Capital Structure, Profitability, And Firm Values

Satria Andhika D. K., Rizky Dwi P., Muhamad Hasan, Isti Fadah

Abstract: The firm value is the investor's view of the level of success of the company associated with stock prices. Factors that influence firm value include capital structure and profitability, both of which have a relationship and influence on inconsistent company values. This study aims to analyze and assess whether capital structure and profitability affect the value of companies. The method used in this study is comparative and literature study by comparing research with one another to obtain a conclusion. The results of this study indicate that the capital structure and profitability affect the value of the company. Because optimal capital structure and high level of profitability can increase the value of the company.

Index Terms: Capital Structure, Profitability, Firm Value.

1. Introduction

The development of information technology that is increasingly developing can help in accessing information optimally. The Indonesian stock market recorded a satisfying performance throughout 2017. Recorded on the Index of Composite Stock Price (CSPI) which reached 19.99%. Some stock sectors have recorded large profits, namely the financial, basic industry and consumption sectors. Many companies are trying to show their existence in the stock market to attract investors to invest their shares in order to get cash injections and company development. Investor responses to the stock market can have an impact on increasing the value of the company. High company value will be followed by high shareholder prosperity [5]. For investors, company value can be used as an indicator in assessing the company as a whole. If the company's debt is too large, then additional debt must be prevented. At some point the increase in debt will reduce the value of the company because the benefits derived from the use of debt are less than the costs they incurred [9]. One indicator that can be used to measure company value is capital structure and profitability level. Capital structure or the use of debt can reduce the value of the company, because debt provides little benefit than the costs incurred in the future. The company must be able to choose and decide on the most optimal use of capital in order to produce the right combination of debt and equity, so that it can generate optimal returns and returns for the company, so that later it can affect the increase in firm value [6]. The use of an increasingly large capital structure can lead to greater interest costs, so that there is a risk of bankruptcy that can hamper the company's operations. Profitability is considered important in relation to capital structure, because the higher the profitability generated, the smaller the use of debt.

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In other words, this shows the capital structure will be smaller if the company has high profitability [6]. The better profitability will make investors more confident to invest in the company. Good profitability will benefit the company and shareholders. For companies, they will get an injection of funds from investors and increase the market value of the company. Whereas for investors, will benefit in the form of dividends or capital gains from the investment. Based on empirical evidence, previous research still shows different results, namely the research conducted by Fitriyana (2014) states that capital structure has a significant effect on firm value, while Rasyid (2015) states that capital structure does not significantly influence the value of the company. Then the research of Ju Chen and Yu Chen (2011) found that profitability affects the value of the company, while Astiari (2014) found that profitability does not significantly influence the value of the company.

2. Review of Literature

2.1 Capital Structure

According to Brigham and Houston (2011) An optimal capital structure is a capital structure that optimizes the balance between risk and return so as to maximize stock prices. Factors that must be considered by the company when making capital structure decisions are sales stability, asset structure, operating leverage, growth rates, profitability, taxes, control, management attitudes, lender attitudes and rating agencies, market conditions, internal conditions of the company, and financial flexibility.

2.2 Modigliaani Miller (MM) Theory

Modigliani and Miller (1958) prove, with a set of very limiting assumptions, that the value of a company is not influenced by its capital structure. The results obtained by MM show that how a company will fund its operations has no influence, so its capital structure is something that is not relevant.

2.3 Trade Off Theory

Modigliani and Miller (1958) state that the company's capital structure is the result of trade-offs from the financial benefits of debt (profitable corporate taxes) with higher interest rates and bankruptcy costs.

2.4 Signaling Theory

Modigliani and Miller (1958) assume that investors have the same information about the prospects of a company like its managers, which is called symmetric information. However, often managers have better information than outside investors, which are referred to as asymmetric information and have an important influence on optimal capital structure.

2.5 Pecking Order Theory
The implications of pecking order theory basically companies do not establish a certain optimal capital structure, but the company establishes a policy of priority source of funds [6].

2.6 Profitability
According to Brigham and Houston (2011) profitability is a net profit from a series of policies and decisions on the company. Profitability can be determined with a variety of relevant benchmarks. Financial ratios are one of the benchmarks in analyzing financial conditions, operating results and the level of profitability of a company.

2.7 Firm Value
According to Brigham and Ehrhardt (2005) the value of a company is the present value of future free cash flow at the discount rate according to the weighted average cost of capital. Free cash flow is the cash flow available to investors (creditors and owners) after calculating all expenses for the company's operations and spending on investments and net current assets. Measurement of company value can use the Tobins'Q method developed by Jamen Tobin. Tobins'Q is calculated by comparing the ratio of the company's market value to the book value of the company's equity [13]. The Tobin's Q formula is as follows :

$$Q = \frac{(EMV+D)}{(EBV+D)}$$

Explanation:
Q = Firm Value
EMV = Equity Market Value
EBV = Book Value of Total Assets
D = Book Value of Total Debt

EMV is obtained from the multiplication of the closing share price at the end of the year (closing price) with the number of shares outstanding at the end of the year while EBV is derived from the difference in the total assets of the company with the total liabilities.

3. Method
The research method used is comparative. Comparative research is comparative research. This study was conducted to compare research with each other. In this study the variables are still independent but for samples that are more than one or at different times. According to Sugiyono (2014) comparative research is a study that compares the state of one or more variables in two or more different samples, or two different times.

4. Result and Discussion

Capital Structure on Firm Value
Research conducted by Fitriyana (2014), Asif and Aziz (2016) that capital structure influences the value of companies. By increasing debt to equity from the company, the company can increase the value of the company. In line with the theory put forward by Brigham, et. al (2011) that companies must be able to choose and decide on the most optimal use of capital in order to produce the right combination of debt and equity, so as to generate profits and returns for the company which can later affect the increase in the value of the company. However, it is not in line with research conducted by Rasyid (2015) stating that capital structure does not have a significant effect on firm value.

Profitability on Firm Value
Sabrin et. al. (2016), Chen and Chen (2011) produce that profitability has a significant positive influence on firm value. The greater the profitability of the company, the more profits the company will get, so that it will result in the higher value of the company. in accordance with the theory of Brigham and Houston (2011) states that the higher the profitability produced, the smaller the use of debt. In other words, it shows that the capital structure will be smaller if the company has high profitability. There are differences in the results of research conducted by Astiari (2014) that profitability does not significantly influence the value of the company.

5. Conclusion
The capital structure affects the value of the company because the most optimal use of capital produces the right combination of debt and equity, so that it can generate profits and returns for the company which can affect the company's value. Then, profitability affects the value of the company. High profitability can reduce the use of debt to companies, so that later the value of the company can increase because it is not dependent on debt.

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