari and Ku Ismail, 2015). Due to that, Bumiputeras have been given the priority for government contracts, increased access to capital, opportunities to buy asset that are privatized and other subsidies (Johnson and Mitton, 2003).

Besides that, the government also initiated Bumiputeras trust agencies under the direction of the United Malay National Organization (UMNO) to obtain equity stakes on behalf of the Malay that previously owned by the Chinese (Gul, 2006; Bliss and Gul, 2012). The opportunity for a greater political participation in the financing of firms are opened since the initiation of NEP although the government seems to selectively choose certain firms to receive beneficial investment resources, for example the Heavy Industries Corporation of Malaysia (HICOM) (Johnson and Mitton, 2003; Gul, 2006; Bliss and Gul, 2012).

Furthermore, political bias is also consequences of informal ties among firms control by Malay, Chinese and Indian businessmen with ruling politician (primarily the former long term Prime Minister, Tun Dr Mahathir Mohammad and his former deputy Anwar Ibrahim). The relationship happens through vigorous solicitation by Chinese businessmen and thus leads to several Chinese political parties joining part of the leading alliances that made up the government (Gul, 2006; Bliss and Gul, 2012).

Since the government has more vigorously handed out aids to firms, businessmen have increasingly used personal connection to affect the allocation of those aids (Johnson and Mitton, 2003). Therefore, by the mid-1990s, the corporate sector was dominated by politically connected firms and business (Gul, 2006).

2.3 Definition of “Political connection”

Based on the prior studies by Faccio, Masulis and McConnell (2006) and Faccio (2006), political connection is defined as direct connection and indirect connection. The firm is defined as politically connected with direct connection if at least one of its top officers (defined as the firm’s chief executives officer, chairman of the board (COB), president, vice president, or secretary of the board) or a large shareholder (defined as anyone controlling at least 10% of the firm’s voting shares) is head of state (such as president, king or prime minister), a government minister, or a member of the national parliament, as of the beginning of 2006.

For example, Malaysian Government-linked companies (GLCs) are controlled by the Malaysian government through Federal Government-linked investment companies (GLICs) or other federal government linked agencies collectively have a controlling

stake. GLICs are investment arms of the government that allocate government funds to the GLCs. There are seven GLICs in Malaysia: (1) Khazanah Nasional Berhad (Khazanah), (2) Employees Provident Fund (EPF), (3) Retirement Fund Incorporated (KWAP), (4) Armed Forces Fund Board (LTAT), (5) Lembaga Tabung Haji (LTH), (6) Minister of Finance (Incorporated) and (7) Permodalan Nasional Berhad (PNB). Furthermore, since the Malaysian government has direct controlling stake and hold major ownership in GLCs, thus government has an influence in the appointment of member of the board of directors and senior management positions and also in making major decisions. The decisions are involving contract awards, strategy, restructuring and financing, acquisitions and divestments.

The second category, indirect connection can be classified into one of three ways. First, the firm is indirectly connected if the relative with the same last name as a head of the state or minister is a top officer or a large shareholder as stated above, as of 2006. For instance, Malaysian Prime Minister Najib Razak's brother, Johari Razak is the COB of Ancom Berhad, so that this study classifies Ancom as indirectly connected with a head of state through a top executive. Second, the firm is recognized as indirect connection when a top executive or a large shareholder has been mentioned by The Economist, Forbes, or Fortune as having a "friendship" with a head of state, government minister, or Member of Parliament. For example, the major shareholder of DRB-HICOM Berhad, Syed Mokhtar Al-Bukhary perceived closeness with Malaysian Prime Minister Najib Razak had been recognized by Forbes, thus DRB-HICOM is categorized as indirectly connected with a head of state via a large shareholder.

Lastly, the third classification is if prior studies spot such a relationship as having in place prior to the early year of the study conducted. Many studies (Johnson and Mitton, 2003; Adhikari, Derashid and Zhang, 2006; Gul, 2006; Bliss and Gul, 2012) use the third category of indirect connected to determine the sample of firms political connection. For example, Johnson and Mitton (2003) label the firms as politically connected if any firms that Gomez and Jomo (1997) distinguished as having officers or large shareholders with close relationships with the government officials.

2.4 Evidence of firm with political connection from foreign countries

In Indonesia, Fisman (2001) is one of the earliest to examine the link between political connections and firm value. The study conducts an event study method to estimate the value of political connection by observing the movement of stock prices when former President Suharto's health was revealed to change. The result from the study states that firm with politically connected, averagely, lost more value during the event than the less-dependent firms. Few variables are used to develop the research, including return on the price of security, total asset, total debt, taxes, net income, and the international standard industrial classification code of the firm's industry. The political connection is measured by Suharto Dependency Index (1995), assigned as variable POL that is firm's Suharto Dependency Number.

Fu, Shimamoto and Todo (2015) provide further evidence of political connection in Indonesia. By conducting firm-level survey to assemble firm's information between September and December in 2014, the study examines the effect of political connections on firm financing in both loan application and loan amount setting process. The firm samples are randomly drawn from the 2012 issues of Manufacturing Industry Directory collected by Central Bureau of Statistics (BPS) and the final sample covers 296 firms in 17 cities across 5 sectors.

As the study also examine the different impact of political connection between Small and Medium Enterprises (SMEs) and large firms, thus the SMEs are defined as firms with fewer than 100 employees, or with annual sales of less than 50 billion Rupiah in 2013. Other variables adopted by the study are political connection and firm characteristic variables (association, employees, foreign, investment, firm age, direct exports, local clients and local suppliers).

Thus, the results had finalized that the political connections reduced financial restraints of SMEs in different phases of the loan application procedure. The political connection firms were more tends to borrow from state-owned banks and to gain the full loan amount they requested for. The political connection play a significant role on ability to access to bank loans. This is because, the political connection firms might be closer to state-owned bank officers, thus when they request for a bank loan, they deal with lower lobbying fees. The political connection firms also might be closer to government-led investment projects and hence, its ease the firms to gain aid from the banks.

More, political connections also arranged firms with easier access to government support programs that might help to lessen collateral demand. However, the finding also stated that the firms with political connection that borrowed from the state-owned banks seem to be less productive compared to other firms. As the SMEs received a significant results due to political connections, but for larger firms, political connection do not seem to engage a significant role in the access to bank loans.

In China, Li et al. (2008) had studied the value of political connections for private tycoons and examined the role and operation of the political affiliation with the Chinese Communist Party (the Party) in improving the performance of private firms. The study had suggested that political connections had a positive effect on firm performance. Furthermore, the study also tested whether political connections help private tycoons to gain access to credit market, avoid red tape, obtain a reduction in taxes or fees and gain better access to the legal system.

The study is conducted through nationwide survey that consist of 3258 privately owned enterprises which represents 0.16% of the total privately owned enterprises nationwide and obtained 2324 complete observations . The amount of loans from state banks and other state institutions are used as dependent variable. While the control variables are categorize as party membership, firm's attributes (firm size and employment), owner's human capital (education, firm age and management experience) and owner's political variable (former public firm manager and former cadre).

Thus, the finding indeed stated that Party membership helps a firm to borrow from banks and other state institutions and also contributed positively to current borrowing. The benefit of securing current bank loans is mainly driven by larger firms that controlled by Party members. Even though, the Party member do not gained favorable treatment in terms of tax and fee payments, but they do had more confidence in the legal system. These results had supported the idea that political connection significantly help firms to control market failures in a transition economy.

Yang, Lian and Liu (2012) had investigated the influence of political connections and institutional differences on private firms for acquiring bank loans. The study also analyzed the impact of bank loans on firm value and allocation efficiency of social resources. The samples employed are private listed firms in China from 2002 to 2007 with 1077 observations. The variables used are political connection, tangible, profitability, firm growth and firm size. Therefore, the finding suggested that political connection effect lending policies of banks and politically connected private firms can acquired more loans from banks. Furthermore, in bad institutional environment, political connections can assisted private firms to acquire more bank loans. This means by having political connection, it will help private firms to overcome the downside of market institutions. More, the bank loans have governance effects on politically connected private firms and can boosted firm value. Lastly, the study also suggested that the bank loans brought by political connections are efficient resource allocation.

Chan, Dang and Yan (2012) had examined the impact of political connection on the financing constraints of listed Chinese firms. The study sample consists of 3585 firm-year observations of 1347 firms for 2005-2007. Out of 1347 firms, 330 firms are identified as politically connected. The study had employed investment, sales, cash balance, capital, debt and stock market as variables. Thus, the finding had suggested that firms with politically connected CEO/Chairman seem to be clear from financing constraint. These firms probably have easier access to external credit through either the personal connections of the firms' top officers, explicit preferential policy treatment, or they identified by lenders to have absolute government guarantee.

