

CHAPTER 1

INTRODUCTION

1.1 Background of the Study

Issues of sustainability are among the areas that have been receiving more comprehensive attention from managers and investors when handling their business investment. In the finance context, the term sustainability has been used to refer to a sustainable growth rate (SGR, hereafter). The SGR is the maximum growth rate a firm can achieve without having to change its financial leverage or sell new equity (Higgins, 1977). It depends on the earnings retention ratio (R) and the return on equity ($SGR = R \times ROE$). SGR is one of the company goals in order to survive and remain attractive to their investors, bankers, and analysts. Johnson and Soenen (2003) stated that firms are required to sustain their growth by strategic planning through handling the inherent limitations and constraints of the firms' policy on leverage and dividend payout. Monitoring the current situation and company's activities by mapping the SGR can help managers to make financial planning in an efficient manner (Rădășanu, 2015).

In general, a company has suitable conditions when it can manage and improve its financial condition or is subject to pressure that requires changes in its operating or financing policies (Emery, 2000). Handling financial (capital structure and dividend policy) and operating activities (profitability and company efficiency) becomes an important factor that can influence the sustainable growth of the company. The combination of a company's operating elements and financial elements into a single measurement is a very valuable financial performance measurement for every company.

The combination of operating and financial elements associated with the SGR includes the profit margin, asset efficiency, and capital structure and retention ratio (Amouzesh, Zahra, & Zahra, 2011). A higher profit margin and debt to equity ratio coupled with a lower dividend payout and assets to sales ratio can increase the SGR and vice versa (Arellano & Higgins, 2007). Therefore, the SGR is a practically applicable concept in the modern financial management context that can be used as a strategic planning and controlling tool by a firm (Fonseka, 2012)

Based on a previous study, the role of the SGR must be considered, as it is a future-oriented measure of firm performance that may have a significant impact on firm stock price (Arora et al., 2018). Moreover, increased costs are not limited to the usual cost variety but also include the impact on the share price of employing what management believes to be excessive debt or distributing what is believed to be too little in dividends (Higgins, 1977). Thus, managing a company's financial and operating activities can increase its value and share price performance (SPP, hereafter). However, it is unclear whether capital structure, dividend policy, profitability and company efficiency directly affect SPP and whether SGR is significantly related with SPP?

In Malaysia, the inclusion and exclusion of Shariah-compliant firms from the Kuala Lumpur Shariah Index (KLSI) provide some good or bad information, which could affect investors' expectations, and, thus, the SPP of the companies involved. Based on Fama (1970), security prices move quickly and fully to reflect the different types of available information in the market whether the weak form (all past price information), semi-strong form (non-public and publicly available market data), or strong form (all information, public and non-public). As suggested by Fama (1970), if the stock market reacts efficiently and investors behave rationally, then the share prices should reflect all the information related to the Shariah-compliant certification. Figure

1.1 showed in detail the movement of FTSE Bursa Malaysia KLCI share price when there is a good or bad information especially the inclusion and exclusion of Shariah-compliant firms from the KLSI. The certification of Shariah-approved securities by the SC has become important to Malaysian companies so as to keep their present investors and to increase their market price and SPP. Therefore, the role of SGR needs to be considered as it is a future-oriented measure of firm performance that may have a significant impact on a firm's stock price (Arora et al., 2018).



Figure 1.1: The Movement of FTSE Bursa Malaysia KLCI Share Price Before and After New Screening Benchmarks in 2013

A new revised Shariah screening methodology of two-tier quantitative assessment for activity-based screening benchmarks and the newly- formulated financial ratio benchmarks, while the qualitative assessment remains the same has been formulated by Shariah Advisory Council (SAC) of Securities Commission (SC). The screening methodology was revised and improved by the SC on not only the operating activities but also the financing and investing aspects of listed firms' business operations. In determining whether a stock is Shariah compliant, a screening procedure is used.

Shariah screening of listed stocks in Malaysia is based on the parameters established by the SAC of the SC. The SAC introduced the first list of Shariah securities in June 1997 and updates the list twice a year in May and November (Abu Bakar & Ali, 2014). In 2012, the SC announced the implementation of new screening methodology benchmarks to identify the status of Shariah-compliant firms. The date of implementation of the new screening methodology effectively started in November 2013.

