THE ROLE OF FOREIGN OWNERSHIP ON THE LINK
BETWEEN FINANCIAL LEVERAGE AND FIRM VALUE :
EVIDENCE IN INDONESIA STOCK EXCHANGE 2009-2015

POST GRADUATE THESIS

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CHAPTER I

INTRODUCTION

1.1 Research Background

Recently Indonesia becomes the member of ASEAN Economic Community (AEC). ASEAN Economic Community (AEC) makes competition force such as product flow, service, technology, and supplying capital to the other country freely. It supports companies to create competitive advantage in business. Companies must be better than competitor companies. Thus, Companies must increase competitive advantage to make possible for competing with competitor companies both domestic and foreign companies. To increase competitive advantages, companies can innovate through Research and Development Department. To do that, needed more funding. To get the funding companies can take financing by credit bank, issue stock or bond. By issuing stock, companies share firm ownership to outsider party, institution or personally. For issuing bond and taking credit bank, companies do not share firm ownership but only adding debt. For listed companies financing comes from outside of companies. By the optimal financing companies will create adding firm value.

Financing that is from bond and credit bank called financial leverage of firm. The financial leverage have strong effect on firm value. Increasing debt is a signal for developing business thereby improving firm value. By increasing debt manager communicate to market that firms have positive prospect in future. Thus, Market
gives positive respond on the increasing debt. Ross (1977) stated that managers will take debt/equity ratio as a signal. The fact that high leverage implies higher bankruptcy risk (and cost) for low level of firm quality. Ross’s model (1977) suggested that firm value will rise with leverage, since increasing leverage can increase the market’s perception of value. The manager will maximize firm value by choosing the optimal capital structure, highest possible debt ratio. Then, The debt level be positively related to firm value.

The pecking order theory (Myers and Majluf, 1984) predicted that firm will follow the pecking order as an optimal financing strategy. It was an assumption of Information asymmetry. If the manager action similar with interest of the owners, they issue securities at a higher price than they are truly worth. The more sensitive of the security, the higher the cost of equity capital, since the action of the manager is giving a signal to the market that the securities is overpriced.

Stulz (1990) stated that debt have both a positive and negative effect on firm value (however there is no corporate taxes and bankruptcy cost). If cost of debt is higher than cost of capital so weighted average cost of capital will increase and decreasing market value. Agency cost hypothesis of Jensen (1986) stated that capital structure has significant positive on firm value.

Capital structure influence market reaction that influence on firm value (Mogdliani and Miller, 1958). Debt and shareholder’s equity has market value. It can influence on firm value. Capital structure theories such as the trade-off theory and the pecking-order theory stated that management behaviours have relationship on
financing decision and board of directors’ composition. The trade-off theory suggests that firms will have an optimal level of mix between equity and debt that maximizes the difference between the benefits and cost of debt.

On the contrary the trade-off theory, the pecking order theory of capital structure stated that a firm has no specific leverage ratio that maximizes its value. In the pecking order framework, information asymmetry stimulate managers to issue equity will be underpriced by the market (Myers and Majluf, 1984).

In addition, financing that is from equity is both domestic and foreign ownership. Thus, foreign ownership have role on market valuation. Foreign ownership have credibility and trust for market. Berger (2009) found that foreign ownership has efficiency impact to firms. Managements have different way with other companies in the world. It is based on ability and mind set management by culture. In addition, foreign investors support many advantages in firms such as supplying capital, technology transfer, good service and networking. It used to develop the firms and create firm value. Outside financing can be used to business expansion. Controlling debt and equity of firms is very important for firms to make good firm value. It is because firm managements have responsibility to investor. Beside that, investors will control firm value. it is because high price stock reflects high return for investor. Thus, firm value is important part of firm ownership.

Previous studies had found that foreign ownership have significant effect on firm value. Li et al (2009) found that the larger listed companies were easier access on financial markets both domestic and international. Sun and Tong (2003) and Bai et
al. (2004) stated that foreign investors will increase market valuation and firm performance. Dewenter and Malatesta (2001) found that state-owned firms have more highly leveraged and bad perform than private firms.

In addition, foreign ownership also have role on the link between debt and firm value. Li et al (2009) Chinese Firms with high foreign ownership have not high leverage that is consistent with the trade off theory. Brislieu and Latrous (2012) shaw that there was relationship in U-shape between shareholders’ ownership and leverage. There was 40% change in the relationship between debt and ownership. Thus, Foreign Ownership can reduce leverage. Increasing stock’s equity can create negative signal for market valuation.

