INTERNAL CAPITAL MARKET EFFICIENCY AND ITS INFLUENCES ON DIVERSIFIED FIRM’S PERFORMANCE IN INDONESIA

(Study on Diversified Firms Listed on IDX 2012 – 2016)

UNDERGRADUATE THESIS

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STATEMENT OF ORIGINALITY

I, Teresa Nirmala Agus, claimed that this undergraduate thesis titled **"Internal Capital Market Efficiency And Its Influences On Diversified Firms in Indonesa (*Study on Diversified Firms Listed in IDX 2012-2016*)"** is my own writing. Herewith, I declared the truth that in this undergraduate thesis, there is no writings which I copy or imitate as a whole or a part in a form of sentence or symbols which represent another writer's idea that I admit as my own, and/or there is no part or a whole writing which I copy or obtain from other's without giving acknowledgment to its owner.

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Semarang, June 21st, 2018

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MOTTO AND DEDICATION

Opportunity looks a lot like hard work, it pays off and it takes you places

Make sure everything you do will be remembered as your masterpiece;

Meraki: to put your heart into anything you do;

Do not ask God to lift your burdens, ask Him to nourish you with strength to overcome the struggle.

This undergraduate thesis is dedicated to

Papa, Mama, Astrid, Ruby, Oma, the Liem family, and the Gee family.

ABSTRACT

Internal capital market becomes one of the strongest motive for firms to undergo diversification. The aim of this study was to see the effect of internal capital market efficiency on firm's performance. The segment who practices internal capital market was divided into 4 categories of efficiency, which were efficient subsidy segment, inefficient subsidy segment, efficient transfer segment, and inefficient transfer segment. Each of category was determined by its resources and investment opportunities. The firm's performance was measured using excess value. The study assumed that efficient internal capital market practices enhanced firm's excess value, and vice versa, the inefficient internal capital market practices harmed firm's excess value.

Research population used was all diversified firms in Indonesia listed on IDX from 2012 – 2016 from 7 industries and excluded financial firms. The samples observed in total were 1276 samples. This research used The Ordinary Least Square method to analyze the influence of internal capital market efficiency to firm's excess value.

The results showed efficient transfer segment had positive significant impact to firm's excess value, while efficient subsidy segment had positive insignificant impact to firm's excess value. Otherwise, the inefficient transfer segment and inefficient subsidy segment had negative significant impact to firm's excess value.

Keywords: Internal Capital Market Efficiency, Transfer Segment, Subsidy Segment, Excess Value, Diversification

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Semarang, June 21st, 2019

Author,

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CHAPTER I

INTRODUCTION

1.1 Background

Diversified business groups are ubiquitous in emerging markets (e.g., Brazil, Chile, China, India, Indonesia, South Korea, Mexico, Pakistan, Thailand, and many more). These groups typically consist of legally independent firms, operating in multiple (often unrelated) industries, which are bound together by persistent formal (e.g., equity) and informal (e.g., family) ties (Khanna and Yafeh, 2015). Table 1.1, shows data about affiliated firms in several emerging countries.

Table 1.1

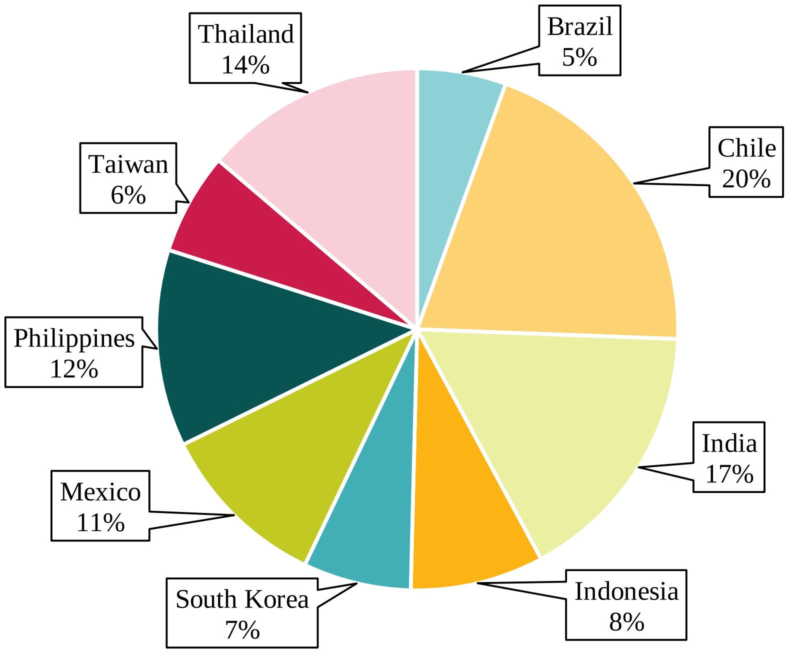
Group Affiliation around the Emerging Countries

