

Chapter 1

Introduction

1.1 Background to the study

Based on the optimal capital structure theory, financing decisions between debt and equity capital are crucial to value creation of the firm (Harris and Raviv, 1991). Modigliani and Miller (1958) were the pioneers who examined the optimal capital structure and found that using a mixture of debt and equity instead of using only equity is more beneficial to the firm. The reason is interest payments of debt financing can reduce corporate income taxes in terms of “tax saving or tax shield”. However, using debt financing may increase bankruptcy costs if the firm cannot pay debt burdens in time and may lead managers of firms with growth opportunities to accept sub - optimal investment opportunities (Chen and Strange, 2005; Gaud, Jani, Hoesli and Bender, 2003). The financial theory merely helps the firm understand how the chosen financial leverage affects the firm’s value but there is no specified rule to determine the appropriate level of debt to achieve the optimal capital structure (Eriotis, 2007). Consequently, financial managers of each firm have to make financing decisions in their own way that a firm’s value is maximized.

Much research in many countries attempted to assist the management of firms by investigating important determinants of financing decisions and found that some specific firm characteristics are the critical factors of capital structure management, for example, the studies of Wald (1999), Cassar and Holmes (2003), Chen and Strange (2005), and Mazur (2007). However, the empirical evidence from prior studies showed mixed results.

Wald (1999) examined the factors that related to capital structure by using the sample in five countries – France, Germany, Japan, the UK and USA in 1993. Wald’s findings showed the significant correlation between a firm’s capital structure as measured by long-term debt/asset ratio and firm factors. However, the results indicated that some firm characteristics including risk, growth, firm size and inventories had

different effects on financial leverage in different countries. For example, in the United States, firms with high growth used less debt than those in other countries and firm size did not appear to be a determinant of capital structure, whereas it was positively linked to debt ratio in other countries.

Cassar and Holmes (2003) investigated the determinants of use of financing and capital structure for small and medium sized enterprises in Australia during the period 1995 - 1998. Their results showed that firm characteristics namely, asset structure, profitability and growth were important factors of financing decisions and capital structure as suggested by the trade - off and pecking order theories but firm size and risk were found to be insignificant.

Chen and Strange (2005) also studied the relationship between firm characteristics and corporate structure on the debt financing behaviour by using a sample of the Shanghai Stock Exchange and Shenzhen Stock Exchange in China in 2003. They found the different results from Cassar and Holmes's (2003) study. His results asserted that size and risk of Chinese firms in the sample were positively related to market value measure of capital structure but surprisingly, tax was not a critical factor in influencing debt ratio. Nevertheless, they found strong evidence indicating that profitability was negatively related to the choice between debt and equity as well.

Mazur (2007) endeavored to test two competing capital structure theories - the pecking order of financing choices and the traditional static trade - off model by using data from a five-year financial statement of Polish companies traded on the Warsaw Stock Exchange in years 2000 - 2004. In his analysis, the signs of coefficients for profitability, liquidity, asset structure, growth opportunities, size and uniqueness, and the insignificance of non-debt tax shield suggested that the trade - off theory was not applicable for the examined companies. The results seemed to confirm the pecking order theory although the influences of risk and dividend policy were not appearing at that time.

For Thailand, there has been very little information regarding research in this area. The present study found one research from Wiwattanakantang (1999) published in the international journal. She examined the determinants of the capital structure of Thai

listed firms in 1996. The results showed that traditional factors including profitability, tangibility, tax and growth were significant to leverage ratio but firm risk as measured by variation in sales was insignificant. Other firm characteristics such as liquidity, dividend policy and financial risk have not been investigated in his work. There remains an inconclusive question that “which firm characteristics are significant determinants of a firm’s financing decisions?” Therefore, to obtain a better picture of the debt-equity choices in Thailand, the study will contribute to this investigation of the relationship between firm characteristics and financing decisions by extending and adapting the analyses of previous studies (e.g., Wiwattanakantang, 1999; Chen and Strange, 2005; Eriotis, 2007; and Mazur, 2007. Public companies listed on the Stock Exchange of Thailand during the period 2002 - 2006 will be a sample for study in this research.

1.2 Research objectives

The objectives of this research are to examine the relationship between the existing firm characteristics and financing decisions of public companies listed on the Stock Exchange of Thailand based on two capital structure theories - the trade - off and pecking order theories. The details are as follows.

1.2.1 To investigate which specific firm characteristics significantly influence financing decisions of public companies listed on the Stock Exchange of Thailand.

1.2.2 To investigate which of the two capital structure theories, the trade-off and pecking order theories, better explains the financing decisions of public companies listed on the Stock Exchange of Thailand.

1.3 Significance of the study

The following significance of the research lies in its theoretical and practical contributions.

1.3.1 In an attempt to investigate the significant factors of financing decisions based on the main capital structure theories, the results of the research will add to the

body of knowledge on capital structure management and financing decisions by providing important evidence from a sample of Thai listed companies.

1.3.2 From the practical perspective, it is expected that a clearer understanding of the relationship between firm characteristics and financing decisions will be important guidelines to assist business executives, chief executive officers (CEO) and financial manager including related persons of each firm to efficiently balance the benefits and costs of the use of debt financing.

1.3.3 In addition, since the research will be undertaken in Thailand, a significant contribution will be made to the Thai business community, which benefits from this study in terms of a greater understanding of the optimal capital structure theories in practice.

1.4 Organization of the paper

The paper contains five chapters including the introduction. This chapter has provided the background to the study and explained the research objectives. It also elaborates on the significance of the study.

Chapter 2 describes two capital structure theories which are the research framework and reviews previous research concerning the relationship between firm characteristics and financing decisions. Its objective is to seek the critical firm factors that influence corporate financing. Then, it presents the hypothesis development and research model.

Chapter 3 addresses the research methodology. It describes the sample, data collection and variable measurement of all variables of the study. It also provides data sources and statistical analysis to be undertaken.

Chapter 4 reports the empirical results of the study following the research objectives in chapter 1. It first discusses the main assumptions of univariate statistical analysis and multiple regressions. After that, it reveals the predictors of corporate

financing and their impact on a firm's financing decisions. It also discusses the hypotheses testing results with previous studies that are reviewed in Chapter 2.

Finally, Chapter 5 contains a summary of the study and the implication of the research findings. It also offers suggestions for future research.

