I LIKE YOUR COMPANY? DIVIDEN PAYOUT RATIO: EFFECT FROM FREE CASH FLOW AND PROFITABILITY

Resmi Afifah Fadilah
Garut University,
Faculty of Economics
E-mail: resmiafifah1@gmail.com

Muslim Alkautsar
Garut University,
Faculty of Economics
E-mail: muslimalkautsar@gmail.com

Nizar Alam Hamdani
Garut University,
Faculty of Economics
E-mail:

Marti Dewi Ungkari
Garut University,
Faculty of Economics
E-mail:

Abstract

The purpose of this research to analyze the effect of the company financial rations performance profitability (ROI), free cash flow toward Dividend payout ratio (DPR). we applied causal method for our research and the data obtained from Indonesian Stock Exhange (BEI) website during the period 2005-2014 on PT Astra International, Tbk (ASII). these data were analyzed by using PLS analysis technique (partial least square) through the PLS software.

Several interesting findings emerged from this study. It turns out, that eventhough FCF affect profitability (ROI), it has no significant direct effect on DPR. Surprisingly, FCF able to affect DPR through ROI. Another interesting finding is that Astra International Tbk can use DPR as part of its strategy to draw the interest of investors to make investment on the company. The evidence shows that the investors are more likely to invest on the company when the company shows a more stable level of DPR. The implications of these findings for future studies are also discussed.

Key Words: *Dividend Policy, Free Cash Flow (FCF), Return On Investment (ROI), Dividend Payout Ratio (DPR).*

1. INTRODUCTION

The complexity of life requires people to solve everything quickly, easily and organized. A lot of business people decide to not directly engage to manage a business. For those who experience a surplus of financial resources, they tend to choose investing on the capital market to earn instant return. Capital market is a market for various financial instruments either under the form of equity or obligation that matured in a year (Lisa & Clara, 2009). For companies, the sales of stock in capital market is one feasible way to raise funds. For investors, purchasing stock is a means to obtain profit or return in the form of dividend yield and capital gain. While dividend yield is some portion of company's net profit that are redistributed to shareholders, capital gain is profit earned by shareholders which derived from reselling the stocks owned at a higher price level. In general, for most of investors or shareholders, dividend yield is more desirable than capital gain.

For companies, the decision to redistribute their profit in the form of dividend will reduce their internal source of funds (Lisa & Clara, 2009). On the contrary, if the companies decide to retain their profits in the form of retained earnings, the internal reserve of funds will be higher. This decision will reduce their dependence on external source of funds and thus will reduce risk (e.g. default risk) (Lisa & Clara, 2009). Additionally, investors are willing to purchase stocks at a higher price level if that stocks promise a higher level of dividend (Arilaha, 2009). Hence, the policy to provide higher dividend payout ratio (DPR) by a company will attract investors to invest their money on that company.

Based on those arguments, it can be concluded that dividend policy must be optimized by considering various factors that affect it and affected by it. Optimum dividend policy must be able to strike the right balance between the amount of dividend to be distributed and the amount of fund to be reinvested to maximize company's stock price (Brigham & Houston, 2004). The ability to distribute dividend primarily depends on cash availability as represented by free cash flow (FCF) (Sutrisno, 2011). Besides FCF, profitability also serves as an indicator of company's ability to obtain earnings that affect the level of dividend. One financial ratio that describe the portion of profits that are distributed as dividend is dividend payout ratio (DPR).

The higher the DPR, the smaller the portion of profits that can be invested internally to produce growth. The relationship between dividend and invested earnings as depicted by DPR indicate some sort of dilemma to companies (Sutrisno, 2000). In this situation, it is obvious that there are two parties with conflicting interest. Those parties are the shareholders and the company itself. Therefore, management must be able to put various factors that affect dividend policy into consideration.

Table 1 *Dividen Payout Ratio* (DPR) PT. Astra International Tbk. during the period 2005-2014 .