Emerging Country	Years of data	Number of firms	Number of group affiliated firms	Affiliated firms compared to the total firms (%)	Median ROA of affiliated firms (%)	Median ROA of unaffiliated firms (%)
Brazil	1990-97	108	51	47,22	3,3	1,8
Chile	1989-96	225	50	22,22	5,9	2,2
India	1990-97	5446	1821	33,44	11,7	9,6
Indonesia	1993-95	236	153	64,83	7,3	7,8
Israel	1993-95	183	43	23,50	6,3	3,9
South Korea	1991-95	427	218	51,05	4,8	5,1
Mexico	1988-97	55	19	34,55	8,2	6,1
Philippines	1992-97	148	37	25,00	7,3	4
Taiwan	1990-97	178	79	44,38	5,1	6,2
Thailand	1992-97	415	258	62,17	2,9	4,4

Source: Khanna and Yafeh (2005), self-processed by author (2019)

The table indicates that, affiliated group from each origin domestically is substantial. In all of the markets shown, group affiliated firms tend to be relatively large and economically important, particularly on on Indonesia, as Indonesia has the highest level of affiliated firms compared to the total firms, which is 64,83% or up to two-thirds of the business market. Furthermore, table 1.2 shows data regarding the diversity level of the firms' structure around the emerging countries.

Table 1.2
Group Diversity Level around the Emerging Countries
(From 1996-2000)



Source: Khanna and Yafeh (2005), self-processed by author (2019)

Based on previous global preview, Indonesia has quite high diversity level, as it displays that the business groups in Indonesia are more diversified than in Brazil, Taiwan, and South Korea. The ubiquity and diversity of business groups make the study of this diversified institution fascinating since it will shed new light on theory for the firm and its boundaries, and one of which is to provide evidence for Indonesia itself.

Indonesia has a market economy in which the state-owned enterprises (SOEs) and large private business groups (conglomerates or diversified firms) play a prominent role as they dominate the domestic economy, up to 81% of companies in Indonesia are multi-segment companies (Harto, 2005). They account for about 40% of Indonesia's gross domestic product (GDP) and create employment to nearly 72 million Indonesians (Indonesian Investment, 2015). This implies that these diversified companies are one of the backbone of the Indonesian economy.

In accordance to PSAK no. 5 revised at 2014, companies which possess multiple business segments must disclose if each segment fulfills certain sale, assets, and profit criteria. The establishment of new obligation in regards to financial report disclosure for the go public companies is one additional indication for the high number of Indonesian companies which have more than 1 segment.

The multi-segment companies in Indonesia have been growing disruptively since before the economic crisis, and many of them survive the crisis up to this moment along with the penetration of several new companies.

In table 1.3 attached the data consists of 16 Indonesian conglomerates who surpassed the 1998 economic crisis successfully along with company rates comparison since the crisis to the recent time.

