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The Consequence Of Investment Opportunity Set In Strengthening Investment Policy On Profitability In Indonesia

Dampak Ketersediaan Peluang Investasi dalam Memperkuat Kebijakan Investasi terhadap Profitabilitas di Indonesia

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Abstract

This study investigates the empirical impact of investment policy components—investment cash flow, investment opportunity set (IOS), IOS strengthening investment policy, institutional ownership, and firm size—on the profitability of manufacturing companies that went public before 2015. Analyzing audited financial statements from 2015 to 2020, our results indicate that investment cash flows exhibit no significant influence on profitability. Conversely, the IOS demonstrates a positive effect, further strengthened by its interaction with investment cash flow. Institutional ownership emerges as a positive contributor, along with firm size, both positively impacting profitability. This underscores the crucial role of identifying strategic investment opportunities in enhancing corporate profitability. These findings provide valuable insights for firms seeking to optimize their investment policies and augment financial performance.

Highlights:

- **Strategic Investment Opportunities:** Emphasizes the pivotal role of identifying and leveraging investment opportunities to enhance corporate profitability.
- **IOS Interaction and Strengthening:** Highlights the positive impact of Investment Opportunity Set (IOS) on profitability, further strengthened by its interaction with investment cash flow.
- **Institutional Ownership and Firm Size Influence:** Underscores the positive influences of institutional ownership and firm size on corporate profitability, providing actionable insights for optimizing investment policies.

Keywords: Investment Policy, Opportunity Set, Cash Flow, Institutional Ownership, Firm Size

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Introduction

The company was founded to prosper shareholders. The prosperity of the shareholders can be measured using the stock price listed on the Stock Exchange. For stock prices to increase, companies must develop or invest, taking into account investment opportunities to obtain maximum profit. Investments made by the company can be reflected in investment expenditures in the form of acquisition and disposal of long-term assets and other investments that do not include cash equivalents. This investment expenditure is expected to win the business competition to increase sales through product diversification and production at an economical scale so that production costs become more efficient, which has implications for increasing company profits. When the company makes an investment, it is strengthened by the investment opportunity set (IOS). [1] stated that IOS describes a company as a combination of assets in place with investment options in the future and influenced by the manager's policies to generate greater profits.

Managers in making investments cannot be separated from shareholder policies; in this case, institutional shareholders are called institutional ownership. Institutional ownership can be separated into two. First, dedicated institutional investors usually have many shares, which can better control and encourage companies to develop more than individual investors because they have adequate resources [2]. These investors are deemed major players in the capital market and influence corporate governance because they can monitor companies [3]. Second, transient institutional investors usually own small shares, and their ownership is short-term because they prioritize capital gains [4]. Furthermore, dedicated institutional investors can be separated into two: pressure intensive (pressure resistance), namely institutional investors who strictly supervise managers and pressure-sensitive, i.e., institutional investors who tend to supervise managers less closely. In addition, large companies can diversify and produce at an economic scale to compete with other companies. It has implications for maintaining and increasing sales, thus increasing profits obtained.

This study was driven by the inconsistent results of previous studies. It is shown that investment cash flow had a significant positive effect on profitability [5], [6], [7]. However, investment cash flow also had a significant negative effect on profitability [8]. Meanwhile, investment cash flow was found not to affect profitability [9], [10].

Moreover, IOS significantly and positively impacted profitability [11], [12], [13]. On the other hand, IOS was shown to significantly and negatively affect profitability. In addition, IOS also did not affect profitability.

Furthermore, institutional ownership had a positive and significant effect on profitability. However, it was also revealed that institutional ownership had a negative and significant influence on profitability. Also, there was institutional ownership, which had no impact on profitability.

Finally, firm size had a positive and significant effect on profitability. However, other researchers found a negative and significant effect of firm size on profitability. Also, firm size has been proven not to affect profitability [14], [15].

For this reason, this study aims to find empirical evidence of the effect of investment policies as measured using investment cash flows, investment opportunity sets, investment opportunity sets strengthening investment policies, institutional ownership, and firm size on profitability. The difference with previous research is that investment opportunities strengthen investment policies.