In Thailand, Bunkanwanicha and Wiwattanakantang (2009), had provided other evidence of political connection by explored a common process that firms applied to acquire state favors which the business owners themselves attempting election to top office. The study was developed by sample that consists of top 2000 largest firms in Thailand classified by total asset as of the end of 2000. Probit model is adopted to analyze the characteristics of the business families that attempt access to political power. Thus, the authors had found that as the business owners depend more on government concessions or the richer they are, the more possibility they are to run for top office. This applied that holding public office might be a process for rent extraction.

Furthermore, the study also explore the impact of political ability on financing. Financing can be directed to politically connected firms in various ways such as through bank debt, long-term debt, debt with preferential terms and also government bailouts. Therefore, in order to investigate the link between political ability and financing, the dependent variables are debt variables that will represent overall debt structure (the ratio of total debt to asset and the ratio of total debt to total asset plus accounts payable to asset) and determine the debt maturity structure (the ratio of long-term debt to total asset and the ratio of long term debt to total debt). The control variables that included are size, asset tangibility, profitability and industry. However, the result had provided evidence which there is no positive effect of political power on corporate debt financing.

Charumilind, Kali and Wiwattanakantang (2006) had examined whether business connections predicted preferential access to long term bank credit. The study sample consists of 270 nonfinancial firms listed in 1996. The variables involve are firm size, market to the book value of total assets (investment opportunities), fixed asset ratio, standard deviation of the percentage changes in sales over the period 1991-95 (volatility of earning) and leverage. The finding indicates that the Thai firms with close links with bank and politician had greater access to long term debt compared to non-connected firms. The study also finds that politically connection firms needed much less collateral to borrow long term than non-connected firms. As the politically connected firms gained more long term debt, it seems like to use less short term debt.

Datta and Ganguli (2014) study's aimed is to justify existence of political connection of firms in India by analyze empirically the movement of stock prices during two state (Uttar Pradesh (UP) and Karnataka) elections in India. A theoretical model of competition among firms is built which applied political connection in a federal set up as a plan to boost higher profit. The study also utilized and reviewed a standard Cournot model of oligopoly to capture the political connections issue. The political connected (PC) firms are distinguished by media report and not financial report since there is lack of clarity in the Indian system considering donations to political parties. Two political events are used to investigate the conception of the market regarding the valuation of the PC firms in terms of theoretical view. The two distinct event are the UP assembly election 2012 and Karnataka assembly election 2013. Thus, the finding suggested that the movement of share prices of PC firms contradicted from the overall movement and also the share prices of winning and losing side firms moved in contrary directions. Hence, this showed that indeed political connections had an effect on share prices.

The theoretical model had identified positive outcome of political connection on profit and also stock prices for the winning-side firm and negative outcome for losing-side firms. However, there also independent firms that the stock prices are not influenced by the political event.

In Pakistan, Khwaja and Mian (2005) had investigated rents to politically connected firms in banking by adopting a loan-level data set of more than 90,000 firms that represents the universe of corporate lending in Pakistan between 1996 and 2002. The variable used are politically connected, government bank, firm size, and firm default rate.

The finding showed that politically connected firms obtained substantial preferential treatment that is totally driven by loans from government banks. The benefits are including 45 percent larger loans and also 50 percent higher default rates on the loan. Furthermore, the government banks also favor politically connected firms by issuing them greater access to credit. This preferential access is even higher for politically connected firms that are larger and have a higher tendency to default and also stronger politicians on their boards.

Berkman and Galpoththage (2016) had adopted a portfolio time-series approach to analyze the effect of five important political events on the value of political connected firms in Sri Lanka. The study is conducted with final sample of 99 listed firms and time period of 2006-2011. The finding indicated no evidence of political connections impact firm value in Sri Lanka. However, the value still changed around major political events that are tends to be advantage (disadvantage), for the leading government did not benefit (harm) politically connected firms compared to politically unconnected firms. The result also showed that the government is not favored towards political connected when permitting major projects.

In United States (U.S), Goldman, Rocholl and So (2009) had investigate the value influence of political connection of major U.S firms, involving all firms in the S&P 500. The authors had employed an original hand-collected data set on the political connections of board members of the firms to classify firms into those connected to the Republican Party and to those connected to the Democratic Party.

The study had addressed two fundamental challenges as the authors attempted to examine the relation between political connection and firms' value. The first challenge is to identify and define a feasible measure of political connections and second challenge is to discover a position that would allow one to examine whether they do certainly affect firms value. Furthermore, the study also had had explored two different events in order to address the second challenge. The events are the 2000 presidential election on November 2007 and the statement of the board nomination of all of the directors who are identified as having a political connection.

Thus, the result had indicated a positive abnormal stock return following the statement of the nomination of a politically connected individual on the board. More, following the announcement of Republican win of the 2000 presidential election, the firms connected to Republican Party increase in value while firms connected to the Democratic Party faced an opposite impact. The findings had showed a firm's value boost in anticipation of future advantages following the nomination of the politically connected individual. Moreover, as the connected board member's political party secured control of the presidency, the value generated by the members rose but the value generated by a director connected to the rival party drop.

In Italian, Menozzi, Urtiaga and Vannoni (2012) had discovered that politically connected directors, who command board of directors in Italian public utilities, strive a positive and significant result on employment but have a negative influence on performance. The result suggested that board size and composition importance even in stated-owned firms with concentrated ownership and public blockholders.

The study had adopted economic, technical and governance variables of 144 Italian public utilities observed annually in 1994-2004. This study also had addressed issue on the impact of board characteristics especially the existence of directors who are politicians on profitability and labor demand. Politically experienced directors usually found in larger firms, where politics had more essential or in firms influenced by the political mechanism through government purchases, trade policy, environmental regulation and lobbying frequently happen.

2.5 Evidence of firm with political connection from Malaysia

In Johnson and Mitton (2003) study, the authors had explored the link between cronyism and capital controls in a democracy along with difference between firms that had connection to winning and losing politicians. This study is conducted in period of initial phase of the Asian financial crisis which is from July 1997 to August 1998.

The authors distinguished 'political connected' variable as "Mahathir connected" who is Malaysian former Prime Minister and "Anwar connected", who is former Deputy Prime Minister before his downfall in September 1998, was second in power to Mahathir and had numerous corporate connections. Other variables that also in this study are dividend-inclusive monthly stock return which present in Malaysian ringgit, firm size, firm growth, leverage, book-to-market ratio, return on asset, profit margin, current ratio, quick ratio, asset turnover, inventory turnover and short-term debt. In addition, industry variable and 'ethnically favored' also included as dummy variables.

In the study, the authors also emphasized the effect of political bias on levels of debt which the regression including the control variables (size, profitability, growth and industry) showed politically connected firms had more debt before the crisis. The debt ratios of politically connected firms are significantly five percentage points higher. Furthermore, the result also mentioned that larger and higher growth firms had higher debt ratios while more-profitable firms had lower debt ratios. Besides that, they also identified that in the early stage of crisis, the stock price of political connected firms drop lower than the non-political connected firms, however once the capital control is imposed, the firms with strong political connection rise quickly and gained greater benefits such as subsidies from the government. The industries that are significantly affected by the crisis are industrial (manufacturing), services and also utilities.

Faccio et al. (2006) provided different evidence of political connection where the authors investigate the prospect of government bailouts of 450 politically connected firms from 35 countries including Malaysia during 1997-2002. Most of the connected firms are from finance, consumer durable, basic industry and construction sectors that made up of respectively 26.89%, 13.78%, 9.56% and 8.22%. The study had discovered that politically connected firms borrow more and are bailed out with higher frequency than are non-connected firms. Besides that, both connected and non-connected firms are tends to be bailed out when their home government receives an International Monetary Fund (IMF) or World Bank (WB) aid than when it does not. However, this aid is not applied to Malaysia therefore Malaysia is excluded during the test. Besides the existing of the IMF and WB funds, the political connected firms also tends to bailed out by their home government when the firms experience economic conflict.

Furthermore, the study also proved that politically connected firms had greater preferences of debt financing than the non-connected firms. One of the factors that lead to great use of leverage among the connected firms is they ability to gain future bailout since the lenders also considered of political connections term in their credit-granting decisions. The bailed-out connected firms also had significantly poorer operating performance than the non-connected firms at the time of the bailout and over the following 2 years.

Fraser et al. (2006) had developed their study to investigate the relationship between leverage and the political patronage by using three different proxies of political patronage and analyzed their influence over a 10 years period, from 1990 to 1999. The proxies are represent as direct government equity ownership, “institutional” equity ownership and informal political ties.

The study sample consist of 257 Malaysian firms which covered 167 firms with government ownership and 41 firms with politician ties. Manufacturing and property sectors are the two sectors with huge number of political connected firms. The variables involved other than three political patronage proxies are leverage as dependent variable, firm size, tangible asset, profitability, investment opportunities and sector dummies. The result had given a positive and statistically significant of relation between leverage and political patronage for all three proxies of political patronage. This results suggested that political connection is linked to a firm’s ability to carry more debt. More, the study also found firm leverage is positively correlated with size, profitability and asset tangibility.

