

# FINANCING POLICY ADOPTED BY COMPANIES AND THEIR FINANCIAL PERFORMANCE: A CASE STUDY ON THE MALAYSIAN GROOM BIG (2) COMPANIES

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## ABSTRACT

This paper intended to study the financing policy adopted by small and medium sized companies (SME). The finding was as a result from a consultancy programme conducted on five out of thirteen Groom Big (2) companies. These companies were identified and selected by the Malaysian Productivity Corporation (MPC), with the initiative to encourage, nurture and develop these SME entrepreneurs to become bigger entity and thus to enable them to compete domestically and globally. The companies comprised of food, pharmaceutical products, fixtures and parts for local car manufacturers as well as multi-service. The study focused more on the financial accounting statements of the companies, in particular the financing of these companies and its performance ratio. Additional information were collected during site and through focus group interviews. The analysis of the financial statements were conducted over three years and the results showed that the financing policy adopted by the Groom Big Companies varies and have different effects on the financial performance.

**Keywords:** firm performance, financing policy, groom big companies, financial analysis

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## **INTRODUCTION**

Small and Medium sized companies that perform well should be able to increase the wealth of the economy through the continuous supply of job opportunities and creativity, thus able to grow and survive despite various obstacles (Kasekende & Opondo, 2003). The governments in most countries view SME development as an effort to accelerate the achievement of wider economic and to alleviate poverty (Cook & Nixon, 2000). Often financial performance will be the medium use to gauge the efficient use of the company's assets to generate revenues. These measure include profitability, liquidity, turnover ratio, cash conversion cycle and gearing.

The financing decision made by SMEs managers will have impact on the company's profitability and liquidity. Thus, it is very crucial for managers to identify the types of finance available for their companies and make the right financing choice.

Many textbook authors believe that one of the main decisions that need to be considered by firms is how to finance its operation. It is because the choice has a direct or indirect impact on the value of the companies. A financial policy needs to be developed whereby it is able to obtain funds and to finance the firm's investment needs and operative needs. It is very important for firms to have access to finance for survival and maintain its performance. Basically for SME enterprises, the funds are required to finance their inventories, labour costs, utilities, suppliers and other creditors.

The financing policy chosen and adopted by managers may affect the liquidity and profitability of the firms. Liquidity means the firms are able to meet the short term obligations and these are possible when cash is available. Apparently cash is said to be the heartbeat of firms, without it firms cannot sustain. To ensure the continued flow of cash in firms, managers therefore need to make profitable investments. It is very crucial for managers to maintain a balance between liquidity and profitability during the day to day operations.

Theories has been introduced in the past; with regards to the choice of capital structure for firms, (externally or internally sources) as well as the policies on financing working capital that relates to the firms risk

level. However, most SME may not be able to follow these theories due to many factors and above all, the attitude of the managers themselves (Romano, Tanewski & Smyrnios, 2001). This study seek to report the effect of financing policies in the Groom Big companies on their financial performance.

Generally, SMEs will invest more on current assets and uses more current liabilities in its day to day operation (Padachi, 2006) compared to non-current assets and long term financing. Too much investments in current assets may lead to lower profitability of firms, whilst low level of current assets may lead to lower liquidity (Van Horne & Wachowicz, 2004). On the other hand, heavy reliance on current liabilities may affect the liquidity of the firm, since firms needs to frequently pay the creditors. In addition, too much dependence on long term source of finance will affect the profitability of the firm, since long term finance is costly.

## **LITERATURE REVIEW**

### **Small and Medium Sized Companies (SMEs)**

SME has been described to be a major source of income, a training ground for global entrepreneurs, provider of employments, feeder industries for larger industries and are responsible for the economic growth and development in most countries in the world (Kraja & Osmani, 2013; Harash, Al-Tamimi & Al-Tamimi, 2014; Kongolo, 2010; Harash, Alsaad & Ahmed, 2013). In Malaysia, SMEs contributed to 99.2% of total business establishments in 2010, with a 32% share of GDP, 59% share of employment and 19% share of total exports (SME Masterplan 2012-2020). The figures indicates the importance of SMEs in shaping the Malaysian economy (Mahmud & Hilmi, 2014).

