AN EMPIRICAL ANALYSIS OF DEBT-EQUITY CHOICE IN INDONESIAN COMPANIES

by:

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Abstract

This study offers new insights by employing Indonesian data. The uniqueness of Indonesian companies is reflected by the common occurrence of ownership concentration among a few large families and affiliation with a corporate group in which seems nonexistent in many developed countries. With regard to the methodology problem, this study uses simultaneous equations model to overcome the endogeneity problem in debt-equity study. It is reported that the external block ownership has dominant position by having majority control and impact on powerless Indonesian managers. The inadequate legal framework for investors' protection, insufficient internal financing and improper development of the capital market occur. With regard to this situation, debt-equity choice was widely practiced. There is evidence that Indonesian companies relied heavily on loans to finance unrealistic rapid corporate expansion. The insignificant relationship between the level of debt and tangibility of assets and profitability indicate the appearance of moral hazard problem before the crisis. This study points out that the dominant external block ownership can have a detrimental effect on the shareholders and debtholders relation. It induces the higher cost of debt which is typically described in forms of asset substitution or risk shifting problem. As a result, severe agency conflict occurs is not between shareholders and managers as often assumed in the previous studies but between shareholders and debtholders.

Analisis Empirikal Tentang Pilihan Hutang-Ekuiti Bagi Syarikat-Syarikat di Indonesia

Abstrak

Kajian ini menyumbangkan pengetahuan yang baru dengan menggunakan data dari Indonesia. Khususnya, pilihan di antara hutang dan ekuiti oleh firma Indonesia berbeza daripada negara maju. Ini terbukti di dalam konsentrasi pemilikan di antara beberapa keluarga terpengaruh dan perhubungan di antara sesuatu kumpulan syarikat yang tidak berlaku di negara maju. Berhubung dengan masalah metodologi, kajian ini menggunakan model persamaan serentak untuk mengatasi masalah endogeneiti yang timbul di dalam setengah kajian ke atas hutang-ekuiti yang lepas. Ia dilaporkan bahawa pemilikan luaran secara blok mempunyai kedudukan yang dominan secara kawalan majority dan ini mempengaruhi pengurus Indonesia supaya menjadi tidak berwibawa. Undang-undang yang tidak lengkap bagi mempertahankan hak pelabur, kekurangan kewangan dalaman dan pasaran saham yang mentah juga berlaku. Berhubung dengan keadaan ini, pilihan hutang-ekuiti diamalkan. Terdapat bukti bahawa syarikat di Indonesia bergantung kuat ke atas pinjaman untuk membiayai perkembangan corporate pesat dan tidak realistik. Perhubungan yang tidak signifikan di antara tahap hutang dan ketaraan aset dan pendapatan membuktikan kemunculan masalah "*moral hazard*". Kajian ini membuktikan bahawa pemilikan luaran secara blok boleh mempunyai kesan negative ke atas perhubungan di antara pemegang saham dan pemberi hutang. Ia mengakibatkan kos hutang yang lebih tinggi yang sering disebutkan di dalam bentuk masalah penggantian asset atau pemindahan risiko. Oleh sebab ini, masalah agensi yang serius di Indonesia berlaku bukan di antara pemegang saham dan pengurus seperti yang diandaikan di negara yang maju tetapi di dalam bentuk di antara pemegang saham dan pemberi hutang.

CHAPTER 1

INTRODUCTION

1.1 Background of the Study

Debt-equity choice is one of the most important decisions in financing policy. The impact of a faulty financing decision on a company could be disastrous as was experienced by many South East Asian companies in the 1997 financial crisis. Many companies were on the verge of collapsing when the economy changed overnight during the crisis (Kim & Mark, 1999). There is an interesting financial phenomenon in Indonesian companies with respect to debt-equity choice as reflected by the high level of debt and high ownership concentration.

A number of previous studies on debt-equity choice have assumed firm debt as an endogenous variable which in turn is determined by several exogenous variables (e.g. Homaifar, Zietz, & Benkato, 1994; Rajan & Zingales, 1995; Titman & Wessels, 1988). A majority of empirical studies employ a model in which the level of debt is regressed on a list of explanatory variables by assuming that Fd = f(Xi), where: Fd is a measurement of firm debt, and Xi is a vector of explanatory variables (Prasad, Green, & Murinde, 2001).

Prior studies also argued that ownership structure is a function of the level of debt and other firm's variables. These two variables, namely the level of debt, firm performance and the ownership structure were used interchangeably as a dependent and an independent variable (Setiawan & Taib, 2002b). This is known as endogeneity problem or jointly determined problem under the econometric point of view (Greene, 2000; Gujarati, 2003).

Studies on capital structure have made great contributions in understanding the behaviour of firms with respect to their choice among the use of debt or equity.

Despite the merits, debt-equity study should be understood critically on the real issues in developing countries namely Indonesian companies which are suffering from high level of debt and ownership concentration. It should also address to the relevant econometric viewpoint such as endogeneity problem.

1.1.1 Financial Phenomenon of Indonesian Companies

Most Indonesian public listed companies (henceforth Indonesian companies) have been substantially financed by credit. As shown in Table 1.1, the debt-equity ratio increased from 240.0 in 1993 to 310.0 in 1997 (Husnan, 2001). It indicates that the higher debt correlate with the lower return on assets. Similar findings were reported in other studies by Claessens, Djankov, and Nenova (2000a), Zhuang, Edwards, Webb, and Capulong (2000).