Literature Review

2.1 Investment Cash Flow

Investment cash flows represent cash receipts and disbursements or disposals and acquisitions of long-term assets and other investments that are not cash equivalents. Investment cash flow relates to the company's resources useful for generating income in the future [16], [17]. It includes, among others, first, cash payments to purchase property, plant, and equipment, including self-constructed property, plant, and equipment, intangible assets, other persistent assets, and , intangible assets, and other long-term assets. Third, it covers the acquisition of shares or other company financial instruments [18]. Fourth, it comprises advances and loans given to other parties and repayment unless made by a financial institution [19]. Fifth, it is cash payments in connection with futures contracts, forward contracts, options contracts, and swap contracts unless the contract is made for trading purposes (dealing or trading) or when the payment is classified as a funding activity [20]. Here, companies implementing investment policies are expected to diversify products, obtain an economical production scale, and win the business competition, thereby increasing sales. Economical production scale has cost efficiency implications so that the company can increase profits.

The research results conducted by used a sample of insurance companies listed on the Nigerian Stock Exchange for the 2009-2014 period [21]. Used a sample of manufacturing companies listed on the Nairobi Stock Exchange from 2007 to 2016. Meanwhile, used a sample of construction companies listed on the Malaysia Exchange for the 2009-2015 period. The three researchers found that investment cash flow had a significant positive effect on financial performance.

H1: Investment cash flow has a positive effect on profitability.

2.2 Investment Opportunity Set (IOS)

IOS is an investment expenditure whose value is determined by management and is expected to generate greater profits. IOS is also a latent variable, so some proxies are needed to measure IOS [22]. This study refers to research conducted by, using a composite of three proxies: the ratio of market to book value of assets (MBVA), market to book value of equity (MBVE), and firm value to book value of property, plant, and equipment (VPPE).

MBVA shows that a company experiencing growth is reflected in the stock price in the market so that the firm value is greater than the book value of its assets. In addition, MBVE displays that companies experiencing growth have a market value of equity greater than the book value of equity. Meanwhile, PPMVA indicates that companies that invest in productive fixed assets can increase their value [23].

Moreover, IOS is an investment option influenced by manager policies to generate greater profits. Future investment choices are not solely aimed at projects supported by research and development activities but also depend on the ability of managers to exploit opportunities to take advantage compared to other companies [24]. Managers in making investments must consider IOS because investing requires large funds, and the payback period is more than one year. In addition, if the investment fails, the company will suffer a large loss because the investment that has been made is not easy to be withdrawn (divested).

Several previous studies showing that increased IOS could increase profitability are, using a sample of non-financial companies from Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Netherlands, Portugal, Spain, Sweden, and England in the period 2004-2015. The results obtained revealed that IOS, as measured using TobinQ, had a significant positive effect on profitability [25].

Used a sample of mining companies listed on the Indonesia Stock Exchange for 2013-2017, researching IOS utilizing CAPMVA and MVEBVE with a partial least squares analysis tool, which resulted in the finding that IOS had a significant positive effect on company performance. In addition, used a sample of manufacturing companies listed on the Indonesia Stock Exchange from 2014 to 2018. The findings obtained were that the IOS measured using the CAPMVA, CAPBVA, and R&D Expenses to Sales composites had a significant positive effect on financial performance.

H2: Investment cash flow has a positive effect on profitability.

H3: Investment cash flow has a positive effect on profitability.

2.3 Institutional Ownership

Institutional ownership can be separated into two. First, dedicated institutional investors usually have many shares and can better control and encourage companies to develop more than individual investors because they have adequate resources. These investors are considered major players in the capital market and influence corporate governance because they can monitor companies. Second, transient institutional investors usually own small shares, and their ownership is short-term because they prioritize capital gains. Furthermore, dedicated institutional investors can be separated into two parts: pressure intensive, i.e., institutional investors who closely supervise managers and pressure-sensitive, i.e., institutional investors who tend to supervise managers less closely.

Several previous studies showing that institutional ownership had a positive effect on profitability are, who used a sample of companies included in the S&P 100 for the 1993-2000 period and found that pressure-intensive investors had a significant positive effect on profitability. Besides, using a sample of companies listed on the Egyptian Stock Market for 2007-2014, uncovered that institutional ownership had a significant positive effect on financial performance.

Meanwhile, used a sample of companies in India listed on the National Stock Exchange from 2007 to 2016 and revealed that pressure-resistant institutional owners had a significant positive effect on profitability, but pressure-sensitive institutional owners had a significant negative effect. This finding indicates that institutional investors who supervised management could increase profitability, while institutional investors who did not supervise management less or tended to agree with management policies could actually reduce profitability.