SMEs play a key role in economic development and make an important contribution to employment and GDP in most countries in the world. In many cases, the SMEs will rely highly on internal source of finance in the early stage of the business. However, at a later stage of the business, the owners and managers may need to inject more funds for further development and sustainability of the firms. The funds may come from the retained earnings

or from the owners personal funds. In some cases, the firms need to borrow from banks or seek other sources such as factoring companies and request for credit extension. These initiatives were also stated in the SME Finance Policy Guide, October 2011.

## **Financing SMEs**

Raising funds may be a challenge to many SMEs as it is getting difficult to get loans from banks. In addition, the risk capital investors like business angels and venture capital fund, expect high growth and rapid exit, which cannot be met by most companies. SMEs often lack access to external finance (Fazzari & Petersen, 1993; Petersen & Rajan, 1997; Whitted, 1992) and thus rely more on internal financing. With limited access to the long-term capital markets, these firms tend to rely more heavily on owner financing, trade credit and short-term bank loans to finance their needed investment in cash, accounts receivable and inventory (Chittenden, Poutziouris & Michaelas, 1998; Saccurato, 1994).

However, the main challenges faced by SMEs is to have access to financing due to poor customer knowledge, poor business enablers, lack of collateral or capital, lack of credit data, low profitability, skills and literacy (IFC, 2013; Harash et al., 2014). Insufficient track records, resulting in a relatively higher risk for capital suppliers (Berger & Udell, 1998) forced many SMEs to turn to debt financing which are considered to be cheaper (Sun & Too, 2014). SMEs limitation in financing their operations may seriously limit their expansion potential and, in particular when it comes to equity and innovation (Akhtar, 2005). Financing was one of the major factors that related to the performance of SMEs (Kristiansen, Furuholt & Wahid, 2003; Mohd Sheriff, Peou & Ali, 2010; Mohd Shariff & Peou, 2008; Swierczek & Ha, 2003).

The two basic financing for SMEs have been identified in the previous literature as internal financing and external financing. Often SMEs rely on internal financing involving fresh injections from the shareholders. There are cases where the firms will use bank loans, hire purchase and leasing (Bonin & Wachtel, 2003; Baum, Schafer & Talavera, 2007; World Bank, 2014). Lower leverage rates are due to the pooling of profits by firms and invest them in firm growth opportunities then spending it on settlement of debts and hence good performance (Rehman, 2013).

Because of the existence of a difference between the cost of short-term and long-term debt, there is scope to determine the optimal mix of debt that satisfies the desire of diversification of financing sources and minimizes its cost (Moro, Lucas & Grimm, 2012)

## **Performance**

SME financial performance is often measured by the increased in sales or turnover, profit margin and the ability to contribute to jobs and wealth as well as sustainability (Sandberg, Vinberg, & Pan, 2002; Chell & Baines, 1998). Accounting based measures based on profitability like Return on Turnover, return on assets and return on equity measures performance of companies (Parker, 2000). In addition, financial performance of SMEs can be determined by using ratios on profitability, efficiencies, liquidity and growth in sales as reported in the financial statements (Dobbins et al., 2000).

Firms' profitability can be increased by reducing the operating cycle (Hutchinson, Farris II & Anders, 2007; Teruel & Solano, 2007). Samiloglu and Demirgrunes (2008) found that there is a relationship between profitability and average collection, inventory and leverage.

Financing performance is a measure of how well a firm utilised its assets to generate revenues (Dess & Robinson, 2003; Kaplan & Norton, 2004) and often represented by profit performance. Financing decisions are influenced by the return on assets among other factors, and when the returns are greater, the firms do not fear to go for external finance (Alslehat & Altahtamouni, 2014). A study by Abor (2005) found a relationship among total debt and profitability to be positive because of the larger proportion of short term financing in total debt, but in the same study he emphasizes low interest rates become a major contributor to profitability. However, in his other study Abor (2007) found that increasing the amount of short-term debt would result in a decrease in the firm profitability. In agreement, Deesomsak, Paudyal and Pescetto (2004) also found a negative relation of leverage level with firm performance; he further adds that when firms have a sizeable amount of profit, they resort to use internally generated source besides borrowing. Krishnan and Moyer (1997) found that the relationship between financing decision and firm performance is partly influenced by the macroeconomics factors.

