

The Effect of Free Cash Flow and Financial Leverage on Financial Performance of Toll Road Infrastructure and Building Construction Companies Listed on the Indonesia Stock Exchange for Period 2014-2018

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Abstract: *This study aims to examine and analyze the effect of free cash flow and financial leverage on the financial performance of toll road infrastructure and building construction companies listed on the Indonesia Stock Exchange for period 2014-2018. This research uses a quantitative approach with panel data regression. The research sample used purposive sampling and obtained 60 data. This study analyzes financial performance with a proxy of Tobin's Q. Free cash flow is considered as excess cash to fund all of company projects and must be paid to shareholders if the company wants to remain efficient for a longer period of time. Financial Leverage used to measured and find out how much the company is financed by debt. This study used 6 control variables, such as Agency Cost, Capital Structure, Industry, Corporate Social Responsibility, Age, and Size. The results of the study are free cash flow negatively effect the company's financial performance while financial leverage does not effect the company's financial performance.*

Keywords: Free Cash Flow, Financial Leverage, Financial Performance, Tobin's Q, Infrastructure, Construction

1. Introduction

The main motive for someone to set up a company is to maximize wealth by having good financial performance. Financial performance can be analyzed from several values, namely comparing financial statements, trends, percentages per component, sources and uses of working capital, sources and uses of cash, financial ratios, changes in gross profit, and break even (Jumingan in Topowijono et. al., 2014 : 2). One of the measurement tools in financial performance is Tobin's Q. Tobin's Q is a ratio that describe the condition or performance of the company in the future (Suryana and Nuzula, 2018: 40). Tobin's Q ratio can reflect market sentiments or expectations (Smithers and Wright in Sitepu, 2015: 14). The higher Tobin's Q value indicates that the company has good prospects.

The infrastructure sector and building construction have an important role in Indonesia's economic growth. Before the 1997 economic crisis, Indonesia allocated 6% for infrastructure but fell to 2% (Keusuma and Suriani, 2015: 3). Therefore, cash flow has an important role in the company, especially to support economic growth in Indonesia. In order to increase dividends and develop new products/services, companies use free cash flow, which is more funds owned by companies that are used to increase company value (Hernat, 2015: 12). High free cash flow can reduce company performance so that the company experiences over investment or excess investment. However, the decline in company performance can be overcome by increasing leverage (Park and Jang, 2013: 11). Free cash flow can be misused by managers for their personal interests so there is a conflict between managers and shareholders, which is called agency theory (Jensen and Meckling, 1976). However, this conflict can be overcome by agency costs, which are costs

incurred by the principal to oversee agents (Jensen and Meckling, 1976).

Indonesia has experienced stable economic growth over the past five years. Indonesia's economic growth increased by 5.17% and the growth was the highest percentage of economic growth since 2013. One of the factors that led to an increase in economic growth in Indonesia in 2018 was the sustainability of infrastructure projects. The number of government projects on infrastructure has made infrastructure companies experience financial performance improvements in recent years. In addition to stabilizing economic growth, the sustainability of infrastructure projects can reduce income inequality and poverty in Indonesia. The infrastructure sector is one of the pillars of the Global competitiveness index which is considered as one of the important factors for the effective functioning of the economy (World Economic Forum, 2016). In addition to the infrastructure sector, building construction has various projects with stable economic growth. In 2018, the market value of building construction reaches USD 11.2 million or equivalent to Rp 161 trillion. Indonesia is known as the second most productive and profitable construction market in Asia. A number of large construction projects from both the housing and non-housing sectors have great demand so that the financial performance of construction companies has increased in recent years (Mordor Intelligence, 2018). The toll road infrastructure and building construction industry sectors have the same characteristics, namely requiring very large investment funds for development and construction, a long investment return period, and are vulnerable to the risk of uncertainty in various conditions (Indonesia Investments, 2017).

