THE EFFECT OF CAPITAL STRUCTURE ON PROFITABILITY: AN EXTENDED ANALYSIS OF BIOTECHNOLOGY COMPANIES LISTED ON THE BURSA MALAYSIA

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5.2 Enhanced Executive Summary

The purpose of this study is to investigate the relationship between capital structure and profitability of biotechnology companies listed on the Bursa Malaysia during a six-year period of January 2005 until December 2010. Regression analysis had been used in the estimation of functions relating the return on equity (ROE), return on asset (ROA) and gross profit margin (GM) with measures of capital structure. The results lead the study to conclude that capital structure choice, in general terms, has weak-to-no influence on the financial performance of listed biotechnology firms in Malaysia. This suggests that biotechnology companies in Malaysia prefer to use surpluses generated from profits to finance investments. It may also indicate that firms generally prefer internal funds over external funds, irrespective of the characteristics of the asset to be financed (i.e. whether it is a tangible or intangible asset).

5.3 Introduction

Capital structure are related to the ability of the firm's manager make a decision to determine the best weight of liabilities and owners' equity to finance the project, hence affect the value of the firm. Most of the literature in capital structure provides similar empirical patterns and can be explained by various different theories.

The decision of the capital structure is important and vital for any firm because of the requirement to maximize owner's wealth and returns. This may involve the internal and external factors that have to be reviewed the impact on firm's performances. Previous empirical studies have shown that the combinations of profitability and types of debt affect the firm's capital structure. According to Abor.J (2005), the capital structure of the firm is a specific mix of debt and equity the firm uses to finance its operations. The appropriate combinations of debt and equity are very important to all firms especially for the emerging and high-technology firms to maximize its overall market value.

Nowadays, biotechnology companies are the example of emerging and high-technology firms. Some of the firms may still be in the research and development stage of their first product and others are in the growth stage. In real world, biotechnology firms may have great possibilities of incurring in losses and have very low possibilities of experimenting gains (risk and return trade-off). For further growth, the firms need huge capital at both investment and operating stage and face high financial risk. The negative relation between the growth of the firm and its capital structure shows that firms with high growth potential employ less debt in their capital structure. The high growth means high variation in earnings which can be interpreted as higher risk. Firms that are risky generally find it difficult to raise debt capital, simply because the lenders will demand higher returns making debt capital more expensive (Erontis.N, 2007).

The purpose of this paper is to present empirical evidence on the determinants of capital structure of biotechnology companies from the context of a developing country. The following section reviews the extant literature on the topic. The next section describes the research methodology. The subsequent section presents and discusses the results of the empirical analysis. Finally, the last section summarizes the findings and concludes the discussion.