



## Free Cash Flow Effect towards Firm Value



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### Abstract

A company is established to raise the value of the firm by maximizing profit and shareholder's wealth. In the capital market, firm value is reflected in the stock price. To raise a firm value, needed to investigate the determinant of firm value. So, this research is aimed to determine the effect of free cash flow on firm value with dividend payout and investment opportunity set as mediator. Population in this research was companies listed on the Main Board Stock Index in Indonesian Stock Exchange for 2013-2017. The sample is 189 observation and it was taken by using purposive sampling technique. Data analysis technique used in this research is path analysis and Sobel test. This research founded that free cash flow has a positive significant effect on firm value and dividend payout, free cash flow has a negative effect on investment opportunity set, dividend payout has a positive significant effect on firm value, and investment opportunity set has a positive significant effect on firm value. Furthermore, dividend payout act as a mediator on the effect of free cash flow on firm value, but investment opportunity unable to mediate the effect of free cash flow on firm value.

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## 1. Introduction

A company is established to raise the value of the firm by maximizing profit and shareholder's wealth. Forgo public company, firm value is the price that investors are willing to pay if the company is sold. The reason is investors need to get high return in investing, so they will choose a company with high value. Kusumajaya (2011), said that "firm value is very important because it reflected how the current performance's company and the prospect of the company

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in the future". In the capital market, the value of a firm is reflected in the price of the company's stock. In 2013-2017, the firm value that listed on the Main Board Stock Index on IDX showed fluctuations, which means that many factors influence the firm value. Brigham *et al.*, (2016), said that "fundamentally, the firm value depends on the expected free cash flow".

Free cash flow is excess cash in a company that shows the level of financial flexibility of the company. It can be a positive signal about the company's performance. When free cash flow is high, the ability of the company to increase the shareholder's wealth also high, so the firm value increased. Previous research regarding firm value has been carried out a lot. Hermuningsih (2016); Al-Zararee & Al-Azzawi (2016); Ghodrati & Hashemi (2014), and Suartawan & Yasa (2016), found that free cash flow has a positive effect on firm value, but Naini (2014) and Embara *et al.*, (2012), found that free cash flow didn't have an effect on firm value. This inconsistency becomes base for adding dividend payout and investment opportunity set as a mediator in the relation between free cash flow and firm value. This relation could be explained with agency theory (Ogunsiji & Ladanu, 2017; Nuryani *et al.*, 2018).

Agency Theory explains that agents and principals have different interests that trigger a conflict of the agency. One source of agency conflict is free cash flow. It is because agents and principals have different interest in making the best choice to use free cash flow. In this situation, management as an agent has to make the right decision regarding it's used whether to be distributed as dividend or will be used to take the existing investment opportunity set.

The dividend is part of a company's net income that distributed to shareholders. The amount of dividends that distributed can increase the wealth of shareholders, so it will lead the increasing of firm value. Previous research regarding the effect of dividend payout on firm value has been carried out by Sedana (2016); Rizqia *et al.*, (2013); Febriana *et al.*, (2016). The result showed dividend payout has a positive effect on firm value. It means the decision to distribute dividend is a positive signal about the liquidity of the company, so that the firm value can increase. Firm value also can be increased when free cash flow is used to take the existing investment opportunity set. Rizqia *et al.*, (2013) and Suartawan & Yasa (2016), viewed the investment opportunity set mastering the positive effect regarded the firm value. Due to it shows company growth for the future. Then, the investor will give a positive response to the company.

Based on the background, this study purposes to analyze the effect of free cash flow on the firm value that listed on the Main Board Stock Index on IDX with dividend payout and investment opportunity set as mediator. The company that listed on the Main Board Stock Index chosen in this study, because this index registers the large companies that have good performance records. It can be guaranteed for the investor who wants to invest in IDX.

### *Literature Review and Hypothesis*

Agency theory describes the relation between agents and principals (Jensen & Meckling, 1976). The agent is a party who has the assignment to manage the company and take every decision based on the interest of the shareholder. One decision that taken by management is regarding use free cash flow.

Free cash flow shows the financial flexibility of the company to welfare shareholders. The research conducted by Hermuningsih (2016); Al-Zararee & Al-Azzawi (2016); Ghodrati & Hashemi (2014); and Suartawan & Yasa (2016), proved that higher free cash flow reflects a good performance that can be a positive signal for investor regarding company's prospect in future. Based on the description, the hypothesis is proposed as follows:

H<sub>1</sub>: Free cash flow has a positive effect on firm value.