Cash conversion cycle is the number of days that the firms take to collect cash from their debtors and pay the suppliers for an earlier purchases. It is considered as cash gap as the period of time between the actual cash expenses for production and actual cash received by a special sale of goods or services (Eljelly, 2004). A longer cash conversion cycle means the firms need to rely on bank loans or overdraft to continue financing their operations that leads to increase in interest payments (Filbeck & Krueger, 2003). However, the length of conversion cycle varies with the sectors of the business.

### **Malaysia Productivity Corporation (MPC)**

Malaysia Productivity Corporation (MPC) is a statutory body under the Ministry of International Trade and Industry (MITI). MPC carries out activities to increase productivity, quality and competitiveness. MPC's main vision is to be the leader in improving productivity towards global competitiveness of a competitive and innovative.

### **Groom Big**

#### **1. The Programme**

The Groom Big Programme is an initiative to encourage, nurture and develop SME entrepreneurs to have a bold vision towards becoming a big entity, ability to compete and progress while having the staying power at the domestic and global level. Its aim is to make SMEs think big so that they can be groomed into larger entities. The Groom Big 1 Programme was conducted in the years 2012-2013, and the focus was on Total Quality Management. The Groom Big 2 was conducted in the years 2014-2016 with emphasis on Business Excellence.

#### **2. The Companies**

Groom Big Companies consist of SMEs that were selected based on their potential to become global players. There were 8 companies that participated in the first programme and 13 companies in the second programme. Three main sectors of the industry were selected and they are the food manufacturer, manufacture and service providers that have been in the business for more than 10 years.

## **METHODOLOGY**

A case study was conducted on all 13 Groom Big (2) companies. These companies were selected by MPC from three main sectors:

1. Food manufacturing
2. Manufacturing
3. Servicing

Due to confidentiality, the name of the companies are not revealed but replaced with codes; F for Food Manufacturing companies, M for Manufacturing companies and S for servicing companies.

Financial statement analysis were conducted on all the 13 companies. This is part of the requirement for the Groom Big programme to determine their overall performance and the readiness of these companies to compete globally. All SMEs were required to submit their 5 years audited financial statement (between 2010 and 2015) during an earlier two days-workshops.

Several site visits or interview sessions were conducted with the owners as well as the key personnel to gather feedback and to rationalize some earlier findings on the financial ratios. To determine the financing policy adopted by these companies, financial statement analyses were conducted focusing on the financial gearing, interest cover ratio and Cash conversion cycle. To determine the overall performance, other financial ratios in particular Profitability ratio, Liquidity ratios and Efficiency ratios were calculated with a trend analysis carried out additionally.

The analyses were conducted according to sectors for better comparisons. The ratios selected for the study are as follow:

**Table 1: Financial Ratios Formula**

	To measure performance	Formula
1	Gross margin	Gross Profit/ Turnover x 100%
2	Operating margin	Operating profit/ Turnover x 100%
	Internal management/ efficiency	Formula
3	Asset turnover	Turnover/ total asset
4	Cash conversion cycle	Debtors collection period + inventory turnover period – creditors payment period
	Financing decision	Formula
5	Debt/equity	Long term debt/Equity
6	Short term finance/Total finance	
7	Current asset/ Total asset	

## FINDINGS

From the thirteen companies, only five companies representing the three sectors illustrated below managed to provide the relevant financial statements to facilitate the study.

## Background of Companies

**Table 2: Background of Companies for Food Manufacturing Companies**

	F1	F2
Company Type	Private Limited Company	Limited Liability Corporation
Type of industry	Food and Beverages	Food and Beverages
Year of incorporation	2004	2003
Core activities	The company's main business is manufacturing and distribution of kebab.	The company's main business is the manufacture, distribution and retailing various types of breads.