Table 1.3
Indonesian Conglomerates Company that Survive the Economic Crisis 1998

Company Name	Owner	Rating by 2012	Rating by 1998
Salim Group	Anthony Salim	1	1
Sinar Mas	Eka Tjipta Widjaja	2	3
Djarum	Budi Hartono	3	9
Lippo	Mochtar Riady	4	5
Gudang Garam	Susilo Wonowidjojo	5	4
Royal Golden Eagle	Sukanto Tanoto	6	25
Bakrie	Aburizal Bakrie	7	17
Wings	Eddy William Katuari	10	94
Aneka Kimia Raya	Haryanto Adikoesoemo	11	79
Gajah Tunggal	Sjamsul Nursalim	12	7
Barito Pacific	Prajogo Pangestu	14	15
JAPFA (Ometraco)	Ferry Teguh Santosa	15	29
Kalbe Farma	Boenjamin Setiawan	16	12
Gobel	Rachmat Goebel	17	32
Panin	Mu'min Ali Gunawan	18	21
Argo Manunggal	The Ning King	20	14

Source: Dr. Yuri Sato (on: Tribun News, 2013)

Besides the names mentioned above, nowadays, new conglomerates have appeared to participate in business competition in Indonesia as it is attached to table 1.4. Those people mostly came from mining, telecommunication, retail, media, and airlines business.

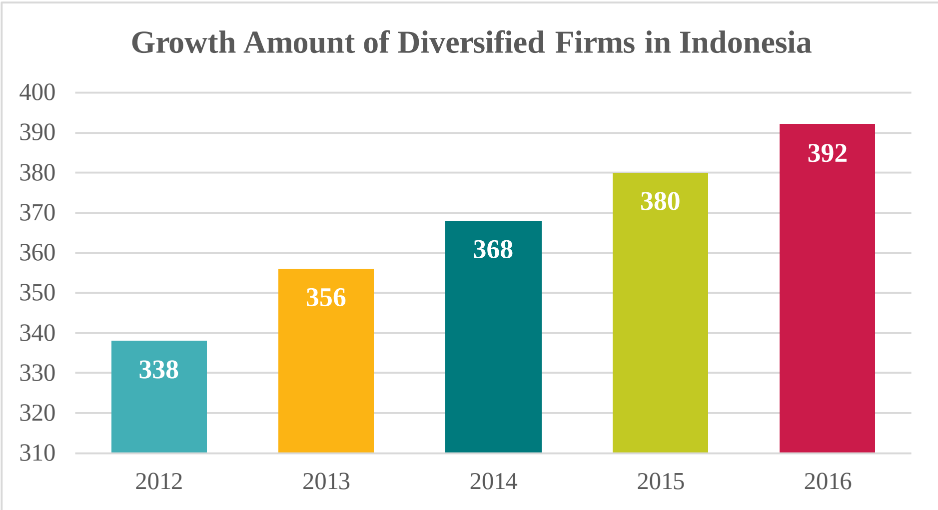
Table 1.4
New Indonesian Conglomerates Company

Companies Name	Owners	Rating by 2012	Rating by 2011
(CT) Para Group	Chairul Tanjung	8	11
Sumber Alfaria	Djoko Susanto	13	21
Bayan Resources	Dato Low Tuck Kwong	26	20
Trikomsel	Sugiono Wiyono	30	36
Bhakti Investama	Hary Tanoesoedibjo	32	32
Darmex Agro	Surya Darmadi	35	31
Harum Energi	Kiki Barki	36	34
Lion Air	Rusdi Kirana	37	28
Harita	Lim Hariyanto	38	-
TiPhone Mobile	Henky Setiawan	40	37
Sugar (Makind)	Gunawan Yusuf	43	74
Borneo Rumpun	Samin Tan	50	44
Sriwijaya Air	Chandra Lie	73	-

Source: Dr. Yuri Sato (on Tribun News, 2013)

The accretion of diversified firms continue not only before and after the economic crisis, but up to today. Looking at the bigger picture in 2019, according to Bloomberg, as it is displayed on table 1.5, number of diversified firms in Indonesia are keep growing since 2012 – 2016. This trend is in a line with the research from Khanna and Yafeh, (2015) saying that diversification act as a strategy to accelerate business performance is common to be executed in emerging countries as it becomes a significant economic pillar on the related countries.