Lau and Tong (2008) had analyzed the impact of government intervention on firm value in the context of Malaysian economy. The study included 15 Government Linked Companies (GLCs) from 2000 to 2006 as the sample. The variables used are percentage of government ownership, government structure, foreign ownership value, size, leverage and profit. Thus, the results had suggested that a positive relationship between government ownership and firm value. This means that the higher degree of government ownership in GLCs, the higher the firm value.

Wei and Hooi (2011) had provided other evidence of the cross-sectional in leverage among the publicly listed Government Linked Companies (GLCs) and non-GLCs (NGLCs) in Malaysia which covered from the year 1997 to 2008. The study also compares GLCs with NGLCs to analyze the association of government affiliation and investigate the financing decisions of GLCs and NGLCs to grab better understanding of capital choice decision by GLCs.

GLCs are described as companies that have a primarily commercial purpose despite the Malaysian government holding a direct controlling stake. Many GLCs had been partly privatized and listed in the Malaysian stock exchange, the Bursa Malaysia. The GLCs exist in Malaysian industries, involving manufacturing, plantation, finance, trading, transportation, shipbuilding and services. The study sample consists of 22 GLCs and match with 22 NGLCs as stated to their homogeneous sector and share price in the industry. The variables used are debt ratio, short term debt ratio and long term debt ratio as dependent variables while firm size, tangibility of assets, profitability, growth opportunities and cash flow as independent variables.

The result showed the firms with political connections tend to have more debt. This is because politically connected firms with strong government support have easier access to loans compared to non-connected firms. Furthermore, the tangible asset and cash flow variables are positively correlated to debt ratio while firm size and profitability variables are negatively associated with debt ratio.

Ebrahim, Girma and Shah (2011), examines the relationship between firm characteristics and capital structure targeting behavior in context of political patronage. The study had divided its sample into two sub periods. The first sample is the period from 1988 to 1997 (pre-crisis) while second period is from 2000 to 2009 (post-crisis). The study used an unbalanced panel data set consisting of 184 firms which have data for both periods. The variables utilized are leverage, business risk (volatility), profitability, growth (investment opportunities), tangibility, and political patronage. The finding argues the direct link between political connection and capital structure during the pre-crisis period.

This result indicated that firms with political connection carry more debt than non-connected firms. The politically connected firms had more debt because the fact that their asset in place had strong support of government. Thus, these firms had better ability to pay their debt in the case of financial distress. However, their connection is insignificant during the post-crisis period. The study also suggested that profitable politically connected firms seem to carry less debt than the non-connected firms for both periods. While tangibility has positive relation with leverage during the post-crisis but has negative relation during pre-crisis period.

This indicated that during the pre-crisis period, the politically connected firms had access to financing without collateral while during the post-crisis period, these firms had begun to use collateral for borrowing.

Bliss and Gul (2012) had explored the linkage between politically connected firms and leverage in Malaysia. The sample of the study is the Malaysian top 500 non-finance public-listed companies in term of market capitalization for years 2001-2004. The variables used are political connection, size, return on assets (ROA), tangible asset, market-to-book value and negative equity. The findings had indicated that political connection, firm size, and tangible asset are positively and significantly related with leverage, while ROA is negatively and significantly connected with leverage. The study also suggested that larger politically connected firms have higher leverage but politically connected firms with higher return on assets are negative and significant with leverage. This result indicated that the higher borrowing political connection firms have lower ROA than non-connected firms due to the lenders had identified political connection firms as being of higher risk and thus they charged higher interest rate to the firms.

Bliss and Gul (2012), investigates the relationship between Malaysian politically connected (PCON) and the cost of debt. The study also had investigated whether two corporate governance attributes (CEO duality and the proportion of independent directors on the audit committee) impact on coast of debt of politically connected firms. The study sample are consisted of 1667 firms of Malaysian top 500 non-finance public listed companies in terms of market capitalization for years 2001-2004. Out of 1667 firms, there are 282 politically connected firms with trading and service sector

(34.75%), industrial product sector (17.73%) and properties sector (17.38%) as the top sectors with large numbers of connected firms.

The study used interest expense as dependent variable. The independent variables are politically connected firm (PCON), CEO duality, firm age, auditor, leverage, cash-flow, firm size, property, plant and equipment, sales growth, whether the firm has negative equity and current ratio. The finding had indicated that politically connected firms is related with higher interest rates on debt. This showed that the lenders identify politically connected firms to be riskier and thus compensate themselves by charging the firms higher rates of interest on their borrowing.

Ebrahim et al (2014), examines the effect of political connection on firms' capital structure following an exogenous shock caused by 1997 Asian crisis. The samples of the study consists of 751 Malaysian firms from 1998 to 2009, yielding 7042 firm-year observations. The study also specified its model to contain two post-shock periods which are 1998 to 2001 (pre-crisis) and 2002 to 2009 (post-crisis).

The independent variable used is leverage and the dependent variables are political patronage, firm size, profitability, growth, tangibility, industry and volatility. The result argued that the relation between politically connected firms and debt are insignificant. This finding reject the claimed that politically connected firms hold significantly higher level of debt.

Moreover, the study also suggested that Malaysian revised capital structure during the crisis and politically connected firms de-lever quicker than non-connected firms. This indicated that politically connected firms suffer more when an exogenous shock limits government's ability to issue privileges and subsidies.

The result is obtained due to the severity of the exogenous shock increases systematic risk, thus causes the government to reconsider its helps in case patronage creates a repercussion to threaten the future of an incumbent government. In post-crisis, politically connected firms are more highly levered than the non-connected firms but insignificants. However, it suggested at least a partial return to the advantages of cronyism and possibly reflects the activities of the government restructuring agencies. This indicated Malaysian government was better able to shield politically connected firms once it imposed capital control and established restructuring agencies to deal with corporate debt.

Johansson (2014), analyze the effect of political connection on the change in leverage after the 2008 Malaysian election. The dependent variable use is the change in average annual leverage and the main independent variable is political connection. The firm-specific variables also include which are size, return on asset (ROA), growth and tangible assets. The leverage level at the end of 2008 also involve in order to control the general level of leverage at the time of election.

By adopting multivariate regression, the study had found a significant and negative relationship between political connection and change in leverage. The author also found that the negative effect is driven by the changes in long term debt. Meanwhile, as for other independent variables, tangible assets and growth have a significant and positive effect on the change in leverage, while the other variables are insignificant.

Al-dhamari and Ku Ismail (2015) explores the impact of cash holding, political connection and their interaction result on earnings quality in Malaysian conditions. The study covers five-year period, from 2007 to 2011 of Malaysian top 100 listed firm based on the 2011 market capitalization. From the total sample of 295 firms, the top two firms with political connection are from trading and service industry made up of 32% of the firms and followed by 19% of firms from consumer product industry. The variables included are accrual quality as dependent variable and also other variables are cash holdings, presence of political influence (PCON), firm size, profitability, leverage, growth opportunities and audit quality. Thus, the finding had suggested that the political connected firms (PCFs) are indicated as the larger the firms, the more leverage in their capital structure and faced lower profitability and quality of earning numbers. The result also showed that the interactive variable of cash holding and PCON is not statistically related with accrual quality due to PCFs are less likely to horde more cash as the firms generally ease from a soft budget restraint, easy access to credit and government bailout assurance.

In conclusion, prior empirical studies had provide evidences regarding political connection influences toward politically connected firms. By having political alliances, a firm is benefited with greater access to credit, the ability to be bailout during financial distress, capital control, and also boost in stock price which later increase the firm's value. Besides that, prior studies also argue the role of political connection in corporate financing. The studies confirm that the politically connected firms have a greater preferences of debt financing. Therefore, based on the evidences, this study attempts to investigate whether Malaysian political connected firms also enjoy the benefits of political alliances including the preferential of debt financing.



CHAPTER III

RESEARCH DESIGN AND METHOD

3.1 Introduction

This chapter outlines the hypotheses, describes sample, defines the variables, and identifies the method of analysis. Section 3.2 and section 3.3 outline the hypotheses. Section 3.4 explains the data used in the study, section 3.5 describes the sample. Section 3.6 introduces the variable measurement including dependent variable and independent variables. Section 3.7 clarifies the model employed and lastly, section 3.8 explains the analysis techniques adopted by this study.

3.2 Hypothesis development

Political connection plays an important role in determining firm financing since the political connected firms gain special treatment from the government including the ability of credit granting. Fraser et al. (2006) suggest that Malaysian politically connected firms have a positive and statistically significant relationship with leverage. According to Wei and Hooi (2011), the firm with political connection tend to have more debt because the firms with renowned government relationships have easier access to loans due they have government backing.