Tahun	DPR (%)
2005	32,59
2006	47,82
2007	**40,00**
2008	38,33
2009	**45,16**
2010	45,07
2011	45,10
2012	45,00
2013	45,00
2014	45,57

Source: Indonesian Stock Exchange (2017)

Table 1 shows the dividend payout ratio of PT. Asrta International Tbk. experienced fluctuations in the first of 4 (four) years, but from every increase and decrease it was recorded that occurred significantly. In 2005 to 2006 recorded an increase of 15.23%, then decrease in 2007 by 7.82%, and recorded a decline back in 2008 of 1.67%, and increased in 2009 by 6.83 %, and the resst in 2010 until 2014 is relatively stable.

Due to dividend policy, there are several different parties of interest, namely between the interests of shareholders and the company. And the size of it must be really considered. For that management needs to consider various factors that will affect the policy to be determined company.

1.1 Research question

Based on research background, the question that emerge and about to be discussed in this paper is whether the DPR of PT. Astra International Tbk is directly affected by FCF or affected by FCF through profitability (i.e. ROI). The findings of this research are expected to provide insights about how PT. Astra International Tbk makes decision regarding the distribution or retention of it's profits. To be more specific, the findings are expected to explain whether cash position (FCF) and profitability (ROI) have some contribution to decision regarding dividend.

2. LITERATURE REVIEW

2.1 FREE CASH FLOW (FCF)

FCF is some amount of cash that can be distributed by company to creditor or shareholders without sacrificing it's working capital or it's investment on fixed assets. FCF also provide evidence for investors that dividend distributed is not just a strategy to increase the price of company stocks (i.e. signalling) (Ross et al, 2000). Companies with higher FCF are expected to have better performance than those with lower FCF because companies with higher FCF will be able to capitalize on more opportunities. Moreover, companies with higher level of FCF also possess higher chance to survive in adverse situation than those who have lower FCF. Furthermore, negative FCF indicate that the internal source of funds is not sufficient to cover the investment needs of the company. In this situation, the company is required to obtain additional funds that can be provided by the issuance of new stocks or obligations.

2.2 RETURN ON INVESMENT (ROI)

Profitability ratio describes company ability to produce profit through any means and through any sources of income including sales (Hararap, 2008). In the effort to improve profitability, ROI is widely known as a useful financial ratio to measure and analyze profitability (Rudianto, 2006). ROI is the comparison between the amount of net profit with the amount of funds invested on assets. In it's calculation, ROI is produced from earning after tax (EAT) divided by the amount of total assets. Hence, ROI shows the ability of a company to utilize the assets in order to produce net profit. Company with high profitability will be more attractive to investors due to higher expected earnings. Higher ROI indicate higher rate of return and hence indicate better company performance.

2.3 DIVIDEND PAYOUT RATIO (DPR)

DPR is the proportion of net profit paid to shareholders in the form of cash dividend (Riyanto, 2008). The level of dividen distributed is depend on the dividend policy. Dividend policy is a set of rules that govern whether the profit earned by the company will be distributed to shareholders as dividend or will be retained to finance future investment (Martono & Harjito, 2010). Factors that might affect dividend level including investment opportunities, profitability, liquidity, access to capital market, income stability, and other limitations (Mamduh, 2010). DPR can be derived from cash dividend per share divided by earning per share (EPS).

3. OBJECT AND METHODOLOGY

3.1 RESEARCH OBJECT

Throughout its long history, Astra has successfully built a positive reputation and become one of the nation's household names. Astra offers a wide range of excellent products and services as well as providing extensive non-business contributions through its corporate social responsibility programs in education, environment, small and medium enterprises (SME) development and health. Such contribution is an integral part of Astra's journey to become the pride of the nation, a company that plays a role in ongoing efforts to improve welfare for the benefit of the Indonesian people at large.

This research to analyze the effect of the company financial rations performance profitability (ROI), free cash flow toward Dividend payout ratio (DPR) on PT Astra International Tbk.

