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Determinants of Firm's Capital Structure in Indonesia

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ABSTRACT

The determination of capital structure has been a focal point of finance research for over six decades, yet it remains a complex and controversial topic, particularly in emerging markets like Indonesia. This study seeks to address a key gap in the literature by examining the firm-specific factors such as profitability, tangibility, growth opportunities, liquidity, and business risk that influence capital structure decisions among Indonesian firms. Despite existing knowledge, limited empirical research specifically addresses the unique financial dynamics of Indonesian firms, many of which rely heavily on debt due to restricted access to equity markets and the prevalence of family-owned enterprises. This reliance on debt raises concerns about financial stability, particularly in light of risks underscored by the Global Financial Crisis of 2008. Using data from public companies listed on the Indonesian Stock Exchange between 2014 and 2023, this study employs panel data regression and multiple regression analysis to investigate these factors. The significance of this study extends beyond academic contribution, offering valuable insights into financial management, policymaking, and investment strategies. By clarifying how firm-specific factors influence capital structure, this research provides practical guidance for financial managers to develop effective financing strategies. Furthermore, it assists policymakers in creating a supportive regulatory environment for businesses and helps investors make informed decisions. Ultimately, this study enhancing financial literacy and stability within Indonesia's growing economy.

Keywords: Capital Structure, Debt to Equity Ratio, Profitability, Tangibility, Growth Opportunities, Liquidity, Business Risk

1. INTRODUCTION

In developing countries like Indonesia, where various economic and regulatory situations influence business financing decisions, firms' capital structure is an important issue for financial research (Ramli et al., 2019). This study measures firm capital structure by its debt-to-equity ratio, which a company uses to finance its operations and support business operations. Understanding firm capital structure is important for practitioners and policymakers, as it can influence firm performance, risk management, and overall economic stability. According to previous studies, firm-specific factors are important in determining the capital structure. Firm-specific factors such as profitability, tangibility, growth opportunities, liquidity, and business risk have been identified in the research as significant factors in how companies choose to fund their operations (Sakti et al., 2020). Profitability usually refers to a lower reliance on debt since profitable companies can generate sufficient cash flows to fund their operations without external funding. Similarly, tangible assets can serve as collateral for debt financing, thus impacting firms' leverage decisions.

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Capital structure plays an important role in business financing. This study measures a firm's capital structure by its debt-to-equity ratio, which is determined by dividing the total debt by the total equity that a firm employs to finance its operations and future growth. This ratio is important in determining a company's financial stability, as it affects its long-term sustainability, cost of capital, and risk profile (Moradi & Paulet, 2019). The capital structure differs significantly among industries, nations, and individual enterprises, influenced by numerous external and internal factors, including macroeconomic conditions, legal regulations, industry norms, and firm-specific factors such as profitability, asset tangibility, and managerial objectives.

Over the past 65 years, capital structure has emerged as the most intriguing and contentious issue in the theoretical and empirical literature on finance. Understanding this dynamic is especially important in emerging economies like Indonesia, where a firm's capital structure is determined by a complex interaction of various firm-specific factors (Chiu, 2022). Despite the existing literature on capital structure, there remains a significant gap in empirical research that specifically addresses the particular determinants affecting firms in these countries. The limited access to equity markets and the prevalence of family-owned businesses in Indonesia have resulted in a significant reliance on debt financing for many firms, which often prefer internal financing methods. Following the lessons from the Global Financial Crisis 2008, which emphasized the vulnerabilities associated with high leverage, this reliance raises concerns about financial stability and risk management (Masera, 2019). In contrast, companies generally possess more varied funding sources but encounter difficulties optimizing their capital structure. Furthermore, it is unclear how different factors such as profitability, tangibility, growth opportunities, liquidity, and business risk affect capital structure choices in Indonesian firms.

2. LITERATURE REVIEW

The relationship between firm-specific factors that affect capital structure decisions has been extensively studied and analyzed by researchers in the past and present, both theoretically and empirically. The capital structure serves as a decision-making tool for management in determining the financing of the long-term company. To increase company profits and achieve high value, the capital structure is essential in determining how different funding sources will be used to finance funding and support business operations. The purpose of this study is to fill in some of the gaps in studies on determining firm-specific factors that affect capital structure in developing countries, especially Indonesia. Capital structure refers to the way a firm chooses to finance its operations by utilizing a combination of debt and equity.

