THE EFFECT OF DEBT RESTRUCTURING SCHEME ON THE PERFORMANCES OF MALAYSIAN FIRMS

BY

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ABSTRACT

Previous studies have found that the out-of-court restructuring strategy was one of the most preferred restructuring exercises practised during the 1997 Asian financial crisis (see Haley, 2000; Mako, 2001). The out-of-court strategy is a strategy that involves negotiation between a company, its creditors and other related parties to find the best solution for the company's debt problems without having to resort to legal proceedings. This strategy seems popular, as many Asian countries have adopted it. In Malaysia, such a strategy is facilitated by the Corporate Debt Restructuring Committee (CDRC) Although the progress of the CDRC is very encouraging (see Chotigeat and Lin, 2001; Nor Azimah, 2001), the effect of the scheme on the companies has never been tested. Therefore, this study has examined the effect of the CDRC's debt restructuring scheme on the companies' performances based on seven public listed companies which had successfully completed the scheme by the year 2000. This study have analysed two areas, i.e., the companies' capital structures (using six leverage ratios) and the companies' financial performances (using three profitability ratios). The hypotheses of this study are that (a) there will be a significant decrease in the companies' leverage ratios after the restructuring process, and (b) there will be a significant increase in the companies' profitability ratios after the restructuring process. Based on the paired sample *t*-test, the Wilcoxon matched-pairs signed rank test and the effect size test, the study finds little evidence to support the hypothesis on the capital structures but finds sufficient evidence to support the hypothesis on the financial performances. Thus, this study concludes that the scheme did not greatly improve the companies' capital structures, but did improve the companies' financial performances.

خلاصة البحث

توصلت الدراسات السابقة إلى أن استيراتيجية إعادة الهيكلة التي لا تعتمد على المحاكمات القضائية تعد من أبرز العمليات التي طبّقت خلال الأزمة الاقتصادية التي مرت بها آسيا عام 1997م (راجع هالي، 2000؛ ماكو، 2001). فالاستيراتيجية التي لا تعتمد على المحاكمات القضائية تستلزم عقد المفاوضات بين الشركات والدائنين وجهات أخرى معنية، وذلك لبحث الحل الأنسب لمشاكل ديون الشركة دون اتخاذ دعاوى قانونية. وتبدو أن هذه الاستيراتيجية شائعة الاستخدام نظرا إلى أن معظم الدول الآسيوية قد قامت بتنفيذها. وعلى صعيد ماليزيا، فإن تطبيق هذه الاستيراتيجية يتم تحت إشراف الهيئة التنفيذية لإعادة هيكلة الديون التجارية (CDRC). ورغم أن تطورات هذه الهيئة بدت مشجعة (راجع شوتيكات ولين، 2001؛ نور عزيمة، 2001)، إلا أنه لم يسبق دراسة مدى أثر تنفيذ هذا المشروع على الشركات. وبناء على ذلك، فإن هذا البحث يقوم بدراسة أثر مشروع إعادة هيكلة الديون التي تشرف عليه الهيئة التنفيذية لإعادة هيكلة الديون التجارية على إنجازات الشركات، وذلك من خلال سبعة شركات مسجلة في سوق الأسهم التي حققت نجاحا كبيرا في تنفيذ المشروع في نهاية عام 2000م. وقد قام البحث بتحليل الموضوع من محورين، هما: هيكل رأس مال الشركات (باستخدام ستة نسب الروافع الاقتصادية)، والكفاءة المالية للشركات (باستخدام ثلاثة نسب إرباحية). ويستند هذا البحث على الفرضيات التالية: أ) حدوث انخفاض ملحوظ في نسب الروافع الاقتصادية للشركات بعد تنفيذ مشروع إعادة الهيكلة: ب) وفي الوقت نفسه، حدوث ارتفاع ملحوظ في النسب الإرباحية لها. وبتطبيق اختبارات النموذج الزوجي (paired sample *t*-test)، وويلشوكسون (Wilcoxon matched-pairs signed rank test) واختبار حجم الأثر الحاصل (effect size test)، فقد لوحظ إلى أن هناك شواهد محدودة تؤيد فرضية هيكل رأس المال، في حين أن هناك شواهد أخرى كافية لدعم فرضية الكفاءة المالية. وبالتالي فقد استنتج البحث أن مشروع إعادة هيكلة الديون لا يترك أثرا فعالا في هيكل رأس مال الشركات، بينما كان لها الأثر الواضح في تحسين الكفاءة المالية لها.