Moreover, ethical investments for Muslims involve financial products approved by the Shariah (Junaina Muhammad, 2015). In order to measure an ethical investment, Muslim investors will choose Shariah-compliant securities. The number of Shariah-compliant firms was reduced from 801 in May 2013 to 653 in November 2013 (refer to Figure 1.1) due to (i) firms' mixed activities, which were previously assessed under the 5, 10, 20, and 25 per cent benchmark, whereas, currently, firm activities are assessed under the 5 and 20 per cent benchmark, and (ii) companies with a high level of conventional debt; previously there was no screening based on the total conventional debt, but, currently, firm financial activities are assessed under the financial ratio benchmarks.

For the financial ratio benchmarks, the screening is based on two ratios, namely, cash over total assets and debt over total assets (Securities Commission Malaysia, 2013). These financial ratios must not exceed 33 per cent to obtain listing as Shariah-compliant firms. Maintaining the financial ratios at not more than 33 per cent is a must for Malaysian public-listed Shariah-compliant firms so that they can retain their Shariah-compliant status. About this issue, in other words, for a firm to be listed as a Shariah-compliant firm and comply with the SC financial ratio or debt ratio benchmarks (the calculation of debt only for non-shariah debt or conventional debt) it encourages

firms to have more Islamic debt instead of conventional debt. As mentioned earlier, the changes in financial and operating activities would have an impact on the SGR of a firm. Hence, financial strategies become one of the important elements for a Shariah-compliant firm to investigate because the changes in financial activities lead to a change in operating activities and would have an impact on SGR performance.

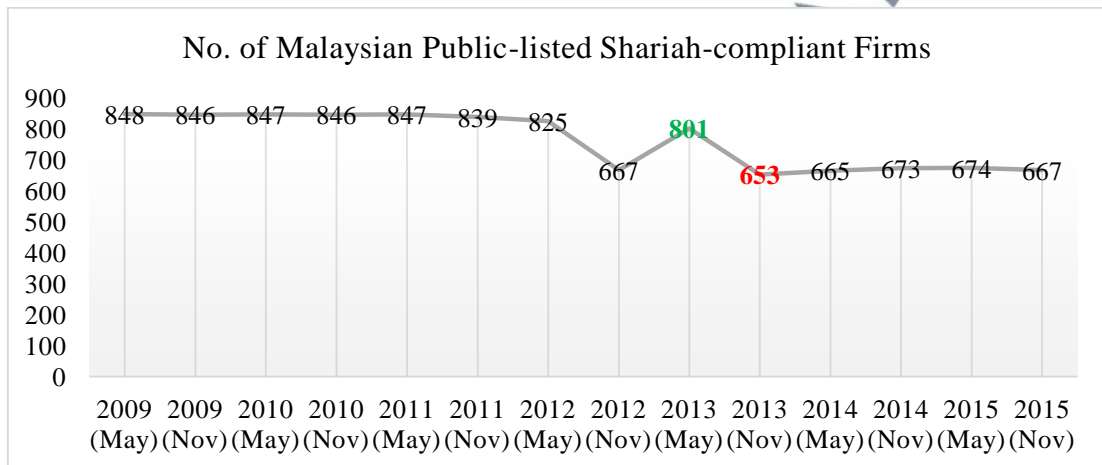


Figure 1.2: Total Number of Shariah-compliant Firms in Malaysia from 2007 to 2015

1.2 Problem Statement

Growth that is too rapid can exhaust resources, but a slow-growing company may not be able to utilise its resources effectively (Chang, 2012), while the combination of rapid growth, high debt, and decreasing profit margin may result in financial distress (McFaddin & Clouse, 1993). Sometimes, too much growth causes financial stress to the company, and therefore, the company will face higher costs and debt, bankruptcy, financial losses, and declining market share (Fonseka et al., 2012). Therefore, managing company's operating and financial strategies become important for a maintaining growth of company and long-lasting performance of company. Sustainable growth in a business context is the maximum platform or benchmark required for a company to grow its

revenue without reducing its financial resources (Higgins, 1977). SGR also can improve its financial performance and help manager in financing decisions. Hence, the company's strategic planning by handling limitations and constraints of policy, referring to leverage and dividend payout, can help the company to sustain its growth (Johnson and Soenen, 2003).

