CHAPTER I

INTRODUCTION

1.1. Background

In carrying out its operational activities, company needs substantial capital, one of which can be obtained from investors. When investors decide to invest in a company, it means they are confident of the company's sustainability. The company will try its best to get as many investors as possible because the more investors attracted, the more opportunities for companies to develop its business. For the invested capital, the company compensates the investors in the form of returns if the investment meets the expected target in exchange for owning the assets and bearing the risk of ownership, it is called cost of equity capital.

In recent years, the level of competition between companies is increasing. Managers have been often pressured to improved company performance in order to maintain their position in the market, both in terms of financial statements and corporate governance. In terms of financial statements, managers are expected to be more transparent in disclosing the financial information. This is due to the increasing number of financial statement manipulation practices so that it cannot be used as a basis for decision making by investors, creditors, and other financial statement's users. Whereas in terms of corporate governance, this issue is often ignored even though in reality this is an important factor for the success of the company in the future.

A good financial statement must be accompanied by three principles of disclosure which are adequate, fair and full. The function of financial statements is to see the actual condition of the company so that it must be made in such way as to be easily understood by users. The low quality of information in financial statements can cause information asymmetry, which is a situation where managers have access to more information than other parties. This can lead to information manipulation made by managers in order to obtain personal benefits without being known to investors and other users. As a result, the investment risk will increase. Investors will expect greater return to compensate for the increase in risk. This increase in returns expected by investors will have an impact on increasing the cost of equity capital. Conversely, if the level of financial statement disclosure is well presented, complete and transparent, the investor's confidence will also increase. This causes investors to increasingly want and to invest and reduce the level of risk in estimating the state of the company. The risk reduction faced by investors will reduce the expected rate of return and reduce the cost of equity capital.

Besides, corporate governance also has a close relationship with company risk (Bassen, Meyer, and Schlange, 2006). The result showed a strong evidence that good corporate governance performance will reduce overall company risk and have a good impact on the company's financial performance. Companies that conduct good corporate governance will better in disclosing information so as to increase the company's stock liquidity and reduce the level of risk estimated by investors (Petrova, Lilly, Sofia, and Bulgaria, 2012). Other studies also conducted that companies that are not socially responsible have the possibility of dealing with explicit claims in the future. It means investors will ask for higher expected rate of return because they have to bear the risk of the claim so that the cost of equity will increase. This shows investors have a view, companies that are not socially responsible will have higher level of risk.

Strict and ever-increasing competition will affect the company's performance, especially for companies engaged in manufacturing. Company performance is the result of management's performance to achieve company goals. Company performance is influenced by several factors, one of which is a business strategy. Companies need the right business strategies that must be compiled from the start when they set it up and must be matched according to its characteristics. This right business strategy will help the company to obtain maximum profit and growth while minimizing the occurrence of the risk. In general, there are three types of business strategy that can be applied in running a company (Wardani, 2017). First, prospector strategy, this strategy has the characteristics of innovation-oriented. Companies that choose this strategy tend to be more flexible to change, focus on research and development, finding and exploiting new products and market opportunities, developing multiple technologies and using decentralization in their organizational structure. While the second strategy is called defender strategy. This strategy focuses on efficiencies in the production and distribution of good and services. Companies that choose this narrow market focus strategy are more stable towards environmental changes, limits their product development efforts, develops related products and services rather than pursuing new products and use centralization in their organizational structure. The third strategy is called analyzer strategy whereby it is the combination between prospector strategy and defender strategy.

This study is different from previous studies because it analyzes the relationship of business strategies using the Miles and Snow model and the cost of equity capital. Previous studies focused more on the relationship between the level of disclosure and cost of equity capital. For research on the relationship of corporate governance to the cost of equity capital has also not been done before. Most previous studies focused on analyzing the relationship of corporate social responsibility to the cost of equity capital. According to Sayekti and Wondabio (2007), the effect of disclosure of the level of corporate social responsibility information on earnings response coefficient is negative. Cheng, Ioannou, and Serafeim (2014) found that good corporate social responsibility can reduce the cost of equity capital. Good corporate social responsibility is associated with superior stakeholders and can reduce agency problems. In addition, companies with high cost of equity capital in the previous year tended to make disclosures in the current year (Dhaliwal, Li, Tsang, and Yang, 2011).