3.2 RESEARCH METHOD

The method used in this research is quantitative method with assosiative problem formulation.. Therefore, a model that explain the relationship between independent, dependent, and intervening variable is tested. As the tool of analysis, Partial Least Square (PLS) is used with the help of SmartPLS software., then the results are further interpreted and discussed. The data gathered in this research are secondary data that are taken from the financial statement of PT. Astra International Tbk between the period of 2005 to 2014.

Table 2. Free Cash Flow, Return on Investment, and Dividend Payout Ratio of PT. Astra International Tbk for 2005 to 2014

No	Year	Free cash flow (billion of rupiah)	Return on Investment (%)	Deviden Payout Ratio (%)
1	2005	-6,280.25	8.92	32.59
2	2006	87,045.45	6.41	47.82
3	2007	7,984.61	10.26	40.00
4	2008	4,214	11.38	38.33
5	2009	7,019	11.29	45.16
6	2010	-2,323	12.73	45.07
7	2011	632	11.58	45.10
8	2012	-611	10.65	45.00
9	2013	12,958	9.07	45.00
10	2014	13,370	8.13	45.57

Source: Indonesian Stock Exchange (2017)

3.3 MODEL AND HYPOTHESIS

The model that is tested and analysed in this research can be described on Figure 1. Based on that model there are three hypotheses that can be formulated as follows:

H1 : free cash flow (FCF) has significant effect on return on investment (ROI).

H2 : free cash flow (FCF) has significant effect on dividend payout ratio (DPR).

H3 : Return on investment (ROI) has significant effect on dividend payout ratio (DPR).

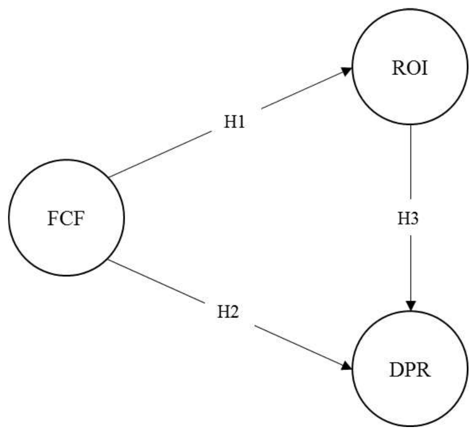

Figure 1. Research Model

4. RESULTS AND DISCUSSION

4.1 CALCULATION RESULTS

4.1.1 OUTER MODEL MEASUREMENT

An indicator can be considered as valid if it has a loading factor above 0.700 toward the intended construct (Ghozali & Latan, 2015). The output of analysis by using SmartPLS for loading factors produce the results as displayed on Table 2.

Table 3. Loading Factor of Free Cash Flow, Return On Investment, and Devidend Payout Ratio

	DPR	*ROI*	*FCF*
Y21	0.999		
Y22	0.999		
Y11		0.986	
Y12		0.983	
X11			0.760
X12			0.759

Based on the result, all of the indicators that are used to measure all of the variables have good validity. In other words, those indicators have fulfilled the criteria of convergent validity. Furthermore, to assure discriminant validity of this model, square root of average variance extracted (AVE) and composite reliability (CR) are used. The values of AVE and CR are displayed on Table 3.

Table 4. Average Variance Extracted and Composite Reliability

	Average Variance Extracted	**Composite Reliability**
Dividend Payout Ratio	0.998	0.999
Return on Investment	0.969	0.984
Free Cash Flow	0.577	0.732

The values of AVE of DPR has higher correlation (0.998) compared to ROI (0.969) and FCF (0.577). Table 3 also shows that the value of AVE for all constructs are higher than 0.500. In respect to composite reliability (CR), all of the constructs have CR value above 0.700. Therefore, all of the constructs described on the model can meet the criteria of discriminant validity (Ghazali, 2015).

4.1.2 STRUCTURAL MODEL (INNER MODEL)

The magnitude of direct effect can be seen from the value of R Square. The findings reveal that the value of R Square for DPR and ROI is 0.974 and 0.447 respectively. Meanwhile the indirect effect of FCF on DPR trough ROI is 0.637.

