CHAPTER I

INTRODUCTION

1.1 Background of the Study

Indonesia is the country of great economic potential and investment activities in Indonesia are increasingly developing. In this present era, more and more people and companies prefer to invest their money to reliable companies in hopes of growing its benefits. Investment itself refers to any amount of money that a company receives to help achieve and further its business goal. It is defined as an act of allocating money or funds to start or expand a business or project in a company. By having investors invest in a company, it allows companies the opportunity to grow their business and to create more innovations to keep track of global trends. Some of the most common investment instruments involve acquiring property, purchasing stock, bond, or certificate of deposit. But the most favored investment is in the form of stock because stocks are considered to provide higher and more attractive level of benefits to investors although the risk is almost higher compared to other instruments.

The capital market in Indonesia known as the Indonesia Stock Exchange, has been serving as a platform for investors to engage in investment activities and source of funding for businesses. It offers investors various investment products and features to help investors consider which investment would give the best benefit for them. In Indonesia Stock Exchange, there are 24 indexes where stocks are being classified into. One of them is LQ45, which is one of the most referred and preferred indexes that contains companies that are well-established and have good performance in the business. It is the index that is known to be the benchmark of stocks in the Indonesia's stock market. In the fast-paced development of shares in the market, LQ45 index is an effective tool in tracking Indonesia's stocks as a whole. These companies give a visual of stable and good financial condition that are likely to be an interest to investors to come up with the agreement of purchasing the company's stock. (Zulfikar, 2016)

However, although LQ45 Index shows good prospect, as a rational future investor, investment decisions in a stock must be preceded by a process of analyzing the variables that are expected to influence stock returns. Investors need to initially conduct a business feasibility study to assess whether the investment is beneficial or not. Companies that accomplish good achievements can attract investors to invest because stock price is an important part that reflects the value of a company. The benefits that investors expect from their investment is called as return. Return were obtained by investors in the form of capital gains and dividend yields in a certain period. The capital gains and dividend yields depend on the financial performance and characteristic of the organization. Investors must be able to analyze both to prevent risk and to predict stock return in order to gain better profits. Investors could not acknowledge the certain amount of return that they obtain from the investment made. Investors can only make predictions and estimates the expected return by considering the risk.

In the investment activity, investors would generally encounter risks. One of the most alarming risk is distress risk. It is the reflection of the company's poor performance which resulted in companies not able to fulfill its obligations due to losses the company has endure. It is important for companies to measure their financial distress initially so that any required actions such as, policies to strengthen the system, can be anticipated prior to the event. Some previous studies implemented Altman Z-score Analysis Method as the tool to calculate and predict risk of bankruptcy. Professor Edward Altman published the Altman Z-score formula in 1968. Altman looked at numerous companies over the years and found that Z-score had an accuracy of between 82% and 94%. Low Z-score value indicates high risk of distress risk which makes the company to suffer unhealthy financial performance. This would signal investors that the company is in its distressed condition which results in the company lowering their stock price. Hence, return will also be lower. (Kenton, 2019)

According to Fama and French (1995), firm size and book to market ratio play dominant roles in affecting the level of stock return. Firm size indicates the monetary value of a company by the total assets that the company holds or the company’s market capitalization. Bigger companies can invite more investors to come because bigger companies can generate higher profit and have greater reputation that would invite investors in the expectation to receive high return. Book to market reflects a company's value seen from the net worth of the company (all assets minus debt and company liability) divided by the number of shares outstanding. It compares company’s book value to its market value. The higher the value of book to market, the lower the market values of the company's shares. The lower the value of the stock market, the company makes little possibility for investors to get returns. (Borad, 2019)

The table below shows the condition of several LQ45 index companies.

Table 1. 1 Distress Risk (Altman Z-Score, Firm Size, Book to Market Ratio and Stock Return in Year 2016-2018

P. T. Telekomunikasi Indonesia (Persero) Tbk. (TLKM)				
Year	**Distress Risk (Altman Z-score)**	**Firm Size**	**Book-to-Market**	**Stock Return**
2016	5.30110	32.82181	0.26308	0.01015
2017	5.05303	32.92173	0.24607	0.01139
2018	4.38083	32.95985	0.34177	0.00000
P.T. Unilever Indonesia Tbk. (UNVR)				
Year	**Distress Risk (Altman Z-score)**	**Firm Size**	**Book-to-Market**	**Stock Return**
2016	7.13105	30.44916	0.07945	(0.03000)
2017	7.64333	30.57052	0.06065	0.02757
2018	8.05771	30.60261	0.55922	(0302575)
P.T. Astra International Tbk. (ASII)				
Year	**Distress Risk (Altman Z-score)**	**Firm Size**	**Book-to-Market**	**Stock Return**
2016	3.28336	33.19881	0.41763	0.01846
2017	3.12151	33.32018	0.46525	0.03106
2018	2.80992	33.47373	0.52365	0.00000

Source: www.idx.com

Out of several non-banking LQ45 companies that are listed in the Indonesia Stock Exchange, the writer chose P.T. Telekomunikasi Indonesia (Persero) Tbk. (TLKM), P.T. Unilever Indonesia Tbk (UNVR) and P.T. Astra International Tbk. (ASII) to showcase the comparison of each ratio. The companies are chosen based on the company with the largest market capitalization during the year 2018 and several criteria that the writer applied to ensure the selected subjects of discussion are suitable to this research. These ratios are summarized based on the writer's calculation where data and numbers are collected from the company's financial statements from the year 2016 to 2018.