The selection of the right business strategy is a crucial matter that must be done wisely because it can either increase or decrease the cost of equity capital. In choosing the right business strategy, it must be based on the goals and objectives pursued by a company. Different goals and objectives will lead to different business strategy. The prospector strategy is a business strategy that always wants to excel in competition, striving to continuously improve the company's performance, and always looking for ways to obtain additional customers. With these criteria and objectives, the prospector strategy has tendencies to conduct irregularities and manipulation of financial statements compared to defenders and analyzers. The reason why prospector management manipulates financial statements is to make them look appealing so that investors are willing to invest in the company. Even though it actually increases the risk because the financial statements do not show the actual situation. This increase in risk can have an impact on an increase in the expected rate of return due to the decrease in investor's confidence. Thus, it will increase the cost of equity capital. In addition, prospector strategy focuses on the use of new technologies and often do research and development. This causes investors to spend larger funds without knowing whether the experiment will succeed or not. Uncertainty in estimating this experiment makes investment risk higher causes the prospector's business strategy to increase the cost of equity capital compared to defender and analyzer. In contrast, companies that implement defender strategies, they focus on efficiency and have lower cost compared to their competitors. Emphasis on efficiency can be seen in strict cost control such as research and development costs and service costs. Defender strategies also survive on existing products and services. Certainty in this defender strategy causes investors to be calm and assure in estimating the condition of the company. The investment risk faced by investors is also low because the defender strategy prioritizes the principle of stability. This will increase investor confidence in investing so that it will reduce the expected rate of return which results in a decrease in cost of equity capital.

Based on the explanation above, the writer is interested in conducting the research on the influence of business strategy applied by a company to cost of equity capital. Therefore, this study aims to find out how the relationship between business strategy, especially prospector business strategy and cost of equity capital.

1.2. Research Problem

Based on the discussion in the background, the writer defines the research problem as follows:

1. How does the prospector business strategy affect the cost of equity capital?
2. Is there any moderating role of ownership structure in the relationship between prospector business strategy and cost of equity capital?

1.3. Research Objective

In composing the objective of the study, the writer holds on to the problem statement. The following are the objectives of the study:

1. Prove empirically that prospector business strategy positively affects cost of equity capital.
2. Prove empirically that the ownership structure has a moderating role in the relationship between prospector business strategy and cost of equity capital.

1.4. Significance of the Study

a. Writer	The result of this study is hopefully could provide deeper knowledge regarding issue being discussed, experience, and the application of knowledge gained during the process of learning in university.
b. Scholar	The result of this study hopefully is able to help students to understand how each business strategy influences the cost of equity capital in manufacturing companies listed on Indonesia Stock Exchange in the period of 2012-2017, so that it can be used as additional insights for further research.
c. Universitas Pelita Harapan	The result of this study hopefully is able to give additional information about application of theories taught during process of learning as well as additional consideration of depth of material to be taught in the

process of learning in class.

d. Next Researchers The result of this study hopefully is able to give additional knowledge for future studies related to factors affecting cost of equity capital, especially prospector business strategy.

1.5. Scope of the Study

Here are some problem limitations in this research explained as follows:

a. The study was conducted only in manufacturing companies listed on Indonesia Stock Exchange
b. The study was conducted only in a period of 5 years, from 2012-2017
c. The writer limits herself to only researching related business strategies: prospector, defender and analyzer in registered manufacturing companies listed on Indonesia Stock Exchange

1.6. Systematic Discussion

This research paper systematically divided into five chapters, explained as follows:

CHAPTER I INTRODUCTION

This chapter will discuss subchapters including background, research problem, research objective, significance of the study, scope of the study, and systematic discussions.

CHAPTER II **THEORETICAL FRAMEWORK AND HYPOTHESIS DEVELOPMENT**

This chapter will discuss in detail about its basic concept definition, related literature review, conceptual framework, and hypothesis development.

CHAPTER III **METHODOLOGY**

This chapter will state in detail what method of research is being used. This includes the population and sample, the empirical model, operational variable definitions, and method of data analysis.

CHAPTER IV **RESULT AND DISCUSSION**

This chapter will discuss the result and empirical findings in the research in relation to the effect of prospector business strategy towards cost of equity capital.

CHAPTER V **CONCLUSION**

This chapter contains the conclusion and suggestion from the result and discussion preceding this chapter, along with the recommendation for the future researches.