Table 5. Direct Effect, Indirect Effect, and Total Effect of Each Construct.

	Direct Effect	**Indirect Effect**	**Total Effect**	
	R Square	**DPR**	**DPR**	**ROI**
Dividend Payout Ratio	0.974	-	-	-
Return on Investment	0.447	-	0.952	-
Free Cash Flow	-	0.637	0.688	0.669

Sumber: Analyzed Data (2017)

Table 4 shows that the magnitude of total effect of FCF on DPR is 0.688 and the magnitude of total effect of ROI on DPR is 0.952. Moreover, the magnitude of total effect of FCF on DPR through ROI is 0.669. The results of analysis are showed by Figure 2.

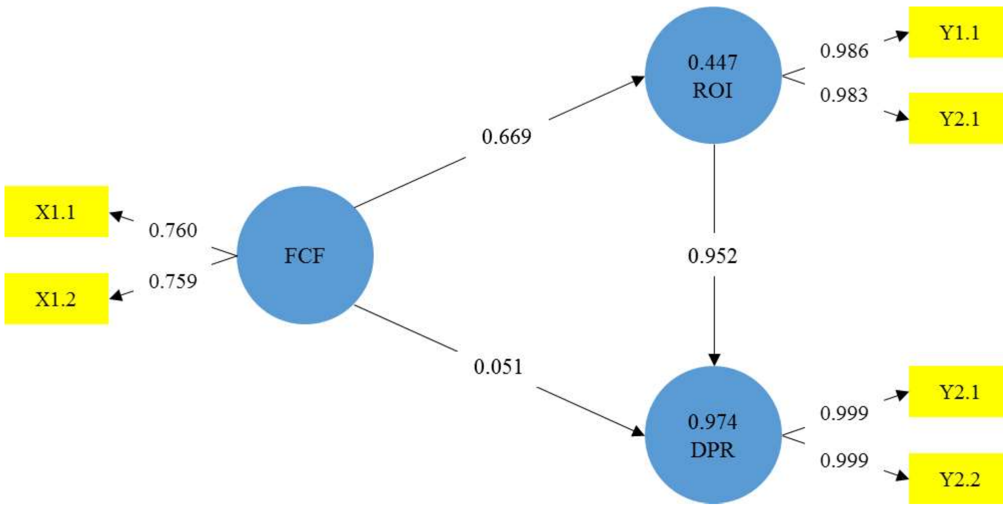

Figure 2. The Relationship Between Variables and The Loading Factor

4.1.3 HYPOTHESIS TESTING

Path coefficient between the construct of latent variables in structural model (inner model) can be used as a means to test hypothesis. Path coefficients that are produced by bootstrapping process also shows the level of significance of each hypothesis that is proposed in this research. The result of bootstrapping process is showed by Figure 3.

