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Political connection and leverage: Some Malaysian evidence

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ABSTRACT

This paper extends prior work on the linkage between politically connected (PCON) firms and capital structure in developing countries. Specifically, this paper focuses on the association between Malaysian PCON firms and leverage, and is motivated by the results of Fraser et al. (2006) who report a positive association between leverage and political patronage. Controlling for a potential misspecification in that paper, this study documents that a significant proportion (almost 12%) of the Malaysian PCON firms have negative equity, and builds on the previous paper by providing fresh evidence that market to book ratio is positively associated with leverage, and that borrowing PCON firms have significantly lower ROA compared to non-PCON firms.

1. Introduction

A number of studies in recent years have focused on "relationship-based" non-Western economies. This interest seems to be driven largely by the comparatively high growth and the subsequent importance of these economies particularly over the last decade. Malaysia is one such country that has spurred a great deal of interest probably due to it having well documented politically connected (PCON) firms (Gomez and Jomo, 1997; Faccio et al., 2001; Gomez, 2002; Johnson and Mitton, 2003; Gul, 2006; Faccio, 2006; Fraser et al., 2006). A recent paper by Fraser et al. (2006) finds that Malaysian PCON firms are significantly associated with higher leverage, and that this association is greater when the firms are larger and more profitable. The objective of this study is to further extend the understanding gained from the Fraser, Zhang and Derashid (2006) paper (FZD hereafter) by considering a previously unreported anomaly which is contended to impact on the results and interpretations made in that paper.

This study uses hand-collected data from 2001 to 2004 annual reports published by firms listed on the Kuala Lumpur Stock Exchange (KLSE). An anomaly considered somewhat unique to Malaysian public companies came to our attention when collecting the data that a significant number of listed firms, predominantly PCON firms, have negative equity. Almost 12% of PCON firms (and just over 3% of non-PCON firms) in this sample are found to have negative equity. Whilst these firms continue to be listed and trade on the KLSE, they are technically bankrupt as the value of the liabilities of these firms exceeds the value of their assets by the extent of their negative equity. It is somewhat surprising that the extant literature that has investigated Malaysian PCON firms have for the most part been silent on the pervasiveness of negative equity within these firms. It is suggested in this study that the results reported by FZD are possibly flawed because of a misspecification in their calculation of their market to book ratio (*MKBV*). This is because a negative book value of equity makes both the calculation of *MKBV* and inclusion of this variable in any regressions extremely problematic.

Evidence of *MKBV* being problematic in FZD is found when the comparative mean statistics indicate that the *MKBV* of firms with government ownership are significantly (at 1% level) lower than that of firms without government ownership. The authors state that this result is "somewhat surprising" (p. 1299). Furthermore, in their regression analysis the authors find an insignificant (and negatively) signed association between leverage (total debt/total assets) and *MKBV*, after controlling for other factors found to be consistently linked to leverage. This result is counter-intuitive and is not consistent with previous literature or again the expectations of the authors (p. 1302) who suggest that the expected lack of a positive and significant association may be explained by political patronage possibly acting as a better proxy for investment

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opportunities than *MKBV*.[1] It is contended from the above discussion that *MKBV* appears problematic in FZD and as a consequence their findings may be influenced by this given the importance of *MKBV* and its documented association with leverage.

This study essentially replicates FZD with three modifications that are considered should not impact on the overall results. First, the data from this study covers 4 years (2001–2004) compared to FZD's 10 years of data (1990–1999). Second, this study only uses one proxy for PCON firms. The criteria used for being assigned as a PCON firm is if it is identified as such in Johnson and Mitton (2003) (one of the criteria used by FZD) making the classification objective as it is based on the firm's previous identification in the literature. Third, in this study estimates are obtained using cross-sectional pooled ordinary least squares regression (OLS) procedures in contrast to FZD who use test using panel data with a random-effects model. It is considered that FZD's use of panel data has two limitations compared to using pooled data. First, the sample size is reduced due to the exclusion of all firms without full data requirements over the full sample period. Second, such exclusion of firms creates a survivorship bias given that only firms that have continued over the sample period are included. It is considered this bias may possibly be quite considerable in the FZD sample as it covers a 10 year period. It is considered that the exclusion of all firms that either commenced or closed during their sample period possibly impacts on the characteristics of the surviving firms, and the subsequent results from testing those firms. One such pertinent characteristic may be that only the more financially viable firms continue as a going concern over the period of a decade. This bias is considered a most important limitation given the focus of the study is on leverage and its associations with various variables and interactions. We are confident that multicollinearity is not problematic in our results given that the highest Variance Inflation Factor (VIF) is 1.816.[2] Additionally, in our interaction testing of variables with political connection, the variables (reported in Table 4) have been mean-centered to control for multicollinearity[3] (see Gujarati and Porter, 2010). Both this study and FZD control for year effects and industry sector effects. In our study, data have been windsorized to the 1 and 99 percentiles to control for extreme values, and all reported *t*-values are White's corrected to control for heteroskedasticity (White, 1980).