H4: Institutional ownership has a positive effect on profitability.

2.4 Firm Size

Large companies can maintain and increase sales so that the profits obtained increase. It is because the company can diversify its products and produce at an economical scale to compete with other companies.

Several previous studies have shown that firm size (FZ) had a positive effect on profitability, such as [26], which found that firm size measured using the Log total assets had a significant positive effect on profitability. Also,

utilized a sample of companies listed on the Abu Dhabi Stock Exchange (ADX) for 2008-2012. In addition, [26] used a sample of companies listed on the Amman Stock Exchange (ASE) for the 2009–2015 period. Employed a sample of companies in Qatar, Kuwait, Saudi Arabia, Bahrain, and Oman from 2000 to 2010. This finding is supported by Masry (2016), who used firm size as measured by log sales.

H5: Firm size has a positive effect on profitability.

Methods

3.1 Population and Sample

The population in this study was manufacturing companies that had gone public before 2015. The sampling technique was the purposive sampling method. The research sample is presented in Table 1.

Table 1: Research Sample							
Description	2015	2016	2017	2018	2019	2020	Total
Population	138	138	138	138	138	138	828
Negative equity	(11)	(11)	(10)	(12)	(8)	(10)	(62)
Institutional ownership	(9)	(10)	(9)	(8)	(8)	(8)	(52)
No investment cash flow	-	(1)	(1)	(1)	(1)	-	(4)
Delisting	-	-	(1)	(4)	(6)	(6)	(17)
Incomplete	(3)	(3)	(3)	(2)	(3)	(4)	(18)
Outliers	(6)	(3)	(2)	(4)	(4)	-	(19)
Total	109	110	112	107	108	110	656

Table 1. Research Sample

3.2 Variables and Measurements

Profitability is the company's ability to generate profits as measured using return on assets (ROA) Investment cash flows (CFI) represent cash receipts and disbursements or disposals and acquisitions of long-term assets and other investments that are not cash equivalents. The investment cash flow value is obtained from the cash flow statement[27]. The investment opportunity set (IOS) is a latent variable measured using the values of the communalities of three variables. Institutional ownership (IO) is ownership of company shares by other institutions [28]. Firm size (FZ) describes the company's ability to generate sales [29]. The formula used to calculate each variable is as follows.

$$ROA = \text{Earnings after taxes} \div \text{total assets}$$

$$CFI = \text{Investment cash flow} \div \text{total assets}$$

$$MBVA = [(\text{Total assets} - \text{total common equity}) + (\text{shares outstanding} * \text{share closing price})] \div \text{total assets}$$

$$MBVE = (\text{Shares outstanding} * \text{share closing price}) \div \text{total common equity}$$

$$PPMVA = \text{Gross property, plant, and equipment} \div (\text{market value of the firm} + \text{noncurrent liabilities})$$

$$IO = \text{Number of shares owned by the institution} \div \text{number of shares outstanding}$$

$$FZ = \text{Log sales}$$

The factor analysis results obtained communalities values are presented in Table 2.

Table 2: Results of Communalities							
	2015	2016	2017	2018	2019	200	
MBVA		0.8611	0.9349	0.8670	0.9063	0.9609	0.8472
MBVE		0.8199	0.9063	0.8448	0.8870	0.9417	0.7548

PPMVA	0.1879	0.2047	0.1271	0.1639	0.0936	0.5083
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Table 2. Results of Communalities

3.3 Analysis Plan

The hypothesis testing in this study used multiple regression analysis of panel data. To choose the appropriate method, namely the fixed effect or random effect method, the Hausman test was employed. The regression equation used is as follows.

$$ROA = b_0 + b_1CFI + b_2IOS + b_3CFI*IOS + b_4IO + b_5FZ + e$$

Hausman test results obtained a chi-square statistic value of 16.3751 and prob. value of 0.0059, indicating that the method used was a fixed effect. The fixed effect method requires the classical assumption test, namely the heteroscedasticity and the autocorrelation tests [30]. The heteroscedasticity test results using the Glejser method obtained an F-statistic value of 1.3715 and a prob. value of 1.097, showing no heteroscedasticity. The autocorrelation test results obtained a DW statistic of 1.8667. The d_L value was 1.7176, and the d_U value was 1.8199. The DW statistic value was from d_U to $4-d_L$, indicating no autocorrelation.