Sources of funds in the form of debt will incur expenses in the form of interest. To find out how much a company is financed by debt can be measured by a ratio called leverage (Fahmi, 2017: 127).

This research is in line with the research of Park and Jang (2013) which proves that financial leverage is an efficient way to reduce free cash flow and can improve the company's financial performance. However, free cash flow that is put to good use can improve a company's financial performance, such as maintaining company assets and can finance the expected new investments. Research by Park and Jang (2013) write that excessive free cash flow is considered not good because it can reduce the value of the company. Therefore, free cash flow must be utilized as well as possible so that the company's financial performance can be assessed as good and not reduce the value of the company.

2. Literature Review

2.1 Free Cash Flow

According to Jensen in Mutende et. al (2017: 56), the concept of free cash flow has a reference to the availability of excess cash flow after paying all profitable business costs. Cash flow is the net cash obtained by a company after paying development costs and added to R&D expenses that reduced by investment expenses. Ambreen (2016) writes that free cash flow has a relationship with growth in company performance. Companies with higher cash flows are likely to face conflicts of interest between shareholders and managers. Free cash flow is considered as excess cash to fund all company projects and must be paid to shareholders if the company wants to remain efficient for a longer period of time. Free cash flow allows the company to take advantage of opportunities to increase shareholder value, namely increasing dividends, developing new products / services, paying off obligations, etc. When free cash flow decreases, cash flow cannot fund operations or business growth. The formula of Free Cash Flow is:

$$\text{Free Cash Flow} = \text{Operational Cash Flow} + \text{Capital Expenditures}$$

2.2 Agency Theory

Jensen and Meckling (1976) define agency theory with the relationship between one or more people (principals) who employ agents or others to provide services for decision making and are delegated to agents. Generally, agency problems arise because there are differences in information between managers as agents and shareholders as principals. Information that is not balanced can make managers act in their personal interests. One such action is that managers can use free cash flow within the company that is used to benefit themselves not in the interests of shareholders or the company. The greater the free cash flow, the greater the opportunity for dividends to be distributed to shareholders (Giriatik, 2016: 249). Agency theory writes that free cash flow can cause conflicts between managers and shareholders because shareholders want free cash flow to be paid as dividends but managers want free cash flow to be invested to increase company growth (Jensen and Meckling, 1976). Agency theory teaches that if managers know there is no

potential for company growth, then free cash flow needs to be used so that it is distributed as dividends. This is the responsibility of a manager to increase shareholder value by dividend distribution (Jensen and Meckling, 1976).

2.3 Financial Leverage

Leverage is a ratio that is measured to find out how much the company is financed by debt. Companies that use debt that is too high can endanger the company because it can be trapped to release the debt (Fahmi, 2017: 127). Harmono (2014: 184) writes that the purpose of financial leverage is to find out how far the company is able to utilize funds through debt to increase operational activities and how much profit the company is able to cover interest costs. One of the leverage's indicator used in this study is debt ratio which is written that the lower the debt ratio, the better because it is safe to be liquidated by creditors. Debt ratio is chosen as financial leverage because it can avoid breach of agreement on debt when the company experiences default. This can be seen by the company's ability to repay debt with collateral owned assets (Kasmir in Hartati, 2015: 37). Financial leverage contains three dimensions (Sartono in Nopitasari et. Al., 2017: 47), namely:

- i. The amount of collateral for loans will be emphasized on the credit provider;
- ii. The company will get a greater profit than the fixed burden if using debt, which company profits will increase;
- iii. The owner of the company gets funds from debt and does not lose control of the company.

