CHAPTER I

INTRODUCTION

1.1 Background

Financing sources are very important for every business organization because choosing the optimal capital structure will give an impact on company value and firm can survives on unfortunate economic shocks. Based on Ahmed Sheikh & Wang (2013) and Chadha & Sharma (2015), the financial manager has to compare the merits and demerits of various sources of finance and select which more efficient and suitable to maximizes the value of its company. So hopefully, the company can minimizes the cost of capital and will be able to get benefits in the future. Financial manager take a responsibility to find the financial balance needed and qualitative composition of the balance sheet as well as possible, the selection of qualitative arrangements on the asset will determine the structure of the company's wealth while from liabilities and equity will determine the financial and capital structure of the company.

There are two categories of financing sources, internal and external financing. Internal financing is obtained from own capital, retained earnings, and reserve owned by the company. External financing is funding from debt and issuance of new stocks. Debt is a sacrifice of future economic benefits that may arise from current obligation, consist of long-term debt and short-term debt. Long-term debt has more than one year repayment, reversely short-term debt has less than one year repayment with low-interest rate than long-term debt, and more flexible because the company can use whenever they need. Based on Abdur Rouf (2015) capital structure refers to the mix of long-term sources of funds, such as debentures, long-term debt, preference share capital and equity share capital including retained earnings, it will influence the strategic plan to achieve the goals. Consider the risk and interest in choosing sources of funds very necessary because it will affect the company decision.

The decision about the capital structure of a firm is determined by many factors that can be grouped mainly under main three categories which are firm-specific, industry-specific and country-specific factors (Sakr & Bedeir, 2019). For industry-specific example, financial companies (especially banks) capital structure are regulated by Bank Indonesia regulations, make the use of bank loans is limited. Because bank should meet the minimum capital by following Bank Indonesia's assessment regarding to the risk of that's bank. In contrary, non-financial companies are more flexible on capital structure decision because it is not bound by Bank Indonesia regulations regarding the minimum capital (Putra, 2018). Business risk level faced by the company give influence to the capital structure, while the level of business risk is influenced by the business type operated. But the differences abilities and needs of each company makes the capital structure of each company in the same industry will not be the same.

Based on Mouna et al., (2017) maximization of firm value is not an easy job because the manager should determine the best combination of financial resources with lowest risk for the company. A wrong decision in the selection process may lead the firm to financial distress and eventually to bankruptcy. Each company has a different way, there are no certain characteristics that become benchmarks manager have chosen the optimal structure. The traditional theory of capital structure suppose the optimal mix of capital ensures a low weighted average cost of capital will maximizes the market value per share (Vătavu, 2015). Optimal capital structure is a topic that had widely done in many kind of the research, noted by Myer (2001) each theory works under it assumptions and propositions, so we cannot find any formula or theory that decisively provides optimal capital structure for a firm.

Since 1958, the theory of capital structure and its relationship with company performance is the interest topic that continuing research doing by academic researchers. Theory by Modigliani-Miller (MM Theorem) is the widely accepted capital structure theory because is it the origin theory of capital structure which had been used by many researchers (San & Heng, 2011). According to MM Theorem, these capital structure theories operate under perfect market and this theory states that the capital structure are not related to company value in perfect market. And other theories which have relation to debt decision, namely trade-off and pecking order theory. Trade-off theory is about perfect market where a tax-free economy with no bankruptcy costs, no transaction costs. Pecking order theory is theory that emphasized the existence preference of company in choosing internal and external financing.

Capital structure is closed link with corporate performance (Zeitun & Tian, 2007). Capital structure significantly affects the cost and availability of capital, which in turn also will also affect a firm's performance. Based on San and Heng (2011), corporate performance can be measured by variables which involve productivity, profitability, growth or, even, customers' satisfaction. Financial measurement is one of the tools that reveal the financial strengths, weaknesses, opportunities and threats. Those measurements are Return on Assets (ROA), Return on Equity (ROR), Return On Investment (ROI), Residual Income (RI), Earning-per-Share (EPS), dividend yield, price earnings ratio, growth in sales, market capitalization, and etc. (Barbosa & Louri, 2005). ROA, ROE and EPS as accounting base derived from financial statement, market-to-book ratio as market base and there is also measurement by combining market and accounting value, namely Tobin's-Q. But Tobin's-Q has weakness that can misleading the market measurement because the difficulty of estimating the reimbursement, advertising expense, research and development of intangible assets (Smithers & Wright, 2007).

