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# 1 Equity Market Timing and Capital Structure: Evidence on Post-IPO Firms in Indonesia

Dewi Ratih

*Widya Karya Catholic University, Malang, East Java, Indonesia*

Achmad Yunus

*Muhammadiyah Surakarta University, Solo, Central Java, Indonesia*

## Abstract

**Purpose** - The purpose of this research is to analyze and to evaluate the impacts of equity market timing on corporate capital structure policies in Indonesia by testing the historical values of stock.

**Design/methodology/approach** - This study uses panel data of companies listed in Indonesian Stock Exchange after IPO. The companies used as research object are 70 firms in the non-financial/non-banking sector with the observation period of 1997-2009. The period of measurement is 5 years after IPO. Using past market value in which equity market timing is measured in two time measurements, i.e. yearly timing and long-term timing to prove its persistence.

**Findings** - Consistent with equity market timing theory, the results suggest that firms tend to issue equities when their market valuations are relatively higher than their book values and their past market values are high. As a consequence, the firms become underleveraged or have their debts reduced in the short run. The results of long-term measurement on equity market timing do not appear to affect the firms' capital structure decisions due to the firms' relatively quick adjustments of optimal capital structures. The conclusion is that equity market timing is an important element in the short run but not in the long run.

**Research limitations/implications** - The results of this study describe how firms in Indonesia take advantage of temporary market share fluctuations through equity market timing in their capital structure policies before ultimately making adjustments to the directions they are targeting.

**Practical implications** – The use of equity market timing is more aimed at reducing the debt ratio and avoiding unfavorable conditions in the debt market, as well as taking advantage of the capital gains derived from the differences in their stock prices. This study also has practical implications on investment policies that need to consider the adaptation factor of the industrial environment when it comes to making capital structure decisions.

**Originality/value** – This research is the first study that to analyze and to evaluate the impacts of equity market timing on corporate capital structure policies on post-IPO firms in Indonesia. This research is an empirical study which investigates the relevance of equity market timing considerations in the determination of debt-equity choices in capital structure.

**Keywords** Capital structure, Leverage, Equity market timing, Historical value, past-IPO, Indonesian stock exchange

**Paper type** Research paper

## **Introduction**

One of the critical decisions faced by a firm for the sake of operations is funding decisions or capital structure decisions. This is a financial decision related to debt composition, preferred stock and common stock used by the company to fund operations and investments. According to Weston and Copeland (1992), capital structure is about how a firm obtains its long-term funds, whether through debt or equity.

Modigliani and Miller (1958) demonstrated that in the case of perfect capital markets, capital structure was totally irrelevant in determining firm value and future performance. Implicitly, this raises an important question: under what conditions a company could determine of capital structure (Harris and Raviv, 1991)? Over the past forty years, researches on capital structure through theoretical and empirical models have raised some fundamental assumptions underlying the MM theorem. These efforts have led to several competing dominant theories in the capital structure theory, known as Trade-Off Theory (TOT) and Pecking Order Theory (POT) (Myers, 1984).

Myers (1984) assumed that there were two perspectives on corporate debt. He mentioned in his hypothesis that firms had tax credits from the use of debt on the cost of bankruptcy known afterwards as the static trade-off theory. Judging from the adverse selection behavior, a firm first looks at the balance of its income, then at debt, and only in extreme circumstances uses equity for financing, known afterwards the pecking order theory. From Myers's perspective, there are at least two major implications of these two theories. The first implication of the trade-off theory is the adjustment of the firm's leverage target so that deviations from the target can gradually be eliminated. While the second key prediction of the pecking order theory is a standardized sequence on corporate funding.

What happens, then, when the firm's leverage position has exceeded its limits or has even increased its financial risk and caused financial distress cost? The answer is the use of equity as a source of funding. This is in accordance with the standardized sequence of the pecking order theory. Looking at financial behaviors, it is proven that the stock market is inefficient as some shares tend to deviate from their intrinsic value in the long run. This provides an opportunity for firms to create value by selling and repurchasing their own shares due to mispricing of shares. Based on this, Stain in 1996 demonstrated a new theory on capital structure, namely Equity Market Timing Theory (MTT). This market timing theory is more about funding with firm equity.

Timing market theory states that firms tend to issue shares when their stock prices are high and make repurchases when the stock prices are low. A firm takes this step when experiencing problems with its debt, where there is a tendency of the corporate debt position to exceed its limit and the firm has difficulties in obtaining

loans from external parties. The underlying question in this case is: does market timing affect financial decisions and alter the capital structure position of the firm? Firms have a prerogative to determine the time of the issuance of shares and bonds after obtaining the principle permit from an authoritative body. Generally, a firm makes a stock issuance when the stock price increases. Ritter (1984) and Pagano et al. (1998) suggested that firms would take advantage of the price rise situation which would lead to the stock price in that industry group to be overvalued. This strategy known as 'windows of opportunity' is beneficial for firms that will conduct an IPO because it reduces the risk of mispricing and adverse selection costs (Elliot et al., 2008). This behavior is in line with the conclusions of Alti (2005) who suggested that a firm's IPO decisions were more driven by market valuation considerations than by the insistence on financing needs.

One common indicator used to look at market valuation associated with timing is market to book ratio, which will increase if the stock price rise is higher than the increase in its book value or vice versa. The probability of a firm conducting IPO during the increase in market to book ratio value will grow. There is then a close relationship between market conditions and the firm's IPO interest. This conclusion was supported by Tobin (1969), later known as the concept Tobin's Q12, stating a similar idea that the increase in market value made replacement cost of capital cheaper ( $Q > 1$ ) and encouraged firms to increase investment through issuance of shares.