Faccio et al. (2006), argue that politically connected firms had greater preferences of debt financing compared to non-connected firms. The finding is due to the ability of politically connected firms to gain future bailout since the lenders considered of the political connections term in their credit-granting decision.

Khwaja and Mian (2005) also report that the preferential access of credit is higher for politically connected firms that are larger and have a higher tendency to default and also stronger politicians on their boards. The study by Charumilind, Kali and Wiwattanakantang (2006) also find that the politically connected firms had a greater preferential access to long term debt prior to the Asian Crisis of 1997-98. Prior studies (Johnson and Mitton, 2003; Ebrahim, Girma and Shah, 2011) find that politically connected firms carry more debt during pre-crisis. Other empirical studies confirm that political connection is significant and positive associated with debt (Li et al., 2008; Bliss and Gul, 2012, 2012; Yang, Lian and Liu, 2012; Al-dhamari and Ku Ismail, 2015; Fu et al, 2015). Thus, based on the prior studies, the study estimates the following hypothesis:

H₁: Political connection has a positive relationship with leverage.

3.3 Hypotheses development: Firms specifics variables

Beside political connection variable, other independent variables are also employed in this study. The variables are firm size, firm growth, tangible asset, liquidity and profitability.

3.3.1 Firm size

The firm size has been considered as one of the specific factors used in explaining a firm's level of debt. Prior studies report the positive relationship between firm size and leverage.

For example, larger firms are presumed to have a higher debt capacity and are able to be more highly geared (Sayilgan, Karabacak and Kucukkocaoglu, 2006). Larger firms are also likely to be more diversified and more tends to have lower financial distress costs than smaller firms (Rajan and Zingales, 1995; Pandey, 2001; Cheng and Shiu, 2007). Furthermore, larger firms also have more stable cash flow and thus the probability of bankruptcy is smaller for large firms rather than smaller firms (Niu, 2008). Larger firms also tends to have easier access to debt market and be able to borrow at lower cost (Padron et al., 2005; Antonio, Guney and Paudyal 2008).

However, there are conflicting outcomes on the relationship between firm size and leverage. If the firms size as an inverse proxy for probability of bankruptcy, size should have a positive impact on the debt supply. Nevertheless, firm size also may also be a proxy for the information outside investor which should increase their preference equity relative to debt (Rajan and Zingales, 1995).

There are studies that suggest the firm size is significant and positively related to leverage (Samarakoon, 1999; Pandey, 2001; Drobetz and Fix, 2003; Johnson and Mitton, 2003; Sayilgan et al., 2006; Brav, 2009). Oppositely, there also studies that found the relationship between firms size are statistically significant and negatively related to leverage (Rajan and Zingales, 1995; Gupta, 1969; Doku et al., 2011; Pontoh and Ilat 2013).

Gupta (1969) finds that small firms tend to depend extremely on debt as greater financial structure flexibility function due to financial constraint the firms face on the availability of equity capital. Plus, the small firms prefer short-term debt while the large firms more often choose long-term debt (Marsh, 1982; Titman and Wessel, 1988). Titman and Wessel (1988) indicate the difference happen due to the high transaction costs that small firm face when they issue long-term debt or equity. Rajan and Zingales (1995), argue that the large firms have lower informational asymmetries between insiders in the firms and capital market. Thus, large firms should be more competent of issuing informationally sensitive securities like equity and should have lower debt.

The mixed findings from the prior studies provoke interesting questions on the influence of firm size on firm leverage in Malaysia. Thus, based on the previous studies, this study develops the following hypothesis:

H₁: Firm size has a negative relationship with leverage.

3.3.2 Firm growth

External resources are important for growing firms. Debt typically grows when investment exceeds retained earnings and thus leverage is estimated to be higher for firms with more investment opportunities (Drobetz and Fix, 2003).

Pandey (2001) argues that growth is significant positive correlated with leverage for all type of debt which are, total debt, long-term debt and short-term debt. The author also states that Malaysian firms have higher short-term than long-term debt ratios.

Hence, it indicates that the firms adopt short term debt to finance their growth. Gupta (1969) also supports the positive relation between growth and leverage as the author states that growth firms tend to have high leverage due to their greater need for financial structure flexibility plus the fact that debt can be acquired and liquidated more easily. The author also adds that the growth firms likely to have a large amount of bank borrowing with respect to their total assets and to make use of available trade credit to greater extent. The other studies also confirmed the results (Johnson and Mitton, 2003; Chen, Jiang and Lin, 2014; Fareed et al., 2014). Hence, certain with previous studies, this study tests the following hypothesis:

H₁: Firm growth has a positive relationship with firm leverage.

3.3.3 Tangible asset

The tangible assets of a firm can be reviewed representative of the real collateral that can be offered to its creditors. Thus, the importance of those assets among total assets influences its level of debt (Padron et al., 2005). Rajan and Zingales (1995) also support the role of asset tangible as collateral and helps in reducing the risk of lender suffering the agency costs of debt. The assets also maintain more value in liquidation. Due to that, the larger the portion of tangible assets, the more lenders tends to supply loans and hence, increase the leverage.

Furthermore, firms with greater portion of tangible assets more tend to be in an industry with lower risks where they can afford greater financial leverage and greater portion of tangible assets. Thus, these tangible assets ultimately have an impact on borrowing decisions of these firms and if in bankruptcy, tangible assets generate more value than firms with higher dependence on intangibles (Sayilgan et al., 2006).

Prior studies, most of the studies confirm that asset tangibility is significant and positively associated with leverage (Rajan and Zingales, 1995; Drobetz and Fix, 2003; Gaud et al., 2005; Shah and Khan, 2007; Brav, 2009). Nevertheless, Song (2005) and Bevan and Danbolt (2000) document the tangibility has a positive relationship with total debt ratio and long-term debt ratio but negatively correlated with short-term debt ratio. The results of the studies are consistent with the maturity matching principle which is long-term debt forms are used to finance fixed assets, while non-fixed assets are financed by short-term debt. Thus based on the previous studies, this study develops the following hypothesis:

H₁: Asset tangibility has a positive relationship with leverage.

3.3.4 Liquidity

Liquidity of the firms indicates the ability of the firm to deal with its short-term liabilities (Masoud, 2014; Suhaila and Wan Mahmood, 2008). Liquid assets provide a shield that would allow the firm to survive a period of low earnings during which the firm might be incapable to access capital markets or could do so only at a very high cost (Anderson, 2002). Firms with more liquid assets can utilize them as another internal source of funds instead of debt, leading to lower debt financing levels (Öztekin and Flannery, 2012; Nyamita et al., 2014). Furthermore, managers can manipulate liquid assets in favor of shareholders against the interest of debt holders (Deesomsak et al., 2004), thus increasing the agency costs of debt and reduces debt financing levels (Nyamita et al., 2014).

Kim, Mauer and Sherman (1996) state that firms will retain excess liquidity for precautionary and speculative motives. Precautionary motive suggests that firms maintain excess liquidity to meet unexpected contingencies, while the speculative motive suggests that firms retain excess liquidity to take advantage of profitability future investment opportunities. The investment in the excess liquidity is one of the ways to reduce the firm's dependence on costly external financing. Suhaila and Wan Mahmood (2008) suggest that firms with high liquidity likely to use less debt due to their ability to generate high cash inflows and thus, can utilize the excess cash inflow to finance their operations and investment activities.

As the firms with high liquidity tends depend less on external financing, thus the liquidity is predicted to has negative relations with leverage. Prior studies indicate that liquidity is statistically significant and negatively related to debt (Deesomsak et al., 2004; Sheikh and Wang, 2011; Sarlija and Hanc, 2012; Masoud, 2014; Nyamita et al, 2015). Therefore, consistent with prior studies, this study tests the following hypothesis:

H₁: Liquidity has a negative relationship with leverage

3.3.5 Profitability

Theoretical predictions yield no consistent conclusions for the correlation between profitability and leverage (Niu, 2008). There are firms prefer using internal sources of financing first, then debt and lastly external equity obtained by stock issues. Briefly, the more profitable of the firms the more internal financing they will have. While, there are also firms that choose debts to benefit from the tax shield when they are profitable (Gaud et al., 2005).

Rajan and Zingales (1995), suggests that profitability is negatively related with leverage for all the countries except Germany. The authors indicate that large firms are likely to issue less equity and the negative influence of profitability on leverage become stronger if the firm size increases. On the other hand, the profitability for small firms may represent for both the amount of internally generated funds and the quality of investment opportunities, which have contradictory effects on the demand for external funds. More profitable firms tend to finance new investment using retained earnings rather than issuing costly debt (Morri and Cristanziani, 2009). Booth et al. (2001) also

suggest that profitable firms have less demand for external financing since it is costly. Other studies also provide similar findings (Samarakoon, 1999; Pandey, 2001; Bevan and Danbolt, 2002; Johnson and Mitton, 2003; Song, 2005; Gaud et al., 2005; Fraser et al., 2006; Antonio, Guney and Paudyal, 2008; Fareed, Zulfiqar and Shahzad, 2014; Dawar, 2014; Chen et al., 2014).