Vision	To be an independent company To be a company that practices good ethics To become a company of international standard company	To be a well-known bread manufacturer; competitive with other companies and achieve productivity levels that meets the valid standards and condition
Mission	To be an international halal food manufacturer through quality products, good services and excellent team.	Strive to improve production quality and kosher bakery owned by Bumiputera and able to penetrate a wider market. Always create a difference from time to time to keep up with competitors.

**Table 3: Background of Companies for Manufacturing Companies**

	M1	M2
Company Type	Private Corporation	Private Corporation
Type of industry	Manufacturing	Manufacturing
Year of incorporation	2006	
Core activities	Produce and market over 100 products. We utilize the latest equipment for large-scale manufacturing of creams and ointments, tablets, capsules, liquid preparations as well as powders and granules.	Provide solution for utility revenue collection system based on smart card technology
Vision	To be Malaysia's leading health provider, strive to provide the right services to help you enjoy life to the fullest. From the way we operate to what we intend to accomplish, both on the local and international front, we apply and hold close a vision of excellence created towards making your life better.	To be an established metering manufacturer and solution provider in global context

	<b>M1</b>	<b>M2</b>
Mission	To become the century's most valued company to patients, customers, colleagues, investor, business partners and the communities where we work and live.	To help the customers in lowering the cost of doing business in the highly competitive energy metering market.  The Research and Development Laboratory is involved in developing new products and metering solution that can meet customer's ever changing requirements.

**Table 4: Background of Companies for Servicing Companies**

	<b>S</b>
Company Type	Private Corporation
Type of industry	Service
Year of incorporation	1980
Core activities	To provide service that covers all aspects of service management, operation and management (O7M) and general services for comprehensive building maintenance. Services include contract cleaning, outdoor cleaning, cleaning specialized services and hygienic services.
Vision	To be a leading service provider for sustainable facility management
Mission	Value highly high performance people as premium resources Offer outstanding services and innovative solutions Implement best practices in environmental protection

## Financial Statement Analysis

**Table 5: Financial Statement Ratios for Food Manufacturing Companies**

	2012	2013	2014
<b>Food Manufacturing</b>			
<b>F1</b>			
Gross margin	25%	25%	24%
Operating margin	5%	6%	4%
Asset turnover	6%	8%	5%
Cash conversion cycle	46 days	72 days	106 days
Debt/equity	16%	41%	53%
Short term finance/Total finance	32%	39%	43%
Current asset/ Total asset	84%	69%	57%
<b>F2</b>			
Gross margin	10%	10%	10%
Operating margin	3%	3%	3%
Asset turnover	14%	9%	7%
Cash conversion cycle	25 days	22 days	55 days
Debt/equity	310%	254%	335%
Short term finance/Total finance	36%	32%	55%
Current asset/ Total asset	33%	33%	31%

The above ratios showed that the gross margin and operating margin of food manufacturing companies F1 and F2 were constant for the three years (2012 to 2014). However, the profit could be further improved if both companies were able to maximize their asset utilizations. During the years 2012 and 2014, the asset utilizations were on an average 10% for company F2 and 6% for company F1. The small operating margin indicated that the companies may not have much profit left for further investments, thus forcing them to turn to external resources.

Small companies like F1 and F2 must compete with larger food manufacturing companies. Their market shares are comparatively smaller than their larger competitor/s. In addition, there are various choices of food that are being produced at the local market and abroad. It is very challenging for both F1 and F2 to penetrate into a larger market. F1 concentrates more in the southern part of Malaysia and Klang Valley, and F2 is able to dominate the Eastern region of the Peninsular and southern part of Thailand. The owners are considering adding more products into their product lines as a strategy to expand their market. F1 is currently working with a local frozen and fast food company to gain cross selling opportunities.

