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Capital Structure Analysis Of Foreign Investment Companies With Domestic Investment Companies In An Effort To Optimize Company Capital Structure

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Abstract

This study provides an overview in determining the optimal capital structure that is able to minimize the cost of capital, and then maximize the value of the company. Although from an academic perspective, the issue of whether there is an optimal capital structure is still controversial, from a practical point of view, capital structure has an effect on firm value. Multinational companies have different characteristics from domestic companies, so that the optimal capital structure for the two types of companies is also different. In other words , can multinational companies achieve a more optimal capital structure when compared to domestic companies.

Key words: capital structure

INTRODUCTION

Modigliani and Miller (MM), argue that capital structure has no effect on company value. If there are two companies that have the same capital structure , but have different values, then there will be an arbitration process that will equate the values of the two companies. Modigliani and Miller (MM) assume perfect capital market conditions and no taxes. If there is a tax, then the cost of debt capital will be cheaper than the cost of share capital. Interest (which is the cost of debt capital) paid by the company can be used as a tax shield, while dividends (which are the cost of share capital) are not taxed. Because the company's cost of capital is lower than the cost of share capital, companies will be encouraged to use more debt. The more money the better. But the greater the debt will increase the probability of bankruptcy, which means it will increase the cost of bankruptcy. Bankruptcy costs include bankruptcy administration fees, legal costs and costs of selling assets. Usually this can reach 20-30% of the value of the company.

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If the probability of bankruptcy is high, then the level of profit implied by shareholders will also be high. This increase reflects an increase in risk compensation. The cost of debt capital will be higher, because lenders will charge high interest rates to compensate for the increased risk of bankruptcy. With the increase in the cost of share capital and debt, the company's gains due to the tax savings from using debt are reduced. So that in this condition the addition of debt will actually reduce the value of the company.

LITERATURE ANALYSIS AND METHODOLOGY

Agency Theory

According to this theory, the capital structure is structured in such a way as to reduce conflicts between interest groups. If the use of debt is high compared to shares, then shareholders will perform asset substitution which causes the company's risk to increase. This will benefit shareholders but not debt holders. The payoff of debt holders will remain the same as the interest paid, not based on the profits earned. Conversely, shareholders will get the biggest share if profits increase. This situation will result in a conflict of interest between shareholders and debt holders.

In other situations, management does not own shares, then the involvement of managers will be even less. If so, managers will take actions that are not in the interests of shareholders. In reality, shareholders want various positions (so that the risks they face are not too high), and there will be partial management ownership (not 100%). This tradeoff will lead to an optimal capital structure.

The pecking order theory

Namely explaining that funding is based on the order of funding that has the smallest risk, namely retained earnings, forests and equity. This theory prefers internal funding so that the debt ratio has a negative relationship with profits. Companies that have the ability to generate high profits tend to use internal funds when the company's debt ratio is below the industry's average debt.

Factors supporting high debt

Availability of capital , multinational companies have wider access to cheaper funds , where the cost of capital is low and can increase the value of the company. If a multinational company borrows in the local market, the loan will not automatically increase the company's exposure. The company will receive cash inflows in the same

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denomination as the loan. If the multinational company's exposure management is effective, foreign loans will not add to the multinational company's currency risk

Liquidity is a factor in lowering the required profit rate. High liquidity will lower the cost of capital. So that many companies seek funds in foreign markets by issuing shares on foreign exchanges. This is done with the aim of utilizing good liquidity and lowering the cost of share capital

Risk reduction through the diversification of multinational companies operating in several countries at once, where the country's economic conditions tend to have a low correlation because each has unique characteristics. Multinational companies can improve their risk and return profiles by leveraging cash flows from various branches of the country that have a low correlatioz

Size, multinational companies tend to have a larger size than domestic companies. This is a comparative advantage of multinational companies. Tax asymmetry, can take advantage of tax policies that are not uniform in the country where the company operates. Meanwhile, domestic companies cannot because they only operate and focus on the domestic market of one country.

The purpose of this study is to analyze the differences in the capital structure of foreign investment companies (PMA) and domestic investment companies (PMDN) in Indonesia based on the perspective of agency theory and contingency theory as well as differences based on trade of theory and packing order theory.

RESEARCH AND RESULTS

Research shows that the capital structure of multinational companies tends to follow the capital structure of the central company. Multinational companies with headquarters in the UK or US will tend to have lower levels of debt than multinational companies with headquarters in other countries.

Unlike the case with Japan, where their stock market is relatively and more active. The bankruptcy costs of each country also tend to be different. Japanese companies have close relationships with banks because banks not only provide loans but also own shares in the companies that are given loans. This will lower bankruptcy costs. Japan. Thus Japan could use a higher level of debt compared to US or UK companies.

Sekely and Collins in their research concluded that cultural factors related to political, economic, social, institutional and tax environment conditions cause differences in debt levels between countries.

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Southeast Asian, Latin American and Anglo-American groups tend to have lower debt ratios. Meanwhile, Scandinavia, the Mediterranean and the Indian Peninsula tend to have higher debt.

Local capital structure

- more consistent with the local situation. Local economic conditions will determine the characteristics of the business in the country the branch operates (locally). This more consistent comparison will also affect the fairness of the branch manager's performance evaluation.
- Reducing criticism of multinational companies. If the multinational company deviates greatly from local conditions, there is a possibility of criticism or displeasure from local circles. For example, if a company uses a debt ratio that is appropriate to the center, which happens to be very high compared to the local debt ratio, branches of multinational companies will be criticized, for example, accused of causing business risk to be too high.

Weaknesses in the local capital structure

- Ignores comparative advantage. Multinational companies can get cheaper funding . The advantages of multinational companies will be reflected in the capital structure which must be different from that of local companies.
- Central company point of view. Investors will look at multinational companies as a whole. Branches or subsidiaries will be insured against the possibility of bankruptcy of the head office, either explicitly or implicitly. Such guarantees would increase overall company risk, even though branch risk would tend to fall. In this situation, overall risk seems to be more relevant than partial branch risk.

The manager of a company in determining the funding to be used. If there is an opportunity to obtain funds at a lower cost in the local market, after adjusting for the risk of changes in exchange rates, managers should take advantage of this opportunity to lower the MNC's overall cost of capital. But the financial structure that deviates from the local normal results in the emergence of certain costs. The manager will thus analyze the trade-off between advantages and disadvantages in deciding on a local or central capital structure.

CONCLUSION AND RECOMMENDATIONS

- The capital structure affects the value of the company, therefore multinational companies try to find the optimal capital structure.

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- Multinational corporations use higher debt than domestic corporations for several reasons: the availability of more capital, risk reduction through diversification, typically larger sizes and attempts to take advantage of tax asymmetries. In relation to the capital structure of foreign subsidiaries or branches, multinational companies have several choices, namely following the head office or following local norms. Each has its advantages and disadvantages.
- Low capital costs are a source of company competitiveness. Several studies have shown that the cost of capital between countries tends to converge . If the company experiences unfavorable competitiveness due to higher capital costs, the company can take several steps such as tax modernization, increase productivity, perform product differentiation, increase investment in human resources.
- The findings of this study reveal that the ratio of FDI debt is lower than the ratio of PMDN debt. The difference in the ratio of PMA and PMDN debt will widen when the difference in profitability, agency costs, bankruptcy costs and investment is more positive. In improving the capital structure, PMA prioritizes internal funding sources , while PMDN prioritizes external funding sources.

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