Researches on the impact of market timing on capital structure have been conducted, but not so widely in emerging markets or developing countries. Conclusions derived from previous studies also vary greatly, both in the proxies and measurement variables used. Baker and Wurgler (2002) studied the tendency of managers to use market timing by employing market-to-book ratio (M/B) and the historical value of market-to-book ratio (external weighted historical market-to-book ratio, EFWAMB) in US markets. They revealed that market timing was significantly related to capital structure and fluctuations in their market appraisal which had a major impact on the capital structure. Barker and Wurgler (2002) claimed that market timing was a "cumulative outcome of past attempts to time the equity market".<sup>1</sup> That claim by Barker and Wurgler (2002) has been successfully derived in an empirical model. The emergence of Market Timing Theory (MTT) by Barker and Wurgler (2002) is expected to be able to provide an answer to the complexity of capital structure.

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<sup>1</sup> Although Myers (1984) actually said that market timing was not a new idea. His views are also enforced by Graham and Harvey (2001) that there were indications of management behavior in equity issuance. While Hovakimian, et al. (2001) said that when stock prices rose, the firm would conduct equity bidding. Then Lucas and McDonald (1990) also mentioned the problem of adverse selection during the issuance. [Details: Frank & Goyal (2003), p.7]

1 Huang and Ritter (2005) found that in US public companies the proportion of funds outweighed their financing deficits with external equity, if the cost of equity capital was low. Alti (2006) found that IPO companies (hot market) were more significantly regarded as the timer of share issuance market than cold market companies. Elliot, et al. (2007) found that equity markets with mispricing played an important role in deciding on the choices between debt equity. The profits of the firms would increase external equities when they felt that their shares were overvalued, although the persistent effects of market timing were not long. Based on some of the diverse research results, the author considers the need for further research to ascertain what factors and how these factors affect the policies of capital structure in Indonesian firms.

Looking at the phenomenon occurring in Indonesia, repurchasing transactions of stock or buyback by firms are aimed at increasing the values of earning per share (EPS) (Bapepam Financial Statement, 2003). Analysts also said that one of the commonly used arguments to explain the issuer's motivations to buy back their shares in the market was to increase the earning value per share. Thus the buyback is also another alternative to cash dividend wherein the firm gives value to its investors (shareholders). Essentially, with buyback various added values will be obtained by the firm, for example, stock price in the market might be more stable. This means that if the market price decreases (undervalued) the issuer can buy it back, whereas if it is overvalued it can be sold to obtain capital gain. So the capital gain obtained will go into the company's cash as non-operating income of the firm. From the 2001-2007 data there are 30 announcements of buyback of shares listed on Indonesia Stock Exchange (IDX). There are some companies that conduct buyback of shares more than once, including: PT Berlian Laju Tanker (2001, 2005 and 2006), PT Telkom (2005 and 2007), PT H.M. Sampoerna (2001, 2002 and 2003) and several other companies. This raises the question: when is the right time for the firm to do public offering and when can the firm buy back its shares?

The lesson learned from the phenomenon occurring in Indonesia as explained above is that it is not easy to implement a capital structure theory. Theories such as Pecking Order Theory (POT), Trade-Off Theory (TOT) and Market Timing Theory (MTT) are each expected to provide potential solutions to leverage targets (Tobing, 2007). However, the determination of leverage targets can never be on the basis of mere practical judgments but must be of empirical studies. Based on this, the author intends to test the market timing of capital structure in Indonesia.

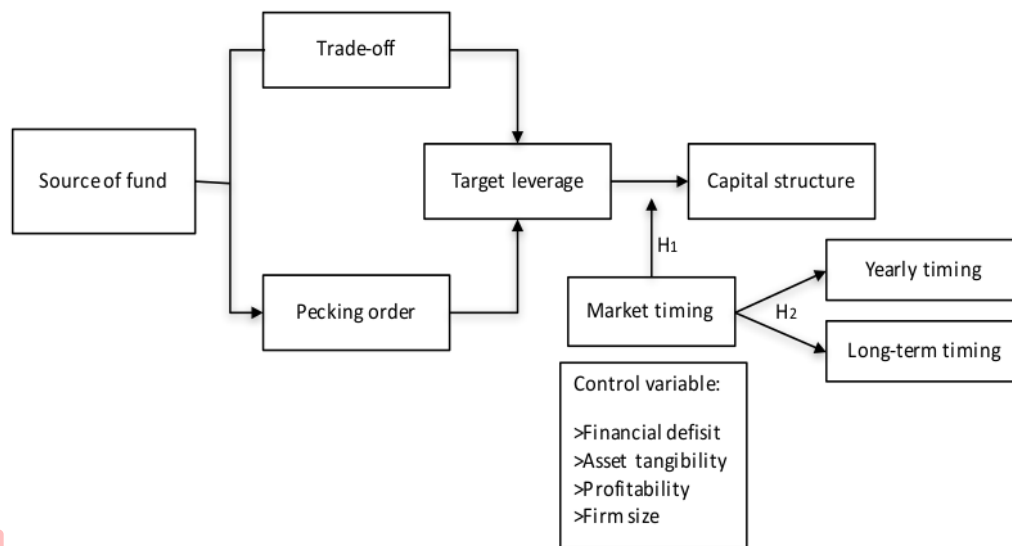
### **Conceptual Framework**

The empirical model employed adopts the one found in Baker and Wurgler (2002) study. The main factor influencing capital structure includes market timing, via external proxy finance weighted historical market-to-book ratio (EFWAMB).

Furthermore, to investigate its long-term effects, as in the study of Kayhan and Titman (2007), external finance weighted historical market-to-book ratio (EFWAMB) is divided in two measurements, i.e. yearly timing (YT) and long-term timing (LT).