Result and Discussion

A. Result

Based on Table 3, the minimum ROA value was -0.4014, the maximum was 0.7160, and the mean was 0.0404. It denotes that the companies used as research samples got a loss of 40.14%, maximum profitability of 71.60% and an average of 4.04%. The minimum CFI was -0.3520, the maximum was 0.4496, and the mean was 0.0457. It shows that the company obtained funds by reducing assets by 35.20%, spending a maximum of 44.96% to increase assets, and an average fund spending to increase assets by 4.57%. Moreover, the minimum IOS was 0.2837, the maximum was 30.4115, and the mean was 1.6443. It signifies that the addition of assets could increase the firm value by 0.2837, a maximum of 30.4115, and on average firm value of 1.6443. In addition, the minimum IO was 0.0150, the maximum was 0.9978, and the mean was 0.7172. It indicates that institutional share ownership was 1.5%, a maximum of 99.78%, and an average of 71.72%. It shows that the institutional share ownership in the company was large. Further, the minimum FZ was 9.9227, the maximum was 14.3788, and the mean was 12.3871. It denotes that the company could generate a minimum sale of IDR 8369509000, a maximum of IDR 239,221,384,751,000, and an average of IDR 2,393,866,901,000.

Table 3: Descriptive Statistics				
Minimum	Maximum	Mean	Std. Deviation	
ROA	-0.4014	0.7160	0.0404	0.0878
CFI	-0.3520	0.4496	0.0457	0.0558
IOS	0.2837	30.4115	1.6443	2.3502
CFI*IOS	-0.1996	0.3677	0.1060	0.0410
IO	0.0150	0.9978	0.7172	0.2059
FZ	9.9227	14.3788	12.3871	0.7016
N = 656				

Table 3.

The regression analysis results presented in Table 4 show that the CFI variable had a regression coefficient value of 0.1046 with a prob. value of 0.0520. It shows that investment cash flow did not affect profitability. Furthermore, the IOS variable had a regression coefficient value of 0.0068 with a prob. value of 0.0003, indicating that the investment opportunity set positively affected profitability. In addition, the CFI variable moderated by IOS had a regression coefficient value of 0.0259 with a prob. value of 0.0077. It denotes that the investment opportunity set could strengthen the effect of investment cash flow on profitability.

Moreover, the IO variable had a regression coefficient of 0.0741 with a prob. value of 0.0071, indicating that institutional ownership positively affected profitability. In addition, the FZ variable had a regression coefficient value of 0.0398 with a prob. value of 0.0149. It shows that firm size positively affected profitability.

Table 4: Regression Analysis Results				
Dependent variable: ROA				
Variable	Coefficient	Std. Error	t-Statistic	Prob.

C	-0.3955	0.1541	-2.5660	0.0106
CFI	0.1046	0.0537	1.9473	0.0520
IOS	0.0067	0.0018	3.6606	0.0003
CFI*IOS	0.0259	0.0097	2.6768	0.0077
IO	0.0741	0.0274	2.7030	0.0071
FZ	0.0398	0.0163	2.4426	0.0149
R2	0.6811			
F-statistic	9.3296			
Prob.	0.0000			

Table 4. Regression Analysis Results

B. Discussion

In this study, the company at the time of investing had not been able to generate profits as expected, although the company could seek investment opportunities, shown by IOS to have a significant positive effect on profitability. Therefore, companies in determining investment policies must consider IOS. In other words, IOS can encourage investment policies to increase profitability. In this case, and found that IOS had a significant negative effect on profitability. It can be explained that the larger the IOS, the greater the information asymmetry; thus, the cost of supervision increases so that profits decrease. Therefore, for IOS to increase profits, it requires close supervision by institutional investors, particularly pressure intensive.

Furthermore, the percentage of institutional ownership was 71.72%, and, in the findings, there was a significant positive effect on profitability, indicating that institutional investors could supervise management so that profits increased. This increase in profit was also influenced by increased sales, product diversification, and production cost efficiency because the company could work on an economical scale [30].

Conclusion

This study uncovered empirical evidence that investment cash flow did not affect profitability, IOS had a significant positive effect on profitability, IOS strengthened the effect of investment cash flow on profitability, IO had a significant positive effect on profitability, and size had a positive effect on profitability. This finding also indicates that the company must be able to see investment opportunities when investing. In this case, institutional pressure intensive investors have an essential role in overseeing management so that the company can increase sales and produce at an economical scale, thus increasing profitability.

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