Based on the data on Table 1.1, it can be seen that the pattern of the relation shows no consistency. As it has been mentioned above, the Z-Score analysis method can be used to determine the rate of financial distress risk of a company. The lower the score indicates that the rate of company's distress risk is higher, and vice versa, the higher the score means that the company's distress rate is lower or the healthier the company will be. In the column of Z-score and stock return, both ratios show no consistency. The shares of P.T. Telekomunikasi Indonesia Tbk. (TLKM) has an average of 4.91165 in Z-score with capital gain on stock return at 0.00718 while P.T. Astra International Tbk. (ASII) has an average of Z-score at 3.07160, the lowest of the three, with the highest average stock return of all at 0.01651. Meanwhile, P.T. Unilever Indonesia Tbk. (UNVR), has the highest average of Z-Score, at 7.61070, which means that the company has a very healthy financial performance compared to TLKM and ASII but the company could not give positive returns to their investors at 0.00939.

While for firm size, bigger companies become more popular among investors because they are more stable and have more access of funding resources and this gives hope for investors in obtaining high returns. In the table, it can be noticed that there is a linear relationship in between with stock return. The average value of firm size for TLKM, UNVR and ASII are 32.90113, 30.54076 and

33.33091 respectively. TLKM has a positive stock return at 0.00718, UNVR shows negative average at 0.00939 with ASII with the highest stock return at 0.01651. The stock return is higher as the firm size is bigger as how ASII, the biggest rate of firm size, has the highest stock return and UNVR, the lowest firm size, also has the lowest stock return out of the three companies.

The phenomenon also happens to book to market ratio. According to Fama and French (1995), low book to market ratio is typical of firms with high average returns on stock, whereas high book to market ratio is typical of firms that are relatively distressed. Theoretically, this can be concluded that book to market ratio has a negative influence towards stock return (Fama & French, 1995). However, as the table has shown, TLKM, UNVR and ASII has an average of book to market ratio at 0.27497, 0.08316 and 0.46884 respectively. ASII has the highest book to market ratio of all but it has the highest stock return compared to the other two companies. Moreover, UNVR has the lower book to market ratio compared to TLKM but opposite to the theory, TLKM has higher stock return than UNVR.

Thus, the comparison has shown very different results of some theories have suggested. Based on the stated background above, the writer is motivated to conduct an in-depth study and analysis about Distress Risk, Firm Size and Book to Market Ratio as how these variables would affect stock return in the sector of non-banking companies listed in LQ45 Index with the period of 2016 to 2018. Hence the title of this research is **"The Influence of Distress Risk, Firm Size and Book-to-Market Ratio towards Stock Return in Non-Banking Companies Listed in LQ45 Index in Indonesia Stock Exchange 2016-2018".**

1.2 Problem Limitation

The companies that are going to be researched are limited to non-banking companies listed in LQ45 index on Indonesia Stock Exchange as these companies are most favoured by investors. Other than that, the companies have consistently paid dividend to their shareholders from 2016 to 2018. The company must not conduct any corporate actions such as stock split or other form of action to prevent any bias in stock price caused by the corporate actions and the company has not been delisting or relisting during the year 2016 until 2018. The dependent variable that will be analyzed is stock return while distress risk, firm size and book-to-market ratio would be the independent variable for this research. The reason of the limitation to non-banking companies is to control the variability in the nature of the company's assets caused by the characteristic of the industry which cannot describes the nature of the company's growth precisely. Moreover, Z-score formula in calculating distress risk is not used for companies of financial services or financial institutions, both private and government. This is because there is a tendency of considerable differences between the balance sheet of a financial institution with other financial institutions.

1.3 Problem Formulation

From the description mentioned in the background of the research, the results are inconsistent regarding the relation between distress risk, firm size, book to market ratio and stock return. It also shows that LQ45 index companies listed on the Indonesia Stock Exchange has no consistent pattern in the relation of distress risk, firm size, book to market ratio and stock return. To achieve the objective of this study, the researcher has gathered research agenda that includes several questions based on the problems:

1. Is there any significant impact of Distress Risk towards Stock Return on LQ45 companies listed on Indonesia Stock Exchange?
2. Is there any significant impact of Firm Size towards Stock Return on LQ45 companies listed on Indonesia Stock Exchange?
3. Is there any significant impact of Book to Market Ratio towards Stock Return on LQ45 companies listed on Indonesia Stock Exchange?
4. Is there any significant impact of Distress Risk, Firm Size, and Book to Market Ratio towards Stock Return simultaneously on LQ45 companies listed on Indonesia Stock Exchange?

1.4 Objective of the Research

As the description of the formulation of problems that has been mentioned above, this research is conducted with the aim of the following list:

1. To analyze whether there is any significant impact of Distress Risk towards Stock Return.
2. To analyze whether there is any significant impact of Firm Size towards Stock Return.

3. To analyze whether there is any significant impact of Book to Market Ratio towards Stock Return.
4. To analyze whether there is any significant impact of Distress Risk, Firm Size, and Book to Market Ratio towards Stock Return.

1.5 Benefit of the Research

This research is conducted as it would be beneficial for several parties such as the management of the companies as the subject of the research, investors, the writer and future academicians in different aspects.

1.5.1 Theoretical Benefit

1. For the writer, this research is expected to be a medium of understanding and application of the theories obtained during lectures in the financial accounting major, mainly about factors affecting stock return.
2. For future academicians, this research is expected to be a reference for similar research in the future, to complement the existing research, and to expand academic knowledge.

1.5.2 Practical Benefit

1. For the management of the company, this research is expected to be an information and consideration regarding decisions of improving company's performance.

2. For investors, this research is expected to be an information or guidance in determining the decisions of future investment regarding factors and risks that affects stock return either positively or negatively.