Adding cash flow deficit/financial deficit to find out whether there is any indication of equity use is more due to hierarchical factor based on pecking order theory (Frank and Goyal 2003). Control variables in this study include tangible asset, size and profitability. For the next stage, (2) the “timing” analysis is measured and a regression model is constructed. (3) Selecting samples to be tested and analyzed with the regression model. Thus, the conceptual framework of this study can be illustrated as follows:

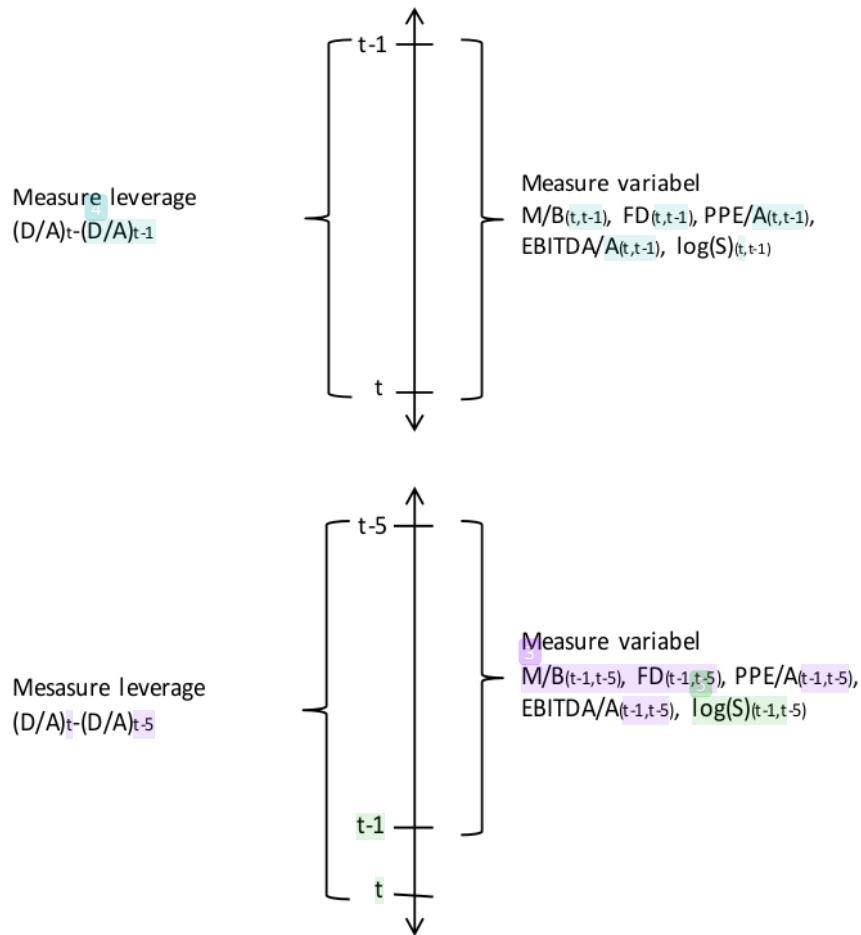
**Figure 3.1**  
**Conceptual Framework**



1  
Source: developed for current study

The measurement of the effects of market timing is based on two measurements: yearly period/timing (YT) and long-term period/timing (LT). This is meant to find out the persistent effects of market timing variable. Yearly Timing (YT) is used to measure the extent of the level of stock mispricing and Long-Term Timing (LT) is used to find out the growth opportunity reflected in stock prices. The timeline concept can be illustrated as follows:

**Figure 3.2**  
**Timeline Concept**



1  
Source: developed for current study

### Research Methodology

The focus of this study is to empirically test the model construction developed by Baker and Wurgler (2002). Integration and identification of the determinant variables of capital structure into the testing of research hypotheses are based on the market timing theory and are conducted via the construction of three empirical research models to solve the research problems.

There are three research models employed in this study. First, the short-term estimation model, where the dependent or endogenous variable is hypothesized on the development of the empirical model, i.e. the leverage variable. The independent variables are the market-to-book ratio, external finance weighted

historical market-to-book ratio, asset tangibility, and firm size. Second, the long-term estimation model, where the dependent or endogenous variables are the external finance weighted historical market-to-book ratio with two timing measurements (yearly timing and long-term timing), market-to-book ratio, asset tangibility, profitability, and firm size.

The leverage rate is calculated from the ratio of total liabilities to total assets (Baker and Wurgler (2002); Pao and Chih (2005); Supanvanij (2006)), but it is based on the book value of leverage and the market value of leverage.

Similar to the literature, leverage will be measured by comparing the total of liabilities and of assets (D/A) as the measure of capital structure. In this study, “total liabilities” and “total assets” are derived from the standard balance sheet in the adjusted corporate financial statements. Therefore, the leverage might be measured by the following equation:

$$\text{Book Leverage} = \frac{\text{Book Debt}}{\text{Total Assets}}$$

$$\text{Market Leverage} = \frac{\text{Book Debt}}{\text{Total Asset} - \text{Total Equity} + \text{Market Equity}}$$

#### 1 **Market-to-book Ratio (M/B)**

The market timing proxy is market-to-book ratio, which is the total equity per share multiplied by the stock’s closing price, formulated as follows:

$$\text{Market to book ratio} = \frac{\text{Market value of share}}{\text{Book value of share}}$$

#### 1 **External Finance Weighted Average Market-to-Book Ratio (M/B<sub>efwa</sub>)**

Referring to Baker and Wurgler (2002) research, M/B<sub>efwa</sub> is a proxy of equity market timing for historical value. M/B<sub>efwa</sub> is the weighted average of market-to-book ratio in the past. Calculations that are too large or too small, due to the mispricing of shares or the presence of the many or few growth opportunities, have the following measurement:

$$\left(\frac{M}{B}\right)_{efwa,t-1} = \sum_{s=0}^{t-1} \frac{e_s + d_s}{\sum_{r=0}^{t-1} e_r + d_r} \cdot \left(\frac{M}{B}\right)_s$$

1 Wherein the net equity issue (e) presents the changes in the initial and end equity values. (d) is the net debt issue as a net debt notification and is defined as the change in the initial and end debt values. M and B each represents the market value and the book value of equity.



