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THE EFFECT OF LEVERAGE ON MALAYSIAN STOCK PRICES
BEFORE AND DURING THE CORONAVIRUS

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The Effect of Leverage on Malaysian Stock Prices Before and During the
Currency Crisis

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DR AZMI OMAR

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“Nineteen ninety-seven is the year of the ox..., as you know the ox pulls the yoke to plow the land and turn over the soil. Accordingly, in 1997, there will be a tendency for many things to be turned upside down.”

Putri Wong Kam (Astrologer/Geomancer)

Jakarta Post, December 1996.

Abstract

The Effect of Leverage on Malaysian Stock Prices Before and During the Currency Crisis

The importance of leverage in current competitive market cannot be under-estimated and its excessiveness, on the other hand, could cause firms to shutdown, lay-offs and the whole society to suffer.

The current economic shape of the country is pervasive with debt and over-leverage. Most Malaysian corporations', in monopolistic and competitive industry, income is not able to sustain the interest obligation once interest rates reach such a depressing and uneconomic level.

These studies assess the stock return performance of 84 companies with varying degrees of leverage. Using differing estimates of expected return, it consistently finds evidence of negative excess return in both periods with a mixed degree of correlation between leverage and stock return. The results might be driven by the overall market pessimism in the regional stock markets and also the country risks embedded in the pricing of the KLSE stocks.

Chapter One

INTRODUCTION

Background of study

The financial crisis that has taken place since July 1997 has put many Malaysian companies in jeopardy. Yet there is some evidence that some companies are less severely affected by the others. The ability of the management to anticipate the event and better able to prepare for it could be one of the factors that certainly help companies in the long run. For other companies which could not react to the crisis and make the necessary adjustments for the survival of the organizations are faced with major disasters. In portfolio management, the ability to understand the unfolding event and the effects of the financial crisis to stock prices could enhance strategic stance in portfolio selection of many funds managers. In consonant with the fundamentals of each company, each stock should perform differently given the same sweeping phenomenon due to various reasons. The sectors that their businesses are in, for example, the capital structure, the management, etc, would influence the direction of their stock prices and, if any, the magnitude of the fall.

Other than the weakening of the Asian domestic currencies, and stock markets spiraling descent, the devastating consequences of the massive outflow of funds would mean increasing inflation, increased jobless figures, declining productivity due to decreasing demand, liquidity crunch and the difficulties that companies would face in getting new credits. Paul Krugman (1996), the economic professor from MIT also writes that “ the crisis is not about the fall in the value of the currencies; it is about real problems in the financial and real sectors, especially structural ones. It is about financial excesses. The excessive risky lending of (financial) institutions that created

inflation - not of goods, but of asset prices. The overpricing of assets was sustained in part by a sort of circular process, in which the proliferation of risky lending drove up the prices of risky assets, making the financial condition of the intermediaries seem sounder than it was.” To worsen the whole situation, as retorted by a managing director of a public listed company, “in Malaysia to be successful in business, it is all about knowing the right people and having the right connections, prudent business acumen does not matter.”(Investors Digest, 1997)¹

Research objectives

This study examines the effects of firms’ financial structure based on market capitalization and leverage on the common stocks return before and during the financial crisis. Under certain conditions, more debt or leverage could increase stock prices and improve companies financial performance as measured in terms of ROE and EPS. Furthermore, equity and number of shares outstanding would shrink if debt replaces equity in the capital structure and companies repurchase and retire their own shares. If equity shrinks disproportionately faster than earnings; ROE and EPS go up dramatically as debt increases. However, it is not without financial risks because as a company’s leverage increases, earning after tax could decline because of increasing interest expenses. If a company is earning a return on capital employed less than after-tax cost of debt, leverage makes income worse no matter how big the market capitalization of the companies. In this regards, ROE and EPS will decrease with increasing leverage because the firm is earning less on capital than it is paying for the use of borrowed funds. This is especially true during the currency crisis. Other than

¹ See also Investors Digest, Mid September 1997, :10-12

the weakening of Asian domestic currencies, stock market decline due to the massive outflows of funds, the devastating consequences of the financial crisis to the Malaysian aggregate economy, small firms with high leverage should perform adversely compared to those with lower leverage. The same with those two segments which contain average and large firms. These consequences should be reflected in their stock prices.

Furthermore, this paper will not only examine the impact of the economic crisis to Malaysian high leverage companies, it will try to provide some insights of the structural characteristics of these companies.

Lastly, this paper will also analyze the efficiency of the market for stocks which are having disproportionate amount of leverage in the capital structure and its consequences during the economic crisis. Several explanations for these findings, if any, will be tested by using the estimates from the expected returns. The results might not be thoroughly explained by the inefficiency of the market but rather by the distinct riskiness of the stocks.

Significance of the study

This study would be significant in at least 3 important areas:

- 1) This study will provide evidence that by having more debt in the capital structure could be more damaging to the company long-term attractiveness. In the viewpoint of the investors, by having more debt, much of the profit is not going to be earned by the company or the shareholders but rather by the lender. In the end, the shareholders would not receive the highest potential dividend.

- 2) This study will also provide the knowledge and understanding of the debt structure of Malaysian companies. Much of the works done in the literature reviews are focused on foreign companies. There is nothing being done on the Malaysian companies especially during the economic crisis.
- 3) Probably, the most important aspect that the paper contributes is the strategic level of debt and equity ratio that Malaysian companies should target for. Pay-off between the two could certainly determine the long-term capital structure of the companies in order to compete strategically and successfully.

This paper consists of six chapters. The subsequent chapter, chapter 2, will present reviews of various researches already conducted in the areas of capital structure, timing of the issues, dividend yield, size of the companies, and the structural characteristics and market beta. Chapter 3 will describe and analyze financial crisis in general and its impacts. A description and analysis of the methodology adopted are discussed in chapter 4, while chapter 5 will analyze the empirical results. Lastly, chapter 6 will conclude the paper.

Chapter Two

Literature Review

Often as noted earlier, performances of companies' stock prices depended on various important factors. These include the capital structure, timing of the issue, dividend yield, size of the companies, structural characteristics and market beta. These elements play in various degree important role and affect differently on different stock prices.

Capital Structure Theory

Capital structure remains as the most important aspect in the survival of a company. The ability of firms to find the cheapest funding cost would reduce the downside risk during hard times. Because of that, firms do have different proportions of debt in their capital structure, shares of different companies, even in the same class, can give rise to different probability distributions of returns (Modigliani, Miller, 1958). Hence, shares are subject to different degrees of financial risk and cannot be a substitute for one another. It is pertinent for portfolio managers to examine these varying degrees of debt exposure and its impacts on the stock returns. Furthermore, the importance of optimal capital structure is evidence in today's corporations especially during the financial crisis. Because of the increased exposure in interest rates, if they have large borrowing, not only heavy debt proportions could affect their share prices, huge debt would affect the firms' long run profitability. A firm optimal debt ratio is defined as a trade off between the cost and benefits of borrowing, by holding its assets and investment plans constant.