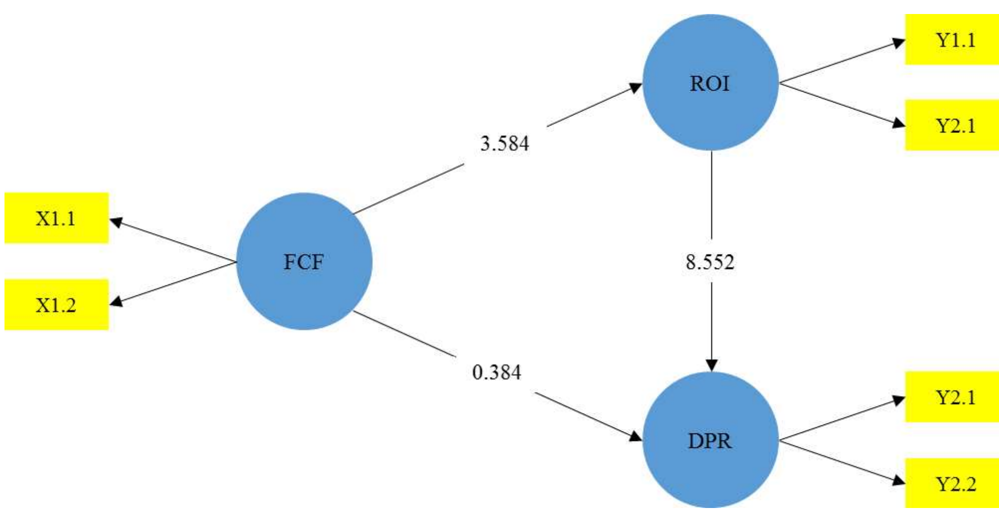

Figure 3. Bootstrapping

Based on Figure 3, the values of t-statistics of each indicator of each construct in the structural model is higher than the t_{table} (2.306). These results can be interpreted that each indicator can be serve as a good predictor of latent variable that it intends to represent. For more details, each path coefficient is explained as follows:

Table 6 Path Coefficient

	Original Sample (O)	Sample Mean (M)	Standard Deviation (STDEV)	T Statistics (|O/STERR|)	P Values
FCF -> DPR	0.051	-0.014	0.143	0.355	0.723
FCF -> ROI	0.669	0.741	0.176	3.810	0.000
ROI-> DPR	0.952	1.004	0.123	7.757	0.000

Table 7 Indirect Effect Bootstrapping

	Original Sample (O)	Sample Mean (M)	Standard Deviation (STDEV)	T Statistics (|O/STERR|)	P Values
FCF-> DPR	0.637	0.750	0.229	2.784	0.006
FCF-> ROI		-0.000	0.000		
ROI -> DPR					

4.2 DISCUSSION OF RESEARCH RESULTS

1. **The effect of free cash flow (FCF) on return on investment (ROI).**

Based on path coefficients table, the result of t-statistics test reveals that FCF bears positive and significant effect on ROI of PT. Astra International. This is showed by the value of $t_{calculated}$ (3.810) is higher than 2.306 with the level of significance of 0.000. Moreover, the value of original sample, that is 0.669, shows positive relationship between FCF and ROI.

This result accordance with Muthusi (2014) that free cash flow has a positive and significant impact on profitability. Hubbard (1998) shows that there is a positive and significant relationship between free cash flow and profitability, an increase in cash flow from a company causes an increase in corporate profits, this increase comes from investment revenue. Griffin & Carroll (2001) stated that the Company can holdin free cash flow for the purpose of investments return in the future that provide high returns with high risk or otherwise.

According to the theory, as well as in PT Astra International Tbk that free cash flow effect on profitability, seen from fixed assets that continue to grow. As in 2007, free cash flow increased due to all aspects of business and expansion in automotive and heavy equipment financing experienced have a very significant increase, as well as an increase in net income and total assets, due to the increase in profit of automotive, agribusiness and heavy equipment units the automotive unit contributed 54.3% to the biggest profit, this was achieved caused Indonesia's conducive economic conditions, among others, supported by lower interest rates, controlled inflation rate, increased purchasing power and stability exchange rate of rupiah.

From the data of free cash flow which tendency to increase for 10 years, give influence to PT Astra International Tbk, seen from the increase of free cash flow give positive influence to profitability, from investment on fixed asset, with return rate from result of investment.

Based on the calculation, it is known that R square obtained is 0.447 or 44.7%, that score gives meaning that the change in profitability influenced by free cash flow of 44.7% while the remaining 55.3% influenced by other factors outside this discussion that also affect profitability .

2. The effect of free cash flow (FCF) on dividend payout ratio (DPR).

Based on path coefficients table , the FCF does not bear any effect on DPR of PT. Astra International Tbk. This is indicated by the value of $t_{calculated}$ (0.355) that is lower than the t_{table} (2.306) with the level of significance greater than 0.05 (0.723).