The literature has identified several factors that influence the SGR. A widely known framework for the SGR was developed by Higgins (1977) and identifies four main factors that influence the SGR: capital structure, dividend policy (under financial constraints), profitability, and asset efficiency. The SGR is influenced by four factors and known as firm specific factors include: (1) the profitability ratio, where an increase in the profitability ratio increases the generation of internal funds with direct impacts on achieving growth; (2) the asset turnover ratio, where an increase in this ratio causes an increase in sales generated per asset unit, which reduces the need for additional assets for an increase in sales and which results in an increase in the SGR; (3) financial policy, where an increase in total debt provides additional resources and increases the SGR; and (4) dividend policy, where an increase in the retention ratio increases the growth of capital and implicitly the SGR (Hartono and Utami, 2016; Radasanu, 2015). Firm size is recognized as the most significant function of the firm growth due to cost differentials between small and large firms (Bentzen, Madsen and Smith, 2012). Firm size had significant negative relationship with SGR (Mamilla, 2019; Lockwood and Prombutr, 2010). Hence, the researchers stated that small firms having a higher SGR while larger firms possess lower SGR. Therefore, SGR must be evaluated with the specific measurement which is the measurement can be described by using the firm specific factors that affect a firm's SGR to help stakeholders (either internal or external management teams or customers) make the right decisions.

The SGR by Higgins (1977) is attained by ignoring inflation and focusing on a company that wants to increase sales at a rapid rate while at the same time maintaining a target payout ratio and capital structure without issuing new equity. SGR is the rate of increase in return on equity in line with a firm's target debt to equity, target dividend payout, profit margins, and total assets to sales ratios (Channon & McGee, 2015). The growth of sales is significantly affected by the previous dividend payout ratio and firms have a target dividend payout ratio that influences the growth of sales (Tarek Ibrahim Eldomiati et al., 2017). Hence, many financial agreements normally require inclusion of target debt equity ratios (Fazzari et al., 1988). This study is based on rational expectations, which assumes that the company maintains its target payout ratio and target capital structure and its operating performance (profitability and company's efficiency). The companies readjust in a rapid speed of adjustment towards TCS and TDP suggests the existence based on dynamic trade-off theory. Therefore, it is also essential for the company to practically identify the existence of target capital structure (TCS) and target dividend policy (TDP) so that handling the constraints and limitations of policy on leverage and dividend policy for the successful future growth of a company.

Having reviewed the relevant literature, it is perceived that fewer studies have addressed the firm specific factors and SGR on SPP. High sustainable growth firms tended to have low default risk, book-to-market ratios, and subsequent returns (Lockwood and Prombutr, 2010). Hence, the role of SGR also needs to be considered as it is a future-oriented measure of firms' performance that may have a significant impact on firm's stock price (Arora et al., 2018). The SGR is managed and controlled by company management while the fluctuation in share price is controlled by the market. Therefore, it is also important to examine the effect of the firm specific factors and SGR on SPP.

Investigating the mediation effect of SGR will be another focus of this study. The increased costs are not limited to the usual cost variety but also include the impact on the share price of employing what the management believes to be excessive debt, or distributing what is believed to be too little in dividends (Higgins, 1977). In particular, excessive debt and pay less dividends can have an impact on SPP. Thus, managing the company's financial and operating activities (capital structure, dividend policy, profitability, assets efficiency and firm size) can increase its value and SPP. Companies believe the outcomes attained from managing the financial and operating activities can help the management to increase the value of the companies and SPP. To the best of my knowledge, only Sutjiati (2017) has investigated the mediating effect of SGR between investment in fixed assets and dividend policy on company value (price book value).

The inclusion of the third variable (the so-called mediator variable) is that SGR might influence the relationship of the two variables; that is, the predictor X (firm specific factors) and the outcome variable Y (SPP). For instance, a higher or lower SGR can increase SPP, and the firm may also consider the use of a higher or lower debt in order to enhance the firm's financial performance and shareholder wealth. Due to the potential ability of SGR to act as a mediator, this study will examine the mediating effect of SGR between firm specific factors (capital structure, dividend policy, profitability, company efficiency and firm size) and the SPP of firms.

The inclusion and exclusion of stocks from the (KLSI) provide some good or bad information, which could affect investors' expectations and thus, the share price of the companies involved. The SC has introduced new screening methodology benchmarks based on financial ratios (cash over total assets and debt over total assets) to be listed as Shariah-compliant firms. The conventional debt must not exceed 33 percent. Due to the new screening methodology benchmarks, the number of Shariah-compliant firms

reduced from 801 (May 2013) to 653 (Nov 2013). One of the reasons for the reduction in the number of Shariah-compliant firms is that companies have higher conventional debt, where the financial ratio are more than the limit or threshold of 33 per cent. Shariah compliant securities or Islamic debt becomes one of the important elements for a firm to seek in order to control its financial ratio at not more than 33 percent. In order to control the firm's conventional debt and remain listed as a Shariah-compliant firm, the firm should have a TCS. In this case, the management can manage and control their capital structure to be not more than 33 per cent.