Market timing measured employed in this study to find out the persistence impact uses two time measurements, i.e. yearly timing and long-term timing, both of which are formulated as follows:

$$\begin{aligned} \text{Yearly Timing (YT)} &= \left( \sum_{s=0}^{t-1} FD_s * (M/B)_s \right) / t \cdot \overline{FD} * \overline{M/B} \\ &= c \hat{\sigma} v(FD, M/B) \end{aligned}$$

$$\begin{aligned} \text{Long-term Timing (LT)} &= \left( \sum_{s=0}^{t-1} M/B_s / t \right) * \left( \sum_{s=0}^{t-1} FD_s / t \right) \\ &= \overline{M/B} * \overline{FD} \end{aligned}$$

The linier combination of yearly timing (YT) and long-term timing (LT) is as follows:

$$\begin{aligned} (M/B)_{\text{timing}, t-1} &= \frac{\sum_{s=0}^{t-1} FD_s * (M/B)_s}{\sum_{s=0}^{t-1} FD_s} \\ &= \frac{c \hat{\sigma} v(FD, M/B)}{\overline{FD}} + \overline{(M/B)} \\ &= (YT + LT) / \overline{FD} \end{aligned}$$

Yearly timing (YT), the sample covariance between total external financing and market-to-book ratio, is based on Baker and Wurgler (2002) in that a firm which increases its external capital at the time the stock prices are relatively high aims more to lower debt ratio. In this case, managers take advantage of short-term assessments for their capital needs via issuing equities. Long-term measure is intended to test whether the managers are acting as if equity financing is inversely proportional to market-to-book ratio. In other words, they finance their financial deficit with equity rather than debt if their market value to equity book value is sufficiently high.

### **Financial Deficit (FD)**

Financial deficit plays the central role in the pecking order effect, as described in Shyam-Sunder and Myers (1999) and Frank and Goyal (2003), and in the timing effect, as discussed by Baker and Wurgler (2002).

$$\text{Financial Deficit (FD)} = \Delta WC + I + D - CF \equiv \Delta e + \Delta d$$

Financial deficit (FD) is defined as the amount of investment (I), dividend (D) and changes in working capital ( $\Delta WC$ ), after being reduced by net cash flow (CF). The amount is identical to net debt ( $\Delta d$ ) plus net equity ( $\Delta e$ ).

#### ***Asset Tangibility (PPE/A)***

Proxied via fixed asset to total asset used as a collateral and may be associated with high leverage. With the presence of asset owned by the firm it can be used as collateral when default occurs. Asset tangibility is measured by:

$$\text{Asset Tangibility} = \frac{\text{Net Plant} + \text{Property} + \text{Equipment}}{\text{Total Assets}}$$

#### ***Profitability (EBITDA/A)***

Profitability is the firm's ability to make a profit. Pecking order theory shows that if a firm is more profitable, then its funding comes from internal sources and the leverage level is low (Myers, 1977). Various proxies have been used to measure a firm's profitability. Return on Assets proxy (Cessar and Holmes (2003); Tong and Green (2005); Pao and Chih (2005)), Operating income to total assets proxy (Titman and Wessels (1988); Rajan and Zingales (1995); Supanvanij (2006)). In this study, profitability is proxied as the ratio of EBITDA to total assets (Baker and Wurgler (2002); Strebulaev (2007); Gaud, et al. (2005)), namely:

$$\text{Profitability} = \frac{\text{EBITDA}}{\text{Total Assets}}$$

#### ***Firm Size (Log (S))***

Firm size is expected to have a significant effect on the level of leverage. Large companies usually diversify their businesses so that the chances of bankruptcy are small. In addition, large companies are more accessible to the public and hence have lower debt costs. In accordance with Titman and Wessels (1988), Rajan and Zingales (1995), Ghosh, et al. (2000), and Baker and Wurgler (2002), this study employs Log(NetSales) proxy in measuring size.

#### ***Model Hypothesis Testing I***

Equity market timing proxy is the external finance weighted historical market-to-book ratio  $(M/B)_{efwa}$ , referring to Baker and Wurgler's (2002) research, wherein the proxy is used to evaluate the mispricing of a firm's historical market value in order to issue shares at share prices which are relatively higher than the shares' book value. This model is used to find out if market timing affects leverage changes.

$$(D/A)_t = \alpha + \beta_1(M/B)_{efwa,t-1} + \beta_2(FD)_{t-1} + \beta_3(NFA/A)_{t-1} + \beta_4(EBITDA/A)_{t-1} + \beta_5 \log(S)_{t-1} + \varepsilon_t$$

Where:

$D/A$  = book leverage or market leverage

$(M/B)_{efwa}$  = external finance weighted average market-to-book ratio

$FD$  = financial deficit

$NFA/A$  = asset tangibility proxy

$EBITDA/A$  = profitability proxy

$\log(S)$  = firm size proxy

### **Model Hypothesis Testing II**

The regression in the following model incorporates a time measurement factor, following the concept in Kayhan and Titman (2007), Kayhan and Titman (2004), which are yearly timing and long-term timing. This is done to examine whether the effects of market timing will persist or have a permanent impact. Share price over a five-year period from year t-5 to t will affect the leverage ratio for a full five-year period.

$$(D/A)_t - (D/A)_{t-5} = \alpha + \beta_1(YT)_{t-5} + \beta_2(LT)_{t-5} + \beta_3(FD)_{t-5} + \beta_4(NFA/A)_{t-5} + \beta_5(EBITDA/A)_{t-5} + \beta_6 \log(S)_{t-5} + \varepsilon_t$$

Where:

$D/A$  = book leverage or market leverage

$YT$  = yearly timing

$LT$  = long-term timing

$FD$  = financial deficit

$NFA/A$  = asset tangibility proxy

$EBITDA/A$  = profitability proxy

$\log(S)$  = firm size proxy

### **Analysis and Discussion**

Companies sampled in this study are those that conducted IPO between 1997 until 2008 with industry classification outside of finance and banking. This study uses eight variables, consisting of dependent variable  $D/A$  and independent variables

$(M/B)_{efwa}$ , YT, LT, and control variables FD, NFA/A, EBITDA/A and log(S). Measurement of descriptive statistics in this study is the minimum and maximum values, average value and standard deviation.