Table 1.1

Debt to Equity and Firm Performance of Indonesian Companies, 1993 - 1997 (percent)

Indicators	1993	1994	1995	1996	1997
Debt-to-Equity	240.0	220.0	220.0	230.0	310.0
Return on Equity	12.5	12.0	11.3	10.7	1.1
Return on Assets	3.5	3.5	3.5	3.2	0.6

Source: Husnan (2001).

Concerning ownership structure, empirical evidence show that Indonesian companies are characterised by high ownership concentration as reflected by Table 1.2. Other studies which employed Indonesian data also reported similar finding (Claessens, Djankov & Lang, 1999a; La Porta, Silanes & Shleifer, 1998a; Taridi, 1999; Zhuang et al., 2000). High ownership concentration has been regarded as one of the factors that lead to excessive borrowing behaviour. This in turn can affect companies' performance negatively (Supratikno, 2000).

A few previous studies of Indonesian companies for examples, Husnan (2001) and Taridi (1999) have investigated corporate governance issues in Indonesia. These studies indicate that Indonesian companies were suffering from high level of debt and ownership concentration. However, the possibilities of the existence of moral hazard problem in debt-equity choice were not examined in these studies. Furthermore, prior studies only provided descriptive explanation with respect to the association between ownership structure and moral hazard problems (Kwik, 1994, 1996; Wibisono, 1998).

Table 1.2

Ownership Concentration of Indonesian Companies, 1993 - 1997 (percent)

Shareholder Rank	1993	1994	1995	1996	1997	Average
Largest	50.5	48.1	47.9	48.5	48.2	48.6
Second Largest	16.6	13.7	14.1	12.0	11.6	13.6
Third Largest	3.0	3.9	4.0	4.2	4.4	3.9
Fourth Largest	2.1	2.0	1.9	1.8	2.1	2.0
Fifth Largest	0.5	0.6	0.8	1.0	1.2	0.8
Total	**72.7**	**68.3**	**68.7**	**67.5**	**67.5**	**68.9**

Source: Husnan (2001).

These financial phenomenons can be explained using agency theory due to the problem may originate from the powerless managers in determining debt and equity to finance the investment. Regarding risk aversion assumption (Jensen & Meckling, 1976), when ownership concentration gets bigger, it is possible that moral hazard behaviour occurs with shareholders shifting their risks to debtholders.

It is widely accepted that debt-equity choice is related to ownership structure (Brailsford, Oliver, & Pua, 1999; Chen & Steiner, 1999; Cho, 1998; Xu & Wang, 1997). To date, there has been no study looking at the relationship between debt-equity choice and ownership structure, and how it affects the moral hazard problem of Indonesian companies. Therefore, this study is going to investigate the interdependency among debt-equity choice, ownership structure and firm performance. Apart from highlighting how Indonesian companies choose debt or equity in financing their investment, it also intends to provide further enlightenment in relation to financial behaviour, namely moral hazard problem.

1.1.2 Methodology Issues

Generally, debt-equity study is associated with three constructs i.e. the level of firm debt itself, ownership structure, and firm performance. However, previous studies basically take the relationships among these constructs in isolation. Jensen and Smith (1985), and Jensen and Warner (1988) conducted prior work that paid attention to the links between ownership structure and control.

A study which discussed the link between corporate strategy and capital structure is conducted by Barton and Gordon (1988). Prasad, Bruton and Merikas (1997) examined long-run strategic capital structure and argued that if capital structure can be identified, a firm could maximize its value by reaching and maintaining its financial mix. Meanwhile, Kochhar (1997) studied the relationship among strategic assets, capital structure, and firm performance.

Brailsford et al. (1999) focused on the link between ownership structure and debt-equity choice. Ang, Rebel and James (2000), de Jong (1999, 2000) and Jensen and Meckling (1976) conducted the study which concentrated on the relationship between debt-equity choice and the agency problem.

There are several notable studies on the determinant of debt-equity choice such as Banerjee, Hesmati, and Wihlborg (1999); Berger, Ofek, and Yermack (1997), Homaifar et al. (1994) and Kester (1986). Studies on the link between investor protection, ownership concentration and the level of debt were conducted by La Porta, Silanes, Shleifer, and Vishny (1997) and La Porta et al. (1998a).

Generally, previous studies used a straightforward regression in analyzing determinants of debt-equity choice. Firm debt is normally assumed to be a dependent variable in most studies, some examples of studies are those of Agrawal and Mandelker (1987); Brailsford et al. (1999); Friend and Lang (1988); Kim and Sorensen (1986); McConnell and Servaes (1995); Moh'd, Perry, and Rimbey (1998); Rajan and Zingales (1995); Titman and Wessels (1988).

A few studies have argued that ownership structure is a function of the level of debt and other firm's variables (McConnell & Servaes, 1990; Morck, Shleifer, & Vishny, 1988). In other words, the level of firm debt has been used interchangeably either as a dependent or an independent variable in previous studies.

Hence, there is a good reason to believe that if the level of firm debt, the ownership structure, as well as the firm performance have been jointly determined, it is necessary to look at these variables simultaneously.

1.2 Research Questions

Indonesia is a developing country with high use of debt and is among the highest ownership concentration in the world (Zhuang et al, 2000). It is interesting to see how these uniques feature of Indonesian market influence the companies' choice of debt and equity:

1. How do Indonesian companies finance their investment?

2. Which block of ownership has prominent role in debt-equity choice? What agency problem might occur in relation to the role of the dominant block in debt-equity?
3. What is the nature of the link between ownership structure and control related to debt-equity choice?
4 How do ownership structure and the level of firm debt have an impact on firm performance?