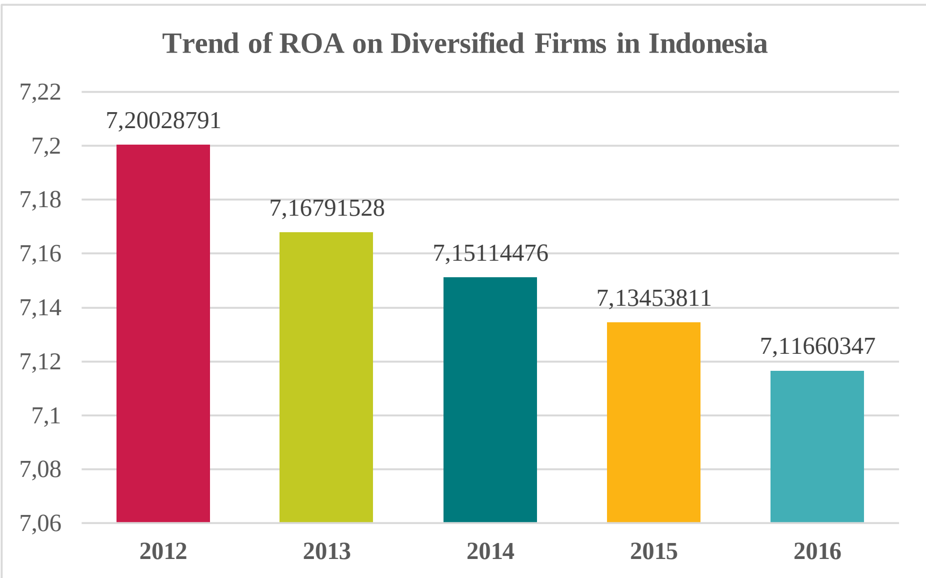
Table 1.5
Diversified Firms Growth in Indonesia



Source: Bloomberg, self-processed by author (2019)

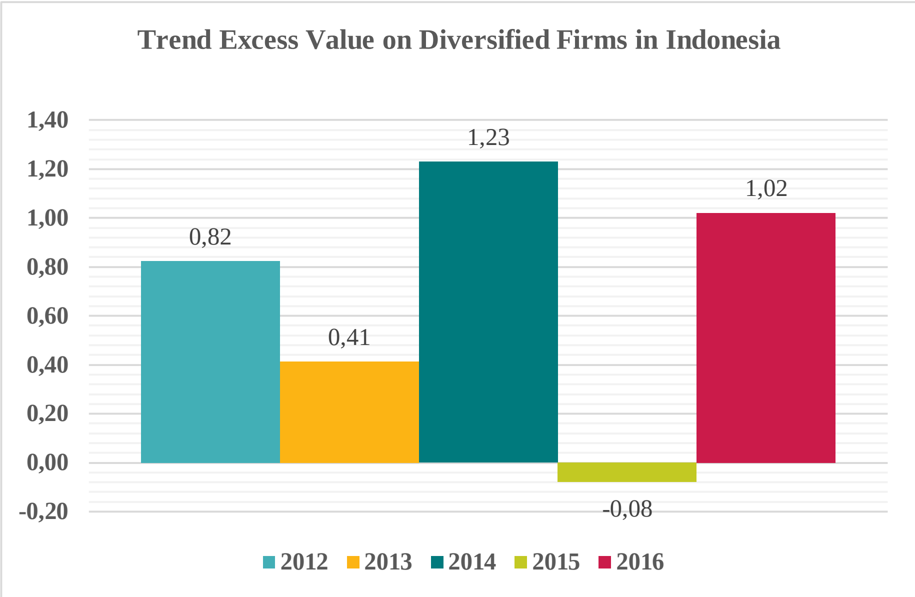
However those facts about the high amount of diversified firms in Indonesia, are not followed with the growing of their firm's performance as it can be seen on table 1.6 and table 1.7.