The results from this study provide evidence of a positive and significant association between leverage and political connection. This is in line with FZD, Johnson and Mitton (2003), and Bliss and Gul (2012). Also, like FZD, our study finds that leverage is significantly and positively associated with firm size, and property, plant and equipment, and is significantly and negatively associated with *ROA*. However, in contrast to FZD, this study provides evidence of the expected positive and significant association between leverage and *MKBV*. This is in line with the findings of Chen and Zhao (2006) that firms with higher *MKBV* are associated with higher extents of borrowing. Additionally, we find no support for FZD's finding that more profitable PCON firms are more highly leveraged. In contrast, we find that borrowing PCON firms have significantly lower ROA compared to non-PCON firms. This result is in line with the findings of Bliss and Gul (2012) that provide evidence that Malaysian PCON firms are associated with higher interest rates being charged by lenders compared to non-PCON firms. These authors argue that this is because of efficient contracting on the part of lenders that consider these firms to be more risky, and provide evidence of reasons for this including PCON firms (1) have higher leverage, (2) are more likely to report a loss, and (3) are more likely to have negative equity.

Our above reported findings are obtained at a high cost of excluding PCON firms that have negative equity. This is a high cost because it is the association of PCON firms with leverage that is of primary interest in this study, and the exclusion of these firms with negative equity must reduce somewhat our understanding of PCON firms given that this attribute is found in a sizeable portion of these firms. The only way to include PCON firms with negative equity in a study of the association between leverage and *MKBV* is to assign some arbitrary value for the *MKBV* of these firms. This has limitations as this arbitrarily assigned measure may not capture the essence of this metric. As an alternative to doing this whilst recognizing the need to undertake testing using the full sample including these firms, regression analysis was performed with modifications to the model by way of replacing *MKBV* with an indicator variable *NEGEQ*, equal to '1' if the firm has negative equity, and '0' otherwise. The coefficients of political connection, firm size, and PPE remain, as previously reported, significant and positively, and the coefficient of *ROA* significant and negatively associated with leverage. The coefficient for negative equity PCON firms is positively and significantly associated with leverage. This result is expected for number of reasons. First, any firm with negative equity by definition has substantial liabilities with a likelihood of being highly geared. Second, just as more profitable firms have been reported in the literature as having lower levels of borrowing, it is intuitive that negative equity firms would have high borrowing notwithstanding that these firms would find it comparatively more difficult to borrow from lenders. It is here that the political connection may make it more viable for lenders to lend to such firms. FZD (p. 1294) suggest that there is a lack of a viable bond market in Malaysia such that firm lending is from banks which the government controls (FZD cite Gomez and Jomo, 1997).

This study makes a further contribution by way of additional analysis using tests of differences of means approach using *t*-tests and *Chi-square* (for indicator variables) on a selection of variables taken from the sample data collected. As well as finding PCON firms to have significantly higher levels of leverage and lower return on assets, it is found that PCON firms are significantly more likely to have negative equity, and are more likely to report a net profit loss.

The rest of this study is organized as follows. The next section outlines the research design and data used in this study, followed by the reporting of the empirical results. Lastly, the conclusion is provided.

2. Data and methodology

2.1. Political patronage proxies

FZD use three proxies for political patronage based on economic, social and personal dimensions: (1) the percentage of direct government equity ownership; (2) the percentage of equity owned by "institutional" investors, (3) firms that have informal ties with each of the three most powerful politicians in Malaysia in the 1990s. It is considered that the FZD proxies are potentially problematic for (1) and (2) given the relatively large proportion of PCON firms that have negative equity. FZD (p. 1295) measure institutional ownership as "a continuous variable that reflects the changing level of political patronage at a point in time." This proxy is further considered potentially problematic given that the authors

[1] Many studies have reported a negative association between *MKBV* and leverage. Chen and Zhao (2006) suggest that this association is driven by a subset of firms with high *MKBV*. Using a sample of US data (1972–2002) these authors provide evidence firms with higher *MKBV* face lower debt financing costs resulting in these firms being associated with greater borrowing. These authors show that the relationship between leverage and *MKBV* is non-monotonic and is positive for more than 88% of COMPUSTAT firms (and more than 95% of total market capitalization).

[2] Mendenhall and Sincich (2003) say that in practice a multicollinearity problem exists if the largest of the VIF factors is greater than 10.

[3] We thank an anonymous reviewer for this suggestion.