APPROVAL PAGE

I certify that I have supervised and read this study and that in my opinion, it conforms to acceptable standards of scholarly presentation and is fully adequate, in scope and quality, as a dissertation for the degree of Master of Science in Accounting.

Unvar Rahman Abdul Muthalib
Supervisor

I certify that I have read this study and that in my opinion it conforms to acceptable standards of scholarly presentation and is fully adequate, in scope and quality, as a dissertation for the degree of Master of Science in Accounting.

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7/10/03

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Mansor Hj. Ibrahim
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DECLARATION

I hereby declare that this dissertation is the result of my own investigation, except where otherwise stated. Other sources are acknowledged by footnotes giving explicit references and a bibliography is appended.

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	Date

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LIST OF ABBREVIATIONS

ANOVA	Analysis of variance
BNM	Bank Negara Malaysia
CAPM	Capital asset pricing model
CCM	Companies Commission of Malaysia
CDRAC	Corporate Debt Restructuring Advisory Committee
CDRC	Corporate Debt Restructuring Committee
Danaharta	Pengurusan Danaharta Nasional Berhad
Danamodal	Danamodal Nasional Berhad
EPS	Earning per share
EVA	Economic value-added
FIC	Foreign Investment Committee
GDP	Gross domestic product
IBRA	Indonesian Bank Restructuring Authority
ICULS	Irredeemable convertible unsecured loans stock
IDRA	Indonesian Debt Restructuring Authority
KLSE	Kuala Lumpur Stock Exchange
LDTCP	Long-term debt to total capital
LDTCZ	Long-tem debt to total capitalization
LDTD	Long-term debt to total debts
M&A	Memorandum and articles of associations
PLUS	Projek Lebuhraya Utara-Selatan Berhad
PN4	Practice note no. 4
NPLs	Non performing loans
ROA	Return on assets
ROB	Registrar of Businesses
ROC	Registrar of Companies
ROE	Return on equity
SC	Securities Commission of Malaysia
SPSS	Statistical package for social sciences
TATE	Total assets to total equity
TDTA	Total debts to total assets
TDTCP	Total debts to total capital
TDTE	Total debts to total equity
UEM	United Engineers (Malaysia) Berhad
UK	United Kingdom
US	United States of America
VIF	Variance inflation factor

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CHAPTER ONE

INTRODUCTION

1.0 BACKGROUND OF STUDY

The outbreak of the Asian financial crisis in July 1997 had caused many companies in Asia to struggle for survival. Due to these unfavorable economic conditions, there were many companies facing financial difficulties (Nor Azimah, 2001). Some of the companies had no choice but to file for bankruptcy while some lucky companies opted for restructuring. Restructuring may help companies to continue to run and delay the process of liquidation for the benefit of their creditors (Altman, 1993).

In response to the above mentioned crisis, the governments of the Asian countries took the necessary action to support their corporate citizens by introducing many corporate restructuring options. Some affected Asian governments also established new government bodies to help those ailing companies to restructure themselves. Prior studies have reported that one of the popular options for many Asian companies was the use of the out-of-court restructuring strategy (see Haley, 2000; Mako, 2001). The out-of-court strategy involves negotiations between the respective ailing company, its creditors and other related parties to identify the best solution for the company's financial and debt problems without having to resort to legal proceedings.

In Malaysia, the government also responded to this crisis by introducing many restructuring options including the out-of-court strategy option. For example, the Corporate Debt Restructuring Committee (hereafter termed the CDRC) was initiated in July 1998 as a non-statutory body to facilitate the operation of this strategy. The main role of the CDRC is to assist those troubled but viable companies in restructuring their debts. Since its establishment, the CDRC has fulfilled its responsibilities successfully. The progress of the CDRC is also very encouraging (see Chotigeat and Lin, 2001; Nor Azimah, 2001). Nevertheless, the effect of the scheme in improving the performances of the companies which had undergone the process has never been tested. We can only assume that those distressed companies were able to reverse their bad financial position and become liquid as soon as they completed the scheme. For this reason, this research attempts to provide some evidence on that matter and study the effect of the debt restructuring scheme on the companies' performances.