Base on insignificant results and from the observation data, most of FCF have the minus, but the company's assets grew annually due to the tendency of companies to holdin free cash flow in order to keep under control of those used as a source of internal funds (retained earnings) to invest by adding assets companies that will certainly encourage the growth of the company than to distribute it to shareholders in the form of dividends.This result accordance with brigham (2012) that the FCF is a cash flow that is really available to be paid to investors after the company invested in fixed assets, new products, and working capital needed to maintain ongoing operations.

According to the theory, as well as in PT Astra International Tbk that the decline in the value of free cash flow even up to minus value, because the company expands through its internal funds. As the data in 2005, free cash flow is negative, but on the other side when free cash flow decreases, it does not cause a decrease or dividend is not distributed, it is mean, although the free cash flow is negative, the company still distributes dividends, seen from the dividend payout ratio in 2005 of 32.59%. And seen from free cash flow data tendency up, inversely with DPR for 10 years is likely to decline, so free cash flow directly does not affect the dividend payout ratio at PT Astra International Tbk.

The variable of free cash flow in this research has no effect on dividend payout ratio in accordance with the result of research of lias dwi haryadi (2014), salvatore and i putu (2014) stated that there is no influence of free cash flow variable to dividend payout ratio and support tarjo statement (2005) in lopolusi (2013) that free cash flow has not received attention in Indonesia because the existing companies do not report their existence explicitly. This condition is different from the conditions in the United States, where free cash flow has received attention. This can be evidenced by the free periodical release of free cash flow by the institution or independent, and also contrary to the results of research conducted by Rosdini (2009) states that free cash flow has a positive effect on dividend payout ratio.

3. The effect of return on investment (ROI) on dividend payout ratio (DPR).

Based on the result of t-statistics test on Path Coefficient table, it is found that profitability (ROI) bears positive and significant effect on DPR. This is indicated by the value of $t_{calculated}$ (7.757) which is greater than t_{table} (2.306) with the level of significance of 0.000. Furthermore, the value of original sample (0.952) shows that the relationship between ROI and DPR has positive direction.

Parthington (1989) states that profitability is the most important factor considered by management in predicting DPR. Companies that are able to manage their assets effectively and efficiently tend to produce good financial performance. This is realized with high profits (referring to high ROI) resulting in greater returns. Thus, the company is considered capable of paying a portion of its profits in the form of cash dividends. The higher the profit that can be generated, the greater the probability of the company to distribute dividends that indicate that the company is able to provide a better level of welfare to shareholders.

According to the theory, as well as in PT Astra International Tbk that an increase in profitability will increase the percentage of dividends are distributed. such as in the 2010 earnings of 14.366 billion with 355 billion earning per share, an increase in 2011 from the previous year due to an increase in sales volume of a profit increase of 17.785 billion with 439 billion earning per share from the previous year. This decline in profitability over the past 10 years also contributes to the downward trend in the dividend payout ratio, thus increasing or decreasing profitability will increase or decrease the profit to be distributed as dividends.

Based on calculations, known R square obtained is equal to 0.9063 or 90.63%. the score means that the change of dividend payout ratio influenced by profitability of 90.63% while more 9.37% influenced by other factors outside this discussion which also influence dividend payout ratio.

This result accordance with elyzabet (2009), and Fira (2009) show that profitability has a positive and significant influence on dividend payout ratio. And in the opinion of Mahmud (2010: 375) companies that have good profitability can pay dividends or increase dividends..

5. CONCLUSIONS AND RECOMMENDATIONS

5.1 CONCLUSIONS

Based on the analysis and discussion in the previous section, there are several conclusions that can be derived from the findings. The conclusions are as follows:

1. FCF significantly affect ROI as the measure of profitability. It can be seen from growing fixed assets of PT. Astra International Tbk as the result of making internal investment. With the value of R square of 0.447, it can be interpreted that as much as 44.7% of the profitability of PT Astra International Tbk can be explained by the variability of FCF.

2. FCF does not bear any effect on DPR. One possible explanation that can be made about this is that PT. Astra International Tbk has some tendency to retain control over FCF rather than to distribute it as dividend. The FCF is used as the source of internal funds to make new investment on assets that are expected to drive company growth in the long run.