Both companies depended highly on external financing as shown by the increasing debt/equity ratio for both companies. These debts were basically used by the firms to acquire the non-current assets like transportation and some imported special machine from Europe. Large amount of borrowing was required to acquire the expensive imported machines.

These companies' cash conversion cycle was increasing; indicating that they were taking longer time to collect money from their debtors to pay their suppliers. This payment collection and payment policy affected their liquidity. In order to ease the liquidity problem, the companies opted to adopt a conservative financing policy. The long term source of finance were used to finance their current assets. Theoretically, the policy should be able to reduce the risk of illiquidity, but at the same time, the move may adversely affect the level of profitability.

Long term source of finance are more costly compared to short term finance. Interest on long term debt is higher compared to short term bank loan. Even if the companies were to rely on equities, the cost of raising equities (dividends paid to equity holders) are higher than the costs of raising debt. This is due to the risk borne by the equity shareholders. Even though the liquidity of the companies are addressed but the profitability of companies are affected due to the high costs.

However, the ratios above showed that the percentage increase in the gearing (debt/equity) did not reduce the profit in the same percentage. The profitability ratios of both companies were constant; indicating that there were other possible reasons (for these two companies, the low operating

costs) that will affect the profitability of the firms apart from the financing decision made by managers. Thus, it is safe to say that the performance of the SMEs in the food manufacturing sectors did not depend on the financing policies of the companies.

**Table 6: Financial Statement Ratios for Manufacturing Companies**

	2012	2013	2014
<b>Manufacturing</b>			
<b>M1</b>			
Gross margin	33%	45%	42%
Operating margin	14%	22%	16%
Asset turnover	16%	21%	38%
Cash conversion cycle	384 days	313 days	144 days
Debt/equity	78%	58%	34%
Short term finance/Total finance	NA	61%	60%
Current asset/ Total asset	NA	80%	70%
<b>M2</b>			
Gross margin	11%	27%	25%
Operating margin	1.2%	2.0%	0.9%
Asset turnover	20%	10%	8%
Cash conversion cycle	-53 days	-282 days	-245days
Debt/equity	52%	45%	43%
Short term finance/Total finance	68%	62%	59%
Current asset/ Total asset	58%	51%	44%

The gross margin and operating margin of M1 increased from year 2012 to 2013 and slightly decreased from year 2013 to year 2014. The operating costs of M1 represented more than half of its gross margin. Most of its raw material were imported and its fixed operating costs were high, thus earning an average operating profit of 17% only. Generally, production and sales of products in M1 were determined by its customers. The sales for

M1 showed an increasing trend. With high investment in machines and low sales value, the asset utilization of M1 was low but showed an increasing trend from 2012 to 2014.

Comparatively, M2's gross margin and profit margin were generally lower than M1. However, it should be highlighted that both companies are not producing similar items. The demand for product M2 was decreasing similarly to the economic conditions of the local and global market. M2 received its raw material from the Europe and Japan suppliers whilst to distribute their product locally and to Indonesia, Thailand and Vietnam. Similar to M1, M2 operating costs were very high; resulting in very low operating margin. This left the company with lower profit for reinvestment purposes.

The asset utilization of M1 showed an increasing trend, in line with its increasing trend in gross margin and profit margin. This indicated that the sales has improved over the years. In the case of company M2, the asset utilization was lower than M1 and was reducing over the three years. This led to lower profit earned by the company as shown by the net profit margin.

The cash conversion cycle of company M1 was very long in 2012 and 2013, where they exceeded 300 days. However, the CCC had reduced to 144 days in 2014, implying that it became more efficient over the three years in collecting cash and paying its creditors. In the case of M2, the cash conversion cycle was negatively implying that the company highly depended on its current liabilities to finance the day to day operation. The company took a longer time to pay its suppliers compared to the collection made from customers. The negative CCC could be a signal that the company might land itself in financial distress unless the suppliers agreed to the stretching of payables period.