The formula of Debt Ratio is:

$$\text{Debt Ratio} = \frac{\text{Total Liabilities}}{\text{Total Assets}}$$

2.4 Financial Performance

Gleason and Barnum (in Mutende et. Al., 2017: 57) write the definition of financial performance is the company's ability to achieve planned results. These results relate to shareholder returns, market performance, and financial performance. Jumingan (in Topowijono et. Al., 2014: 2) analyzes the financial performance of several values, namely comparing financial statements, trends, percentages per component, source and use of working capital, sources and uses of cash, financial ratios, changes in gross profit, and break even. Fahmi (2017: 240) analyzes financial performance based on 5 stages, namely:

- i. Financial report data review;
- ii. Perform calculations;
- iii. Compare the calculation results obtained;
- iv. Interpretation of the problems found;
- v. Providing solutions to various problems found.

2.5 Tobins Q

One of the measurements to assess financial performance is Tobin's Q. The greater Tobin's Q ratio value indicates that

the company has good growth prospects because the greater the values of the company's assets, investors are willing to spend more funds for the company (Cahyaningtiyas and Hadiprajitno, 2015). Tobin's Q is often used in financial literature as a proxy for future investment opportunities. Tobin's Q has wide use so it is considered important in various variables (Singhal et. Al., 2016: 2).

The advantages of Tobin's Q are as follows (Smithers and Wright in Sitepu, 2015: 14):

- i. Reflect all assets owned by the company;
- ii. Able to reflect market sentiment;
- iii. Reflect intellectual capital owned by the company;
- iv. Can prevent and overcome problems by predicting the level of profit or marginal cost of the company.

While the weakness of Tobin's Q is the turnover of costs, advertising costs, as well as the costs of research and development of intangible assets is difficult to estimate so that it can result in an incorrect measurement of market power (Smithers and Wright in Sitepu, 2015: 14).

The formula of Tobin's Q ratio as follows:

$$\text{Tobin's Q} = \frac{(\text{Market Capitalization} + \text{Liabilities Total})}{\text{Assets Total}}$$

The criteria values of Tobin's Q are as follows (Walidayni, 2015: 18)

- i. Tobin's Q moves at number < 1 or undervalued, means the company does not manage assets well;
- ii. Tobin's Q moves at number 1 or average, means the company is not experiencing development;
- iii. Tobin's Q moves at number > 1 or overvalued, means the company is managing assets well.

2.6 Agency Cost

Agency cost occurs because there is a conflict between the interests of the principal and the agent. Agency costs are costs incurred by principals to oversee agents (Jensen and Meckling, 1976). Excessive free cash flow values in companies can lead to agency costs because managers can use them for personal gain. Reducing agency costs can improve performance because high agency costs reflect agency conflicts that are increasingly complex in the company so that company operations are unstable (Herliana et. Al., 2016). Measurement of agency costs uses the operating expense ratio, because OER has a relationship between company expenses and company operations. The formula of Agency Cost as follows:

$$\text{OER} = \frac{\text{Operational Expenses}}{\text{Net Sales}}$$

2.7 Industry

Industry is a characteristic of a company that is related to the line of business, business risk, employees, and corporate

environment. Industry types are divided into 2, namely high profile and low profile industries. The type of high profile industry is a company with operational activities that have the potential of wide interests and often becomes the spotlight of the public compared to the type of low profile industry (Robert in Ahmad, 2014: 4). This research divides industrial categories based on the category, namely:

0: Non BUMN 1: BUMN

2.8 Capital Structure

Weston and Copeland in Fahmi (2017: 179) define capital structure with permanent financing represented by long-term debt, preferred stock, and shareholder equity. However, Fahmi (2017: 179) defines a capital structure with a picture in the form of a financial proportion of the company with an indicator of capital sourced from long-term debt and own capital which is a source of financing for a company. The capital structure is expected to maximize the value of the company. The company feels that the capital structure is important because it is able to strengthen a stable financial condition so as to increase the value of the company (Fahmi, 2017: 185).

There are several factors that can affect a company's capital structure, namely

- i. Business characteristics;
- ii. The scope of business operations activities;
- iii. Management characteristics;
- iv. Characteristics, policies, and desires of the owner;
- v. Micro and macro economic conditions in the country and abroad that affect corporate decision making.

