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Determinants of the Capital Structure in Shariah-Compliant Financially Distressed Firms

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ABSTRACT

This study examines the factors influencing the capital structure in Shariah-compliant and financially distressed firms, focussing on the long-term debt-to-equity (LTDE). Given the Shariah restrictions on interest-bearing debt and the financial constraints of distressed firms, understanding their financing decisions is essential. Using the dynamic panel data analysis on 75 firms (374 firm-year observations), the study evaluates eight key factors: liquidity, profitability, efficiency, growth opportunities, asset tangibility, corporate governance, firm size, and political connections. The dynamic approach enhances accuracy and addresses endogeneity. Results show that past financing decisions (lagged LTDE) and profitability positively impact the LTDE, suggesting firms maintain previous debt levels and use debt when the firms are in a profitable position. Other factors, including liquidity, growth opportunities, asset tangibility, firm size, and corporate governance, show no direct impact, though corporate governance indirectly influences financing decisions. These findings provide insights into how Shariah-compliant and distressed firms manage the capital structure. The study contributes to the Islamic finance and corporate financial distress research, offering practical implications for policymakers, investors, and financial institutions in enhancing financial stability.

Keywords: Capital structure, financially distressed firms, Islamic finance and leverage, shariah-compliant firms

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INTRODUCTION

Capital structure remains a central topic in corporate finance, with ongoing debates about its determinants (Bui & Nguyen, 2021). Despite extensive research, no single theory fully explains the capital structure choices due to the firm-specific and macroeconomic variations (Chadha et al., 2021). This study examines the long-

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term debt-to-equity ratio (LTDTE) in Shariah-compliant and financially distressed firms, considering their distinct financial constraints. The Shariah-compliant firms follow the Islamic finance principles, avoiding interest-based transactions and excessive debt, with the Malaysia's Securities Commission enforcing strict compliance (Lee & Isa, 2023). Financial distress, on the other hand, reflects a firm's difficulty in meeting obligations, often requiring restructuring (Bhutta et al., 2020). Given the Malaysia's advanced Islamic financial system, it serves as an ideal setting for this study (Saba et al., 2020). The research hypothesises that the financial distress and Islamic finance principles significantly shape the capital structure decisions. By adopting a dynamic approach, this study deepens the understanding of the capital structure determinants, offering insights for policymakers, investors, and corporate leaders.

DETERMINANTS OF CAPITAL STRUCTURE

Several factors shape a firm's capital structure, including liquidity, firm size, profitability, efficiency, growth opportunities, asset tangibility, corporate governance, and political connections. High liquidity reduces debt reliance (Opler et al., 1999), but distressed firms may hoard cash for stability (Almeida et al., 2004). Larger firms generally have better debt access, though in distressed cases, cash flow stability is more critical than size. Profitability encourages internal funding (Myers & Majluf, 1984), but tax advantages make debt attractive (DeAngelo & Masulis, 1980). More efficient firms borrow less, while weaker firms depend more on debt (Hovakimian et al., 2001). High-growth firms prefer equity financing (Myers, 1977), but distressed firms may still seek debt despite lender reluctance (Aivazian et al., 2005). Asset tangibility supports borrowing, but Shariah-compliant firms follow risk-sharing principles instead of collateral-based lending (Abdullah & Tursoy, 2021). While corporate governance enhances financial management (Shleifer & Vishny, 1997), its influence weakens in distressed firms (Ghosh, 2007). Politically connected firms gain easier access to debt (Faccio, 2006), though excessive reliance can lead to inefficiencies. These factors influence the capital structure differently, especially in Shariah-compliant and distressed firms, warranting further research.

METHODOLOGY

This study explores the factors influencing the capital structure in financially distressed Shariah-compliant firms, using the long-term debt-to-total-equity ratio (LTDTE) as the dependent variable. The independent variables include liquidity (LIQ), firm size (SIZE), profitability (PROF), efficiency (EFF), growth opportunities (GROW), asset tangibility (TANG), corporate governance (CG), and political connections (PC). To analyse these relationships, the study applies the System Generalised Method of Moments (System GMM), a dynamic panel data approach that addresses endogeneity and improves estimation efficiency (Blundell & Bond, 1998). A variable selection technique (Lindsey & Sheather, 2010) is used to refine the model by retaining only significant factors.

FINDINGS AND DISCUSSION

This study explores the factors influencing the capital structure in Shariah-compliant firms, using data from 75 firms listed under PN4, PN17, and APN17 of Bursa Malaysia. The focus is on the long-term debt-to-equity ratio (LTDTE) as the key measure. Initially, eight factors were considered, but after applying the variable selection technique, six remained: liquidity, profitability, growth opportunity, firm size, asset tangibility, and corporate governance. Political connections and efficiency were excluded due to their insignificant impact on the LTDTE. A dynamic model was chosen over a static one, with the System GMM being used for its ability to reduce bias and improve estimation efficiency. Findings show that past leverage (LTDTE) and profitability significantly influence the LTDTE. Firms with higher past debt tend to maintain high leverage, supporting the dynamic trade-off theory. Profitable firms also take on more debt to maximise tax benefits (Myers, 1977). However, liquidity, growth opportunity, asset tangibility, firm size, and corporate governance had no significant impact. The results suggest that distressed firms prioritise short-term liquidity (Opler et al., 1999), while creditors hesitate to fund their growth opportunities (Myers & Majluf, 1984). Asset tangibility has little effect, as Shariah-compliant financing does not rely solely on collateral (Abdullah & Tursoy, 2021). Firm size does not guarantee easier debt access, as creditors prioritise cash flow over size. Corporate governance appears weak in distressed firms, reducing its influence on debt decisions (Ghosh, 2007). Overall, while the capital structure theories apply to stable firms, their impact is less pronounced in Shariah-compliant, financially distressed companies.

CONCLUSION

This study examines the factors influencing the capital structure in Shariah-compliant, financially distressed firms in Malaysia, using a sample of 75 firms. Key variables being analysed include liquidity, profitability, efficiency, growth opportunities, asset tangibility, firm size, corporate governance, and political connections. The results indicate that lagged debt ratios and profitability significantly affect the long-term debt-to-equity ratio (LTDTE). Corporate governance also plays a crucial role, with stronger governance linked to higher LTDTE. Firms with growth opportunities tend to rely more on long-term financing. However, liquidity, firm size, and political connections show no significant impact. While this study provides valuable insights, some limitations exist. The reliance on specific financial data may introduce bias, and the 2018-2022 timeframe may not capture long-term trends. Future research should consider wider datasets, multiple economic cycles, and alternative financial or industry-specific variables for a deeper understanding of capital structure in these firms.

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