The debt to equity ratio of M1 reduced at average of 22% per annum indicating that the company relied less on its long term financing and thus reduced its financial risk. On the other hand, M1 showed an increasing trend in its reliance on short term financing. One can assume that the company is slowly replacing a more expensive finance with a cheaper source of finance. Obviously, this affected its liquidity position. Its reliance on short term finance means that M1 is slowly adopting aggressive financing policy that resulted in improved profitability.

The debt to equity ratio of M2 has reduced by an average of 4.5% only over the three years. The company is not highly leveraged and thus can avoid paying high financing cost. Theoretically, this should enable M2 to earn higher percentage operating margin. But since a large portion of the operating costs consist of administration costs especially salaries of the managers and employees, the operating costs remained low. Generally, the breakdown of its total financing and the total assets showed that the company had adopted a policy that nearly matches its total assets. The policy adopted should be able to balance between the liquidity and profitability of company M2.

**Table 7: Financial Statement Ratios for Servicing Companies**

	2012	2013	2014
<b>Service</b>			
<b>S2</b>			
Gross margin	18%	15%	28%
Operating margin	6%	10%	17%
Asset turnover	126%	137%	133%
Cash conversion cycle	41 days	20 days	7 days
Debt/equity	23%	14%	11%
Short term finance/Total finance	31%	28%	26%
Current asset/ Total asset	57%	62%	68%

The gross margin and operating margin for company S2 showed an increasing trend. The company holds a large market share in the industry and has reached the maturity stage of the business cycle. Most companies at this stage of the business cycle are mostly cash cow.

The services provided by the company requires the investment of machines that were imported from overseas and manned by its large number of trained employees. Apparently, S2 is also the sole distributor for such machine in Malaysia. The company is supported by good demand and high revenue plus its excellent services, thus the asset utilization of S2 increased over the three years.

The cash conversion cycle has reduced tremendously that enable the company to ease their cash flow. The company's liquidity ratio was also very low. The debt to equity ratio is low and showed a decreasing trend; indicating that the company has low financial risk. This way, S2 was able to avoid high financing cost and could obtain high operating profit. However, the administration costs, especially salaries of its employees, were very high. This left the company with a 10% average profit margin.

The analysis of total assets showed that S2 invested a larger amount of current assets compared to its fixed assets, indicating that it was adopting a conservative investment policy. Its high reliance on equity: especially its retained earnings also indicates that it was practicing conservative financing policy. The Pecking theory approach is preferred by company S2.

## **LIMITATION**

The common limitation of this study is similar with other case studies. Firstly, the credibility of generalizations made from the Groom Big companies' findings. The data perceived as producing 'soft' data and this approach is criticized for its lack of degree of rigorousness. It is also difficult to define an absolute and clear-cut decision as to what source of data is needed to incorporate in this study. Access to documents, people and settings can also generate ethical problems in terms of issues such as confidentiality. The presence of the researchers can lead to the observer effect (those being researched might behave be indifferent).

In addition to these normal limitations on conducting any case studies, there are also specific limitations. The study is not a longitudinal study as it was conducted on a specific months identified by MPC on the Groom Big programs. The subject matter required the respondents to rely on their memories (which may inevitably involve inaccuracies) of several prior years' events. The research was based on interviews and document analysis. Only minimal direct observation by the researchers of the events was possible.



## CONCLUSION

From the case study on the Groom Big 2 companies result and subsequent discussions, there is a relationship between the financing policy adopted by the company and the performance of the company. It can be concluded that a high reliance on long term debt affect liquidity negatively. When the company rely more on the long term debt as in F2 and M1 companies, the liquidity of the companies were low. Liquidity was indicated by the cash conversion cycle of the companies. The longer the cash conversion cycle means that companies were taking longer time to meet its short term obligations; thus this led to lower liquidity.

A high reliance on long term debt affects profitability negatively. The costs of financing long term debt was high, as in the case of company F2 and M1, thus pulling down the profit level. Low reliance on long term debt but high operating expenditure will affect operating profit margin and asset utilization of the companies adversely as in the case of M2 and S2. The different companies within the same industries adopted different financing policy, as in the case of M1 and M2 but resulted in constant profit margin.

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