The Results of Regression Analysis of Model I on Book-Leverage-based D/A

Variable	B	t-count	p-value	Effect
$(M/B)_{efwa}$	-0.021	-2.111	0.040	Negative and significant
FD	3.25E-009	0.093	0.926	Not significant
NFA/A	0.186	2.309	0.025	Positive and significant
EBITDA/A	-0.284	-1.074	0.288	Not significant
Log(S)	0.003	0.118	0.906	Not significant
Constant	= 0,062			
Coefficient of Determination ( $R^2$ )	= 25.8%		Critical value : $t_{table} = 2.013$	
F-count	= 3.203		$F_{table} = 2.417$	

Source: Treated secondary data, 2011

From the table above, the following regression equation is obtained:

$$(D/A)_t = 0.062 - 0.021 (M/B)_{efwa,t-1} + 0.0000000325 FD_{t-1} + 0.284 (NFA/A)_{t-1} - 0.284 (EBITDA/A)_{t-1} + 0.003 \log(S)_{t-1}$$

$R^2 = 50.3\%$

The above table describes the simultaneous test results and the partial effects of the five independent variables on book-leverage-based  $(D/A)_t$ . In the part of F test the value of  $F_{count}$  obtained = 3.203 (greater than  $F_{table}$ ) and the coefficient of determination is 25.8%. The results of this test describes that a significant effect is simultaneously obtained from the five independent variables on  $(D/A)_t$  with a contribution of 25.8%.

The partial effect of  $(M/B)_{efwa,t-1}$  to  $(D/A)_t$  is achieved via t-test. The result of t-test for the regression coefficient is significant ( $p\text{-value} < 0.05$ ). The variable  $(M/B)_{efwa,t-1}$  with regression coefficient of -0.021 significantly and negatively affects  $(D/A)_t$ . This is evident from the t-count value = 2.111 which is greater than  $t\text{-table} = 2.013$  or  $p\text{-value} = 0.040$  which is smaller than  $\alpha = 0.05$ , thus statistically there is a significant effect with negative direction of  $(M/B)_{efwa,t-1}$  to  $(D/A)_t$ . These results suggest that the diversity of  $(D/A)_t$  can be explained by  $(M/B)_{efwa,t-1}$ .

The effect of the financial deficit variable  $(FD)_{t-1}$  to  $(D/A)_t$  is partially achieved using t-test. The t-test result for this regression coefficient is not significant (p-value  $> 0.05$ ).  $FD_{t-1}$  variable with regression coefficient of 0.0000000325 has no significant effect on  $(D/A)_t$ . This is evident from the t-count value = 0.093 which is smaller than t-table = 2.013 or p-value = 0.926 which is greater than  $\alpha = 0.05$ , thus statistically there is no significant effect of  $FD_{t-1}$  to  $(D/A)_t$ . These results suggest that the diversity of  $(D/A)_t$  cannot be explained by  $FD_{t-1}$ .

The next variable is the partial influence of the variable  $(NFA/A)_{t-1}$  to  $(D/A)_t$  which is achieved using t-test. The t-test result for this regression coefficient is significant (p-value  $< 0.05$ ). Variable  $(NFA/A)_{t-1}$  with regression coefficient of 0.186 has positive and significant effect to  $(D/A)_t$ . This is evident from the value of t-count = 2.309 which is greater than t-table = 2.013, or p-value = 0.025 which is smaller than  $\alpha = 0.05$ , thus statistically there is a significant influence with the positive direction of  $(NFA/A)_{t-1}$  to  $(D/A)_t$ . This result suggests that the diversity of  $(D/A)_t$  can be explained by  $(NFA/A)_{t-1}$ .

The variable  $(EBITDA/A)_{t-1}$  to  $(D/A)_t$ , as proxy of profitability, is achieved using t-test. The t-test result for this regression coefficient is not significant (p-value  $> 0.05$ ). Variable  $(EBITDA/A)_{t-1}$  with regression coefficient of -0.284 has no significant effect to  $(D/A)_t$ . This is evident from the t-count value = 1.074 which is smaller than t-table = 2.013, or p-value = 0.288 which is greater than  $\alpha = 0.05$ , thus statistically there is no significant effect of  $(EBITDA/A)_{t-1}$  to  $(D/A)_t$ . This result suggests that the diversity of  $(D/A)_t$  cannot be explained by  $(EBITDA/A)_{t-1}$ .

The partial influence of the variable  $\log(S)_{t-1}$  to  $(D/A)_t$  is achieved using t-test. The t-test result for this regression coefficient is not significant (p-value  $> 0.05$ ). Variable  $\log(S)_{t-1}$  with regression coefficient of 0.003 has no significant effect to  $(D/A)_t$ . This is evident from the t-count value = 0.118 which is smaller than t-table = 2.013, or p-value = 0.906 which is greater than  $\alpha = 0.05$ , thus statistically there is no significant effect of  $\log(S)_{t-1}$  to  $(D/A)_t$ . This result suggests that the diversity of  $(D/A)_t$  cannot be explained by  $\log(S)_{t-1}$ .

### **Regression Analysis of Model II – Book Leverage**

Model II is a hypothesis that explains the influences of variables YT, LT, FD, NFA/A, EBITDA/A, and  $\log(S)$  on D/A using multiple linear regression analysis. The outline of the regression results are presented in table 5.8 below.