According to Zeitun and Tian (2007), long term debt ratio and short term debt ratio is significantly and negatively related to firm's profitability while total debt ratio has a negative and insignificant impact on the profitability. Pandey (2001), however find a negative correlation with all total debt ratio, long-term debt ratio and short-term debt ratio. Therefore, based on the prior studies, this study develops the following hypothesis:

H₁: Profitability has a negative relationship with leverage.

3.4 Data

This study employs secondary data collected from DataStream database and also firms annual reports. All firm specific factors data such as total debt, firm size, firm growth, profitability, liquidity and asset tangibility are extracted from the DataStream database while data on political connection variable are extracted from firms' annual reports. The empirical analysis covers period from 2006 until 2015. The lists of Government-Linked Companies (GLC) and Government-Linked Investment Companies (GLIC) are obtained from The Putrajaya Committee Homepage (<http://www.pcg.gov.my/index.asp>).

3.5 Sample

The sample of the study consists of Malaysian listed firms from two sectors which are trading and services sector and industrial products sector, as identified by Bliss and Gul (2012) for having a large number of political connected firms. The final sample size consists of 292 firms after excluding firms with missing data. The summary of final sample is shown in Table 3.1.

Table 3.1: Sample Selection

Sectors	Number of Firms	Less: Number of Firms Dropped from the Sample	Final Sample
Trading and Service Sector	232	111	121
Industrial Products Sector	278	107	171
Total	510	218	292

3.6 Variable measurements

This study uses debt ratio as dependent variable while independent variables are lists of firm specific factors that contribute to debt preference of the firm. Harris and Raviv (1991) suggest that leverage increases with fixed assets, nondebt tax shields, growth opportunities, and firm size, while it decreases with volatility, advertising expenditures, research and development expenditures, bankruptcy probability, profitability and the uniqueness of the product. However, this study only focuses on five variables which are firm size, firm growth, profitability, asset tangibility and also liquidity. The political connection variable is included to identify whether the firms are politically favor.

3.6.1 Dependent variable

LEV (Debt ratio)

In this study, the dependent variable is LEV (debt ratio). The estimation model uses debt ratio to compute the firm's level of leverage which also interpreted as the proportion of a firm's asset that financed by debt.

The ratio of debt to asset or debt to capital is most generally used as a measure of leverage in the prior empirical study (Pandey, 2001). As Rajan and Zingales (1995) argue that the extent of leverage and the choice of the most applicable measure depend on the analysis. Harris and Raviv (1991) emphasize that different measures of leverage can produce different results. Marsh (1982) suggest that a firm's choice of financing instrument will depend on the difference between its current and target debt ratios. Thus, since the choice of the leverage is highly sensitive, consistent with Pandey (2001) and Nyamita et al. (2015), this study employs three different measures of leverage which are total debt to total assets, long-term debt ratio to total assets and short-term debt to total assets ratios.

3.6.2 Independent variable

The independent variables that used in this study are PCON (political connection), SIZE (firm size), GROWTH (firm growth), LIQUID (liquidity), PROFIT (profitability), and TANG (asset tangibility).

PCON

PCON is employed to identify whether the firms are politically favor. This study applies the approach by Faccio (2006) and Faccio et al., (2006) in the process of identifying political connection variable. PCON is set equal to one if firm has political connection and zero otherwise. In this respect, PCON is recognized via several steps:

- i. First, through firm's annual report, the identity of firm's top officers (the firm's chief executives officer (CEO), chairman of the board (COB), president, vice president or secretary of the board) are identified.
- ii. Then, the status of top officers whether politically connected (directly connected or indirectly connected) are examined through board directors profile. If the profiles do not state the position of top officers in politic then the status are next being checked through the official website of Prime Minister's Office of Malaysia, (<http://www.pmo.gov.my/home.php>) and also the Official Portal of the Parliament of Malaysia, (<http://www.parlimen.gov.my/index.php>). The websites provide information on the list of His Majesty the King, members of cabinet, federal minister until list of Member of Parliament. This step used to analyses the status of the top officers through direct connections.
- iii. Next, if the top officers still have not been recognized as politically connected through direct connections, subsequently, this study searches the relation through indirect connection. The top officers with indirect political connection identified through their relatives or their well-known friendship as spotted by Forbes, The Economist of Fortune, if they hold important position in

government rulers such as head of state, government minister, or Member of Parliament.

- iv. Secondly, PCON also determined through firm's major shareholder as listed in annual report of a firm. If the relationship between firm and political connection is not been recognized via firm's top officers, then the relation being examined through a major shareholder of the firm. In order to identify whether the major shareholder is politically connected or not, the steps involved are the same as the steps described for top officers.
- v. Government-Linked Companies (GLCs) are example of firms with strong political connections via major shareholder since Malaysian government hold direct controlling stake of GLCs. GLCs are controlled by the Malaysian government through Khazanah Nasional Berhad (Khazanah), Minister of Finance (Incorporated), Retirement Fund Incorporated (KWAP), and Central Bank of Malaysia; or where federal Government-Linked investment companies (GLICs) and/or other federal government linked agencies collectively have a controlling stake. Besides Khazanah, KWAP and Minister of Finance (Incorporated), other GLICs in Malaysia include Employees Provident Fund (EPF), Armed Forces Fund Board (LTAT), Lembaga Tabung Haji (LTH), and Permodalan Nasional Berhad (PNB).
- vi. Finally, if either top officers or major shareholder do not provide any evidences of political connection, then the firm is classified as having no political connection.

According to Fraser et al., (2006), Malaysian political connected firms are positively and statistically significant related to leverage. Wei and Hooi (2011) suggest that Malaysian politically connected firms tend to have more debt because the firms have easier access to loans compared to non-political connected firms. Thus, PCON is expected to have a positive relationship with LEV.

SIZE

SIZE is proxied by the natural logarithm of total assets. SIZE is measured to determine the relationship between the firm size and firm leverage. Gupta (1969) argue that firm size is negatively related with leverage. The author finds that small firms tend to depend extremely on debt. Prior studies (Marsh, 1982; Titman and Wessel 1988) suggest that large firms more often choose long-term debt while small firms prefer short-term debt. Thus, based on prior studies, SIZE is expected to have negative relationship with LEV.

GROWTH

GROWTH is employed to examine the growth opportunities of the firm. GROWTH is measured by the growth of total asset which defined as total asset in year t divided by total asset in year t-1 minus 1. Pandey (2001) finds that growth is significant positive correlated with leverage for all type of debt which are, total debt, long-term debt and short-term debt. The growing firms tend to have high leverage due to their greater need for financial structure flexibility (Gupta, 1969). Thus, GROWTH is expected to have positive relationship with LEV.

LIQUID

LIQUID is measured by a ratio of current assets to current liabilities. Liquidity of the firms indicates the ability of the firm to deal with its short-term liabilities (Masoud, 2014; Suhaila and Wan Mahmood, 2008). Prior studies suggest that liquidity is negatively correlated to leverage (Deesomsak et al., 2004; Sheikh and Wang, 2011; Sarlija and Harc, 2012). Firms with more liquid assets use less debt since the firms able to utilize their liquid assets as another internal source of funds (Öztekin and Flannery, 2012; Nyamita et al., 2014).

Suhaila and Wan Mahmood (2008) suggest that firms with high liquidity likely to use less debt due to their ability to generate high cash inflows and thus, can utilize the excess cash inflow to finance their operations and investment activities. Hence, LIQUID is estimated to have negative relationship with LEV.

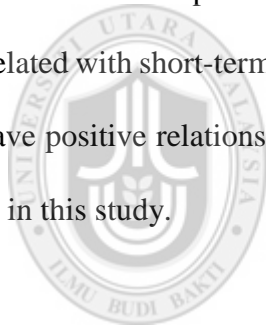
PROFIT

PROFIT is calculated by ratio of earnings before interest and taxes (EBIT) to total assets. Booth et al. (2001) suggest that profitable firms have less demand for external financing because it is costly. So, the profitable firms likely to finance new investment by using retained earnings (Morri and Cristanziani, 2009). Pandey (2001), also argue that profitability have negative relation with all total debt ratio, long-term debt ratio and short-term debt ratio. Thus, PROFIT is assumed to have negative relationship with LEV.

TANG

TANG is measured by ratio of fixed asset to total assets. TANG can be reviewed as the representative of the real collateral that can be offered to its creditors since the amount of tangible assets among the total assets influence its level of debt (Padron et al., 2005). Rajan and Zingales (1995) argue that asset tangibility is significant and positively associated with leverage. The finding suggests that as the portion of tangible assets increase, the more lenders tend to supply loans and thus, increase the leverage.

