THE DETERMINANTS OF OPTIMAL INVESTMENT LEVEL (OPT) FOR THE FIRM VALUE: REVIEW OF THE LITERATURE

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Abstract

The inaccuracy of imperfection financial market information will contribute to reduce the firm level of investment towards the expected return on investment returns. Furthermore, this issue will adversely affect investors and financial management companies who are facing difficulties in obtaining external funds to finance investment opportunities and investment decisions that do not reach the maximum level of corporate value. Hence, this paper is to highlight the problems and factors that influence the company's management in determining the optimum level of investment in the company. Several secondary sources have been used to strengthen the study framework that can be used for further research.

Keywords: The optimal investment level (OPT), Underinvestment, Overinvestment, Firm Investment decision
INTRODUCTION

In imperfect financial markets contributing firms face the difficulties of getting external finance to fund investment opportunities, the external funds are more expensive than internal funds and investment decisions not reach the maximum of firm value. (Aggarwall & Zong, 2006).

Additionally, the mission of the business firm is always to maximize shareholders’ wealth or to maximize the value of the firm and it will be maximized when the optimal investment level (OPT) is reached. (Dogru & Sirakaya-Turk, 2017). Furthermore, Tobin-Q has been a fundamental theoretical for the firm’s decision. (Kong, Xiao, & Liu, 2010). Therefore, their studies show that Tobin-Q indeed has a significant positive effect on the firm investment. Moreover, theory of Tobin Q suggests, an investment below the optimum investment level is considered an underinvestment, whereas an investment beyond the optimum investment level is considered an overinvestment.

Both underinvestment and overinvestment are problematic for the firm because overinvestment levels are beyond the maximum firm value while, underinvestment problems occur when there is a substantial difference between the cost of internal and external funds that turns a positive net present value (NPV) investment to negative. Furthermore, if the firm only focus on internal funds to make investment it will get into suboptimal investment level which is below the maximum firm value (Hadlock & Pierce, 2010). For instance, hotel firms’
investments, such as mergers and acquisitions and development and building of hotel properties require substantial capital spending. However, a hotel firm may not be able to finance all of its value-increasing projects with available internal funds and thus face the underinvestment problems. (Lee & Upneja, 2007; Dogru & Sirakaya-Turk, 2016).

LITERATURE REVIEW

THEORY OF TOBIN Q

The theory of Tobin Q always being the fundamental subject by the investor to make optimal portfolio investment decision in order to maximize the value of firm. Tobin’s Q is the ratio of the market value of the firm to replacement cost of the firm’s assets. (Dogru & Sirakaya-Turk, 2017). Therefore, the value of Tobin’s Q should be higher more than 1 or the industry average suggests that firms have great investment opportunities and growth prospects, whereas a Tobin’s Q lower than 1 or the industry average indicates that firm does not have profitable investment projects or potential to generate excess cash flows from the existing projects. In addition, based on (Francis M. Mathooko, 2015) discussed the theory of Torbin Q is about the comparison between the value of the firm in financial markets and its book value or capital stock. Furthermore, there are a lot of empirical evidence on investment has shown that issue on overinvestment and underinvestment able to identify firms’ overinvestment or underinvestment problem.

THE OPTIMAL INVESTMENT LEVEL

Base on (Dogru & Sirakaya-Turk, 2017) stated that there are several factors will contribute to the optimal investment level which are asymmetric information, the negative value of investment, the total financing of firm is more than total investment of firm and uncertainty event.

Asymmetric Information

The results from the empirical finance literature showed significant evidence that financing and investment decisions are not separated. There is asymmetric information that exists in the capital markets and hence firms’ investment can deviate from the optimal level because of under or overinvestment problems (Stein, 2003)

Prior research finds that capital market imperfections, such as information asymmetry and agency’s problems, may lead firm managers to make inefficient investment decisions that result in either under-investment or over-investment (e.g., Jensen and Meckling, 1976; Myers, 1977; Myers and Majluf, 1984; Jensen,
Therefore, the consequence is the firm will not be able to increase the value of the firm.

**The value of investment negative**

Underinvestment problems occur when there is a significant difference between the cost of internal and external funds that turns a positive net present value (NPV) investment to negative. (Dogru & Sirakaya-Turk, 2017). This negative value affected by the cost of internal and external funds. Furthermore, over-investment arises from the incoherence between the interests of firm managers and shareholders. In the presence of free cash flows, firm managers have a propensity to expand their firms, even if that means undertaking investment projects with a negative NPV that reduce shareholder value (Aivazian, V.A., Y. Ge and J. Qiu, 2015).

**Financial Market Uncertainty**

Rashid (2011) investigating the impact of uncertainty on the investment decisions of privately held manufacturing firms in the UK provides evidence that firms’ investment decisions are more sensitive to financial market (aggregate) uncertainty. Thus, this investment decision was influence to the optimal investment level. For instance, in the hotel firms industry investments, such as mergers and acquisitions and development and building of hotel properties require significant capital spending to hotel operation. (Lee & Upneja, 2007; Dogru & Sirakaya-Turk, 2016). However, a hotel firm may not be able to finance all of its value increasing projects with available internal funds and they will face underinvestment problems. This issue also agreed by Baum, C.F., Caglayan, M. and Talavera, O. (2010) study the effects of firms own uncertainty and its effects through cash flows on investment utilizing a large panel data set for US firms. They find that uncertainty plays a pivotal role in shaping the desired level of investment. Further, they show that the impact of firms own uncertainty is positive, whereas, the effect of market uncertainty through cash flows on investment is negative.
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FRAMEWORK OF FACTOR INFLUENCE THE OPTIMAL INVESTMENT LEVEL

Asymmetric Information

Value of Investment Negative

Financial Market Uncertainty

The Optimal Investment Level

The proposed framework of factor influences the optimal investment level

Base on the several past literature reviews discuss related to the level of investment, this study has proposed framework of factor influence towards the optimal investment level on firm. Consequently, this finding provide some insight on the effect on the level investment of the firm.

CONCLUSION

As conclusion, the novel elements of investment decision will be constructed base on factors influence on the optimal investment level on firms. Given this, the firm decision investment by top management of firm should be highlighted and focus more on the features, such as asymmetric information occurs the capital market, value of investment negative and financial market uncertainty. Aspects important for this study will give an awareness and knowledge contribution to the future study related to firm investment decision making.
REFERENCES