### Results of Model II Regression Analysis on Book-Leverage-based D/A

Variable	B	t-count	p-value	Effect
YT	1.85E-007	0.772	0.444	Not significant
LT	-1.66E-007	-0.640	0.525	Not significant
FD	-2.07E-008	-0.049	0.961	Not significant
NFA/A	0.401	0.767	0.447	Not significant
EBITDA/A	2.781	1.663	0.103	Not significant
Log(S)	0.043	0.263	0.794	Not significant
Constant	= -0.39			
Coefficient of			Critical value :	
Determination (R <sup>2</sup> )	= 9.1%		t <sub>table</sub> = 2.014	
F-count	= 0.650		F <sub>table</sub> = 2.308	

Source: Treated secondary data, 2011

From the table above, the following equation is obtained:

$$(D/A)_t - (D/A)_{t-5} = -0.039 + 0.000000185 Y_{T,t-5} - 0.000000166 L_{T,t-5} - 0,000000000207 F_{D,t-5} + 0.401 (NFA/A)_{t-5} + 2.78 (EBITDA/A)_{t-5} + 0.043 \log(S)_{t-5}$$

$$R^2 = 9.1\%$$

The table above describes the simultaneous test results and the partial influence of the six independent variables on  $(D/A)_t - (D/A)_{t-5}$  based on book leverage. In the F test section the F-count value obtained = 0.650 (smaller than F-table) and the coefficient of determination is 9.1%. The results of this test explains that simultaneously there are non-significant effects from the six independent variables on  $(D/A)_t - (D/A)_{t-5}$  with a contribution of 9.1%. The non-significance of the simultaneous test results explains that partial test results need not to be explained in more detail, as the results say that the effects of all independent variables are not significant.

### Regression Analysis of Model I – Market Leverage

The regression coefficients on Model I which explains the effects of variables  $(M/B)_{efwa}$ , FD, NFA/A, EBITDA/A, and log(S) on D/A are achieved via multiple linier regression analysis. The outline of the regression analysis results is presented in the following table 5.9.

Results of Model I Regression Analysis on Market-Leverage-based D/A

Variable	B	t-count	p-value	Effect
$(M/B)_{efwa}$	-0.024	-2.305	0.026	Negative and significant
FD	2.45E-008	0.690	0.494	Not significant
NFA/A	0.157	1.912	0.062	Positive and significant
EBITDA/A	-0.385	-1.427	0.160	Not significant
Log(S)	-0.018	-0.708	0.483	Not significant
Constant	= 0.181			
Coefficient of Determination ( $R^2$ )	= 25.7%		Critical value : $t_{table} = 2.013$	
F-count	= 3.183		$F_{table} = 2.417$	

Source: Treated secondary data, 2011

From the table above, a regression equation is obtained as thus:

$$(D/A)_t = 0.181 - 0.024 (M/B)_{efwa_{t-1}} + 0.0000000245 FD_{t-1} + 0.157 (NFA/A)_{t-1} - 0.385 (EBITDA/A)_{t-1} + 0.018 \log(S)_{t-1}$$

$R^2 = 25.7\%$

Table 5.9 above describes the simultaneous test results and partial effects of the five independent variables on  $(D/A)_t$  based on market leverage. In the F test section the value obtained for F-count = 3.183 (greater than F-table) and the coefficient of determination is 25.7%. The results of this test explain that simultaneously there are significant influences of the five independent variables on  $(D/A)_t$  with a contribution of 25.7%.

The partial effect analysis of variable  $(M/B)_{efwat-1}$  on  $(D/A)_t$  is done using t-test. The t-test result for this regression coefficient is significant ( $p\text{-value} < 0.05$ ). Variable  $(M/B)_{efwat-1}$  with regression coefficient of -0,024 has negative and significant effect on  $(D/A)_t$ . This is evident from the value of t-count = 2.305 which is greater than t-table = 2.013, or p-value = 0.026 which is smaller than  $\alpha = 0.05$ , thus there is a statistically significant influence with a negative direction from  $(M/B)_{efwat-1}$  to  $(D/A)_t$ . This result explains that the diversity of  $(D/A)_t$  can be explained by  $(M/B)_{efwat-1}$ .

The second independent variable is financial deficit, in which the effects of variable  $(FD)_{t-1}$  on  $(D/A)_t$  is achieved via t-test. The t-test result for this regression coefficient is not significant ( $p\text{-value} > 0.05$ ).  $FD_{t-1}$  with a regression coefficient of 0.0000000245 has no significant effect on  $(D/A)_t$ . This is evident from the value of

t-count = 0.093 which is smaller than t-table = 0.690, or p-value = 0.494 which is greater than  $\alpha = 0.05$ , hence there is no statistically significant influence of  $FD_{t-1}$  on  $(D/A)_t$ . This result explains that the diversity of  $(D/A)_t$  cannot be explained by  $FD_{t-1}$ .

The partial effect of the variable  $(NFA/A)_{t-1}$  on  $(D/A)_t$  is achieved using t-test. The t-test result for this regression coefficient is not significant (p-value > 0,050). Variable  $(NFA/A)_{t-1}$  with regression coefficient of 0.157 has no significant effect on  $(D/A)_t$ . This is evident from the t-count value = 1.912 which is smaller than t-table = 2.013, or p-value = 0.062 which is greater than  $\alpha = 0.05$ , hence there are statistically significant influences with positive direction of  $(NFA/A)_{t-1}$  on  $(D/A)_t$ . This result explains that the diversity of  $(D/A)_t$  cannot be explained by  $(NFA/A)_{t-1}$ .