1.3 Objective of the Study

This study tries to examine the Indonesian financial phenomenon particularly in debt-equity choice such as: (i) whether the debt-equity choice is related to ownership structure. The ownership of the Indonesian companies was concentrated among a few large families as opposed to companies in developed countries where ownership structure is more dispersed; (ii) whether the affiliation with a corporate group has impact to debt-equity choice. The affiliation with a corporate group which widely practised in Indonesian companies, as for this phenomenon does not existing in many developed countries (see also Claessens, Djankov, & Lang, 2000c).

1.4 Contributions of the Study

Building on well-known capital structure theories and principal agency model, this study attempts to provide some contributions to this field by comparing the findings before, during the crisis, and in the overall period. It also provides new insights by paying attention to the curvilinear relationship among firm debt, ownership structure, and firm performance in an integrated link.

The application of agency theory will give clear explanations about moral hazard problem which might occur related to how firms in Indonesia prefer debt or equity to finance their investment. Specifically, these contributions are taken in the form of:

1. Documenting descriptively financial pattern, ownership concentration and ownership composition of Indonesian companies, and examine it by presenting the type of control and monitoring of Indonesian companies. With regard to ownership concentration, this study has two proxies, namely the largest external block ownership shareholder (henceforth the largest shareholder) and the top five external block ownership shareholders (henceforth top five shareholders).
2. It offers new evidence of moral hazard behaviour when there are sufficient condition for the problem to occur for instance, high ownership concentration and insufficient legal framework for investors' protection. It contributs in the following ways:
    - 2.1. Examining the debt-equity choice of Indonesian companies before and during the crisis.
    - 2.2. This study would seek answer as to why Indonesian companies prefer debt to equity.
    - 2.3. This study re-examines debt-equity choice where high ownership concentration occurred.
    - 2.4. This study re-examines the agency problem encountered by Indonesian companies.
3. Contributing methodologically by using simultaneous multiple equations. Besides having its advantages, it offers a series of tests provide method which has adequate result.

1.5 Outline of the Thesis

The rest of the thesis is organized in the following manner. Chapter 2 presents the general description of Indonesian companies with emphasis on descriptive results of debt-equity choice, ownership structure, control and monitoring in Indonesian companies. Chapter 3 presents a review of debt-equity choice theories and how it jointly determines the ownership structure and firm performance. This chapter also presents the theoretical framework and hypotheses development. Chapter 4 presents the methodology and the statistical method and findings.

There are three chapters concerning examination of the hypotheses i.e. chapter 5, 6, and 7. Chapter 5 presents the debt-equity choice in Indonesian companies by examining the trade-off theory and pecking order theory. Agency problems related to the debt-equity choice in Indonesian companies are presented in chapter 6. Chapter 7 illustrates the link between ownership structure, firm performance and the level of debt.

The last chapter that is chapter 8 presents the conclusion and suggestion for the future studies and implementation.

CHAPTER 2

THE LEVEL OF DEBT, OWNERSHIP STRUCTURE, CONTROL AND MONITORING OF INDONESIAN COMPANIES

2.1 Introduction

This study intends to offer some new evidence with regards to debt-equity choice by utilizing data from Indonesian companies. Indonesia is a unique developing country characterized by high level of debt, high ownership concentration and insufficient legal framework for investor protection. Such characteristic are predicted to give rise potential moral hazard problem in debt-equity choice. This chapter will discuss how the moral hazard problem might arise in relation to the uniqueness of Indonesian companies as stated above.

The rest of the chapter is organized in the following manner. Section 2.2 provides the empirical findings that illustrate high level of debt among Indonesian companies. It also shows the financing patterns of these companies. Section 2.3 describes the ownership structure and how controlling mechanism are practised by most of Indonesian companies. Section 2.4 presents some related legal frameworks such as investor protection and debt recovery process. The discussion is presented in section 2.5 and summary of the chapter are presented in section 2.6.

2.2 Description of Financial Patterns and Performance of Indonesian Companies

2.2.1 Indonesian Companies Debt

Companies have three main sources of capital, i.e. usage of retained earnings, borrowing through debt instrument, and issuance of new shares (Megginson, 1997). Debt-equity choice is expected to be more complicated in developing countries where capital markets do not always work properly (Glen & Pinto, 1994). Prior studies also indicated that, the usage of capital markets as a source of external financing in Indonesia is very limited. Sartono (2001) argued that the Indonesian capital market is not efficient due to the finding that the stocks or bonds issued by the companies are not fairly priced.

Empirical evidence suggests that external financing is important in both developed and developing countries. However, the breakdown among the sources of capital is not well documented for developing countries compared to those in developed countries (Glen & Pinto, 1994).

Table 2.1

Financing Patterns of Indonesian Companies from 1993 to 2000 (ratio)

	1993	**1994**	**1995**	**1996**	**1997**	**1998**	**1999**	**2000**
Total Debt to Total Equity	0.99	1.08	1.32	1.46	3.38	20.58	4.08	5.05
Total Debt to Total Assets	0.44	0.47	0.50	0.52	0.68	0.78	0.77	0.78

Sources: Jakarta Stock Exchange, Indonesian Capital Market Directory 1993 to 2001, JSX Watch 2002 as analysed by the author.