Prior studies (Song, 2005; Bevan and Danbolt, 2000) report that the tangibility has a positive relationship with total debt ratio and long-term debt ratio but negatively correlated with short-term debt ratio. Thus, based on the prior study, TANG is expected to have positive relationship with LEV. Table 3.2 shows the summary of variables used in this study.



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Table 3.2 Variables measurement

Variables	Description of Measurement	Expected Effect on Leverage	Prior Studies
Dependent variables			
LEV	Total debt/ total assets		Pandey (2001), Zeitun and Tian (2007), Wei and Hooi (2011), Fauzi et al., (2013), Nyamita et al., (2015)
LEVLTD	Long-term debt/ total assets		
LEVSTD	Short-term debt/ total assets.		
Independent variables			
PCON	Dummy variable, 1 if the firm is politically connected.	Positive	Johnson and Mitton (2003), Faccio et al., (2006), Bliss and Gul (2012, 2012)
SIZE	Natural logarithm of total assets	Negative	Johnson and Mitton (2003), Padron et al., (2005), Zeitun and Tian (2007), Niu (2008), Ali (2011), Fauzi et al. (2013)
GROWTH	Growth of total assets Defined as total asset in year t divided by total asset in year $t-1$ minus 1.	Positive	Wu and Yue (2009), Lim et al., (2012), Imtiaz, Mahmud and Mallik (2016), Alipour, Mohammadi, Derakhshan (2015)
LIQUID	Current asset/ current liabilities	Negative	Niu (2008), Sangeetha and Sivathaasan (2013), Krishnan and Mohandas (2013), Dawar (2014), Nyamita et al., (2015)
PROFIT	Earnings before interest and tax/ total assets	Negative	Pandey (2004), Song (2005), Cheng and Shiu (2007), Niu (2008), Ali (2011), Nemati and Muhammad (2012), Ghazouani (2013)
TANG	Net fixed asset/ total assets	Positive	Rajan and Zingales (1995), Samarakoon (1999), Pandey (2001, 2004), Brav (2009), Sangeetha and Sivathaasan (2013)

3.7 Model

This study adopts a model used by Bliss and Gul (2012) with some modifications to investigate the effect of political connections on firms financing in Malaysia. The model also used by prior studies (Rajan and Zingales, 1995; Samarakoon, 1999; Johnson and Mitton, 2003; Fraser et al., 2006; Wei and Hooi, 2011; Alkhatib, 2012; Bliss and Gul, 2012).

Model 1

$$LEV = a + b_1(PCON) + b_2(SIZE) + b_3(GROWTH) + b_4(LIQUID) + b_5(TANG) + e_i$$

Where:

LEV= debt ratio, (total debt ratio, long-term debt ratio and short-term debt ratio)

PCON= 1 if the firm is politically connected, 0 otherwise

SIZE= Natural logarithm of total assets

GROWTH= Growth of total asset

LIQUID= Current asset divided by current liabilities

PROFIT= Earnings before interest and tax divided by total assets

TANG= Net fixed asset divided by total assets.

3.8 Analysis technique

To test the hypothesis, ordinary least square (OLS) regression, fixed-effect model (FEM) (Pandey, 2001) and random-effect model are used (Fraser et al., 2006). Simple-pooled OLS regression cannot fix for firm-specific and time specific effect, which if correlated with other explanatory variables would generate an omitted variables bias and a mis-specified regression. Thus, FEM and REM are also used to overcome the problem by adjusting for these effects through the firm-specific and time-specific intercepts. The firm-specific intercepts capture the unobserved and/or unmeasurable firm-specific characteristics. The time-specific intercepts capture the unobserved and/or unmeasurable time-varying characteristics (Fraser et al., 2006). All the analysis including descriptive statistics, univariate analysis, correlation analysis, OLS regression, FEM and REM are analyzed using STATA12.

3.9 Hausman test

The study also conducts the Hausman specification test (Hausman, 1978) to compare the FEM and REM. If the model is correctly specified and if individual effects are uncorrelated with the independent variables, fixed effect and random effect estimators should not be statistically different (Aivazian, Ge and Qiu, 2005). Simply, if the test is significant at 5% level of confidence, then there is no correlation and the FEM figures are reliable (Nyamita et al., 2015). The statistics are reported in Table 4.4, page 74 and are equal to 96.97, 13.72 and 119.05 respectively, for three alternative measures of leverage (LEV, LEVLTD and LEVSTD). The null hypothesis is rejected at the 1% significant level for LEV and LEVSTD and at 5% significant level for LEVLTD.

Thus the results suggest that the FEM is most appropriate in estimating the leverage of firms. Therefore, this study will report the results from FEM. Lemma and Negash (2013) suggested that empirical studies favors FEM rather than REM for research based on capital structure since the fixed effects allow for control on biasness that may be caused by the firm's specific characteristics and time effect.



Chapter IV

EMPIRICAL RESULTS AND DISCUSSION

4.1 Introduction

This chapter presents the empirical results of the study. In the first section, a summary of descriptive statistics for the nine variables will be presented. Second section discusses the univariate analysis and followed by the correlation analysis between dependent and independent variables. Last section is the discussion of regression analysis of this study.

4.2 Descriptive statistics

The analysis of the results starts with a range of descriptive statistics. Table 4.1 presents the descriptive statistics of dependent as well as independents variables of the study. It shows the mean, standard deviation, maximum and minimum values of the 2920 observations related to the 292 firms included in the study.

As shown in Table 4.1, the mean of firms leverage is proxied by total debt ratio (LEV), long-term debt ratio (LEVLTD) and short-term debt ratio (LEVSTD) is 0.2247, 0.0905 and 0.1342 respectively. The total debt ratio indicates that 22.47% of the firm's assets are financed with total debt during the study period. The LEVLTD shows the smallest numbers among the three debt ratios which explain that the firms from industrial products industry and trading and services industry prefer higher proportions of short-

term debt in their capital structure avoiding indebtedness over long periods. Most of Malaysian firms prefer to secure their control over firms by financing its operations with more equities rather than usage of debt that exposed them to the fixed obligations toward creditors that have main claimant in the event of bankruptcy (Suhaila and Wan Mahmood, 2008).

The mean of firm's size as determined by SIZE and also firm's growth computed as the growths of total assets are 12.85 and 0.7187 respectively. The profitability defined as PROFIT is ranged from -5.550 to 3.910 and has a mean of 0.0542. The positive ratio indicates the firms indeed make profit during the period of study. The profitable firms have stronger base to face odd scenario such as financial distress and can proceed their operation more smoothly rather than unprofitable firms in long run (Imtiaz et al., 2016).

Tangible asset defines as TANG shows mean 0.3610. This explains the entire firms' fixed asset consists of 36% of total assets average. The fixed asset to total assets for the study is ranged from 0 to 0.9582 with standard deviation 0.1912. The mean of liquidity as measured by LIQUID is 2.743 and standard deviation of 5.153. The political connected variable is ranged from 0 to 1 and shows mean value of 0.2647 with 0.4413 of standard deviation.

Table 4.1 Descriptive Statistic

Variable	Observations	Mean	Std. Deviation	Min	Max
LEV	2920	0.2247	0.2713	0	6.592
LEVLTD	2920	0.0905	0.1421	0	3.588
LEVSTD	2920	0.1342	0.2134	0	6.573
SIZE	2920	12.85	1.522	8.908	18.58
GROWTH	2920	0.7187	11.18	-0.9996	474.7
PROFIT	2920	0.0542	0.1594	-5.550	3.911
TANG	2920	0.3610	0.1912	0	0.9582
LIQUID	2920	2.743	5.153	0.0441	190.2
PCON	2920	0.2647	0.4413	0	1

Notes: LEV is total debt divided by total assets; LEVLTD is total long-term debt divided by total assets; LEVSTD is total short-term debt divided by total assets; SIZE is the natural logarithm of total assets. GROWTH is growth of total assets, defined as total assets in year t divided by total asset in year $t-1$ minus 1; PROFIT is earnings before interest and tax divided by total assets; TANG is net fixed asset divided by total assets; LIQUID is current asset divided by current liabilities; PCON is 1 if the firm is politically connected, 0 otherwise.

4.3 Univariate analysis

Table 4.2 shows the financial characteristics of the sample firms classified by whether the firms with political connection or without political connections. Analysis of these data does suggest a relationship between firm leverage and political favoritism.

Firms with political connection have a total debt to total assets ratio of 25.60% as compared to a lower 21.34% for firms without political ties. This difference is statistically significant at the 1% level. The long-term debt ratio of politically connected firms is 12.65% as compared to a lower 7.75% of non-politically connected firms. The difference is statistically significant at the 1% level. While, short-term debt ratio and the profitability of the two groups of firms do not differ, there are substantial differences between the rest of variables for the two groups of the firms.