1.1 RESEARCH OBJECTIVES

The purpose of this research is to study the effect of the CDRC's debt restructuring scheme on the capital structures and financial performances of the distressed companies. There are two areas to be observed. First, is to examine the changes in the companies' capital structures. Second, is to identify the differences in the companies' financial performances. In addition, this study is also interested in testing the relationship between the capital structures and the financial performances. This is to find evidence as to whether the changes in the companies' capital structures can significantly affect the changes in the companies' financial performances.

1.2 SIGNIFICANCE OF THE STUDY

This study contributes to academia in at least four important areas. Firstly, this study enables us to evaluate the effect of the CDRC's debt restructuring scheme on the capital structures and financial performances of the companies. The result of this study can provide evidence of whether the implementation of such a scheme is effective or otherwise in improving the companies that faced financial difficulties. This is important as we do not only need to study the factors that caused financial difficulty (Liu, 2000), but we also need to be aware of the effective ways of overcoming the problem.

Secondly, this study allows us to document the types of changes which took place in the capital structures and financial performances of the companies that had implemented the restructuring scheme. This information will enable investors, stock analysts, creditors, shareholders as well as the companies themselves to understand the scheme better.

Thirdly, this study documents evidence on the relationship between the companies' capital structures and the companies' financial performances. This fact contributes to the knowledge of investors, analysts and researchers in analyzing and understanding the capital structures behavior of companies in Malaysia.

Finally, this study also gathers details on the CDRC. Thus, this study can be a useful reference to analysts, academicians and members of the public who are interested in knowing and learning more about the CDRC.

1.3 OUTLINE OF THE STUDY

This study consists of eight chapters. The next chapter, chapter two, reviews prior studies in the areas of financial difficulties, capital structures, leverage, the 1997 Asian financial crisis and corporate restructuring schemes. Chapter three provides a brief background on the Malaysian business environment as well as the operational part of the CDRC. Then, chapter four discusses the research questions and hypothesis development. Next, chapter five describes the data selection procedures and data compilation, i.e., the sample and data used in this study, while chapter six explains the research method. The empirical results are analyzed in chapter seven. Finally, chapter eight provides a summary and conclusion to the study.

CHAPTER TWO

LITERATURE REVIEW

2.0 INTRODUCTION

Borrowing is beneficial to companies as a tax shield but it can also increase the risk to the companies (Mansor and Jin-Ken, 2001). For example, during bad times, a company's burden may increase to a level at which it is unable to fulfill its obligation to service the interests on the debts. With losses and excessive debts, the situation may trap the company in a situation of financial distress.

The 1997 Asian financial crisis had forced many companies into financial difficulties (see Gray, 1999; Nor Azimah, 2001). With the increase in interest rates, the situation became worse, as many highly leveraged companies were unable to meet their interest payment commitments. Knowing the companies' inability to meet their debt obligations, the respective governments in many affected Asian countries initiated substantial corporate restructuring schemes to assist their corporate citizens.

This chapter aims at analyzing the corporate restructuring schemes that evolved in some Southeast Asian countries subsequent to the 1997 financial crisis, including a detailed explanation of the corporate restructuring schemes that were made available by the Malaysian government. This chapter, also, highlights prior studies which show that the high leveraged companies are more exposed to financial distress than the low leveraged companies, especially during times of crisis.

The remainder of the chapter is organized into five sections. Section 2.1 briefly discusses the relationships of debt, leverage and financial difficulties. Section 2.2 provides examples of corporate restructuring schemes that evolved in some Southeast Asian countries other than the sample country, Malaysia. Section 2.3 describes the corporate restructuring schemes in Malaysia before and after the financial crisis. Section 2.4 analyses the overall performances and the effect of newly implemented corporate restructuring schemes in Malaysia. Lastly, section 2.5 provides a summary of the chapter.