Table 1.6
Trend ROA on Diversified Firms in Indonesia



Source: Bloomberg, self-processed by author (2019)

Table 1.7



Trend Excess Value on Diversified Firms in Indonesia

Source: Bloomberg, self-processed by author (2019)

These finding in regards to the constantly declining ROA and the fluctuating excess value of diversified firms in Indonesia are intriguing matters. The diversified firms adopted diversification strategy to expand their business so that they will be able to employ the benefits as it enhances the firm's performance. Nonetheless, it is clear that diversified firms are not performing as they are expected to be. It leads to a major question on the underlying purposes that drive diversification strategy to be implemented and the mechanism following the execution of diversification strategy.

Company motivation to undertake diversification is influenced by several factors, such as what has been mentioned by Kuncoro (2006); (1)

to acquire the benefits of synergy through asset sharing which is implicated to join cost for obtaining cost advantage, (2) to acquire the benefits of synergy through risk reduction by sharing the risk by means of substitution product development to overcome the risk of declining product cycle, (3) to acquire the benefits of synergy through fund sharing which is implicated on fund transfer from one business unit to another unit. Thus, the choice to diversify the firm is related with what is the underlying motivation, the company can choose unrelated diversification for risk sharing and fund sharing purpose, otherwise related diversification is chosen for asset sharing a purpose.

Chatterje and Wernerfelt (1991) clarify positive result regarding diversification decision. They state that diversification enables easier coordination on a company which has multiple different divisions that able to do internal transactions. In practice, the diversification strategy possibles the subsidy and transfer between segments which is known as the internal capital market. Furthermore, Berger and Ofek (1995) state that one of the diversification advantages are the tax reduction caused by the internal capital market.

However, there is abundance of argument, mention how diversification decreases the firm's value. Berger and Ofek (1995) state that companies which do diversification tend to overinvest, one of them is through subsidizing segments which underperform that can lead to cause the declining of firm's value. Furthermore, Klein (2001) clarifies that firm which performs diversification is not more valuable, not more profitable, and has higher leverage compared to undiversified. This is caused by the agency cost conflict, which is the difference of interest between shareholders and managers. Nevertheless, uniquely, refer to Harto (2005), Indonesia has dissimilar situation compared to the western trend, the agency conflict tends to happen between the majority share-holder against the minority shareholder. The huge inequality of ownership concentration provide strong authority to those with high concentration possession is indicated as the main reason why the agency conflict between share-holder happens. Even, they can control managers to execute company policy in order to fulfill their needs, which disadvantage the minority shareholder. Eventually, any kind of agency conflict, either it is between shareholders and managers, or the majority and minority shareholders, both are found to dissuade the diversification strategy to enhance a firm’s performance.

Several previous studies have also tried to examine further the correlation between diversification and company’s performances, but the empirical evidence is indeed still contradictory. The results of Stulz (1990), Lang and Stulz (1994), Berger and Ofek (1995), Servaes (1996), Lins and Servaes (1999), Rajan et al. (2000), Campa and Kedia (2002), and Martin and Sayrak (2003) found a negative correlation between diversification and company’s performances. Meanwhile, the results of Maksimovic and Phillips (2002), Gomes and Livdan (2004) as well as Santalo and Becerra (2008) found a positive correlation between diversification and company performances. Recent research has tried to discover the difference in correlation between diversification and performances in different companies. For example, Lee and Li's study (2001), found the correlation between diversification and performances is not linear or inconsistent on the different level of the company's performances. The result shows that diversification was negatively related to Return on Equity (ROE) when the company posted good performance, yet gave a positive correlation to ROE when the company posted poor performances. They assumed a negative correlation between diversification and company's performance disappears and become positive as the poor company's performance.