Free cash flow is an excess of the company's cash flow that can be used to finance investments and pay a dividend. Jensen (1986) declares that "free cash flow should be distributed as dividend or used to pay debts for avoiding the possibility of investing in a negative net present value". The existence of free cash flow encourages shareholder to ask management to use free cash flow for paying a dividend to improve the shareholder's wealth. Previous research found that free cash flow has a positive effect on dividend policy which is proxied by dividend payout ratio (Mancinelli & Ozkan, 2006; Kouki & Guzani, 2009; Rosdini, 2009; Thanatawee, 2011; Lucyanda & Lilyana, 2012; Arfan & Maywindlan, 2013; Efni, 2013). Based on the explanation, the hypothesis is proposed as follows:

H<sub>2</sub>: Free cash flow has a positive effect on dividend payout.

Suherli & Harahap (2004), said that "when the company in a good condition, management tends to use free cash flow for taking investment opportunity set to get benefit in the future rather than paying a dividend". When free cash flow is high, the opportunity for management to take investment opportunity set by using free cash flow is getting higher. Based on the explanation, the hypothesis is proposed as follows:

H<sub>3</sub>: Free cash flow mastering the positive effect regarded the investment opportunity set.

Dividends are part of the company's net income that distributed to shareholders. Based on agency theory, management and shareholders have a different interest related to the distribution of dividends. Management tends to hold profit of the company as retained earnings, meanwhile, shareholders want to be distributed as dividends. Gordon (1963), states that "the distribution of high dividends can increase the firm value". This is consistent with bird in the hand theory, which states that investors prefer returns as a dividend rather than capital gain. Fenandar (2012); Rizqia *et al.*, (2013); Febriana *et al.*, (2016); Sedana (2016); Senata (2016), and Esana & Darmawan (2017), found that dividend payout has a positive effect on firm value. Based on the explanation, the hypothesis is proposed as follows:  
H<sub>4</sub>: Dividend payout has a positive effect on firm value.

Investment opportunity set is an investment opportunity which is a combination of investment and future investment choices with a positive net present value (Myers, 1977). Myers (1977) and Fama & French (1998), state that "investment is a very important decision for the company because it is directly related to the company's goal to raise firm value". Previous research on investment opportunity set conducted mastering positive effect on firm value (Rizqia, *et al.*, 2013 and Suartawan & Yasa, 2016). The hypothesis is proposed as follows:  
H<sub>5</sub>: Investment opportunity set mastering a positive effect on toward firm value.

Free cash flow is an excess of the company's cash flow that can be used to raise the shareholder's wealth by dividends payout. When the goal of the company to raise the wealth of shareholder is achieved, the firm value will increase. Therefore, when free cash flow is high, the chances of dividend payments will be greater, so the public will give a positive response regarding the company's financial condition. Aftereffect, the firm value will increase. The hypothesis is proposed as follows:  
H<sub>6</sub>: Dividend payout is able to mediate free cash flow effect toward firm value.

Myers (1977) and Fama & French (1998), explain that investment is a very important decision that directly related to the goal of the company to raise the firm value. As an agent, management prefers the free cash flow is used to fund existing investment opportunity to get more value added in the future. The hypothesis is proposed as follows:  
H<sub>7</sub>: Investment opportunity set is able to mediate free cash flow effect toward firm value.

## 2. Materials and Methods

The population in the current study was a company. There was listed on Main Board Stock Index in IDX 2013-2017 period. The sample is taken by a non probability sampling method and purposive sampling technique. Type of data used in this study is quantitative data and secondary data source. Analysis data technique used in this study is path analysis and Sobel test. The conceptual model of the study can be seen in Figure 1 below.