To have an idea of how Indonesian companies finance their activities, a sample of 75 companies was drawn from Jakarta Stock Exchange. The financing patterns as shown in Table 2.1 can provide an insight into how Indonesian companies make decisions on debt-equity choice. The ratio of total debt to total assets increased from 0.44 in 1993 to 0.78 in 2000, whereas the ratio of total debt to total equity increased sharply from 0.99 in 1993 to 5.05 in 2000.

Another reason why the level of debt increased during the crisis was the depreciation of *Rupiah*. The companies' foreign currency debt has risen as a result of the *Rupiah* depreciation on companies' foreign currency debt. This in turn increased the debt to equity ratio (Kumar & Debroy, 1999). These empirical findings suggest that Indonesian companies are suffering from a higher level of debt. This finding is in line with studies conducted by Husnan (2001); Pangestu and Harianto (1999), and Taridi (1999. Hereby, it is justifiable that Indonesian companies relied heavily on bank loans to finance rapid corporate expansion because internal financing was insufficient and the capital market was not developed properly.

2.2.2 Financial Performance of Indonesian Companies

According to Brealey and Myers (1988), companies will have an incentive to invest when Tobin's Q is greater than 1, and they will stop investing only when it is less than 1. As shown in Table 2.2, although Tobin's Q is higher than 1 in all periods tested (1993 to 2000), it declined from 1.55 in 1993 to 1.08 in 1998, and increased to 1.50 in 1999. In 2000, it declined again to 1.32.

2.3 Ownership Structure, Control and Monitoring of Indonesian Companies

2.3.1 Ownership Structure on Indonesian Companies

It is noted that managers' block ownership (MBO) owns a small percentage of outstanding shares in both periods before and during the crisis. As shown in Table 2.2, MBO own 11.13 percent of outstanding shares in 1993. It declined to 2.85 percent in 2000.

External block ownership has traditionally been defined as the shares owned by large non-managerial investor (De Jong, 1999). Similar to Demsetz and Lehn

(1995), and Husnan (2001), this study measures ownership concentration by the proportion of shares owned by the largest shareholders, and the top five shareholders (Demsetz & Lehn, 1995; Husnan, 2001).

Table 2.2

Financial Performance and Ownership Structure of Indonesian Companies, 1993 - 2000 (percent)

	1993	**1994**	**1995**	**1996**	**1997**	**1998**	**1999**	**2000**
Tobin's Q	1.55	1.27	1.15	1.18	1.02	1.08	1.50	1.32
MBO	11.13	9.77	10.22	8.44	5.50	2.91	2.81	2.85
Largest	51.80	52.68	53.18	53.84	54.99	55.29	56.04	55.38
Top five	88.33	89.58	89.06	90.74	92.75	95.58	96.45	96.38

Sources: Jakarta Stock Exchange, Indonesian Capital Market Directory 1993 to 2001, JSX Watch 2002 as analysed by the author.

The top five shareholders are examined as an attempt to investigate whether there is a separation of ownership. If the top five shareholders own more than 50 percent of outstanding shares, it implies that concentration of ownership is high which means there is lack of separation. A shareholder(s) who own 50 percent of the shares plus one more share can exercise total control of the firm if she or he wants, because this individual or group can outvote all the other shareholders combined (McConaugby, Mattews, & Fialko, 2001).

This study reports that the largest shareholder owns 51.80 percent of the outstanding shares in 1993, and 55.38 percent shares in 2000. Top five shareholders own 88.33 percent shares in 1993 and 96.38 percent shares in 2000. This indicates that external block was more dominant during all periods tested. As the largest shareholder owns more than 50 percent of outstanding shares, the findings observed for the largest shareholder may be similar to that of the top five shareholders.

Some empirical evidence show that Indonesian managers seem to own a large percentage of shares. However, this does not imply that they have a prominent role in debt-equity choice. They own large percentage of share due to their positions as the owners of the companies not as a professional manager per se.

The following examples provide some evidence with respect to the ownership of share held by these managers. H. Probosutedjo as the president director of Cipendawa Farm Enterprise had 36.76 percent of outstanding shares from 1993 to 1997. In the Tobacco sector, Putera Sampoerna, as the president director of Hanjaya Mandala Sampoerna, had 46.75 percent of outstanding shares in from 1993 to 1996. In Plastic & Glass Products, Atmadja Tjiptobiantoro as the president commissioner of Berlina Co. Ltd. had 34.30 percent of outstanding shares in 1993 and 1994. Lisjanto Tjiptobiantoro as the commissioner had 34.30 percent in 1993 and 1994. Gunawan as the president director of Jaya Pari Steel had 15.53 percent of outstanding shares in 1994 to 2000. Robby Sumampow as one of the board of directors of Brata Mulia had 22.25 percent of outstanding shares in 1993 to 1996. Hendry Pribadi as a member of the board of directors had 14.42 percent in 1993 to 1994.

This illustration gives an understanding on how dominant family business in Indonesian companies is. In recent studies, the term ‘manager’ refers to the professional manager which is not the ‘owner manager’ (McConaugby et al., 2001). This evidence in line to Tabalujan’s (2002a) and he pointed out that this phenomenon is dominant in the setting of Indonesian companies.

> In many listed companies, the founders or founding family may decide to retain say, 70percent of the company stock, while floating off the remaining 30percent to the public. The result is that the 30percent spread may be held by say, 5,000 shareholders, but the publicly listed companies are still largely owned and controlled by the founders or founding family (Tabalujan, 2002a: 11).