There are several studies about relationship between capital structure and company performance with different result. Such as research by Ahmed Sheikh and Wang (2013) found that capital structure as measured by long-term debt ratio (LDR), short-term debt ratio (SDR) and total debt ratio (TDR) have significant negative impact to performance by using ROA as measurement. It is consistent with the research by Salim & Yadav (2013), El-Sayed Ebaid (2009) and Sakr & Bedeir (2019). Ahmed Sheikh & Wang (2013) also using other measurement of company performance, Market-to-book Ratio (MBR). They found TDR and LDR have negative significant effect to MBR, while STD has positive insignificant impact to MBR.

Other researcher Vătavu (2015), analyze manufacturing company in Bucharest Stock Exchange on 2003-2010 found that capital structure as measured by LDR, SDR and TDR have negative and significant effect with performance (ROE). It is persistent with research by Salim & Yadav (2013) on Malaysia listed manufacturing company in 2003-2009. While Sakr & Bedeir (2019) research on listed company in Egypt during 2003-2016, found LDR and TDR have positive and significant impact to ROE. There are many different results were found related to relationship between capital structure and performance, because the researchers use the different measurement and sampling study.

This research conducts model from Ahmed Sheikh & Wang, (2013) that study about the impact of capital structure on company performance in Pakistan that will be retested in Indonesia. Choosing the optimal capital structure is expected to reduce the possibility of financial risk obtained by the company in the future and increase the value of the company. This study use Return on Assets and Market-to-Book Ratio to measure company performance, because ROA can give reflection how efficiently the company use their asset and MBR use to evaluate the company's current market value to its book value. Capital structure measure by Long-term Debt Ratio, Short-term Debt Ratio, and Total Debt Ratio to deliver the difference of debt maturity used by the company, because debt maturity will influence the company investing option. The purpose of this research is to find the relationship between capital structure and company performance in Indonesia with data sample period year for 2015, 2016, and 2017.

1.2 Problem Definitions

Various results gather from research on the impact of capital structure on performance. Then, the problem definitions to be explore in this study as follows:

a) Does the total debt ratio influence the company's performance?

b) Does the short-term debt ratio influence the company's performance?

c) Does the long-term debt ratio influence the company's performance?

1.3 Research Objectives

In accordance with the problem definition above, the objectives to be achieved in this research are:

a) The influence of total debt ratio on company's performance.

b) The influence of short-term debt ratio on company's performance.

c) The influence of long-term debt ratio on company's performance.

1.4 Research Benefits

This research is expected to provide benefits in the form of:

a) For researcher

This research can give knowledge about the association of three key measures of capital structure such as total debt ratio, long and short-term debt ratio influence the performance of non-financial company in Indonesia.

b) For Investor or Creditor

This research can be consideration for investor to protect shareholder's interest through providing useful information about factor that can influence company's performance in form of Return on Assets (accounting-based) and market-to-book ratio (market-based) as dependent variables and could give contribution to the investors in investment or credit decision to the company.

c) For Company's Board and Managers

This research can be used as input and evaluation to enhance company's performance through considering the optimal selection of the capital structure and corporate governance mechanism.

d) For Further Research and others

This research can be used as a reference and development for similar research in the future and expected to give knowledge about relationship between capital structure and company's performance.

1.5 Scope of Research

This research focuses on eight variables to be tested. Dependent variable describe the company's performance, use Return on Assets (ROA) and Market to book ratio (MBR) as the proxy measurement. Independent variables include Total Debt Ratio (TD), Long-term Debt Ratio (LTD) and Short-term Debt Ratio (STD). There are also three control variables that may affect the company's performance, including firm size (SIZE), Asset tangibility (ATNG), and Growth (GROW). The researcher limits the research context by focusing on non-financial company listed on Indonesia Stock Exchange.

1.6 Writing Systematic

Writing systematic is a pattern in the presentation of scientific papers to obtain a clear picture of research plot. That's gives an understanding about the content for each chapter, this research contains five chapters.

Introduction contains the general description about the topic of research, which consists of the background, problem definitions, research objectives and benefits, scope of research, and writing systematic.

Second, Literature Review contains the explanation about basic theories underlying to this research which are gathered from different sources (such as: opinions from the experts, books, and journals) and review of previous researches to support the hypothesis generation of the study.

Then, Research Method provides information of an overview of plan in doing the research. That's include the research design, research model, operational definition and research variable, population and sampling, data and data collection method, and analysis method.

Analysis and Discussion give explanation about the data processing result based on research methodology and analysis as well as discussion of the research results regarding the impact of total debt ratio, short-term and long-term debt ratio on company performance.

Last Chapter is Conclusion and Suggestion. This chapter describes the conclusion from analysis of data, limitations of this research, research implications, and also the suggestions for further research.