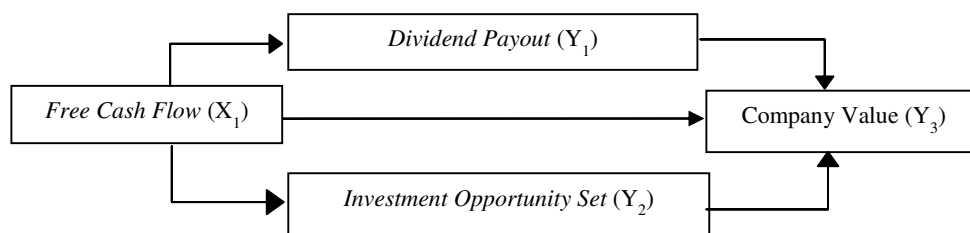


Figure 1. Research model

## 3. Results and Discussions

### Path Analysis

Path analysis is used to analyze the indirect effect of the independent variable on the dependent variable. The path analysis result is showed as follows:

Table 1  
The direct effect of variables

	Unstandardized Coefficients		Standardized Coefficients	t	Sig.
	B	Std. Error	Beta		
FCF to PBV	0,970	0,201	0,372	4,823	0,000
DPR to PBV	0,382	0,088	0,289	4,329	0,000
IOS to PBV	1,148	0,346	0,250	3,322	0,001
FCF to DPR	0,441	0,141	0,224	3,139	0,002
FCF to IOS	-0,285	0,036	-0,502	-7,927	0,000

Based on Table 1, the structural regression equation and the effect indirectly variable can purpose as follows:

a. Effect of FCF, DPR, and IOS on PBV

$$PBV = 0,970FCF + 0,382DPR + 1,148IOS + \varepsilon_1 \quad (1)$$

b. Effect of FCF on PBV

$$DPR = 0,441FCF + \varepsilon_2 \quad (2)$$

c. Effect of FCF on IOS

$$IOS = -0,285FCF + \varepsilon_3 \quad (3)$$

Information:

PBV = Price to Book Value

FCF = Free Cash Flow

DPR = Dividend Payout Ratio

IOS = Investment Opportunity Set

Based on Table 1, the result of sobel test can be seen in following table.

Table 2  
The indirect effect of variables

	Path coefficient	Quadratic Path Coefficient	$S_{p2p4}$	$t_1$
p <sub>2</sub>	0,441	0,194481	0,067536	2,494
p <sub>4</sub>	0,382	0,145924		
Sp <sub>2</sub>	0,141	0,019881		
Sp <sub>4</sub>	0,088	0,007744		
	Path coefficient	Quadratic Path Coefficient	$S_{p3p5}$	$t_2$
p <sub>3</sub>	-0,285	0,081225	0,107643	-3,039
p <sub>5</sub>	1,148	1,317904		
Sp <sub>3</sub>	0,036	0,001296		
Sp <sub>5</sub>	0,346	0,119716		

Based on Table 2, founded  $t_1$  is 2,494 and t-table with significance level is 0,05 and *degree of freedom (df)* 185 is 1,653. It means  $t_1$  is higher than the t-table. Therefore, dividend payout is able to mediate the effect of free cash flow on firm value. Meanwhile,  $t_2$  is -3,039 that smaller than t table, so investment opportunity set is unable to mediate the free cash flow effect regarded the firm value.

#### Model Validity Check

The validity of the regression model can be seen from the total coefficient of determinant that shows how the ability of independent variables' variants to explain the variants of the dependent variable. The result can shows as follows:

Table 3  
R Square

Dependent Variable	Dependent Variable	R Square
PBV	DPR, IOS, FCF	0,246
DPR	FCF	0,050
IOS	FCF	0,252

Based on Table 3, the total coefficient of the determinant is calculated as follows:

$$R_m^2 = 1 - \{(1 - R_1^2) (1 - R_2^2) (1 - R_3^2)\}$$

$$R_m^2 = 1 - \{(1-0,246) (1-0,050) (1-0,252)\}$$

$$R_m^2 = 1 - (0,754) (0,950) (0,748)$$

$$R_m^2 = 1 - 0,5357$$

$$R_m^2 = 0,4643$$

The total coefficient of the determinant is 0,4643, explaining that 46,43% variance of firm value is determined by variables in the model while remaining 53,57% is determined by variables outside the model.

#### *Hypothesis Test*

##### *Effect of free cash flow on firm value*

The result shows that free cash flow has a positive significant effect on firm value so that the first hypothesis is accepted. That effectively means a company with higher free cash flow can survive even in bad condition. This can be a positive signal for investor regarding the prospect of the company in the future. This result accordingly with previous research by [Hermuningsih \(2016\)](#); [Al-Zararee & Al-Azzawi \(2016\)](#); [Ghodrati and Hashemi \(2014\)](#); and [Suartawan & Yasa \(2016\)](#), found free cash flow effect was positively regarded the firm value. This research also supports agency theory that explains how management makes a decision to improve the firm value.