This finding leads to a strong prediction that the external block has a dominant role in financial decision, and logically managers, as “worker manager” will not have the ability to pursue their own agendas of self-gain as assumed in the theories.[1]

Figure 2.1 illustrates the ownership concentration in both periods tested. However, Taridi (1999) argued that ownership concentration contributed positively to the firm performance of Indonesian companies, and he concluded that ownership concentration had led to an increase of firm’s debt.

With regard to agency problem, Jensen and Meckling (1976) argued that ownership concentration has a positive impact on corporate value. Since ownership diffusion may lead to increasing power in the hand of managers, in turn it may not coincide with the shareholders’ interest. Hence, managers with small percentage of ownership fail to maximize shareholder’s wealth because they have an incentive to consume perquisites.[2] Therefore, the concentrated ownership will minimize agency cost by aligning the interest of managers and shareholders (Claessens, Djankov, Fan, and Lang, 1999c; Jensen & Meckling, 1976).

In spite of theories substantiating positive relationship between ownership concentration and firm performance, evidence in developing countries show that high

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[1] It should be noted that the requirement for a listed public companies at least 300 shareholders is not at all fulfilled (Tabalujan, 2002a). Claessens, Djankov, and Lang (2000b) by using 1996 data, point out that the top 15 family groupings in Indonesia controlled a massive 61.7 per cent of the total value of listed corporate assets, representing 21.5 per cent of Indonesian Gross Domestic Product. Top 1 family grouping controlled 16.6 per cent, and top 5 family grouping control 40.7 per cent of the total value of listed corporate assets.
[2] Perquisites are executive fringe benefits such as luxurious offices, use of corporate planes and yachts, personal assistants, and general use of business assets for personal purpose (Brigham, 1992).

concentrated ownership leads to poor corporate governance, due to its leading to excessive borrowing behaviour of the companies, which in turn deteriorates corporate performance (Taridi, 1999). Furthermore, when the level of firm's debt is used as a control variable, the relationship between ownership structure and firm's performance may not always be positive.

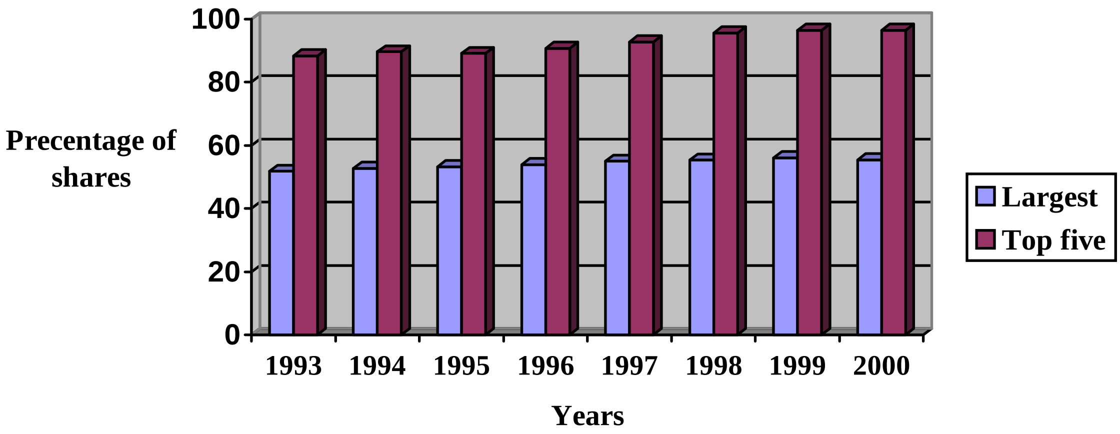

Figure 2.1 ***Ownership concentration of Indonesian companies before and during the crisis.***

2.3.2 Control and Monitoring of Indonesian Companies

Ownership refers to the term having control over a corporation. It implies that someone has the capacity to determine policies and actions of the corporation. It is usually defined as;

> ….the legal rights over the use, disposal and fruits of the means of production in society, and control generally refers to a social relationship in which one party has the capacity to influence the decisions or actions of another party even in the presence of opposition by the latter (Lim Mah Hui, 1978: 3).

The notion of separation between ownership and control was pioneered by Berle and Means (1932) in their book *The Modern Corporation and Private Property*.

Their basic argument is that modern day corporations have grown so large that few of these control a major proportion of the financial assets of the corporate economy.

Table 2.3

Five Types of Control

1	Private ownership control	80 per cent or more of the stocks held by an individual or a group of business associates.
2	Majority control	50 – 80 per cent held by such persons
3	Minority control	20 – 50 per cent stock ownership
4	Management control	Less than 20 per cent stock ownership
5	Legal device	Pyramiding, this involves owning a majority of stocks of one corporation, which in turn holds a majority of stocks of another-a process, which can be, repeated a number of times.

Source: Berle & Means (1932: 108)

Control is measured simply by one variable, i.e. the percentage of stock owned by an individual or group of stockholders. As illustrated in Table 2.3, there are five different degrees based on the percentage of ownership held by the shareholders of control (Berle & Means, 1932). The focus of this study is to examine the ownership structure and debt-equity choice. It is beyond the scope of this study to consider the legal device since it is related to the discussion of business groups. Private ownership control occurs when a single individual or a small group of associates own all or practically all of the outstanding shares (Berle & Means, 1932). While majority control means a single individual or a small group virtually has all of the legal powers of control which would be held by a sole owner of the enterprise and in particular the power to select the board of directors. Minority control may be said to exist when an individual or a small group holds sufficient stock interest to be in a position to dominate a corporation through their stock interest (Berle & Means, 1932).