2.1 DEBT, LEVERAGE AND FINANCIAL DIFFICULTY

Bukics and Engle (1994) state that the key factor that affects the company's inability to meet its financial obligations and commitments is cash shortage. The cash deficiency may come from various business events or trends, and may be temporary or permanent in nature. If the cash shortage cannot be reversed, the company may be forced into bankruptcy and has to liquidate its business assets in order to satisfy its creditors. Similarly, Section 218 (1)(e) of the Malaysian Companies Act, 1965 states that the court has the right to wind up a company if the company is unable to pay its debts. Section 217 (1)(b) of the same act states that any creditor has a right to sign a petition to the court in order to wind up a company. For this reason, highly leveraged companies are prone to be forced into liquidation by others when they are short of cash and unable to pay their debts.

The leverage patterns among Malaysian firms have been studied by Mansor and Jin-Ken (2001). They study the leverage patterns of 174 Malaysian public listed companies over a decade, i.e., from 1990 to 1999, in seven different industries.[1] They examine the leverage patterns of the companies using three debt ratios, i.e., total debts to total assets (hereafter termed the TDTA), long-term debt to total capitalization (hereafter termed the LDTCZ) and long-term debt to total debts (hereafter termed the LDTD). Using the one-way ANOVA[2] and the Kruskal-Wallis test, they find that the first two ratios are significantly different across industries and over time. On the other hand, the LDTD is different across industries but stable over time within the same industry.

Mansor and Jin-Ken (2001) also focused on the effect of leverage on the companies' financial performances in three of the largest industries, i.e., consumer products, industrial products and trading services, to study the influence of the level of debts on the companies' performances. The leverage is defined using the TDTA, and the financial performances are measured using three profitability ratios, i.e., economic value-added (hereafter termed the EVA), return on asset (hereafter termed the ROA), and return on equity (hereafter termed the ROE). They have divided the companies in each industry into four quartiles based on the TDTA and analyze the data using the ANOVA and the Kruskal-Wallis tests. The results demonstrate that leverage has an impact on the financial performances of the companies. In general, the means of firms with a lower leverage ratio have always outperformed, i.e., the means of profitability ratio always been higher than the means of firms with a higher leverage ratio. Even during the crisis years, i.e., 1997-1998, the results were consistent.[3]

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[1] The seven industries are consumer products, industrial products, construction, trading, services, properties, plantation, and mining

[2] Analysis of variance

[3] During the normal economic year as well as during the financial crisis year

Another study on the effect of financial crisis is by Norezuan (1999). He studies the effect of leverage on the stock prices before and after the 1997 Asian crisis using the CAPM.[4] His sample consists of 84 public listed companies, and is divided into three different quintiles based on the market capitalization. Each quintile is further divided into two groups with different levels of leverage using the total debts to total equity ratio (TDTE). The results indicate that the low leveraged companies experienced lower decline in returns compared to the higher leveraged companies, especially for the small firms. Thus, the study concludes that high levels of leverage can negatively affect the companies' stock performances.

The above studies show that the performance of a company can be affected by the level of debts. Normally, the companies with high debt and leverage ratios would possibly face financial difficulties when the economic conditions change. One possible scenario where such circumstances arise is when there is an increase in interest rates, and such an event is common during times of economic crisis. The increase in the interest rate caused by the Asian 1997 financial crisis had affected many companies (see Mako, 2001). This is because the income of the companies is not enough to sustain the interest obligations once the interest rate is at the depressing and uneconomic level (Norezuan, 1999). When companies are unable to meet the debt repayment schedules, they are further burdened with heavier debts. Due to this unfavorable economic condition, there was an increase in the number of companies filing for bankruptcies. Nor Azimah (2001) provides evidence that in Malaysia there were 681 cases of dissolution in 1996, 1,898 cases in 1997, 4,800 cases in 1998, and

[4]CAPM or capital asset pricing model, is a model that relates the required rate of return for a security to its risk as measured by beta. CAPM predicts the relationship between the risk and equilibrium expected returns on risky assets (Bodie et. al, 1998).