The formula of Capital Structure as follows:

$$\text{Capital Structure} = \frac{\text{Long Term Debt}}{\text{Own}}$$

2.9 Corporate Social Responsibility

Corporate social responsibility, commonly abbreviated as CSR, is a commitment within a company to improve society by conducting business practices and contributing corporate resources. World Business Council for Sustainable Development in Awuy et. al (2016: 17) defines CSR with the company's ongoing commitment to contribute to economic development. The value of the company can increase if the company does CSR in the company. The better or more active a company is in carrying out CSR, then the public will judge the company's performance well, which can attract investors to invest in the company (Widianingsih, 2018: 42). The formula of Corporate Social Responsibility as follows:

$$\text{CSRI}_j = \frac{\sum X_{ij}}{n_j}$$

Explanation:

CSRI_j: Corporate Social Responsibility Disclosure Index on company.

n_j: Total item on the company.

X_{ij}: Dummy variable, 1 = item is exposed i; 0 = item i does not exposed.

3.0 Size

Company size is a picture of the size of the company with indicators of total assets and total sales (Sujianto in Rumondor et. al., 2015: 161). The size of large companies holds broader interests so that their policies have an impact on the public interest compared to small company sizes. The formula of Company size as follows:

$$\text{Size} = \ln (\text{Assets Total})$$

The total value of assets has a large value when compared with other variables. Therefore, company size needs to use natural logarithms to refine the value of a variable so that it has the same units as other variables.

3.1 Age

The age of the company is an illustration of how long the company has been standing. Companies that have been established for long times generally have high competitiveness because they understand the industry well (Goldwin and Christiawan, 2017: 221). Company age determines how far the company manages resources in its business (Tonggano and Christiawan, 2017: 400).

3. Methodology

The population of this study consists of 3 toll road infrastructure companies (Appendix A1) and 9 building construction companies (Appendix A2) which are listed on the IDX. The sample of this study is purposive sampling.

This research used secondary data on financial performance. The data analysis technique used in the study is panel regression analysis. According to Basuki and Prawoto (2017: 275), panel data is a combination of time series and cross section data. The data analysis tool used in this study is STATA14. The formula of panel regression as follows:

$$Y_{it} = \alpha + X_{1it} \beta_{1it} + X_{2it} \beta_{2it} + X_{3it} \beta_{3it} + X_{4it} \beta_{4it} + X_{5it} \beta_{5it} + X_{6it} \beta_{6it} + X_{7it} \beta_{7it} + X_{8it} \beta_{8it} + e_{it}$$

Explanation:

Y: Financial Performance

α: Constant Coefficient

β₁-β₈: Regression Coefficient

e: Error

i: 1, 2,..... 12

X₆: Size

X₈: Industry

t: 2014, 2015, 2016, 2017, 2018

X₁ : Free Cash Flow

X₂ : Financial Leverage

X₃ : Agency Cost

X₄ : Capital Structure

X₅ : CSR

X₇ : Age

The CEM model can use the ordinary least square approach or abbreviated as OLS to estimate the panel data model.

2) Fixed Effect Model or FEM

Fixed Effect Model or commonly abbreviated FEM is a model that has a variety of independent variables in each individual. Fixed effects can use dummy variable techniques in distinguishing the intercepts of each company. FEM can also be called Least Square Dummy Variable because FEM models use dummy variables.

3) Random Effect Model or REM

Random Effect Model or commonly abbreviated as REM is a model that can estimate panel data, which errors will correlate between time and between companies. The REM model has the advantage that it can eliminate the heteroscedasticity test in the classical assumption because REM can use the Homalizedasticity Generalized Least Square test.

There are 3 types of tests done to find out which model is good for managing panel data, i.e:

a) Chow Test

Chow Test is a test used to determine which model is appropriate to use in estimating panel data between fixed effects or common effects. If the probability value is more than 0.05 then H₀ is accepted. However, if the probability value is less than 0.05 then H₁ is accepted and H₀ is rejected.