Both sizes of the firms as well as the firms' growth opportunities of politically connected have higher ratios compared to the firms without political linked. Politically connected firms also have higher tangible asset ratios, which may in turn explain their higher leverage. More, the liquidity is likely more favor for firms without political connection since the political connection firms have much lower liquidity ratio. The mean differences of SIZE, GROWTH, TANG and LIQUID are statistically significant at 1% level.

Table 4.2 Univariate analysis

VARIABLE	MEAN			MEAN DIFFERENCE (t-statistics)	
	All Firms (N=2920)	PCON=0 (N=2147)	PCON=1 (N=773)	(pooled)	(satterthwaite)
LEV	0.2247	0.2134	0.2560	(-3.751)***	(-3.236)***
LEVLT	0.0905	0.0775	0.1265	(-8.312)***	(-6.108)***
LEVST	0.1342	0.1359	0.1295	(0.7135)	(0.7563)
SIZE	12.85	12.58	13.60	(-16.69)***	(-14.61)***
GROWTH	0.7187	0.3125	1.847	(-3.278)***	(-2.035)**
PROFIT	0.0542	0.0526	0.0587	(-0.9192)	(-1.151)
TANG	0.3610	0.3488	0.3929	(-5.782)***	(-5.580)***
LIQUID	2.743	2.912	2.273	(2.961)***	(4.228)***

Notes: LEV is total debt divided by total assets; LEVLT is total long-term debt divided by total assets; LEVST is total short-term debt divide by total assets; SIZE is the natural logarithm of total assets. GROWTH is growth of total assets, defined as total assets in year t divided by total asset in year $t-1$ minus 1; PROFIT is earnings before interest and tax divided by total assets; TANG is net fixed asset divided by total assets; LIQUID is current asset divided by current liabilities; PCON is 1 if the firm is politically connected, 0 otherwise; *, **, and *** indicate significance at 90%, 95% and 99% confidence level respectively

4.4 Correlation matrix of variables

Table 4.3 shows the correlation matrix among the explanatory variables. Correlation test is conducted to determine the relationship between dependent variable and independent variables. The low correlations found between the explanatory variables indicate that the problem of multicollinearity is not serious in the data set (Fraser et al., 2006). Since the result presented in Table 4.3 show that most cross correlation terms for the explanatory variables are fairly small, thus indicating no cause for concern about the problem of multicollinearity among the explanatory variables.

There are substantial correlations between the dependent and independent variables. Most of the independent variables show statistically significant correlation regardless which debt ratios are measured with. LEV measured by total debt ratio and LEVLTD computed by long-term debt ratio show a significantly positively correlated with political connections (PCON) variable, however short-term debt ratio, LEVSTD is negatively insignificant correlated with the PCON. The LEV and LEVLTD also positively significant correlated to firm's size as measured by SIZE and firm's tangible assets measured by asset tangible ratios, TANG. Both TANG and SIZE has opposite relation with of LEVSTD where TANG is positively significant correlated while SIZE is negatively correlated. While firm's growth as computed by GROWTH shows insignificant relationship with all the debt ratio, firm's profitability as measured by PROFIT and LIQUID computed by current ratio show a negatively significant relationship with all three leverage ratios.

Furthermore, political connected variable shows a significantly positively correlated with SIZE, GROWTH and TANG but negatively significant related to LIQUID and positively insignificant correlated with PROFIT. All the other independent variables also show mixed relationship among other which either positive or negative correlated.



Table 4.3 Correlation matrix of variables.

	LEV	LEVLTD	LEVSTD	SIZE	GROWTH	PROFIT	TANG	LIQUID	PCON
LEV	1.0000								
LEVLTD	0.6256***	1.0000							
LEVSTD	0.8545***	0.1294***	1.0000						
SIZE	0.1046***	0.2928***	-0.0620***	1.0000					
GROWTH	0.0135	0.0327*	-0.0046	0.1330***	1.0000				
PROFIT	-0.2742***	-0.0537***	-0.3128***	0.0981***	0.0084	1.0000			
TANG	0.1620***	0.2460***	0.0421**	0.0787***	0.0139	-0.1038***	1.0000		
LIQUID	-0.2024***	-0.1329***	-0.1688***	-0.1094***	-0.0154	0.0513***	-0.1874***	1.0000	
PCON	0.0693***	0.1521***	-0.0132	0.2952***	0.0606***	0.0170	0.1064***	-0.0547***	1.0000

Notes: LEV is total debt divided by total assets; LEVLTD is total long-term debt divided by total assets; LEVSTD is total short-term debt divided by total assets; SIZE is the natural logarithm of total assets. GROWTH is growth of total assets, defined as total assets in year t divided by total asset in year $t-1$ minus 1; PROFIT is earnings before interest and tax divided by total assets; TANG is net fixed asset divided by total assets; LIQUID is current asset divided by current liabilities; PCON is 1 if the firm is politically connected, 0 otherwise. *, **, and *** indicate significance at 90%, 95% and 99% confidence level respectively

4.5 Regression analysis

Table 4.4 demonstrates the finding that obtained from three different sets of estimations. First column of Table 4.4 reports the result of Panel A, using the LEV dependent variable. Second column of Table 4.4 reports the result of Panel B, using the LEVLTD as dependent variable. Lastly, third column of the Table 4.4 reports the finding of Panel C, using LEVSTD as dependent variable. The result of this study is discussed based on the comparison of the results obtained from the fixed effect model (FEM).

According to Panel A, the result shows that PCON is positively significant related to LEV. The relationship is statistically significant at 5% level with t-statistic 2.58. The finding indicates that Malaysian politically connected firms had higher debt ratio. This result is consistent with (Johnson and Mitton, 2003; Fraser et al., 2006; Bliss and Gul, 2012) which suggest that political connected is linked to a firm's ability to carry more debt. This evidence strongly support the study hypothesis.

Furthermore, the results also suggest that SIZE is negative and statistically associated with LEV. The relationship is statistically significant at 1% level with t-statistic -6.58. The finding indicates that smaller firms in Malaysia had higher debt ratio compared to larger firms. This result consistent with Gupta (1969), who argues that small firms tend to depend extremely on debt. The finding also supports the study hypothesis.

Meanwhile, GROWTH is indicates insignificant as reports by Panel A. This result is certain with Fraser et al (2006), which argue the political patronage may be a better proxy for growth opportunities than GROWTH in Malaysia. Thus, this study rejects the hypothesis that indicates the Malaysian growing firms had more debt.

More, according to Panel A, PROFIT influences the LEV of firms in Malaysian industry negatively. PROFIT is negative and statistically significant at 1% level associated with LEV. the result shows that the profitable firms carry less debt, despite the fact that interest payment is also tax-deductible in Malaysia (Fraser et al., 2006) The finding is consistent with (Booth et al., 2001; Morri and Cristanziani, 2009; Baltaci and Ayaydi, 2014) that suggest firms with higher profitability will prefer internal financing over debt. Nyamita et al (2014) indicate that profitable firms use less debt for funding their investment. The result obtains is certain with this study hypothesis.

The finding on TANG as shown by Panel A is indicates that TANG has positive relationship with LEV. The relationship is statistically significant at 1% level with t-statistic 3.18. This result is consistent with this study hypothesis as well as prior studies (Rajan and Zingales, 1995; Sayilgan et al., 2006) that argue the firms with large portion of tangible assets attract the lenders to supply loans and hence increase the firm leverage. Furthermore, tangible assets have collateral value for the attainment of secured debt, which in turn increases the debt capacity of the firms and allowing them to borrow more (Antonio, Guney and Paudyal, 2008). Fraser et al (2006) argue that in a bank dominated financial system, as applies in Malaysia, firms may well have no choice but to initiate strong relationship with their banks. Thus, explain the favor of tangibility toward debt in Malaysian firms.

Lastly, based on the Panel A, the result shows that LIQUID is negative and statistically correlated to LEV. The relationship is significant at 1% level with t-statistic -5.52. This finding is consistent with (Deesomsak et al., 2004; Sheikh and Wang, 2011; Sarlija and Hanc, 2012; Masoud, 2014; Nyamita et al., 2014). Huberman (1984) argues the desirable of liquidity is due to the ability of firms to use its own liquid assets quickly without going to the capital market under a certain circumstances. Therefore, the prominent negative correlation result can be indication that the firms in Malaysia, with more liquid assets used them as internal sources of funds instead of debt.

Next, according to the Panel B, the result indicates that PCON is positively associated with LEVLTD. The relationship is statistically significant at 1% level with t-statistic 3.62. This result suggests that political connection firms in Malaysia tends to adopt long-term debt as one of their funding sources since long term debt is a practical way to get immediate funds to finance and operations. This finding is in line with Charumilind, Kali and Wiwattanakantang (2006) that indicate the politically connected firms had greater preferential access to long term debt. The result is certain with the finding estimates by Panel A.