The next variable is the effects of variable  $(EBITDA/A)_{t-1}$  on  $(D/A)_t$  which is also achieved via t-test. The t-test result for this regression coefficient is not significant (p-value > 0.05). Variable  $(EBITDA/A)_{t-1}$  with regression coefficient of -0.385 has no significant effect on  $(D/A)_t$ . This is evident from the value of t-count = 1.427 which is smaller than t-table = 2.013, or p-value = 0.160 which is greater than  $\alpha = 0.05$ , thus there is no statistically significant influence of  $(EBITDA/A)_{t-1}$  on  $(D/A)_t$ . This result explains that the diversity of  $(D/A)_t$  cannot be explained by  $(EBITDA/A)_{t-1}$ .

The t-test result for the regression coefficient of  $\log(S)_{t-1}$  on  $(D/A)_t$  is not significant (p-value > 0.05). Variable  $\log(S)_{t-1}$  with regression coefficient of 0.003 has no significant effect on  $(D/A)_t$ . This is evident from the value of t-count = 0.708 which is smaller than t-table = 2.013, or p-value = 0.483 which is greater than  $\alpha = 0.05$ , thus there is no statistically significant influence of  $\log(S)_{t-1}$  on  $(D/A)_t$ . This result explains that the diversity of  $(D/A)_t$  cannot be explained by  $\log(S)_{t-1}$ .

### **Regression Analysis of Model II – Market Leverage**

The hypothesis of regression coefficients in model II which explains the effects of variables YT, LT, FD, NFA/A, EBITDA/A, and  $\log(S)$  on market-leverage-based D/A is achieved using multiple linear regression analysis. The description of the regression analysis obtained is presented in table 5.10.



### Results of Model II Regression Analysis on Market-Leverage-based D/A

Variable	B	t-count	p-value	Effect
YT	4.77E-007	1.921	0.061	Not significant
LT	-3.19E-007	-1.192	0.239	Not significant
FD	-1.47E-007	-0.334	0.740	Not significant
NFA/A	0.432	0.799	0.428	Not significant
EBITDA/A	0.543	0.314	0.755	Not significant
Log(S)	0.062	0.366	0.716	Not significant
Constant	= -0.383			
Coefficient of			Critical value :	
Determination (R <sup>2</sup> )	= 12.1%		t <sub>table</sub> = 2.014	
F-count	= 1.037		F <sub>table</sub> = 2.308	

Source: Treated secondary data, 2011

From the table above, a regression equation is presented as follows:

$$(D/A)_t - (D/A)_{t-5} = -0.383 + 0.000000319 Y_{T,t-5} - 0.000000147 L_{T,t-5} - 0.000000000147 F_{D,t-5} + 0.432 (NFA/A)_{t-5} + 0.543 (EBITDA/A)_{t-5} + 0.062 \log(S)_{t-5}$$

$$R^2 = 12.1\%$$

Table 5.10 above describes the simultaneous test results and partial influence of the six independent variables on  $(D/A)_t - (D/A)_{t-5}$  based on market leverage. In the F test section the F-count value obtained is 1.037 (smaller than F-table) and the coefficient of determination is 12.1%. The results of this test explain that simultaneously there are insignificant influences of the six independent variables on  $(D/A)_t - (D/A)_{t-5}$  with the contribution of 12.1%. The simultaneous test results are not significant so that the partial test results need not to be described as the effects of all independent variables are not significant.

### Research Results Discussion

#### Analysis of the Effect of Equity Market Timing (M/B<sub>efwa</sub>) on Leverage

Baker and Wurgler's (2002) main findings show that firms with low debt ratios will increase their funds when market valuation is high, while firms with high debt ratios will increase their funds when market valuation is low. The study of Baker and Wurgler (2002) on capital structure is explicitly influenced by a significantly negative effect of market valuation on leverage through equity issuance. High market valuation will encourage managers to issue securities and refuse financing via debt to avoid increasing future agency costs of equity (Fama and French (2002). Myers and Majluf (1984) affirmed that rational managers and investors would issue securities rather than debt when they were very enthusiastic about the outlook of corporate earnings.

The results of statistical test on equity market timing on model I with both book leverage and market leverage indicate significant figures wherein the regression coefficients are negative with real test level  $\alpha = 0.05$ , although it is not absolute for model II. The results of this test show that the issuance of equity when last year stock prices are high will cause companies to increase their operational fund needs by issuing shares. These results provide evidence that managers and investors of industrial companies outside of financial services and banking in Indonesia are utilizing their rationality in making decisions on the time of the market. In which the issuance of equity when stock prices are high will result in managers refusing debt financing to improve the optimum leverage target so that this will change the composition of the company's capital structure.

The results of this study are empirically able to prove the main premise of Baker and Wurgler (2002) and these results reveal the fact that the strength of the creditor or debtholders can motivate the management and shareholders of firms in Indonesia to adjust their efforts to the optimal leverage target even if it is not for the long run.

#### **Analysis of the Effect of Financial Deficit (FD) on Leverage**

Based on the results a regression coefficient value for financial deficit of 0.093 is obtained with prob. value 0.926, wherein this value is not significant at the 0.05 significance level. In this first model, which is viewed from book leverage, it is suggested that financial deficit does not affect target leverage. So it can be concluded that the hypothesis for FD on leverage is rejected, because the financial deficit variable in this study does not have enough significance although there is positive leverage. This means that firms with high or low financial deficits tend to have no effect on leverage targets. The results are inconsistent with the results of Kayhan and Titman (2007), which stated that financial deficit positively affected leverage.

#### **Analysis on the Effect of Asset Tangibility (NFA/A) on Leverage**

Kuo and Wang (2005) revealed that the composition of a firm's tangible assets structure that could be used as collateral had a positive effect on the structure of corporate capital. Companies that have debt guarantees will be easier to get debt than ones that do not have debt guarantee, because investors or creditors will always provide loans when there is a guarantee (collateral value of assets). The results of Kuo and Wang (2005) are consistent with the consensus of financial researchers that debt ratio is positively influenced by asset tangibility, so NFA/A is an important element of capital structure.