The issues of capital structure threshold has been extensively studied in capital structure and firm value literature. Most of the studies examine whether there is a threshold effect in the relationship between capital structure and firm value (Nieh et al., 2008; Lin & Chang, 2009; Cheng et al., 2010; Cuong & Canh, 2012; and Abd. Halim Ahmad & Nur Adiana Hiau Abdullah, 2013). Therefore, managing the company's financial and operating activities, especially on financial leverage, can help the company to comply with the financial ratio benchmarks (conventional financial limit or threshold less than 33 percent) and sustain the company's growth rate. This study can provide information to the Malaysian Shariah-compliant firms that the maximum debt is not limited to 33 percent, in that when the conventional debt is more than 33 percent, the remaining debt for the maximum SGR can be raised from Islamic debt. This study also will enhance the literature by examining whether there is a capital structure threshold in the relationship between the capital structure and the SGR of Malaysian Shariah-compliant firms.

In the light of the literature discussed so far, it becomes pertinent to conduct studies in linking firm specific factors (capital structure, dividend policy, profitability, company efficiency and firm size), SGR and SPP in the context of Malaysian Public-

listed Shariah-compliant firms. This study will provide understandings related to the issues and challenges that are faces by Malaysian Public-listed Shariah-compliant firms in the view of SGR and SPP. Futhermore, this study will help management team of companies to decide an appropriate capital structure and dividend policy for the company to maintain a stable capital structure and dividend payment in order to have the financial health of a company. The sustainable growth rate is important for helping firms to manage, guide, control and plan their operating and financial strategies. The sustainable growth rate can also improve share price performance. To determine the robustness of results, other well established evidence by industries and matrix financing behaviour have been included in the analysis of the study.

1.3 Research Questions

This study will attempt to answer the following questions:

1. Does target capital structure (TCS) and target dividend policy (TDP) exist in Malaysian Public-listed Shariah-compliant firms?
2. Does sustainable growth rate (SGR) mediates the relationship between firm specific factors (capital structure, dividend policy, profitability, company efficiency, firm size) and share price performance (SPP)?
3. Is there any capital structure threshold in the relationship between capital structure and sustainable growth rate (SGR)?

1.4 Research Objectives

This study uses public-listed Shariah-compliant companies in Malaysia to get a clear picture of the firm specific factors, sustainable growth rate (SGR) and share price performance (SPP) of the firms. To achieve this, the study has the following specific objectives:

1. To investigate the existence of the target capital structure (TCS) and target dividend policy (TDP) of Malaysian public-listed Shariah-compliant firms. Based on rational expectation in sustainable growth rate (SGR), this study assumes the company maintains its target capital structure (TCS) and target dividend policy (TDP) which reflect the existence of both target capital structure (TCS) and target dividend policy (TDP). For the preliminary analysis, it is practically applicable to identify the existence of TCS and TDP.
2. To investigate the mediating effect of sustainable growth rate (SGR) on the relationship between firm specific factors (capital structure, dividend policy, profitability, company efficiency and firm size) and share price performance (SPP).

Sub-objectives:

- i. to examine the direct effect between the firm specific factors and SPP,
 - ii. to investigate the direct effect between the firm specific factors and SGR,
 - iii. to investigate the relationship between the SGR and SPP, and
 - iv. to examine the mediating effect of the SGR on the relationship between the firm specific factors and SPP.
3. To examine whether there is a capital structure threshold in the relationship between capital structure and the sustainable growth rate (SGR) of Malaysian Shariah-compliant firms. This study can provide information to the Malaysian Shariah-compliant firms that the maximum debt is not limited to 33 percent for sustainable

growth rate (SGR). Hence, when the capital structure threshold is more than 33 percent, the conventional debt is limit to 33 percent but the remaining debt can be raised from Islamic debt for sustainable growth rate (SGR).

1.5 Scope of the Study

SGR refers to the maximum growth that a firm can achieve without borrowing more money and selling new equity. Monitoring the current situation and the company's activities by mapping the SGR can help managers to do financial planning in an efficient manner. Handling financial constraints, profitability, and asset efficiency become important factors that can influence the SGR of the company. In addition, managing the financial ratio of not more than 33 per cent is a must for Malaysian public-listed Shariah-compliant firms to maintain their listing status as Shariah-compliant firms and to solve firms' financial problems in order to sustain their growth.