2.1 Profitability affects firm capital structure

Company finance literature has extensively examined the relationship between profitability and capital structure. Profitability is an important factor in determining how companies establish their capital, affecting both their debt and equity financing decisions.

From a theoretical perspective, the pecking order theory argues that firms prioritize their sources of financing based on the idea of least effort or resistance. According to this theory, firms prefer internal financing (retained earnings) over external financing (debt or equity). A profitable firm generates sufficient internal cash flows, reducing its need to incur debt or decrease equity. As a result, profitable companies tend to have lower debt levels, as they can fund their operations and growth through retained earnings, thereby maintaining a more conservative capital structure.

Several studies have empirically examined the impact of profitability on capital structure across various situations and countries. For instance, a study by Rajan and Zingales (1995) revealed that profitable firms tend to rely more on internal financing and have lower leverage ratios than less profitable companies. Booth et al. (2001) support this finding, discovering that companies in developing countries that are more profitable tend to prefer equity financing and are less likely to use debt. Research by Nur'aini, A., et al. (2020), demonstrating a significant negative relationship between profitability and leverage in publicly listed companies. The study showed that the pecking order theory is aligned with findings that firms' dependence on debt financing decreases as their profitability increases. This development is especially important in the Indonesian market, where firms experience various economic fluctuations and capital access.

These findings have various implications. Financial managers may establish strategic decisions regarding financing by understanding the relationship between profitability and capital structure. A conservative capital structure may be advantageous for companies with higher profitability, as it allows them to prevent the accumulation of high levels of debt that could increase financial risk. Furthermore, these companies may capitalize on their profitability to improve their financial stability by arranging more favorable terms with potential investors and creditors.

The empirical evidence consistently supports the theory that profitability significantly affects capital structure decisions. The study emphasizes the significance of financial performance in determining company financing decisions by showing that profitable firms favor internal financing. Consequently, companies operating in Indonesia and related emerging markets should thoroughly evaluate their profitability levels when determining their optimal capital structure. This will ensure their financing decisions are consistent with their financial health and growth objectives.

2.2 Tangibility affects firm capital structure

According to Tamba and Purwanto (2021), tangibility assets significantly and positively affect the capital structure of property and real estate in Indonesia. The finding shows that a company's reliance on debt financing increases proportionally with the value of its tangible or fixed assets. The proportion of

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tangible assets owned by a company is represented by its tangibility, which can be determined by dividing the total fixed assets by the total assets (Khemiri & Noubbigh, 2018). The consideration of asset tangibility was provoked by the finding observed by Titman and Wessel (1988) that companies comprising a significant portion of tangible assets suitable for debt collateral generally faced lower bankruptcy costs. This certainly affects the capital structure of a company significantly. This study's findings support the trade-off theory that proposes a positive relationship between the debt ratio and asset tangibility. Particularly, a company with more assets prefers to raise debt financing more frequently, using those assets as collateral. It is obvious that to obtain a loan, companies must have tangible assets that can serve as collateral.

2.3 Growth opportunities affects firm capital structure

This study includes growth opportunities as a determinant of capital structure. Based on the study conducted by Zulvia and Roza (2019), the growth opportunities of Indonesian manufacturing companies have a significant positive impact on their capital structure. Growth opportunities are measured by market to book ratio, which is market price per share divided by book value per share (Fatoki and Nasieku, 2017). Additionally, growth opportunities represent a prospective investment opportunity. Additionally, investment potential is represented by growth opportunities. By comparing the ratio of financial growth opportunities, financial analysis determines the extent to which growth opportunities exist in companies with varying debt levels (Filsaraei et al., 2016). Particular factors, including debt ratios and growth opportunities, are essential for investors to understand in order to make well-informed choices regarding investment decisions.