Along with the rapid growing of interest towards diversification study, many theoretical and empirical research have also analyzed on from which sources diversified firms raised their capital, whether from the internal or external capital market. Khanna & Palepu, (2000), clarify that diversification serve as an organizational response to the weak institutional context of emerging economies. In emerging economies, financial transactions can be particularly costly because of weak investor protection, contract enforcement, bad communication, and information disclosure. Hence, a diversified firm utilizes internal financial market where its capital can be allocated among its subsidiary firms, which can lead to economic advantages, notably when external financing is constrained due to scarcity and uncertainty. Khanna and Palepu (2000) discover evidence that affiliates and subsidiaries of the most highly diversified Indian business groups outperform stand-alone firms, indicating that internal capital markets within Indian business group functions effectively.

The financing decision was likely to be a complex group-wide trade-off between benefits and costs of internal and external financing. Those companies that raised external capital market were exposed by an abundance of risks such as the loss of control risk, the loss of ownership risk, and the working capital risk. Conflict of interest, the non-existed advanced and detailed mechanism of the external capital market, and information asymmetry between providers of capital and the recipients were factors which worsen the condition as well.

External financing could come from the issuance of new stock which leads to the decreasing of ownership amount. While for debt based external financing, if a default was to take place, legal proceedings may force a loss of control when a judge appointed someone to oversee the operations, moreover proxy voting fights or attempts at hostile takeovers were also might happen. A company which relied too heavily on external financing may take themselves to be manipulated by outsiders. Even though external financing added more company’s cash flow, it could greatly affect the working capital usage. The previous risks regarding payments for principal and interest for debt financing and or dividends for equity financing could limit the amount of working capital to invest in research, marketing activities, or expansion initiatives. The loss of working capital could harm the continuance of the company's operations unless they increased their leverage.

Above those reasons, the major obstacle faced as a consequence of raising external financing was the cost. Debt financing has associated interest payment and an under struggle company could be pushed to accept the high-interest rate on a loan or be forced to issue bonds with a higher than the anticipated interest rate. Equity financing could lead to fewer future profits which were kept within the company, as investors and shareholders claimed profits or dividends. Therefore, a fast growing company needed to make careful profit projections and understood that future profits lost to outside ownership interests could be the biggest cost of external equity financing.

Considered these prominent disadvantage factors of external financing, internal capital allocation through diversification is dominantly preferred, particularly for large firms. The research of Erdorf and Matz (2012) provides supporting statements that major significant reason for diversification is the internal capital market. Huang and Zhou (2012) also agree that the internal capital market is an important financial issue inside the company. Internal capital market enabled a company to obtain efficient allocation within the organization and prevented the use of external capital market which acquired more cost and dynamically fluctuated in regards to the market condition. The efficient allocation by shifting the capital from low investment opportunities business segment yet possessed higher cash flow to high investment opportunities yet had a capital crisis.

Martin and Sayrak (2003) encourage internal capital market positive impact for financial efficiency for a company. First, it increases internal working capital as it is less expensive than seeks capital externally. Firms will be able to avoid transaction cost from securities, in line with the countermeasures of the information asymmetry problem that happens when selling securities in the capital market. Furthermore, with internal financing, managers could learn about the decision making for selecting a project, instead of letting the investment decision depends on investment behavior who lacks on external capital market understanding for a company. Like what has been mentioned by Stein (1997), a manager who possesses more information about the company, will function better on project selection or is also called “winner picking” which eventually can elevate value for the firms. In short, holding company could place the capital from segments that generated limited investment opportunities to other segments that able to generate more profitable values. This was supported by the research from Billet and Mauer (2003) who said that the internal capital market can help a subsidiary company to survive while encountering external financing frictions.

An internal capital market could be alternative since it minimized the cost compared to access the fund from an external capital market. Besides, segments that had better investment potentials yet faced capital crisis could be saved instead of letting those segments stood alone or became a single company. With the dividend policy for external financing accessor, it will be difficult for a single company to face that if they did not yet have sufficient capital and strong management (Billet and Mauer, 2003).