Lastly, management control means ownership is so widely distributed that no individual or small group has even a minority interest large enough to dominate the affairs of the company (Berle & Means, 1932).

Table 2.4

Summary of Type of Controls of 75 Indonesian Companies before the Crisis (The Largest Shareholder)

	Sector	N	Private Ownership	Majority	Minority	Management
1	Agriculture	1	-	1	-	-
2	Animal Feed	3	-	1	2	-
3	Mining Services	1	-	1	-	-
4	Food and Beverages	8	-	5	3	-
5	Tobacco	3	-	2	-	1
6	Textile Mill Products	5	-	4	1	-
7	Apparel & Other Textile Product	5	-	4	1	-
8	Lumber & Wood Products	1	-	-	1	-
9	Paper & Allied Products	3	-	3	-	-
10	Chemical & Allied Products	2	-	1	1	-
11	Adhesive	3	-	1	2	-
12	Plastics & Glass Products	4	1	2	1	-
13	Cement	3	-	1	2	-
14	Metal & Allied Products	8	1	1	6	-
15	Cables	6	-	4	2	-
16	Electric & Electronic Equipment	4	-	2	2	-
17	Automotive & Allied Products	5	-	2	2	1
18	Photographic Equipment	2	-	2	-	-
19	Pharmaceuticals	5	-	5	-	-
20	Consumer Goods	3	1	1	1	-
		75	3	43	27	2
	Percentage	100	4	57.33	36	2.66

Sources: Jakarta Stock Exchange, Indonesian Capital Market Directory 1993 to 2001, JSX Watch 2002 as analysed by the author.

As shown in Table 2.4, before the crisis, 3 (three) companies applied a private ownership control. The company, which applies a private ownership control for the largest shareholder is Igar Jaya in Plastic and Glass Products sector, Unilever

Indonesia in Consumer Goods sector, and Texmaco Perkasa Engineering in Machinery sector (Table A.14 in Appendix A reported a detail finding).

Table 2.5

Summary of Type of Controls of 75 Indonesian Companies during the Crisis (The Largest Shareholder)

	Sector	N	Private Ownership	Majority	Minority	Management
1	Agriculture	1	-	1	-	-
2	Animal Feed	3	-	2	1	-
3	Mining Services	1	-	1	-	-
4	Food and Beverages	8	-	7	1	-
5	Tobacco	3	-	3	-	-
6	Textile Mill Products	5	-	2	3	-
7	Apparel & Other Textile Products	5	-	4	1	-
8	Lumber & Wood Products	1	-	-	1	-
9	Paper & Allied Products	3	-	3	-	-
10	Chemical & Allied Products	2	-	1	1	-
11	Adhesive	3	-	1	2	-
12	Plastics & Glass Products	4	-	3	1	-
13	Cement	3	-	2	1	-
14	Metal & Allied Products	8	-	2	6	-
15	Cables	6	-	4	2	-
16	Electric & Electronic Equipment	4	-	3	1	
17	Automotive & Allied Products	5	1	2	1	1
18	Photographic Equipment	2	-	2	-	-
19	Pharmaceuticals	5	-	5	-	-
20	Consumer Goods	3	1	2		-
		75	2	50	22	1
	Percentage	100	2.66	66.66	29.33	1.33

Sources: Jakarta Stock Exchange, Indonesian Capital Market Directory 1993 to 2001, JSX Watch 2002 as analysed by the author.

Majority control is noted in 43 companies, and minority control in 27 companies. Only 2 (two) Indonesian companies applied management control and the companies were Hanjaya Mandala Sampurna in Tobacco sector and Brata Mulia in Automotive and Allied Product sector.

Similar pattern was observed during the crisis. Table 2.5 illustrates that there are 2 (two) companies applied a private ownership. Those companies are Indospring in Automotive and Allied Products sector and Unilever Indonesia in Consumer Goods sector. It reported that 50 companies applied majority control. The number of companies with minority control was 22 and only 1 (one) company applied a management control.

Based on this evidence, it can be concluded that Indonesian companies are suffering from high ownership concentration with a majority control. The ownership composition is reported in Table 2.6. Before the crisis, individuals only owned of 3.93 percent of the outstanding shares, while, manager owned 10.69 percent of the outstanding shares. The lowest percentage owned by the state was 1.84 percent of the outstanding shares, and the highest percentage owned by institutions was 38.72 percent of the outstanding shares.

Institutions had majority control on Agriculture sector (68.86), Lumber & Wood Products (79.88), Paper and Allied Products (70.85), Chemical & Allied Products (54.20) sector. Foreign institution has a majority control in Mining Services (78.71), and Pharmaceuticals (56.29) sectors. Managers had management control in all sectors except in the Consumer Goods (29.37) and Adhesive sector (38.49) in which they had minority control. The state only had minority control in the Cement sector (31.91).

