

# Mandm theory or capital structure irrelevancy theory

Countries



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Modigliani and Miller (1958) stated that M&M theory also known as capital structure irrelevancy theory. It stated that financial leverage does not affect the firm's value in perfect market because without taxes, transactions cost or bankruptcy costs in perfect market and all information are symmetries. (Faruk Ahmeti and Burim Prenaj, 2015) Thus, value of levered firm is same as the value of unlevered firm (Abeywardhana, 2017; Michael, 2017) and financial leverage is direct proposition to cost of equity which risk increase commensurate with high cost of equity.

However, world without taxes were impossible in reality so Modigliani and Miller (1963) introduced Tradeoff Theory of Leverage which emphasised firm's value increase with leverage in presence of taxes due to tax shield. (Alifani et al., 2013; Borad, 2018) When debt percentage in capital structure increases, WACC can be decreased (Brigham and Ehrhardt, 2010) because interest payment of debt is tax deductible. As a result, ratio of corporate tax is equal to current value of savings from taxes due to WACC decrease whereas firm's value will increase but high debt may cause high probability in bankruptcy.

As we can see that, Ireka's debt to equity in year 2017 has increased from 13% to 20% in order to deduct more tax from its debt's interest payment. Thus, WACC can be reduced by issuing more debt and Ireka's value was increasing as well. However, Ireka's high degree financial leverage (DFL) is higher than its leader company of industry-Gamuda. Therefore, it caused increasing in bankruptcy cost due to its debt are unable to covered by its total assets.

Pecking Order Theory is suggested by Donaldson but modified by Myers and Majluf in 1984. Myers and Majluf (1984) stated that pecking order assumes target capital structure is absent and managers rely on internal funds before they consider issuing any securities (Abosedo, Adebisi Julius, 2012) because managers have more insider information than investors and benefit old shareholders. Some company with less accounting transparency will have high asymmetry of information because investors may not know all information about the firm and caused high risk in company.

Information of asymmetries, scrutiny of suppliers of capital and floatation costs can be prevented by using retained earnings to support investment opportunities (Li-Ju Chen and Shun-Yu Chen, 2011) unless its retained earnings is not enough to support the investment. If external funds are required, debt will be chosen before equity to avoid selling under-priced securities and cost of debt is less than equity. (B. T Matemilola and A. N. Bany-Ariffin, 2011)

Ireka had retained earnings in year 2015 which is RM13, 732, 811 so Ireka use its internal fund to expand business and support investments but Ireka did not have any retained earnings in year 2016 and 2017. Ireka had accumulated loss in year 2016 and 2017 which is - RM 30, 949, 239 and -RM 26, 754, 578 respectively. Thus, Ireka will prefer to issue more debt in year 2016 to raise its source of capital instead of equity because debt's cost is lower than equity and ownership of Ireka will not be diluted due to bondholder without voting right.

Capital Asset Pricing Model (CAPM) is developed by William Sharpe (1964) and John Lintner (1965). CAPM attempts to describe the relationship between the investment risk and the investment expected return in order to decide a suitable price for the investment. (Eugene et al., 2004; Yang, 2013) CAPM is an integral part of WACC as CAPM used to calculate cost of equity (David W, 1982; CFI, 2018) and a project-specific discount rate to use in investment appraisal. CAPM-derived project-specific discount rate is used and caused the project IRR lies below the SML of the CAPM. (ACCA, 2018)

Thus, project IRR offers insufficient return to compensate for its level of systematic risk. Hence, project unable to generate profit that can cover its cost so the profitability of firm will be affected and decrease shareholder's wealth. Ireka's rate of return on sales showed that it decreased from -0.57 to -15.03 in 2016. Not only that, ROA and ROE also decrease very much in 2016 due to slow efficient of total assets turnover and receivable turnover.

The decrease in total assets turnover and receivable turnover lead to insufficient of fund and profitability issues. Ireka's inefficient investment in construction projects will cause decrease in sales and directly lower down the profit. The beta of CAPM increase and investors will feel risky, so cost of equity will increase as well due to investors expect more return to compensate the risk. Therefore, high cost of equity will increase the WACC but low IRR unable to cover the WACC so Ireka has profitability issues.

