CHAPTER I

INTRODUCTION

1.1 Research Background

Nowdays, the number of manufacturing company in Indonesia is always increasing. According to the data of Ministry of Industry, during the period of 2015-2017 the number of industrial and medium business units was increase significantly, reaching 4.433 business units until the second quarter of 2017, compared to 2014 with only 1.288 business units. This increase will continue in the next two years to reach about 8.488 business units by the end of 2019. Along with this growth, the growth of capital needs also increase, because every company needs capital to start and run their business. When these manufacturing company run their business, they should concern about how financial aspect of their company can financially handled well including capital structure.

Capital structure is the mixture composition between debt and equity for funding the company’s operation. Capital structure is very important to notice because when company starting their operation, they need capital. The company can raise capital from two sources which are external and internal sources. The external sources comes from borrowing money through debt from creditor such as bank or issued bond for bondholders and raising capital through equity by issuing shares in capital market. While internal sources is from retained earnings. Since that, the composition between debt and equity will be an important decision for agent (manager) cause that would be impact on company’s future financial condition. Some of companies relied more on debt rather than issuing shares in the market for investor, as the trade of theory stated that companies tend to use debt because collecting fund through debt itself is more easier and timeless rather than issuing share, moreover based on transaction costs, borrowing money on creditor are cheaper than the costs of new share emission transactions. Beside that, when the company have higher of debt, they can get the tax shield through the addition of interest expense. So the company can decrease their tax legally, and that's what happen on some company as their strategy to decrease the expenditure on tax payment. In the other side, debt itself is like a teeter game, higher of debt give a bad impact to company as well. When the company relied more on debt, the probability of financial bankruptcy is increasing in case if company can not manage the debt as the company's capital efficiently and company would not be able to pay the loan plus the interest. More than that, high debt shows that the capital structure is financed more by loans so that the company's dependence on creditors is increase. As a result, the company earns profits and it will be absorbed to pay off debt and then, the profits distributed to shareholders will be smaller and investors being reluctant to invest on or buy some of company's shares, then companies will go down and difficult to improve the operation. This could be a bad signal for market especially on investor perspective whether they will invest on that company or not. For that reason, the financial manager should considerfully about the benefit and the cost of debt as their capital sources. The inappropriate composition of capital structure can make disruption or problem in financial condition and finally market share price will fall down.

We have heard some cases like TimkenSteel Company (TMST) that has the poorest leverage condition of the steel watch list group as it is theoretically undefined given EBITDA (Earning Before Interest Tax Depreciation and Amortization) of -$31 million over the past year, and roughly $200 million in total debt and company's shares have tumbled 76% over the past 12 months. The other example like big mining company Freeport-McMoRan (FCX), that also has oil and gas businesses, which has $20.4 billion in debt. Freeport-McMoRan Company which reported earnings on Jananuary 26, reported a fourth-quarter loss of $3.47 a share. The company said that it is targeting to reduce its debt by $5 billion to $10 billion. From those case, we can see that capital structure issue is very important because it can affect directly firm value through share price.

Firm value is the value of the company that would be reflected on company share price. This price would be an indicator as the company's value. According to Husnan (2006) for companies that have not gone public the value of the company is a number of costs that are willing to be issued by prospective buyers if the company is sold, while for companies that have gone public the value of the company can be seen from the value of shares in the capital market. Share price becomes a reflection of the value of company. When the price of company's share is high, then the value of that company is also high, and coverserly if the share price is low then the value of that company is also low. As we know, the investor would choose to invest on the company that can give them a benefit in the long term or short term. So shareholders will invest more and new investor will be attracted to invest on the company that really has a good financial condition including the financial sources of the company.

Nowdays the investor really consider about every financial aspect of the company that they will invested on, including capital structure. The investor see whether the company that they invested on has good or bad capital structure composition which depended on the way company raising their capital. Through the financial report which issued by company every year, the investor can calculate which company that have good prospect in the future. They can make a calculation, analyze the impact, and comparing whether the financial resource more from debt or quity that can be fortunate on value of the company itself, and we named it as debt to equity. Fama and French (1998), said that the optimization of firm value which is the company's goal can be achieved through the implementation of financial management functions, where each financial decision taken will influence other financial decisions and have an impact on the firm value.

There are so many topic that discuss about the impact of capital structure on firm value. Each of them has different result whether capital structure give significant relation or not to firm value. As stated by Myers, that essentially there is no concept of capital structure which can applicable universally, every theory is only suitable for certain conditions, if the environment change then, the policy must be adjusted. Each factor can be dominant for some companies or in some circumstances, but in other places the factor does not important (Herry Subagyo, 2009). It means some country and some bsuniess sector has certain preference about capital structure. This topic is started to discuss since the publication of the seminar paper of Modigliani and Miller (1958). This topic is really interesting if applying it on Indonesia manufacturing company as the country that has growth in industrial sector.

The author want to see how the company's share price which describe the firm value fluctuate along with their capital structure. So, that's why here the author try to find and make a research with the title The Impact of Capital Structure on Firm Value of Manufacturing Companies Listed on Indonesia Stock Exchange for 2015-2017.

1.2 Problem Statement

Based on the research background and some previous research which elaborated in this research, this study want to examine the impact of capital structure to the firm value. The indicator in this research is Tobin's Q. So the question that appeared is " Does capital structure affect firm value?"

1.3 Research Scope

1. This research focused on the impact of capital structure on firm value of manufacturing companies
2. In this research capital structure will be measured using debt to equity and the firm value will be measured using Tobin's Q
3. The data of the manufacturing company will be taken on Indonesia Stock Exchange for 2015-2017, yahoo finance website, and company's official website

1.4 Research Objectives

There are so many research about capital structure, but very few of them that investigate it on impact on the firm value. While capital structure is very important for the sustainability of the company, lot's of financial manager also still not really concern about their capital strucutre. The objectives of this research is to obtain empirical evidence about the impact of capital structure on firm value of maufacturing companies listed on Indonesia Stock Exchange. Where as capital structure will be measured by debt to equity and for the firm value will be measured using Tobin's Q.

1.5 Research Contribution

1. The contribution of the theory

   This research is expected to be an additional reference about the effect of the capital structure to the firm value

2. Practical contributions

   The results of this study are expected to be used as consideration for manager in making decisions related to getting their financial resources whether through debt and issuing share. This result also give consideration to the investor to concern about the composition of debt and equity to see financial condition on company that they want to invested on.

1.6 Data Analysis

The data of this study will be analyzed using the classic assumption test which involves normality test, multicolinearity test, heterocedasticity test, and autocorrelation test in which to test whether the data have been collected is not bias or the data is reliable and fulfill the feasibility in conducting the research. The hypothesis in this study tested using multiple linear regression.

1.7 Research Outline

The systematical discussion are as the following:

CHAPTER 1 Introduction

This chapter consist of introduction of research, research problem, research objective, research contribution and systematical discussion.

CHAPTER 2 Theorethical Framework and Hypothesis Development

This chapter consist of supporting theories and description of capital structure, firm value, description of previous research and the development of hypothesis.

CHAPTER 3 Research Methodology

This chapter consist of method used in the research that contains population and sample, data used, source of the data, data collecting technique, research variables, variable measurements and also method analysis that consist of classical assumption test and hypothesis testing.

CHAPTER 4 Results and Analysis

This chapter consist of the result of research and further analysis of the result regards to the impact of capital structure to the firm value.

CHAPTER 5 Discussion and Conclusion

This chapter consist of research conclusion that based on the analysis result, also consisting the research limitation and suggestions to the next related research.