Table 2.6

Summary of Ownership Composition, 1993 - 1996

	Sector	Ownership Compositions (percent)						Total
		Individual	Manager	State	Institutions	Public	Foreign	
		Mean	Mean	Mean	Mean	Mean	Mean	
1	Agriculture	0.55	1.05	0.00	68.86	29.55	0.00	100.00
2	Animal Feed	5.83	17.50	0.00	41.13	23.12	12.42	100.00
3	Mining Services	1.29	0.00	0.00	0.00	20.00	78.71	100.00
4	Food and Beverages	0.81	9.51	3.75	44.41	24.41	17.11	100.00
5	Tobacco	13.42	18.41	0.00	26.36	17.97	23.83	100.00
6	Textile Mill Product	0.55	6.84	0.00	26.92	27.73	37.97	100.00
7	Apparel & Other Textile P	1.14	3.46	0.00	49.57	32.01	13.82	100.00
8	Lumber & Wood Product	0.00	7.98	0.00	79.88	12.14	0.00	100.00
9	Paper & Allied Product	0.05	0.00	0.00	70.85	19.59	9.51	100.00
10	Chemical & Allied Products	2.92	8.97	0.00	54.20	30.40	3.50	100.00
11	Adhesive	7.37	38.49	0.00	32.57	21.56	0.00	100.00
12	Plastics & Glass Product	8.63	18.87	0.00	34.67	37.83	0.00	100.00
13	Cement	0.00	0.00	31.65	34.21	31.91	2.23	100.00
14	Metal & Allied Product	4.17	14.49	0.00	36.38	28.93	16.03	100.00
15	Cable	17.00	3.49	0.83	40.08	27.62	10.98	100.00
16	Electric & Electronic Equipment	4.00	8.79	0.26	36.73	38.87	11.34	100.00
17	Automotive & Allied Product	4.19	17.70	0.00	48.20	29.92	0.00	100.00
18	Photographic Equipment	4.00	8.79	0.26	36.73	38.87	11.34	100.00
19	Pharmaceuticals	0.75	0.00	0.00	11.40	31.56	56.29	100.00
20	Consumer Goods	1.85	29.37	0.00	1.28	23.06	44.45	100.00
	Average	3.93	10.69	1.84	38.72	27.35	17.48	100.00

Sources: Jakarta Stock Exchange, Indonesian Capital Market Directory 1993 to 2001, JSX Watch 2002 as analysed by the author.

Table 2.7 reports the ownership composition during the crisis. In this period, managers owned 3.74 percent of the outstanding shares. Institutions owned 41.41 percent of the outstanding shares, and the public, 29.91 percent of the outstanding shares. With regard to the type of control, Institution have majority control in Agriculture (60.46), Animal Feed (51.18), Lumber and Wood Products (68.36), Paper and Allied Products (63.45), Chemical and Allied Products (60.40), Adhesive (59.50), and Automotive and Allied Product (61.04) sector. Foreign institutions have a majority control in Mining Services (79.57), and the Pharmaceuticals (57.87) sector.

Table 2.7

Summary of Ownership Composition, 1997 - 2000

	Sector	Ownership Compositions (percent)						Total
		Individual	Manager	State	Institutions	Public	Foreign	
		Mean	Mean	Mean	Mean	Mean	Mean	
1	Agriculture	0.09	0.70	0.00	60.46	37.18	1.57	100.00
2	Animal Feed	2.47	4.38	0.00	51.18	32.54	9.44	100.00
3	Mining Services	0.43	0.00	0.00	0.00	20.00	79.57	100.00
4	Food and Beverages	0.06	0.83	3.50	38.09	31.88	25.64	100.00
5	Tobacco	1.62	0.80	0.00	38.23	30.29	29.06	100.00
6	Textile Mill Product	0.89	5.48	0.00	24.73	28.24	40.65	100.00
7	Apparel & Other Textile P	0.67	1.23	0.00	46.01	29.03	23.06	100.00
8	Lumber & Wood P	0.00	7.97	0.00	68.36	17.50	6.18	100.00
9	Paper & Allied Product	0.05	0.00	0.00	63.45	31.55	4.95	100.00
10	Chemical & Allied Products	0.00	0.00	0.00	60.40	36.09	3.51	100.00
11	Adhesive	0.08	6.62	0.00	59.50	32.70	1.09	100.00
12	Plastics & Glass Product	4.36	5.75	0.00	48.98	38.34	2.58	100.00
13	Cement	2.42	0.00	26.68	36.42	27.28	7.20	100.00
14	Metal & Allied Product	4.36	7.07	0.00	37.50	21.31	29.76	100.00
15	Cable	1.19	1.13	0.00	45.21	30.05	22.42	100.00
16	Electric & Electronic Equipment	3.20	7.89	0.00	26.98	43.35	18.58	100.00
17	Automotive & Allied Product	0.76	10.88	0.00	61.04	22.93	4.39	100.00
18	Photographic Equipment	3.20	7.89	0.00	26.98	43.35	18.58	100.00
19	Pharmaceuticals	0.00	0.00	0.00	15.40	26.73	57.87	100.00
20	Consumer Goods	2.46	6.12	5.82	19.38	17.94	48.28	100.00
	Average	1.42	3.74	1.80	41.41	29.91	21.72	100.00

Sources: Jakarta Stock Exchange, Indonesian Capital Market Directory 1993 to 2001, JSX Watch 2002 as analysed by the author.

2.4 The Legal Framework for Investor Protection in Indonesia

Investor protection is related to security. In traditional finance of Modigliani and Miller (1958), it is recognized by their cash flows (La Porta et al., 1998a). Debt has a fixed promised stream of interest payment. It entitles creditors to the power, for example to repossess collateral when the company fails to make promised payments.

Equity entitles its holder to receive dividends, and typically gives their owner the right to vote for directors of the companies. Shareholders receive dividends because they can vote out the directors who do not pay them. Without these rights, investors would not be able to get paid, and therefore firms would find it harder to raise external finance. These rights depend on the legal rules of the jurisdictions in which securities are issued. In general, commercial laws come from two broad traditions (La Porta et al., 1998a):

1. Common law, which is English in origin
2. Civil law, which is derived from Roman law. Within the civil tradition there are only three major families that modern commercial laws originate from: (i) French, (ii) German, and (iii) Scandinavian.

