

CORPORATE CHOICE BETWEEN STRAIGHT DEBT AND CONVERTIBLE DEBT  
IN MALAYSIAN CAPITAL MARKET

By

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## DECLARATION

I hereby declare that the project paper is based on my original work except for quotations and citations that have been duly acknowledged. I also declare it has not been previously or concurrently submitted for any other Master's programme at UUM or other institutions.

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Date: 24 APRIL 2008

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## ABSTRACT

Malaysia capital market financing is developing along with the economy. It is aimed to meet the expanding financing needs. This study is interested to examine the firm specific characteristics that determine corporate choice between straight debt and convertible debt. 136 debt offerings are identified as the sample for the study, consisting of 107 straight debts and 27 convertible debts from year 2001 through 2007. Nine predetermined explanatory variables namely tax consideration, debt ratio, tangibility, firm size, growth opportunities, profitability, net operating cash flow (NOCF), interest coverage and board of listing are analysed by using binary logistic regression. Tax consideration is proxied by non debt tax shield and debt tax shield in which they are regressed separately. This study also introduces two additional explanatory variables i.e. interest coverage and board of listing. Initially, only two explanatory variables are found to be statistically significant i.e. debt ratio and growth opportunities, denoted by market-to-book ratio. Subsequently, the predictive quality of each equation is examined and found that there is an existence of multicollinearity. As a result, corrective analysis is presented. It illustrates that non debt tax shield; debt ratio and firm size are statistically significant. These results explain that tax consideration, debt ratio and firm size influence the corporate choice when deciding between straight debt and convertible debt. It is reported that firms with higher non debt tax shield are more likely to issue straight debt which is in contrast to the tradeoff theory. This shows that firms in Malaysia are also utilising the potential tax benefit from non debt item such as depreciation in addition to tax deductible interest payment. Therefore, the empirical results from this study do not completely conform to the tradeoff theory. As for debt ratio, the finding is consistent with the implications of the financial distress and tax benefits hypotheses in which firms with higher debt ratio have a tendency to issue equity-like instrument, i.e. convertible debt. Conversely firms with lower debt ratio would issue straight debt. Results also show that firms with larger firm size are more likely to issue straight debt whereas firms with smaller firm size are more likely to issue convertible debt. This postulates a positive relation between firm size and debt which is also consistent with tradeoff theory since larger firms have been shown to have lower bankruptcy risk and relatively lower bankruptcy cost. In addition to the above results, it is discovered that non debt tax shield is more appropriate to represent tax consideration in the Malaysia capital market instead of debt tax shield. This study also introduces two additional explanatory variables i.e. interest coverage and board of listing of companies in Bursa Malaysia. However, both variables are insignificant, thus they could not explain the choice between straight debt and convertible debt.

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## LIST OF ABBREVIATIONS

9MP	Ninth Malaysian Plan
BL	Board of listing
BNM	Bank Negara Malaysia
CMP	Capital Market Master Plan
DR	Debt ratio
DTS	Debt tax shield
EBIT	Earning before Interest and Tax
FS	Firm size
GDP	Gross Domestic Product
GO	Growth opportunities
IC	Interest coverage
MGS	Malaysia Government Security
NDTS	Non debt tax shield
NOCF	Net operating cash flow
PDS	Private Debt Security
PR	Profitability
TG	Tangibility

# **CHAPTER ONE**

## **BACKGROUND OF STUDY**

### **1.0 Introduction**

Chapter One discusses the background of the study. This chapter is then subdivided into a few sections. Section 1.1 reviews the economic growth and development in Malaysian capital market, followed by problem statements in section 1.2 and research objectives in section 1.3. Subsequently, section 1.4 states the significance of the study while section 1.5 mentions about the limitations of the study. Section 1.6 provides conclusion for chapter.

### **1.1 Economy Growth and Development in the Capital Market**

In 2006, Bank Negara Malaysia (BNM) in its annual report affirmed that the Malaysian economy was stronger and more resilient given that real gross domestic product (GDP) expanded by 5.9%, up from 5.2% in 2005. A significant development during the year was the release of the Ninth Malaysia Plan (9MP) in March 2006. Over the lifetime of the Plan, the Federal Government has targeted a 17.6% increase in spending on development and infrastructure projects. Henceforth, public sector expenditure was higher specifically on supplies and services for maintaining and improving public delivery system (BNM Annual Report, 2006). Table A in the appendix shows that public sector expenditure increased by 7.2% in 2006 as

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The significant variables could also guide the policy makers in promoting the issuance of PDS securities to enhance the capital market. Given the financial characteristics, policy makers could forecast the potential issuance of these PDS instruments, can better identify potential issuers as the target group for promotion and education activities. Moreover, based on this study the choice of financing instrument can now be used as a signalling device. Investors could predict the degree of excellence of the firms as a going concern and evaluate the trade off of the risk and return of their investments.

Last but not least, for those who wish to investigate further on corporate financing choice, it is suggested that they cover other firm specific characteristics, together with tax consideration, firm size and debt ratio, as determinants of financing choice. Future researchers on this topic may also use survey and interview method to gauge top management perspectives on this issue. The findings will provide interesting comparison to the findings from this study.

#### **5.4 Conclusion**

This chapter wraps up this study by discussing the overview of research process, the summary of the findings and comparison with some prior studies. Results show that tax consideration denoted by non debt tax shield, debt ratio and firm size are the determinants of security choice for firms in Malaysia. This study is expected to contribute to the decision making of a firm when deciding for external funds.

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