H₀: Common Effect

H₁: Fixed Effect

b) Hausman Test

Hausman Test is a test that is used to determine the fixed effect or random effect model that is appropriate for panel data estimation. If the Chi Square probability value is less than 0.05 then H₀ is rejected while the Chi Square probability value is more than 0.05 then H₀ is accepted.

H₀ : Random Effect

H₁ : Fixed Effect

Lagrange Multiplier Test

Lagrange Multiplier Test is a test used to determine the random effect model or common effect that is appropriate for estimating panel data. If the LM statistical value is greater than the Chi Square value, then H₀ is rejected while the LM statistical value is less than the Chi Square value, then accepts H₀.

H₀ : Common Effect

H₁: Random Effect

4. Results and Findings

Table 1: Model Summary for Chow Test

Value	Prob > F
0.0000	

Source: *Research Data, 2019*

Based on table 1, the probability value of F obtained from the Chow test results is 0,000 which means less than 0.05 meaning rejects H₀ and the fixed effect model is the right model.

Table 2: Model Summary for Hausman Test

	Value
Prob > Chi ²	0.3322

Source: *Research Data, 2019*

Based on table 2, the probability value obtained from the Hausman test results is 0.3322, which means more than 0.05 meaning rejects H_0 and the random effect model is the right model.

Table 3: Model Summary for T - Test

	z	P > z
Free Cash Flow	- 2.38	0.01
Financial Leverage	- 0.74	0.45
Agency Cost	0.03	0.97
Structure Capital	2.05	0.04
CSR	- 0.91	0.36
Size	- 3.59	0.00
Age	- 0.39	0.69
Industry	5.15	0.00

Source: *Research Data, 2019*

The free cash flow variable has a P value less than 0.05 with a negative coefficient so it can be concluded that free cash flow has a negative effect on the company's financial performance. Financial leverage variable has a P value of more than 0.05 with a negative coefficient so it can be concluded that financial leverage has no effect on the company's financial performance.

Control variables consists of capital structure, agency cost, corporate social responsibility, size, age and industry, which have an influence on the company's financial performance are capital structure, industry, and size. But the size variable has a negative influence on the financial performance of the company while the capital structure and industry have a positive effect on the financial performance of the company.

The following regression as follows:

$$\text{TobinsQ}_{it} = 270.64 - 0.058\text{FCF}_{it} - 0.519\text{FL}_{it} + 0.00007\text{AC}_{it} + 0.538\text{SC}_{it} - 2.497\text{CSR}_{it} - 0.610\text{Size}_{it} - 0.002\text{Age}_{it} + 1.424\text{Industr}_{it}$$

Explanation:

FCF : Free Cash Flow FL: Financial Leverage
AC : Agency Cost SC: Structure Capital
CSR : Corporate Social Responsibility
i : 1, 2, 12
t : 2014, 2015, 2016, 2017, 2018

Based on the results, free cash flow has a negative effect on the company's financial performance and the greater the value of cash flow, the company's financial performance will decline. Based on research by Hong et. al (2012), most of the cash flow in the infrastructure, construction, real estate and property industries is used for operational activities and development of new projects. Ilori et. al (2018) likens cash as oxygen in business health to construction companies. Therefore, consistent and early payments are the main key so that construction companies have a sufficient supply of operating cash flow. On the other hand, a budget that is not according to plan can cause problems in cash flow for

construction and infrastructure companies. If the company's toll road infrastructure and building construction clients can pay off payments on time, the existing cash flow inventory at the company can get a positive value.

