CHAPTER I

INTRODUCTION

1.1 Background

The main purpose of a firm is to maximize profits for its owners. The owner of a firm is its shareholders. Shareholders wealth can increase through the increasing return generate by the firm. Return can be in the form of capital gains or dividends. Dividends are more attractive for long-term investors rather than capital gains. Capital gains are the gains or losses from a sale of stock. Thus it will only exist when investors have sold the stock they owned. Dividends are the amount of profit that a firm pays to the investors who own its stock. Dividends are more certain and relatively stable than capital gains because stock prices are always changing. According to Paramita (2015), dividend payment is inflluenced by investors' behaviour who think that dividends received today are more valuable than the capital gains received in the future.

According to BEI in 2013 (investasi.kontan.co.id; 1 February 2013), some firms in Indonesia has a trend to pay no dividend. A firm's decision not to distribute dividend might due to the need for business expansion, pay debts, loss, or if the firm has negative retained earnings. As stated in UU No. 40 Year 2007, firms may only distributed dividend if it has positive retained earnings and approved by RUPS. However, according to BEI, the reason for expansion are often misused and some firms are simply reluctant to pay dividends. The decision to pay dividend or not is the right of the firms. For that reason, BEI as the regulator can not punish firms that do not distribute any dividends.

Indonesian Capital Market Directory (ICMD) that issued by ECFIN published a financial highlight that also contains the information about dividend payment by all listed firms in the last five years (2012 – 2016). From the ICMD 2016, the researcher found the dividend trend that happened in Indonesia. The trend describe the dividend trend from 2012 – 2015. According to ICMD, in the last four years (2012 – 2015), listed firms in Indonesia that pay dividend is still very low. The average of firms that generate profit in the whole period (2012 – 2015) is quite high, about 79%. Moreover, the number of firms with positive retained earnings is also high, around 76%. But the average of firms pay dividend in the period (2012 – 2015) is just around 37%. This number is low if we compare with the percentage of firms with profit and positive retained earnings that actually can pay dividends. BEI also stated that there is also a firm that only pay a very low dividend, and assumed that it's just a formality.

The firms that pay dividend is the firm that have a profit. In reality not all firms with profit distribute dividend even though the firms is in good condition. One of the reason why firms choose not to pay dividend is because it will decrease the firm's source of internal fund. If a firm does not pay any dividend, the cash is kept as retained earning that can be used for reinvestment purpose. Smaller and younger firms also generally did not pay cash dividends. This kind of firms may retain all its earnings for many years to help finance its growth. As firm matures, typically it will distribute dividend. At some point the firm will increase the proportion of its earning that are paid out in dividends.

Dividends are one of the factors why an investor decide to invest in a certain firms. Dividend can be one of the indicator if the firm is in a good condition. Firms that always pay dividends will get a negative reaction if the firms lower its dividend payout. Conversely, if a firm increase its dividend payout, or give more return, the firm will get positive reaction from the investor.

Shareholders that expect dividends payment are always looking for a factor to predict the dividend pay out. There are a lot of research that investigate the determinants of dividends. However, free cash flow is remain the key factors for the dividend payments. This is because the free cash flow is the main source of cash that firms will use to pay dividends. The free cash flow that is not used for dividend payment will go to the firms' retained earnings.

As an investor, it is important to know about the firm's free cash flow. It is one of the measurement to help investors understand the true profitability of a firm. Free cash flow is harder to manipulate rather than net income. Thus, free cash flow can give a better picture of how well a firm generate cash and profits. According to Richardson (2006), free cash flow is cash flow beyond what is necessary to mantain firm resources and to finance new investments. Ross et al. (2003) defined free cash flow as cash that is free to distribute to creditors and shareholders because it is not needed for working capital or investment in fixed asset. According to Habib (2011), free cash flow is the difference between operating cash flows and capital expenditure. Positive free cash flow indicate that a firm has a cash surplus after paying all its obligations and necessary investments. A negative free cash flows occur when the firm's expenditure is too much and the cash is falling down which is not always a bad news but the reason behind the number should be analyzed.

Free cash flow is one of the factors that can affect dividends. According to Brigham and Daves (2004), a firm can use its free cash flow for several purposes such as to repay debtholders, pay dividends ot repurchase stock from shareholders. Firm with substantial free cash flow can face agency problem because management and investors are likely to have different interest

about how to use the cash. Management tends to use the cash for poor investment or firm inefficiencies. Shareholders, on the other hand always expect return from their investment and want the cash to be given back to them through dividend payment.

The researcher wants to know if the phenomenon of low dividend payout in Indonesia is affected by firm's free cash flow. Prior research have been investigate the relationship between free cash flow and dividend payout ratio. Noroozani and Kheradmand (2014) investigated the factors affecting the dividend policy in Tehran and found that profitability, free cash flow, sales growth, and firm size have positive relationship with dividend payout ratio. Labhane and Das (2015) conducted the same research in Indian firms and found that firms with high free cash flow, larger size, more profitable and mature firms have higher dividend payout ratio.

From prior research, the researcher conclude that free cash flow has an impact in dividend payout ratio. This research will use manufacturing firms, which is the largest group of listed firms in Indonesia Stock Exchange (BEI) and has a characteristic of high sensitivity reacting to the economic changes. Manufacturing firms is choosen becasue it is more appealing for the study of free cash flow (Khan et al., 2012). The research period is taken from 2012 until 2015.

1.2 Research Problem

The key question of the impact of free cash flow and dividend payout ratio can be summarized as follows:

"Does free cash flow have a positive impact on dividend payout ratio in manufacturing firms in Indonesia?"

1.3 The Objective of Research

The objective of this research is to give empirical evidence about the impact of free cash flow on dividend payout ratio in manufacturing firms listed in Indonesia stock exchange from 2012 until 2015.

1.4 The Contribution of Research

This research is expected to give contribution as follows:

1. Investor purpose; this research will give some knowledge for investors that free cash flow is one of the factor that is important in the distribution of dividend and thus can be used as a consideration for investment decision making. Firms with large free cash flow are

expected to give more dividends than firms that generate small free cash flow.

2. Academic purpose; this research provides empirical evidence about the impact of free cash flow on dividend payout ratio in Indonesia and expected to be used for further studies.

1.5 Writing Structure

This research was prepared by sistematic as the following:

CHAPTER I INTRODUCTION

Chapter I is an introduction in the preparation of the research which consists of background, research problem, research objectives, research contribution, and writing structure.

CHAPTER II LITERATURE REVIEW AND HYPOTHESIS DEVELOPMENT

Chapter II constains literature review outlines, theoretical basis and previous research to be used as a references, framework, and hypothesis development.

CHAPTER III RESEARCH METHODOLOGY

Chapter III consists of data related to the research such as sample used, criteria of the sample, data collection method, variable measurement, data analysis and hypothesis testing method.

CHAPTER IV DATA ANALYSIS AND DISCUSSION

Chapter IV contains the result and discussion of the research through a data processing and analysis. Whether the result is meet the criteria and proved the hypothesis also can be seen in this chapter.

CHAPTER V CONCLUSION

Chapter V contains conclusion of the research that has been done, limitation and suggestion for the next research.