3,778 cases up to September 1999 (more issues on leverage and financial distress are also discussed in chapter four).

The respective governments in the Asian countries took some precautionary measures to assist the companies that were financially troubled during the crisis. Many corporate restructuring schemes have evolved in these affected countries either through legal proceedings or under informal out-of-court settlements (see Haley, 2000; Mako, 2001). However, many countries favored the latter method as it is found to be more effective in assisting the financially troubled companies (see Mako, 2001; Nor Azimah, 2001).

2.2 CORPORATE RESTRUCTURING SCHEMES

Haley (2000) states that there are at least three broad strategies that exist for corporate restructuring schemes, i.e., centralized, decentralized and the London approach to restructuring schemes. In the centralized approach, the respective governments play significant roles and the approach requires a high level of stakeholders' confidence in the government. These types of strategies are suitable for small corporate debts and simple corporate structures. This approach was used in Sweden in the early 1990s and in Hungary in the mid 1990s.

The second strategy, i.e., the decentralized approach, is proven to be more effective for restructuring companies with large debts and more complex corporate structures. This is when the financially troubled companies enter into a restructuring agreement voluntarily with their creditors without the government's involvement. This strategy was common in the United States (US) in the 1990s.

The third strategy, i.e., the London approach, is known as an intermediate strategic approach. It evolved in the United Kingdom (hereafter termed the UK) during the recession of the early 1970s. The strategy under the London approach involves informal guidelines and out-of-court negotiations. The government acts only as a mediator in this voluntary agreement between companies and their creditors. The parties involved in the restructuring schemes are encouraged to follow specific guidelines set out by the government. The most important one is that it aims at minimizing losses among all parties concerned (Mako, 2001).

Although the development of corporate restructuring in each of the Southeast Asian countries has not been the same, Haley (2000) points out that these countries had followed the London approach according to which the out-of-court restructuring schemes were practised in these countries. Mako (2001) also finds that many of the affected countries have adopted the London approach with some modifications in their corporate restructuring strategies. Such practise in Indonesia, Korea, and Thailand are discussed briefly below:

The Indonesian government established the Indonesian Bank Restructuring Authority (IBRA) in January 1998 and the Indonesia Debt Restructuring Agency (IDRA) in July 1998 to assist in restructuring the troubled banks and foreign corporate debts respectively. Further, in November 1998, the Jakarta Initiatives were purposely launched to help financially troubled companies. The system of the Jakarta Initiatives is similar to the London approach as it involved out-of-court negotiations between the financially troubled companies and their creditors (Haley, 2000; Mako, 2001).

The Korean government introduced three different restructuring strategies. The government helped the big four *chaebols* to (a) reduce their debt-equity levels to below 200 percent by the end of 1999, (b) eliminate the existing cross guarantees between subsidiaries in different lines of business, and (c) consolidate businesses by exchanging non-core business with other *chaebols*. For the medium-sized *chaebols* and large corporations, the government followed the London approach strategies to mediate out-of-court solutions between the troubled businesses and their creditors. As in the case of small and medium-sized enterprises, the government postponed their restructuring operation and left this process to be sorted out between the creditors and the debtors. However, they were given the privilege of easy access to working capital loans for survival (Haley, 2000).

In Thailand, the Bank of Thailand issued new regulations for debt restructuring exercises and established the Corporate Debt Restructuring Advisory Committee (hereafter termed the CDRAC) in July 1998 (Mako, 2001). The approach used by the CDRAC basically resembled the London approach as it required out-of-court negotiations between the parties to the debt agreements. The CDRAC is responsible for determining the policies concerning debt restructuring and acts as a mediator of the negotiations between the parties concerned (Haley, 2000; Chotigeat and Lin, 2001).

2.3 CORPORATE RESTRUCTURING SCHEMES IN MALAYSIA

Nor Azimah (2001) studies the implementation of the Malaysian corporate restructuring framework both before and after the outbreak of the Asian financial crisis in 1997. She states that financially troubled companies are normally given two options to proceed with restructuring, i.e., statutory or non-statutory options. While the