Foreign ownership is both Foreign Direct Investment (FDI) and Multinational Companies (MNC). Foreign ownership in Indonesia Stock Exchange (IDX) is prosentase of shareholder’s equity. Foreign ownership in IDX show moving up every year. Buying foreign tend to increase every year thereby increasing capitalization in IDX (figure 1.1 and 1.2).

Figure 1.1
Figure 1.1 shows that buying foreign in Indonesia Stock Exchange (IDX) tend to increase during 2004-first quartal 2016. Even though in 2006, 2009 and 2015 the graphic of foreign moving down but trend of graphic tend to move up. It means that foreign investor interest to invest in Indonesia both MNC or buying stock. Beside that, capitalization in IDX shows moving up every years (figure 1.2). It means that capitalization IDX is so high. Even though, in 2008 capitalization tend to decrease so significant. It is because of financial crisis in Asia. The moving of buying foreign tend to similar with the moving of capitalization. Thus, Indonesia firm stock is interest for foreign investor.

This study provides results on consumer, trade, service and investment, and miscellaneous industry in IDX. Consumer, service, trade, and investment, and miscellaneous industry provides primary goods. Consumer industry create 23.41 %,
trade, service, and investment industry 10.15%, and miscellaneous industry 6.67% of market capitalization in IDX during 2016. Thus, consumer industry create index 2,064,910; trade, service, and investment industry 849,527; miscellaneous industry 1,057,275 of 4,593,008 IHSG value in 2015.

There were different results of previous studies about financial leverage and firm value. Stiglitz (1969) and Rubinstein (1973) found that capital structure does not influence on firm value. It was not assuming bankruptcy costs or agency costs. Thus, Greenwald et al (1984) stated that a higher level of leverage is a bad signal in the Future. Vo and Ellis (2016) stated that there was a negative relation between financial leverage and shareholder value. It was an indicated that the proportion of cost to debt financing greater than profit for Vietnamese firms. They found that only low leveraged firms can create value for shareholders. Inconsistent with Modigliani and Miller’s theorem (1958). The theorem stated that incomplete and perfect capital markets, the percentages of debt and equity in the capital structure of the firm influence on firm value. In addition, Jensen (1986) stated that higher leverage can reduce agency costs, thereby improving value.

In previous study there were different results about the influence of financial leverage on firm value. Thus, it is a few study about the role of foreign ownership on the link between financial leverage and firm value in Indonesia. THEREFORE, THE TITILE OF THIS STUDY IS “THE ROLE OF FOREIGN OWNERSHIP ON THE LINK BETWEEN FINANCIAL LEVERAGE AND FIRM VALUE:
EVIDENCE IN INDONESIA STOCK EXCHANGE IN 2009-2015” that is important to be examined.

1.2 Problem Statement

a. What does the effect of financial leverage on firm Value?

b. How does the role of Foreign Ownership on the link between financial leverage and firm value?

1.3 Research Objectives

Firstly, This study is to get empirical proof the influence of financial leverage on firm value. The last, This study is to get empirical proof the role of foreign ownership on the link between financial leverage and firm value.

1.4 The Benefit of Research

This study expected that it can deliver information as references for stockholder on controlling financial leverage, for firm management in controlling firm value and corporate governance, and for government in making decision on foreign investment in domestic firms.

1.5 Originality of Research

There were many studies about capital structure theory. They were Lutbakin M and Chartejee (1994), Sun and Tong (2003), Bai et al. (2004), Dahya (2010), Kim and Black (2010), Vo and Ellis (2016), Hasbi (2015), Ardalan (2015), Harris and Raviv (1990), and Alves et al (2015). They reexamine and develop capital structure theory from Mogliani and Miller (1958). Ross (1977) examined and found about signaling theory from capital structure. Alves et al (2015) examined Board of

This study examines capital structure theory from Modigliani and Miller (1958) with moderation effect from foreign ownership. This study examines the role of foreign ownership on the link between financial leverage and firm value. This study measures financial leverage with debt to equity (DER) as proxy. This study considers capital structure theory from Modigliani and Miller (1958) as financial leverage and how it gives effect on firm value. This study also considers Agency Theory (Jensen and Meckling, 1976) and Asimetry information theory (Myers and Majluf, 1984). Foreign ownership can not direct control firms. There is asimetry information between owners and manager. How foreign ownership can influence capital structure which increasing market reaction and firm value.

This study uses non financial firms especially consumer, trade, service, and investment, and miscellaneous industry listed in Indonesia Stock Exchange (IDX). This study considers firm age and growth opportunity as control variable in the model of the influence of capital structure on firm value. This study collected data in 2009-2015.