Osuji and Oditia (2012) studied the effects of capital structure on the financial performance of Nigerian organisations and companies' capital structure had strongly negative related on firm's financial performance. (Zeitun et al. ,

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2007; Omorogie et al., 2010) Not only that, a negative correlation between capital structure and firm performance in US and UK corporation.

(Abeywardhana and Krishanthi, 2016) Thus, the higher the capital structure, the poorer the financial performance of firm in developing countries and developed countries. However, Abor (2005) and Saeedi et al. (2011) argued that capital structure has positive relationship with ROA which proxy the firms' performance in Ghana and Tehran.

Effect of capital structure and financial leverage on the performance of Jordanian firms and Canadian firms showed that capital structure was negatively associated with firm performance. (Soumadi et al., 2011; Gill et al., 2011) but it also found that there was no significant difference between high financial leverage and low financial leverage on firm performance. Thus, firms with lower leverage performs better thereby supporting the pecking order theory from the point of view that profitable firms use their earnings to finance their new projects and in so doing reduce their level of debt.

However, financial leverage of firm in developed and developing countries will not affect the company profit due to the result show it has insignificant relationship. (Obehioye et al., 2013) On the other hand, some studies argued that financial leverage is has significant positive effect on performance of firms in Nigeria and US. (Gill et al., 2011; Akhtar, et al., 2012; Akinmulegun, 2012) Therefore, it can be indicated that financial leverage will impact the profitability of firms in developing countries and developed countries as well.

As we know that, steel is one of the main raw material that used in construction so price of steel play significant role in the cost of the

construction project. China as the leader in steel production and China decided to shift away its economy from manufacturing to services in last year. (General Steel, 2018) Thus, China announced that production of steel will decrease more than 165 million tons by 2020 (Lapo et al, 2018) and this will affect the price of steel increases rapidly due to demand exceed supply. World Steel Association stated the price of steel will be increased 8% due to a prediction increase in global steel demand up to 0. 5%.

As Ireka is a construction and engineering company, all the cost of construction projects will increase due to the increase in global price of steel. Steel can consider as a fixed cost because steel is the main raw material of construction so expenses will increase and profit will decrease slightly. As a consequence, Ireka need to invest in a higher IRR projects to cover the cost or else it will affect the profitability and liquidity of Ireka.

Besides that, economy of Malaysia able to affect the real estate price and construction industry. In the past two years, economy of Malaysia was slowing down and ringgit is depreciating due to the high debt and scandal of 1MDB. (Lim, 2016) As the house prices continue to rise, demand for house is dropping. Hence, property transactions and building construction activities are slowing down dramatically. However, economy start to recover and ringgit will start to appreciating again after the election of 2018.

Valuation and Property Services Department (JPPH) stated that residential property transactions improved about 4% compared to last year.

(Mahalingam, 2018) As economy grow, interest rate falls and demand for properties will increase due to easy to obtain mortgage loan. High demand in

properties will encourage Ireka to construct and develop more residential projects. This will increase the revenue and share price of Ireka.

Moreover, growth of industry also will affect Ireka Corporation by increasing in constructing more mega projects. The Construction Industry Development Board (CIDB) expected the booming in construction industry in 2018 with the real growth at 9% on the back of Malaysia's overall GDP growth of 5.3%.

(Bernama, 2018) Construction industry's growth was driven by infrastructure project and follow by residential project and these project will brings positive growth in construction industry then boost the economy. (The Star, 2017)

There are numerous mega projects has developed in Malaysia such as Mass Rapid Transit 2 (MRT2), Pan Borneo Highway and Petroliam Nasional Bhd's refinery and petrochemical. Ireka Corporation also affected by the growth of construction sector which Ireka had bid for a few projects that worth RM1.2 billion.

Current construction order book includes Imperia Puteri Harbour in Nusajaya, Johor and MRT Package V7. Ireka Corporation is one of the subcontractors of the MRT project which built from Bandar Tun Hussein Onn to Taman Mesra. According to research analyst InsiderAsia, Ireka's next major catalyst will be the condominium and RuMa hotel residences project at Jalan Kia Peng in the KLCC area. (The Edge, 2013) This will increase the revenue of Ireka and the stock price may increased as well due to anticipated by the investor towards the future development of the company.