Company law is concerned with the legal relations between corporate insiders (members of the corporation, i.e., shareholders and directors), and the corporation itself. It is known as the shareholder's rights. The legal relation between the corporation and certain outsiders, particularly creditors, is known as creditor's rights.

Indonesia is under the French-civil-law reflected poor investor protection. Companies in countries with poor investor protection have more concentrated ownership of their shares due to the following reasons:

1. Large, or even dominant, shareholders who monitor the managers might need to own more capital, ceteris paribus, to exercise their control rights and thus to avoid being expropriated by managers.
2. When they are poorly protected, small investors might be willing to buy corporate shares only at such low prices that make it unattractive for corporations to issue new shares to the public.

2.4.1 Creditor's Rights

With regard to Indonesia, bankruptcy and moratorium fall under the Bankruptcy Act of 1906 (*Staatsblad* 1905 No. 217 *juncto Staatsblad* 1906 No. 348), the Company

Law of 1995 (*Undang-Undang No 1 – 1995 tentang Perseroan Terbatas*), and Bankruptcy law of 1998 (*Undang-Undang No. 4 Th. 1998, Perpu No.1 Th. 1998*).

The Act is aimed at giving importance to creditors and does not allow debtors to continue with the original business, which is deemed insolvent. It applies to both private companies (domestic and foreign) as well as state enterprises (Hussain & Wihlborg 1999). The important component of the law is that in order to file for bankruptcy the debtor must be liable to two or more creditors.

(Article 1 of *Perpu. No. 1 Th 1998*):

> *Debitur yang mempunyai dua atau lebih kreditur dan tidak membayar sedikitnya satu utang yang telah jatuh waktu dan dapat ditagih, dinyatakan pailit dengan keputusan Pengadilan yang berwewenang sebagaimana dimaksud dalam Pasal 2, baik atas permohonannya sendiri, maupun atas permintaan seorang atau lebih krediturnya.*
>
> (A debtor who has two or more creditors and fails to pay at least one due and collectable debt, will be declared bankrupt by the court as stated in Chapter 2, either by self request or at the request of one or more creditors)

The judicial process in Indonesia is considered unpredictable due to the cultural and political influences the actual insolvency procedures (Hussain & Wihlborg, 1999). Both creditors and debtors seldom resort to actual court proceedings at time of distress.[3]

Table 2.8 illustrates the comparison of processes for debt recovery between Indonesia and Malaysia. In this evaluation, the score which is close to 3 indicate that Indonesia suffered from high cost, difficulties, inefficient, and very slow process. On

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[3] Hussain and Wihlborg (1999) studied the process of debt recovery in Indonesia, Korea, Malaysia, Philippines, Taiwan, and Thailand. The summary of processes evaluation for debt recovery based on quantified responses obtained from the study conducted by the Asian Development Bank (1998). Lines 1 – 7 related to the cost, efficiency, and speed of various procedures are the responses by the legal practitioners on the questionnaires to the specific questions, of either of the following: a) low of cost (not expensive), expensive, very expensive; b) easy, difficult, very difficult; c) very efficient, efficient, inefficient; d) quick, slow, very slow.

the other hand, Malaysia has a low cost, easy, very efficient, and quick process as the score is close to 1.25.

Table 2.8
Summary Evaluation of Processes for Debt Recovery

		Indonesia	Malaysia
1 = low cost (or not expensive), easy, very efficient, quick; 3= very expensive, very difficult, inefficient and very slow.			
1	Process for acquiring security (collateral) over land	2.75	1.25
2	Process for acquiring security over other property	2.75	1.25
3	Process for enforcement of security over land	3	1.25
4	Process for enforcement of security over other property.	2.5	1.25
5	Process for debt collection	2.5	1.25
6	Process for winding up insolvent corporation	2.5	2
7	Process for reorganization / restructuring	2.5	2
8	Time for winding up	4-6 months	6 – 12 months
9	Time for formal organization	12 – 18 months	8 – 12 months
10	Time for informal workout	4 – 8 months	2 – 4 months
11	Incidence of bankruptcy / liquidation	Very low	High
12	Incidence of reorganization / restructuring	N/A	High
Workout preferred because:			
13	Bankruptcy procedures are a real alternative	Adverse effect	Yes
14	Better outcome that under formal procedures	no	Yes
Predictability of positive outcome of:		1 = very high; 5 very low.	
15	Process for security enforcement: other than land	5	2
16	Process for security enforcement; other than land	5	2
17	Judicial handling of security enforcement	5	2
18	Judicial handling of debt collection	5	2
19	Judicial handling of bankruptcy/liquidation	5	2
20	Judicial handling of rehabilitation	5	3

Source: Asian Development Bank, Local Study of insolvency Law Regime (1998), cited from Hussain & Wihlborg (1999: 13).

Lines 1 – 7 relate to the cost, efficiency, and speed of various procedures. The process for acquiring security or collateral, process for enforcement, time for workout, and incidence of reorganization or liquidation are related to lines 15 – 20. Judicial handling from the creditor's point of view is evaluated in lines 17 – 20. According to Hussain & Wihlborg's (1999) study, Malaysia provides the strongest protection to creditors during insolvency while Indonesia the weakest.