In this study there are 6 control variables, namely agency cost, capital structure, CSR, size, age, and industry. Agency cost variable does not affect the company's financial performance, which means the company's manager does not misuse funds in the company for his personal interests so that agency theory does not apply to the negative influence of free cash flow on the company's financial performance (Herliana et. al, 2016). Capital structure in the toll road infrastructure and building construction companies is something that needs attention, especially if the company has characteristics that require a lot of capital. Therefore, the capital structure affects the company's financial performance because the characteristics of the company in the study are the need for capital. Company performance can be said to be good if the company is active in doing CSR, but the value of the T test in this study shows that CSR does not affect the company's financial performance. That is because the toll road infrastructure and building construction companies do not damage the environment so CSR does not have too much impact on the company.

The age of the company does not affect the company because the length of time the company was established did not interpret the stability of the company's toll road infrastructure and building construction business. That is because the two industrial sectors in this study are concerned with the development of projects to improve company performance so that old or new companies do not affect the company's financial performance.

Based on industry characteristics, the company is divided into two ownership, namely BUMN and Non BUMN. In this study, the industry affects the company's financial performance and based on Table 3 and Industry variable regression coefficients, the performance of BUMN companies is better than Non BUMN. That is because BUMN companies are controlled directly by the government so the government ensures that BUMN companies are able to fulfill their obligations. On the other hand, state-owned companies in this sector.

Based on the partial test results, financial leverage has no influence on the company's financial performance. If the company depends on equity, the factors that cause financial leverage do not affect the company's financial performance is that in this study there are no indicators of net income on the company's financial performance. The financial performance of a company that is proxied by Tobin's Q does not have an indicator of net income so that it becomes a factor that causes financial leverage does not affect the company's financial performance. The role of the net profit indicator is that it can reduce corporate tax where there is a correlation between financial leverage and tax reduction, which is the company's profit (Nopitasari et. al, 2017).

Financial leverage contained in the study depends on equity versus debt so that fluctuating stock prices can affect financial leverage. Fluctuating stock prices are judged by the

size or size of the company because the larger the size of the company, the funds spent by investors in investing the greater, and vice versa, if the company has a small size then investors do not need to spend a lot of funds in investing in company. This shows that the size of the company has an influence on the company's financial performance (Widyaningsih, 2018: 42).

Financial leverage can be used as a tool to discipline company management so that companies do not have debts that are too high so as not to cause financial performance limitations (Evgeny, 2015: 1). However, this applies if the company's financial performance is proxied by profitability ratios because financial leverage has a correlation between debt and tax reduction.

5. Conclusion

Free cash flow has a negative effect on the company's financial performance variables. It is because the toll road infrastructure and building construction companies utilize cash flow for operating activities and develop new projects so that the operating cash flow value in the study period is negative.

Financial leverage does not affect the company's financial performance variables. It is because the toll road infrastructure and building construction companies are vulnerable to excessive investments.

The company needs to began balancing their investment levels with company performance that is associated with market sentiment so that the flow of company performance is getting better. Companies need to develop efficient cash flow control strategies.

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Appendix

Appendix A1

List of Toll Road Infrastructure Companies

No.	Company's Code	Company's Name
1.	CMNP	PT Citra Marga Nusaphala Persada Tbk
2.	JSMR	PT Jasa Marga (Persero) Tbk
3.	META	PT Nusantara Infrastructure Tbk

Appendix A2

List of Building Construction Companies

No.	Company's Code	Company's Name
1.	ADHI	PT Adhi Karya (Persero) Tbk
2.	PTPP	PT PP Tbk
3.	WSKT	PT Waskita Karya (Persero) Tbk
4.	WIKA	PT Wijaya Karya (Persero) Tbk
5.	ACST	PT Acset Indonesia Tbk
6.	DGIK	PT Nusa Konstruksi Enjiniring Tbk
7.	NRCA	PT Nusa Raya Cipta Tbk
8.	SSIA	PT Surya Semesta Internusa Tbk
9.	TOTL	PT Total Bangun Persada Tbk

Author Profile



Finna Delphinia Santoso received the B.M. and M.M. degrees in Business Management from Ciputra University in 2019 and 2020, respectively.