3. Profitability (ROI) significantly affect DPR with the value of R square of 0.9063. It can be interpreted that profitability is able to explain DPR by 90.63%. It is not surprising that decreasing profitability of PT Astra International for 10 years is followed by decreasing value of DPR. On the contrary, the rise and fall of profitability (ROI) will increase or decrease the proportion profits that are distributed as dividend.

5.2 RECOMMENDATION

Based on the findings, there are several recommendations that might be of value for future research dedicated to investigate dividend policy. Some of the findings can also be used to improve the decision quality of PT. Astra International Tbk in respect to dividend. For more details, the recommendations are as follows:

1. The DPR of PT. Astra International Tbk is improving after the 2008 crises. It is indicated by relatively stable values of DPR from 2009 to 2014 with 45.15% on average. On the contrary, during the previous years, the DPR of PT. Astra International Tbk is substantially fluctuated. It can be presumed that the stability of DPR attracts investors to make investments on the company. Therefore, the value of DPR should really be considered by the management of PT. Astra International Tbk. Thus, using DPR as performance evaluation tool for internal and external parties can be part of the strategy by PT. Astra International Tbk. It is better for the company to not only rely on internal funds to support assets growth. The company should also consider to distribute the available funds to investors in the form of dividend based on the number of stock owned or as agreed upon.

2. Prior to making investment decision, it is better for investors to review factors that might influence the level of DPR. One of those factors is the level of company profitability. The rationale behind this is that the level of profitability affects company ability to distribute dividend or even increase the dividend that eventually improve shareholders wealth.

3. For future studies, it is suggested to also add other financial ratios that possibly affect the level of DPR. The addition of other financial ratios as variables is expected to improve the accuracy and completeness of the model. The extension of research period will also produce more useful information for investors since they are likely to prefer long run prediction rather than the shorter one. In that way, the investors are able to discern company’s growth rate in longer time horizon.

References

Arilaha, M. A. (2009). Pengaruh Free Cash Flow, Profitabilitas, Likuiditas, dan Leverage terhadap Kebijakan Dividend. *Jurnal Keuangan dan Perbankan*, 78 - 87.

Ghozali, I., & Latan, H. (2015). *Partial Least Squares Konsep, Teknik dan Aplikasi Menggunakan Program Smartpls 3.0.* Semarang: Universitas Dipenogoro.

Hanafi, M. M. (2010). *Manajemen Keuangan.* Yogyakarta: BPFE.

Jensen, M. C. (1986). Agency Costs of Free Cash Flow, Corporate Finance, and Takeover. *American Economic Review*, 323-329.

Marlina, L., & Danica, C. (2009). Analisis Pengaruh Cash Position, Debt To Equity Ratio, Dan Return On Assets Terhadap Dividendd Payout Ratio. *Jurnal Manajemen Bisnis*, 1-6.

Martono, & Harjito. (2010). *Manajemen Keuangan.* Yogyakarta: BPFE. .

Ramdhani, M. A., & Ramdhani, A. (2016). *Penelitian Pemasaran.* Bandung: UIN Sunan Gunung Djati.

Riyanto, B. (2008). *Dasar-dasar Pembelanjaan.* Yogyakarta: BPFE.

Sartono. (2009). *Investor, Investasi dan Pasar Modal dalam Pendekatan Teori dan Implementasi.* Semarang: Badan Penerbit UNDIP.

Sugiyono. (2013). *Metode Penelitian Kuantitatif, Kualitatif dan R&D.* Metode Penelitian Kuantitatif, Kualitatif dan R&D. Bandung : Alfabeta: Alfabeta.

Suseno, N. S. (2013). The Influence Of Independence, Size Of Public Accountant Office Toward Audit Quality And Its Impact On Public Accountant Office Reputation. *International Journal of Scientific & Technology Research*, 123-126.

Sutrisno. (2001). Analisis Faktor-faktor yang mempengaruhi Dividendd Payout Ratio. *TEMA*.