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The Development of Debt to Equity Ratio in Capital Structure Model: A case of micro franchising

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Abstract

This paper aims to develop a capital structure model in micro franchising within Malaysia's perspective. This study will emphasize on the factors that contribute to the development of a capital structure model focusing on debt to equity ratio. The regression model is used to analyse the debt in micro franchising. The independent variables in this research are growth, tangibility, profitability, firm size, liquidity and age, while the dependent variable is debt to equity ratio.

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Keywords: Capital structure; Micro franchising

1. Introduction

Franchising originated from the United States and Europe in the late 1940s. Meanwhile, Isaac Singer is the founder of Singer Sewing Machine Company. During that time, he wanted to expand the distribution of his sewing machines by appointing an independent salesman for business expansion. So this was the time where franchising was created (A. Hamid & Omar, 2005). According to Mohd Harif et al. (2011), the franchising of Singer Sewing machine Company was the first franchise business being introduced in Malaysia, while A&W was the first fast food in this industry (Baputey, 1998)

People normally associate franchising with famous brand names which require a huge of startup cost, but Malaysia has expanded its franchise business by introducing micro franchising. Micro franchising is the business

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opportunities that help to overcome poverty, increase individual's self-reliance and help in terms of the country's economic development (Braccken et al., 2006). Malaysia is still new in this franchise business because it was just being introduced in 2011. The role of micro franchising in Malaysia is to encourage perspective entrepreneurs with lower income opportunity to venture into business with low risk. In order to assist the potential entrepreneurs venturing into franchise businesses, the government has introduced Micro-Franchising Scheme which offers a maximum funding up to RM50,000.The scheme provides financing to prospective entrepreneurs to venture into micro-franchising which offers systematic and less risky businesses. There are some institutions that are designated to give financial support and also training to upcoming micro franchisees. These include PNS, SME Bank and others.

The financing decisions may affect the value of the firm if they made the incorrect decisions (Gomez et al., 2012). For example, high exposure to debt will lead to bankruptcy (Oino, 2014).The main objective of most profit-making businesses is to maximize shareholders' dividend. However, the manager needs to acquire the appropriate selection of mix between debt and equity (Ukaegbu & Oino, 2012). This study will develop the most appropriate capital structure model. There is lack of study being conducted in this particular field. This could be due to the difficulty in accessing data from small firms (Saarani & Shahadan, 2013). Firm managers are often faced with difficulties in determining the optimal capital structure. During credit expansions, companies have been unable to build enough liquidity to survive the contractions, especially those enterprises with unpredictable cash flow streams which end up with excess debt during business failure (Handoo & Sharma, 2014).

When the firm is facing different level of debt and equity used in capital structure, it is suggested for the managers to employ firm-specific strategies to improve firm's performance (Gleason, Mathur & Mathur, 2000). However, to increase firm's performance, attaining the appropriate mix of debt and equity is not easy (Ukaegbu & Oino, 2014). According to Ramalho and Silva (2007), the issues of different size may have different composition of capital structure determination. SMEs also have limited access to external financing and eventually they are more dependent on internally generated funds resulting from profitable operations (Uyar & Guzelyurt, 2015). This argument is also supported by Coleman (2000), who stated that SMEs have inability to secure adequate sources of finance and this causes SMEs failure. There are several studies conducted to determine the factors that determine capital structure. For instance, the studies by Hashemi (2013), Al-Najjar and Taylor (2008) state that growth, firm size and profitability affect the composition of debt in capital structure, while Gomez et al. (2001) and Ondieki, Gaster and Moraa (2013), and Saarani and Shahadan (2013) in their study suggest that liquidity also affects the composition of debt in capital structure.

Therefore, this paper aims to develop a capital structure model of debt to equity ratio in micro franchising to improve the financial position in the micro franchise business to compete in this competitive market. Besides that, the capital structure model also makes easier for the upcoming franchisee to reduce the overall risk of the company, to make adjustment according to business environment and to generate idea on a new source of fund by using the suitable formula. On the other hand, this new model will assist the government to match the composition of micro franchise scheme and consequently, increase the number of entrepreneur involvements in this business.

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2. Problem Statement

With regard to the above issues, none of studies conducted had developed a debt to equity in the capital structure model for this particular field. Therefore, this paper aims to develop the capital structure of debt to equity ratio in micro franchising and to improve the financial position of franchise business. In addition, this study will realign the factors that contribute to the composition of debt to equity ratio with capital structure in micro franchising.

3. Research Objectives

The objectives of this study are:

a) To identify the relationship between growth and the capital structure of debt to equity ratio in micro franchising.
b) To identify the relationship between tangibility asset and the capital structure of debt to equity ratio in micro franchising.