The results of the test on model I in this study reveal that the hypothesis that assets tangibility positively affects a firm's debt ratio is accepted, although the findings

are not in agreement for the second model. These findings prove that large asset tangibility allows firms to apply for large loans. These large loans can be used by firms to finance investments when they are experiencing financial difficulties, but the desire to invest will decrease as business risks and guarantee for tangible assets are needed to obtain higher debts.

High management of assets by the management into productive investment projects leads to a decrease in the availability of assets that can be used as collateral to obtain external sources. It will therefore reduce the firm's reliance on external funding sources, and will encourage the management to productively use the assets to obtain better sources of revenue and business opportunities. This revenue source is a source of internal funds to finance the firm's operations, thereby reducing its reliance on external funding sources. This fact is consistent with the pecking order theory that firms with high structural assets composition fund their investments internally (Tong and Green, 2005; and Kuo and Wang, 2005). Thus, the findings of this study successfully answer the first research question that assets tangibility is a determinant of corporate capital structure.

#### **Analysis of the Effect of Profitability (EBITDA/A) on Leverage**

The research model shows that profitability has a negative value on the ratio of corporate debt with prob. 0.288 which means it is not significant, both for model I and model II. Pecking order theory shows that if a firm is more profitable, then its funding comes mostly from internal sources. Weston and Copeland (1997) said that profitable companies generally borrowed in small numbers, while less profitable firms tend to have high debt ratios due to inadequate internal funds and debt being the preferred source of external funds rather than their own capital. Baskin (1989) argued that the more profitable a company is, it is expected to have higher internal funding. Therefore, pecking order theory states that profitability has a negative relationship with debt ratio (Myers, 1984; Ozkan, 2001; Cassar and Holmes, 2003; and Akhtar, 2009).

#### **Analysis of the Effect of Firm Size (log(S)) on Leverage**

Hypothesis testing of firm size's effect on leverage suggests that there are no effects on model I and model II. These results are inconsistent with the findings in previous studies, that firms with larger and more complex asset sizes have no difficulty in obtaining external sources of funds or loans. Conversely, few companies with smaller asset sizes get external sources of funds. Therefore, based on the trade-off hypothesis, the amount of assets (SIZE) has a positive effect on the ratio of corporate debt.

Ozkan (2001) also mentioned that large companies that had the ability to recover their debts would gain the trust of creditors to issue large debts. Other empirical

evidences are presented by Bevan and Danbolt (2002), and Low and Chen (2004). But the empirical studies of Frank and Goyal (2003) reveal contrary evidence, that firm size negatively affects the debt ratio.

### **Hypothetical Conclusion**

Based on data analysis and findings, as well as discussion of research results, conclusions of research hypotheses can be drawn as follows:

1. The results of this study successfully answer the first research question that market timing, proxied through external finance weighted historical market-to-book ratio  $((M/B)_{efwa})$ , has a significant negative effect on D/A, on book leverage and market leverage. The results of the analysis show that the measurements of variable  $(M/B)_{efwa}$  based on market leverage is more capable to explain its influence to D/A variable. This indicates that market timing will have more impact on market leverage changes. The results also indicate that the current capital structure is closely related to the past market value, wherein the firm will issue equity based on the stock market valuation. So it can be concluded that when their stock price is high, the company increases the number of its shares in circulation and repurchases them when the company's stock price is low.

The results also support the opinion of Barker and Wurgler (2002) who examined the tendency of managers to consider market timing via the use of market-to-book ratio (M/B) and external finance weighted historical market-to-book ratio (EFWAMB) as a measure of market timing. Barker and Wurgler (2002) found that market timing was significantly related to capital structure and that fluctuations in market valuation had a large impact on capital structure.

2. In the second research model, when long-term measurements are used by including time measurements,  $t$  on  $t-5$ , the results show that market timing has no influence on the sampled firms' decision-making of whether they will add or will buy shares of the company. Test results figures show insignificant values, either based on book value or on market value.

This result is consistent with the research conducted by Kayhan and Titman (2007) that divides EFWAMB into two parts, namely yearly timing (YT), which is used to measure stock mispricing levels, and long-term timing (LT) used to find out growth opportunities reflected in stock price. In their research, they found that market timing did have an impact on capital structure but the impact was not persistent.

### **Managerial Implications**

The practical implications of the results of this study for management will provide guidance for managers in considering the benefits and the costs of chosen funding

sources when it comes to balancing capital structure. Selection and screening of important factors that determine capital structure can be decided from the findings of this study. Similarly, they may provide management guidance on the timing of the market or equity market timing when it comes to deciding when to issue equity or debt. The results of this study also have practical implications on investment policies that need to consider the adaptation factor of the industrial environment when it comes to making capital structure decisions.

### **Recommendations**

Based on the results of this study, the author would like to provide some suggestions which may be useful for the development of capital structure theory of public companies in Indonesia for further research, among others:

1. Future researches are encouraged to increase the number of firm samples and have longer observation periods, so that the results obtained may reflect the general condition of the firms.
2. Using hot-cold market proxy as a proxy of market timing, so that rational or not rational behavior of the sample firm can be detected. In addition, other proxies of market timing, such as the earnings-based valuation model and stock returns, have characteristics similar to market-to-book ratios, and proxies that use manager survey can only produce qualitative analysis thereby reducing the prevalence rate of research data because it is not supported by quantitative data.
3. Taking into consideration other factors that are able to explain changes in corporate leverage. So it is expected that research factors can thoroughly explain the changes in leverage.
4. Selecting sample firms from the industrial sector or similar industry segments, so the characteristics of the industrial sector can be known and compared to other sectors or segment characteristics in accordance with the topic of the research.

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*Silvia*  
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