Based on the Panel B, only TANG is consistent with the result argues by Panel A while the other four variables provide different evidences. The result on SIZE indicates positive correlation with LEVLTD. The correlation is statistically significant at 1% level with t statistic 4.63. This result indicates larger firms in Malaysia carry more debt especially long-term debt.

This result is supported by prior studies (Samarakoon, 1999; Pandey, 2001; Drobetz and Fix, 2003; Johnson and Mitton, 2003; Sayilgan et al., 2006; Brav, 2009). Chen et al., (2014) suggest that larger firms are associated with high leverage due to their better debt financing capability. However, GROWTH, PROFIT and LIQUID are indicated insignificant as reports in Panel B.

According to Panel C as shown in Table 4.4, PCON is indicated insignificant related to LEVSTD. This shows no evidence that politically connected firms favor short-term debt as their one of financing sources. Furthermore, three variables (SIZE, PROFIT and LIQUID) have consistent results as estimates by Panel A. SIZE, PROFIT and LIQUID are negative and statistically related to LEVSTD. All the relationships are significant at 1% level with t-statistics -10.58, -12.63 and -6.16 respectively. GROWTH and TANG however, provide different findings.

From Panel C, the result shows that GROWTH is positively related with LEVSTD. The results are statistically significant at 10% level with t-statistic 1.76. This finding is consistent with Pandey (2001) which suggests that Malaysian firms favor short-term debt as one of the finance source for their firms' growth. Meanwhile, TANG is reported as negative and statistically connected with LEVSTD. The correlation is significant at 5% level with t-statistic -2.07. The result is supported by (Song, 2005; Bevan and Danbolt, 2000) that report the tangibility has a positive relationship with LEV and LEVLTD but negatively correlated to LEVSTD which consistent with maturity matching principle. The principle indicates that long-term debt are used to finance fixed assets while non-fixed assets are financed by short-term debt

Table 4.4 Regression analysis

Independent variable	Panel A	Panel B	Panel C
	Dependent variable: LEV	Dependent variable: LEVLTD	Dependent variable: LEVSTD
	FEM	FEM	FEM
Constant	1.0407*** (8.06)	-0.2772*** (-4.31)	1.3179*** (12.14)
SIZE	-0.0656*** (-6.58)	0.0230*** (4.63)	-0.0886*** (-10.58)
GROWTH	0.0004 (1.10)	-0.0001 (-0.76)	0.0005* (1.76)
PROFIT	-0.2596*** (-10.54)	0.0020 (0.17)	-0.2617*** (-12.63)
TANG	0.1153*** (3.18)	0.1782*** (9.87)	-0.0629** (-2.07)
LIQUID	-0.0048*** (-5.52)	-0.0003 (-0.67)	-0.0045*** (-6.16)
PCON	0.0452** (2.58)	0.0316*** (3.62)	0.0135 (0.92)
R-square	0.0768	0.0511	0.1078
F-statistics	36.35***	23.51***	52.83***
Hausman test Chi ² (6)	96.97***	13.72**	119.05***
Observation	2920	2920	2920

Notes: LEV is total debt divided by total assets; LEVLTD is total long-term debt divide by total assets; LEVSTD is total short-term debt divided by total assets; SIZE is the natural logarithm of total assets. GROWTH is growth of total assets, defined as total assets in year t divided by total asset in year $t-1$ minus 1; PROFIT is earnings before interest and tax divided by total assets; TANG is net fixed asset divided by total assets; LIQUID is current asset divided by current liabilities; PCON is 1 if the firm is politically connected, 0 otherwise; *, **, and *** indicate significance at 90%, 95% and 99% confidence level respectively

4.6 Conclusion

Of all the independent variables chosen for this study, SIZE, PROFIT, TANG and LIQUID has the most statistically significant relation to leverage. PCON also has a statistically relation with leverage especially with long-term debt ratio. This indicates that PCON also do play an important role in determinant of financing sources.



CHAPTER V

CONCLUSION

5.1 Introduction

This chapter concludes the overall study and consists of five sections. Section 5.2 reports the findings' summary while section 5.3 outlines the implications of the study. Section 5.4 provides the limitations of the study and lastly section 5.5 provides the recommendation for future research.

5.2 Summary of the study

This study explores the link between political connection and corporate financing of 292 Malaysian listed firms over 10 year period, 2006 to 2015. This study only focuses on two sectors in Malaysia which are trading and service sector and industrial products sector. This study adopts fixed effect method (FEM) in order to test the hypotheses.

The main hypothesis of the study is the political connection firms have a positive relationship with firm debt. In line with this hypothesis, the result shows a positive and statistically significant relationship between political connections (PCON) and debt ratio (LEV). The result is also consistent with Johnson and Mitton, (2003), Fraser et al.,(2006) and Bliss and Gul,(2012) whose find firms with political connections bear more debt compared to firms without political connections.

This study also includes other variables such as firm size (SIZE), firm growth (GROWTH), profitability (PROFIT), liquidity (LIQUID) and asset tangible (TANG) in order to explore the elements that influence the decision of corporate financing. The results of the study show that SIZE, PROFIT, LIQUID and TANG along with PCON have an effect on corporate financing.

In addition, the findings show that firm size (SIZE) has negative links with total debt ratio (LEV) and short term debt (LEVSTD) but positive links with long term debt (LEVLTLD). This indicates that in Malaysia, bigger firms more favor long term debt compared to smaller firms that prefer short term debt for their funds (Marsh, 1982; Titman and Wessel, 1988).

Furthermore, the results also show that asset tangible (TANG) has a positive association with debt and long term debt but a negative relationship with short term debt. The findings are consistent with maturity matching principle (Song, 2005; Bevan and Danbolt, 2000). The principle indicates that fixed assets are financed by long term debt while non-fixed assets are supported by short term debt.

Moreover, the findings also suggest that both profitability (PROFIT) and liquidity (LIQUID) has negative connection with firms' debt. This indicates that the more profitable firms in Malaysia prefer internal financing over debt, thus the firms use less debt to fund their investment (Baltaci and Ayaydin, 2014; Nyamita et al., 2014). Besides that, the firms with more liquid asset in Malaysia tends to use their own liquid assets as internal sources of funds instead of debt.

5.3 Implication of the study

This study has provided empirical evidence the practice of establishing political connection is common among the Malaysian firms. This practice surely could disrupt the unbiased resources allocation for the Malaysian firms if such activity is not reduced since the politicians and governments adore the politically connected firms. Politically connected firms tend to obtain substantial benefits from their association with government such as easier access for credit and subsidies compare to firms without political connections. Such relationship would lead to the opportunity for corruptions among the politicians, governments and the Malaysian firms. In a long run, mixture of politics and business will ruin the future economy of Malaysia since resources are not being used systematically. Therefore, it recommends that Malaysian government has to strengthen the supervision of political connection between firms and politicians.

5.4 Limitation of the study

Several main limitations are recognized in this study. Firstly, this study only focuses on two sectors that listed in Main Market of Bursa Malaysia which are trading and service sector and industrial products sector. There are other non-financial sectors that have been left out including consumer products, construction, mining, technology, plantations and properties. The finance based firms are excluded as under Financial Service Act 2013 (FSA) and governed under different regulatory body (Bliss and Gul, 2012). Thus, the results do not portray the other sectors in Malaysia. In order to get more satisfying and accurate result, a larger sample should be employed.

The study also only focuses for Malaysian firms which would condescendingly imply that the finding or information obtained from this study only give practical knowledge for policy maker and investors in Malaysia. Other countries other than Malaysia is encouraged to investigate this issue in order to supply practical knowledge for their policy makers and also investors as different countries have their own policy, background and even culture.

Furthermore, data gathering particularly for political connection variable is crucial in to this study. However, the information of political connection firms is identified based on suggestions by Faccio et al., (2006). This study identifies the firms' connection solely based on the firms' annual report and online information through the 10 year period. This hand-collected information might provide inaccurate information regarding the politically connected firms. Furthermore, the data obtained from DataStream also incomplete thus some firms need to be removed from the sample.

5.5 Recommendation for future research

This study provides a basis for future research on political connections and corporate financing based on the Malaysian trading and service sector and industrial products sector. Future research is needed to fully understand the determinant of firms' financing. Recommendations for future research are:

1. This study only concentrates on Malaysian politically connected firms from trading and service sector and industrial products sector. An exploration on larger sectors would provide more satisfying and accurate findings.

2. Future study could also include Islamic debt along with conventional debt as one of the possible variables to be examined since Malaysian capital market consists of conventional and Islamic market. By examining the differences between Islamic debt and conventional debt, researchers would be able to learn whether Islamic debt is more expensive than conventional debt.
3. Furthermore, this study also recommends future research to include other firm specific variable such as tax in order to capture the benefits of debt financing.
4. Since this study only limited in Malaysia only, further research could provide evidence from other countries in order to enhance the understandings on political connection from different geographical background.



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