##### *Effect of free cash flow on dividend payout*

The result shows that free cash flow has a positive significant effect on dividend payout so that the second hypothesis is accepted. This occurs because the existence of free cash flow encourages shareholder to ask management to use free cash flow for paying a dividend to improve the shareholder's wealth. If free cash flow tended to increase, the opportunity of the dividend payment will increase. This research supports the previous research that free cash flow effect is positive on dividend policy. It is proxied by dividend payout ratio ([Mancinelli & Ozkan, 2006](#); [Kouki & Guzani, 2009](#); [Rosdini, 2009](#); [Thanatawee, 2011](#); [Lucyanda & Lilyana, 2012](#); [Arfan & Maywindlan, 2013](#); [Efni, 2013](#)). Free cash flow effect on the investment opportunity set

The result shows free cash flow mastering negative significant effect regarded the investment opportunity set so that the third hypothesis is rejected. In this study, if free cash flow raises, the ratio of Capital Expenditure to Book Value Asset (CAPBVA) which is the proxy of investment opportunity set will decrease. It occurs because free cash flow that available in company prefer used to pay a dividend, so the free cash flow that available for investing will decrease. This can explain with agency theory that agent and principle have a different interest to use free cash flow. Principle more interests when free cash flow used to pay dividend than take investment opportunity.

##### *Effect of dividend payout on firm value*

The result shows that dividend payout has a positive significant effect on firm value so that the fourth hypothesis is accepted. This relation shows a dividend policy taken by management can increase firm value. The number of dividends which distributes to shareholder act as a positive signal about the capability of the company to increase shareholder's wealth. This study in line with previous research of [Fenandar \(2012\)](#); [Rizqia et al., \(2013\)](#); [Febriana et al., \(2016\)](#); [Sedana \(2016\)](#); [Senata \(2016\)](#); and [Esana & Darmawan \(2017\)](#), that found dividend payout ratio has a positive effect on firm value. This consist of agency theory and birth in the hand theory which explains investors prefer to get a return as a dividend than the capital gain to increase their wealth.

#### *Effect of the investment opportunity set on firm value*

The result shows that the investment opportunity set has a positive significant effect on firm value so that the fifth hypothesis is accepted. The meaning of this result is decisions which management took about investment opportunity is very important because directly related to the aims of the company. The capability of the company in funding the opportunity set is act as a positive signal for the investor, so that the firm value that proxied by price to book value can increase. This study in line with previous research of Rizqia *et al.*, (2013) and Suartawan & Yasa (2016), that found it has a positive effect on firm value. Agency theory can explain this relation because the different interest between management and principle can handle with the capability of management to increase firm value.

#### *Free cash flow effect on firm value with dividend payout as a mediator*

The result shows that dividend payout is able to mediate free cash flow effect on firm value so that the sixth hypothesis is accepted. The ability of dividend payout as mediator shows the higher free cash flow will encourage shareholder to tend management for distributing dividends. The amount of dividend payment can influence investors to invest in the company, so the stock price can increase. Aftereffect, firm value will arise.

#### *Free cash flow effect on firm value with a set of investment opportunity*

The result shows that the investment opportunity set is unable to mediate the free cash flow effect on firm value so that the seventh hypothesis is rejected. Unableness of investment opportunity as a mediator, because management's decision in using free cash flow for taking investment opportunity set can't increase firm value. Shareholder or investors prefer free cash flow is used to pay dividends to the shareholder's wealth can increase. Furthermore, dividend payout is able to mediate free cash flow effect on firm value, however, investment opportunity unable to mediate it.

## **4. Conclusion**

The result of this study are free cash flow has a positive significant effect on firm value and dividend payout, meanwhile has a negative significant effect on investment opportunity set. Then, dividend payout and investment opportunity set included mastering positive significantly effect regarded firm value.

#### *Conflict of interest statement and finding sources*

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#### *Statement of authorship*

The authors have a responsibility for the conception and design of the study. The authors have approved the final article.

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