However, the internal capital market also has negative sides, capital allocation internally can be inefficiently caused by the agency cost conflict. High tier managers on conglomerate companies are possible to prioritize personal intention and also a negotiation between department managers regarding this capital allocation and investment return can be inefficient and more costly (Scharsfstein and Stein, 2000). This statement was also supported by Agarwal, et.al (2010) who mentions that the internal capital market is no longer functioning efficiently due to the authorization conflict between departments. Moreover, the possibility of parent companies to subsidize subsidiary companies which had lower investment return and end up losing the investment opportunities at another segment could trigger the decline of firm’s performance rate.

The debate of internal capital market efficiency had been such a long journey through prior researches which had not yet clarified the key points about whether it was efficient or not to implement internal capital market within the conglomerate's company to improve firm’s value. If the internal capital market were indeed inefficient, it raised a question on why many companies in Indonesia still did diversification strategy that could disadvantage a firm's performance. Otherwise, if internal capital were indeed proven to be efficient for conglomerates company, how efficient was that and did that influence the conglomerate firm's performance or not.

Results were also mixed in the previous empirical literature. Some theoretical research argues that diversified conglomerates can perform a capital market function, allocating scarce resources to projects with higher productivity, overcoming imperfections from external financial markets, and improving access to funding of otherwise constrained firms (Williamson, 1975; Gertner, et al., 1994; Stein, 1997). This was supported by the recent studies evidence that allocative efficiency improves during times in which financial constraints are more likely to be binding (Kuppuswamy and Villalonga, 2010; Hovakimian, 2011; Matvos and Seru, 2014). Yet, on the one hand, there is evidence that, on average, internal capital markets in diversified conglomerates allocate resources inefficiently (Shin and Stulz, 1998; Rajan, et al., 2000; Ozbas and Scharfstein, 2010).

These elucidations pertaining to: (1) the remarkable growth of diversified firm in emerging countries especially Indonesia; (2) the underlying motivations that drive diversification strategy to be chosen; followed by the existing arguments regarding: (1) advantages and disadvantages of the diversification strategy; (2) the correlation between diversification and firm's performance; and (3) the internal capital market as a financing system on diversified firms, take Indonesia to be a natural candidate for analyzing the internal capital market performance and role on diversified firms. This relationship as a research purpose is supported by Edorf, Hartmann and Matz (2012), who state that there are 3 empirical approaches to determine the average value of diversification. The first approach is the cross-sectional studies which indirectly determine the relative value of diversified firms compare to the single-segment firm. The second approach is through study analysis that showcases how the stocks market reacts towards acquisition. The third approach is pointed to study on investment efficiency of the internal capital market within diversified firms which related to this study topic.

Mostly, in earlier work, the focus was on external providers of capital to the firm, e.g. the stocks market, the bond market, banks, and financing institutions. Also, although, many studies had chosen diversification as their study theme, apparently studies which directly appoint to internal capital market remained scarce. Moreover, the empirical study in regards to this topic also is rarely to be found especially in Indonesian business market.

This research measured the efficiency value of the internal capital market as diversified firm's financing decision. In order to investigate the internal capital market performance, it is important to also determine the measurement method. The empirical measures of the efficiency of the internal capital allocation were adapted from the method developed by

Rajan, Servaes, & Zingales, (2000) which were through the determination of investment opportunities and resources available on the firm. This method incorporate both firm and industry adjustments. Subsequently, it is combined with Billet and Mauer (2003) model of measurement that divide the internal capital market into 4 components named as efficient transfer segment, inefficient transfer segment, efficient subsidy segment, and inefficient subsidy segment.

According to efficient internal capital market theory, efficient transfer or subsidy involving the parent's company and the subsidiary will enhance firm’s performance. Furthermore, firm’s performance is proxied by excess value (Berger & Ofek, 1995), where a higher (lower) excess value supposed to represent more efficient (inefficient) internal capital allocation inside the firm.

This research also didn’t neglect the controlling variable during the measurement. On this analysis the controlling variables included were the firm size, the leverage ratio, and the firm’s profitability.