Therefore, to answer the above research questions and research objectives, this study used a quantitative approach to collect data from the Thomson Reuters Database. In this study, 181 public-listed Shariah-compliant securities in Malaysia were selected during the period from 2007 to 2016. This study employed panel data analysis by using pooled effect, random effect, fixed effect, generalised method of moments (GMM), and structural equation model (SEM) and threshold regression. The panel data analysis was performed using STATA software.

For the preliminary analysis, it is practically applicable to identify the existence of TCS and TDP. Then, the main part of analysis is to investigate the mediating effect of SGR in the relationship between firm specific factors (capital structure, dividend policy, profitability, company efficiency, firm size) and SPP. In order to comply with the financial ratio benchmarks (conventional financial limit or threshold less than 33

percent) and sustain the company's growth rate, the last analysis is to examine whether there is a capital structure threshold in the relationship between capital structure and SGR.

1.6 Significance of the Study

This study makes significant contributions in the theoretical and contextual aspects to the organisation. First, there are four important contributions in the theoretical aspect, which are:

- i. This study investigates the factors that influence the SGR in the Malaysian context, especially among the Shariah-compliant firms.
- ii. This study provides empirical evidence concerning the effect of SGR on SPP, which has received little attention in past research. Most of the previous studies focused on the factors that influence the SGR. Therefore, this study addresses this issue by examining the effect of SGR on SPP.
- iii. This study uses SGR as a mediating variable between firm specific factors and SPP by applying the panel data analysis using STATA software.
- iv. This study investigates whether the different situations on financing behaviour would have different impacts on the SGR. The matrix financing behaviour can be divided into four categories, namely firms that are (i) Over-levered (OL) and Over-paying of dividend (OP), (ii) Under-levered (UL) and Over-paying of dividend (OP), (iii) Over-levered (OL) and Under-paying of dividend (UP), and (iv) Under-levered (UL) and Under-paying of dividend (UP).

Furthermore, three important contributions of this study in the contextual aspect are:

- i. It is important for the organisation or firm to understand that there are firm specific factors that influence the SGR. This involves the planning and managing of the firm's financial and operating activities.
- ii. This study provides important information to strengthen the SGR performance and SPP of the firms and face the future Islamic capital market, which caters to investors seeking for Shariah-compliant investments.
- iii. This study can give information to the Malaysian Shariah-compliant firms that the maximum debt is not limited to 33 percent in that when the conventional debt is more than 33 percent, the remaining debt can be raised from Islamic debt to achieve maximum SGR. Thus, firms can remain listed as Shariah-compliant securities and face the future Islamic capital market that caters to investors seeking for Shariah-compliant investments and sustain the growth of companies.
- iv. The findings of this study will be used as a reference for future studies on the other aspects of SGR, especially for non-Shariah firms concerning how to manage financial and operating activities to comply with the stock screening benchmarks issued by the SC and make the firms more successful in the future.

1.7 Structure of the Study

This study comprises seven chapters. Chapter One provides the introduction and outlines the objectives and significance of the thesis. Chapter Two reviews the literature relevant to SGR based on the Higgins model to establish the theoretical context. This review primarily concentrates on the existing or previous studies focusing on the impact of revised screening methodology, SGR based on the Higgins model, firm specific factors affecting SGR and SPP. Due to the lack of empirical investigation on SGR in the context of finance theory, this study applies the existing theories and empirical

investigations to support the results of this study. Moreover, this chapter provides the research framework and the hypotheses.

Chapter Three presents the methodology, data used in this study, the measurements of the variable, and the model specification employed for the empirical analysis. Next, Chapter Four provides a discussion on the empirical results of objective one on the target capital structure and target dividend policy. Chapter five presents a discussion on the empirical results of objective two on the the mediating effect of SGR on the relationship between firm specific factors (capital structure, dividend policy, profitability, company efficiency and firm size) and SPP. Chapter six provides a discussion on the empirical results of objective three using a panel threshold regression analysis. Finally, Chapter seven provides the conclusions and recommendations.

1.8 Conclusion

This study comprises seven chapters. The first chapter of this study explained the background of the study, problem statement, research questions, research objectives, scope, and significance of the study. After the introduction in chapter one, chapter two discusses the literature review from the current literature related to the topic and research framework together with hypotheses. In chapter three, this study explains the research methodology in detail. Chapters four, five, and six present the results and discussions. Lastly, chapter five concludes and outlines the recommendations of this study.