2.4 Liquidity affects firm capital structure

Liquidity is one of the important factors that determine the capital structure. Liquidity is measured by dividing the total value of a company's current assets by its current liabilities (Khan et al., 2020). The study conducted by Mardani et al. (2023) proves that liquidity significantly affects capital structure in Indonesia. The finding of this study is consistent with the pecking order theory, which proposes that companies prefer internal financing and, if external funding is required, will seek external financing through the issuance of securities (Myers, 1984). Companies that have high liquidity have the ability to fund their operations primarily through current assets. As a result, these companies generally employ a reduced amount of debt, as the funds required for the company's operations are already enough. Capital structure was negatively affected by liquidity, according to the findings of this study, which confirmed the conclusions obtained by previous researchers (Titman & Wessels, 1988; Rajan & Zingales, 1995).

2.5 Business risk and firm's capital structure

Business risk is measured by dividing the ratio of non-performing loans by the total number of loans (Khan et al., 2020). According to Tamba and Purwanto (2021), the capital structure of property and real estate in Indonesia is significantly and negatively affected by business risk. The debt-to-equity ratio is significant and negatively affected by business risk. As business risk increases, debt utilization in capital structure decreases, as explained by the negative effect of business risk influence. This is because companies experiencing an increase in business risk are advised to obtain financing with a lower level of debt. On the contrary, companies with a higher business risk might face challenges in repaying or withdrawing their external funding in the form of debts if they prefer a higher debt level. This study's findings are consistent with Pacheco and Tavares (2017), who concluded that business risk is highly significant in capital structure.

3. CONCLUSION AND RECOMMENDATIONS

The purpose of this study is to examine firm-specific factors that affect firm capital structure in Indonesia. This study aims to determine whether profitability, tangibility, growth opportunities, liquidity, and business risk affect the firm's capital structure of public listed firms in Indonesia from 2014 to 2023. This study also to evaluate the implications of these firm-specific factors affecting capital structure decisions for financial management practices in Indonesian firms. By understanding the dynamics of capital structure with firm-specific factors, this study aims to provide insights that can inform effective and efficient financial management strategies and practices, improving the economic stability and performance of companies operating in Indonesia.

The significance of this study is to provide a comprehensive understanding of the factors influencing capital structure decisions among publicly listed companies in Indonesia, a rapidly developing economy. By determining firm-specific factors, this research contributes to the existing literature on company finance in several key ways:

1. Enhancing Academic Knowledge: This research contributes to the knowledge of understanding regarding capital structure theory, especially in emerging markets. This study examines the literature gap regarding the particular challenges and opportunities experienced by Indonesian firms.
2. Informing Financial Management Practices: The findings of this study are expected to provide actionable insights for financial managers and corporate decision-makers. By identifying the critical factors influencing capital structure decisions, firms can develop effective financial strategies aligned with their operational goals and market conditions. This can result in enhanced firm performance and improved economic stability.
3. Guiding Policymakers: By comprehending the factors that influence capital structure in Indonesian companies, policymakers can establish a regulatory environment more conducive to business financing. By acknowledging the factors that influence firms' capital structure decisions, policymakers can establish guidelines that encourage sustainable economic growth and stability in the financial sector.

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4. Contributing to Investor Decision-Making: This study provides investors with valuable insights regarding the influence of firm-specific factors on capital structure decisions. By expanding their comprehension of these dynamics, investors can make more informed decisions regarding their investment strategies, enhancing portfolio performance and risk management.
5. Enhancing Financial Literacy: This study has the potential to enhance financial literacy in Indonesia by sharing the findings with a broader audience, which includes students, educators, and industry professionals. Ultimately, a well-informed business community that can more effectively navigate the complexities of capital structure decisions can encourage a more resilient economic environment.

The significance of this study extends beyond academic research. It has the potential to provide practical insights that might enhance financial decision-making among firms, inform investors, guide policymakers, and promote financial literacy within Indonesian companies. Through its findings, this study aims to play a pivotal role in influencing the future of company finance in Indonesia. These individuals can make informed decisions in their respective industries by understanding which firm-specific factors will significantly affect firm capital structure in Indonesia. Additionally, the study sample size should includes all listed firms in Indonesia and considered more independent variables in future research.

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