As we examined the internal capital market performance to the excess value of the diversified firm’s in Indonesia, it allowed us to reveal whether: (1) internal capital market can bring a higher value for the firm; (2) internal capital market is performed efficiently in Indonesia’s diversified firm. Built upon previous explanations, this research was given a title as **Internal Capital Market Efficiency and its Influences on Diversified Firm’s Performance in Indonesia.**

1.2 Research Problem

The argumentation from prior researches has been continued ceaselessly regarding whether internal capital market as one of the strong motive behind the diversification strategy can either really improve the firm's performance or not. Few studies indicated that the efficient internal capital market could alleviate the financial constraints faced by the subsidiary company and thus, can efficiently improve a firm's performance. Meanwhile, at other sides, few studies disagreed by stating that internal capital market functioned inefficiently due to information asymmetry and agency cost conflict, or other possible factors, hence, the internal capital market gave a negative impact for firm's performance. Another point of view on this research yet still related is the statement that the allocation of internal capital funding does not ease the firms that under financial constraints since they would prefer the companies with better investment return, better performance, and better growth opportunities, in other words, those companies are not companies that financially constrained because they are actually able to raise external financing as independent legal firms.

The given situation showed the urgency to undergo this study in order to reveal evidence and information for diversified firms in Indonesia, whether it was efficient or not to implement internal capital market as one of the driving factor to improve firm's performance proxied by firm's excess value, reflected from parent's consolidated financial statement.

Along with understanding whether internal capital market increases parent's excess value or not, it needs to be emphasized, that this study limits its investigation scope on the transfer and subsidy between parents to subsidiaries, without including transfer and or subsidy between subsidiaries. Thus, it is easier to ascertain the reciprocal relationship among internal capital market and the parent's consolidated excess value. To be more exhaustive, the study considered the controlling variables within the firm, which were the liquidity, profitability, debt ratio, and firm size.

In order to examine the efficiency of the internal capital market of diversified firms in Indonesia and its different impact on the firm's performance, this study adopted the empirical measurement method by Rajan, et.al (2000) using investment opportunities and firm's resources method to find out the efficiency category of the internal capital allocation accompanied by Billet and Mauer (2003) who also studied the efficiency of internal capital market and classify the performance into 4 categories which were efficient transfer segment, inefficient transfer segment, efficient subsidy segment, and inefficient subsidy segment.

This research aimed to suggest which category of internal capital market that accelerated or otherwise, impaired the firm's performance alongside with the controlling variables. Thus, the problem addressed in this research which needed to be answered were divided:

1.2.1 Does the efficient internal capital allocation through transfer in Indonesian diversified firms improve the firm's performance?

1.2.2 Does the inefficient internal capital allocation through transfer in Indonesian diversified firms reduce the firm's performance?

1.2.3 Does the efficient internal capital allocation through subsidy in Indonesian diversified firms improve the firm's performance?

1.2.4 Does the inefficient internal capital allocation through subsidy in Indonesian diversified firms reduce the firm's performance?

1.3 Objective of the Research

In accordance with the previous explanation, the aim of this research is to obtain empirical evidence, which as follows:

1.1.1. To investigate whether efficient internal capital allocation through transfer enhance the parent firm's performance.

1.1.2. To investigate whether inefficient internal capital allocation through transfer alleviate the parent firm's performance.

1.1.3. To investigate whether efficient internal capital allocation through subsidy enhance the parent firm's performance.

1.1.4. To investigate whether inefficient internal capital allocation through subsidy enhance the parent firm's performance.

1.4 Writing System

This research was divided into five chapters, which will be organized as follows:

Chapter I Introduction

This chapter explained and described about the background of the research, research problems, the purpose of this research, and the writing system of this research.

Chapter II Literature Review

This chapter explained about previous research literatures which aligned with the topic of this research.

Chapter III Research Methodology

This chapter clarified about the process of choosing samples, research data, data source, data processing method, and research model.

Chapter IV Result and Discussion

This chapter declared about discussion of results analysis by using theories explained in CHAPTER II and using methods explained in CHAPTER III of this research.

Chapter V Conclusions

This chapter explained the conclusions which obtained through data analysis during the study. This chapter also provided suggestion that could be useful for further lines of research.