Ireka should improve collection of accounts receivable to reduce high financial leverage ratio because prevent risk of bankruptcy. Ireka should

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communicate with customers about the period of time to make payments and both parties agree to make payment in a certain time. Ireka may implements new policy and regulations where Ireka will give some discount to customers if customers pay their bills within 2 months.

Ireka also should remind the customers before the payment date to prevent become bad debt and follow up with customers in order to keep track of the payment of customers. Besides that, Ireka should restructuring debt to reduce the debt to equity ratio. (Maverick, 2018) Company can seek to refinance its existing debt if firm is paying high interest rates on its loans. This will reduce both interest expenses and improve company's bottom-line profitability. As a result, liabilities can be decreased and capital of investors can be use to invest other assets.

One of the strategies to improve profitability of the firm is create business strategies plan and financial plan. Ireka should refer to leader company of industry as a benchmark revenue because the leader company provide a blueprint and strategies to increase the profit. (Amos et al., 2009) Thus, Ireka should amend strategies plan of leader company according to its current situation and include a minimum five-year outlook strategies plan with short and long-term goal. As a construction company, most of its revenue is from project-based so it is crucial to have a clear vision about the type of most profitable projects for its bottom-line growth. Therefore, Ireka need to analyse projects and give up 10% of unprofitable projects in strategic plan so capital. (In. Corp, 2018).



Thus, Ireka also should created financial plan so budget of firm can be monitored. Ireka should develop a cost accounting system such as Enterprise Resource Planning (ERP) to determine the rate of required return of projects. This allows Project Managers (PMs) to adjust budget and actual cost on time. (Torrance, 2013) Budget able to keep track on its expense and reduce the unnecessary expenses. Budget also need to be reviewed monthly in order to remain aligned with growth of business. As a result, the profit of firm can be maximized in long-term.

Furthermore, Ireka can increase its profit by expanding its market at developing countries such as Indonesia, China and Japan. Ireka enter into joint venture or strategic alliances with their suppliers or customers to market each other's products. Ireka had joint venture with Beijing-based CRRC Urban Traffic Co Ltd into urban rail projects and they signed share subscription agreement which Ireka holding 51% and CRRC UT holding 49%. (Eusoff, 2017) Ireka partner with CRRC UT to explore more business opportunities in areas of logistics, building materials and specific rail projects. Joint venture able to provide more opportunities to Ireka and reduce the uncertainty risk in the sector that are not familiar by Ireka.

Corporate Social Responsibilities (CSR) is another important strategy because CSR able to motivate employees by providing extra training and workshop. Ireka should spend extra time to train and educate its employees in order to increase ability and skills of employees.(Pajo and Lee, 2011; Jones et al., 2014) As a result, employees understand the expectation of firm and become more productive. Although training may increase expenses of Ireka but company can operate well in long-term and increase reputation in return.

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Furthermore, reward and compensation will encourage and increase motivation of employees. (Caligiuri et al., 2013; Glavas and Kelley, 2014) Ireka should reward employees who have outstanding performance in company by providing promotion or bonus. When employees get rewarded, employees will work harder and increasing the work-ethic within company. As a consequence, high productivity will affect improve profitability and maximised the shareholder's wealth in long term.

Net income will affect retained earning significantly so Ireka should increasing the liquidity by having an effective asset management. Ireka should sell off idle assets and increase the efficiency of assets to generate profit. (Fernandez, 2006) Assets will be depreciated so sell off not useful assets to decrease the losses. Besides that, inventory can take up a very sizable amount of a company's working capital so Ireka should evaluate their efficiency of inventory being managed which monitor the days sales of inventory ratio (DSI) by reordering inventory when firm are nearing redline level of available and the cash conversion cycle (CCC). (Morah, 2018)

In additional, cost of gold sold should be reduced by decreasing the cost of raw material and labour cost. Labour cost can be reduced by outsourcing and replace with part-time workers. As cost and expense decrease, more profit can be generated if assets are fully utilised. As consequence, Ireka's cash flow is more liquid and retained earning can be increased.