Paper 33

Capital Structure Strategy for Improving Value of PT Unilever Indonesia Tbk

Khalida Nurdiana Ramadhani and Erman Arif Sumirat

ICMEM

The 7th International Conference on Management in Emerging Markets

Abstract - **The goal of the firm is to maximize the value of the firm and increase the shareholders prosperity. PT Unilever Indonesia Tbk (UNVR) is one of the fast-moving consumer goods (FMCG) companies and has been a market leader for several consumer goods products. During 2021, UNVR stock price was corrected for -44.08%, indicating a decrease in firm value. This was contributed by a declining financial performance as the net income decreased -19.62%. Financing decisions are one of the most important to consider in order to maximize the firm value. UNVR financing decision has been almost all equity financing with debt to capital ratio at 1.06%. Based optimal capital structure simulation using Damodaran framework, increasing the debt to capital ratio to 10% can minimize the cost of capital to 11.52% and maximizing the firm value to Rp 174,883,942 million. To apply the change in financing mix, it is recommended for the company to use the debt financing in a new investment and do stock buyback.**

Keywords – **Optimal Capital Structure, Firm Value, Financing Decisions, PT Unilever Indonesia Tbk.**

I. INTRODUCTION

PT Unilever Indonesia Tbk. (UNVR) is one of the fast-moving consumer goods companies and has been a market leader for several categories of consumer goods products. UNVR business is grouped into two principal products which are Home and Personal Care, and Foods and Refreshments [1]. Home and Personal Care products contributed for 67% of total revenue, meanwhile Foods and Refreshments products contributed for 33% of total revenue during 2021 [2].

Currently, fast-moving consumer goods companies have been significantly impacted by market conditions as the pandemic created challenges for most of the firms and stock market. UNVR's stock price was corrected -44.08% [3] during 2021 and below the Indonesia market return (IHSG) indicating that investors earned less than the market return.

Decline in stock price was mainly driven by financial performance [4] that has been declining due to the fluctuating consumer demand [5]. Based on the audited financial statement as of 31 December 2021, UNVR's net income was experiencing a negative growth for -19.62% compared to the previous year, mainly contributed by sales decrease and high cost incurred.

As a public company, the main objective of UNVR is to maximize shareholder value and take decisions that are expected to increase the stock price. Declining financial performance and stock price movement shows that UNVR was ineffective in maximizing shareholder value. Therefore, the company needs to implement a new strategy to focus on actions that create value for shareholders by increasing firm performance and firm value [6].

Financing decision is one of the factors influencing the firm value. The basic long-term financing decision is a capital structure which is a financing composition consisting of debt and equity [7]. UNVR's debt ratio was 1.06%, representing the company was relying more on equity financing. As the firm relies more on equity capital, the cost of capital will be higher since equity holders will demand higher return. Thus, raising new equity as a financing decision is more costly compared to issuing debt.

Higher cost of capital also could minimize firm value as the future cash flow will be discounted with a higher discount rate. This also could lead into a weak valuation and might be seen as unattractive by investors. Considering this issue, this research will conduct a deeper analysis on the firm value of the company and capital structure strategy to maximize the firm value.

II. METHODOLOGY

This research was conducted through four stages. The first stage is about the background of the research, company profile, business issue, research objectives, and research scope and limitation. The second stage is the Company's business analysis by conducting internal and external factors analysis. The third stage is data analysis through financial statements, annual reports, and articles to determine what are strengths, weaknesses, opportunities, and threats for the company. The fourth stage is to construct the business solution by analyzing current cost of capital. In this stage, the solution of capital structure strategy will be conducted in order to improve UNVR value. The last stage will summarize the result from the previous stage and propose the recommendations for the Company. The recommendations will consider several aspects including internal and external factors, financial performance analysis, and valuation results.

Research methodology used in this research is a qualitative and quantitative approach. Qualitative approach is used

for external and internal factors analysis. Meanwhile, a quantitative approach is used to analyze the financial performance, perform the firm valuation, and determine the capital structure strategy. The source of data for this research is obtained from the secondary data including the company annual report, financial statements, and journals, without obtaining the primary data.

III. RESULTS

A. Business Situation Analysis

Based on the external and internal analysis performed previously, UNVR has several strengths including the strong brand equity, strong corporate governance, sophisticated physical resources, strong human resources capabilities and sustainable raw material handling. These strengths may lead the company to retain its position as a market leader and maintain its growth in the future. The company could also utilize the opportunity in the market such as large number of Indonesian populations as a target market, consumer preference in basic necessities [8], and technological development [9]. However, UNVR weaknesses such as the declining financial performance in the current year and high cost of capital incurred might cause the company exposed to threat including intense competition, risk of changes in brand preference, and change in economic condition [10] [11].

According to the analysis, the root cause of declining UNVR stock price is due to the ineffective capital structure which makes the cost of capital high and lowered the firm value. During 2021, the Company faced the challenge of the fluctuating consumer demand especially during the social restriction and increase in commodity prices. In addition, the company heavily relied more on equity financing which makes the cost of capital higher. As a result, the projected future cash flow of the company was decreasing and firm value generated perceived to be unattractive. Thus, optimal capital structure is required to minimize the cost of capital in order to maximize the firm value and achieve the goal of maximizing the stock price.

B. UNVR Capital Structure

Based on the calculation, WACC of the company is at 11.55% which is above the industry average of 11.03%. The high cost of capital might be due as the company cost of equity was higher due to a significant proportion of equity capital which is 98.94%. Therefore, this research will provide the solution on optimal financing mix to the company to minimize the cost of capital.

C. Capital Structure Strategy

The Damodaran framework will be used as a framework to determine the financing mix implementation of optimal capital structure [12]. Based on the framework, it has to be determined first whether the current debt ratio is over levered or under levered.

To calculate the optimal capital structure for the company, simulation was applied at a debt to capital ratio from 10% until 90% to obtain the cost of capital at each level of debt. The purpose is to determine the lowest cost of capital that will generate the highest firm value. The simulation was conducted using the worksheet from Damodaran for the optimal capital structure simulation [13].

Prior the calculation, several inputs required are summarised in Table I.

Table 1 - INPUT FOR CALCULATION

Input	Data	Source
EBIT	8,756,359	Financial Statement
Depreciation	1,076,908	Financial Statement
Capital spending	686,727	Financial Statement
Interest expense	184,876	Financial Statement
Tax rate	22.00%	Financial Statement
Pre-tax cost of debt	9.66%	Damodaran
Share outstanding	38,150	Financial Statement
Price per share	4,510	Yahoo Finance
Beta stock	0.69	Pefindo [14]
Cash	325,197	Financial Statement
Book value of debt	1,850,000	Financial Statement
Risk free rate	7.37%	PHEI [15]
Risk premium	6.12%	Damodaran
Country default spread	1.62%	Damodaran

Based on the calculation result, the growth rate is 7.60% which is higher than the applicable risk-free rate used in this research which is 7.37%. Since using a high growth rate might exaggerate the firm value estimation, a minimum rate will be used which is the risk-free rate of 7.37% for the perpetual growth rate.

Table 2 - CALCULATION RESULT

Calculation	Current	Optimal	Change
D/(D+E) Ratio	1.06%	10.00%	8.94%
Beta for the Stock	0.69	0.74	0.05
Cost of Equity [16]	11.60%	11.92%	0.33%
After-tax cost of Debt [17]	7.53%	7.90%	0.37%
WACC	11.55%	11.52%	-0.03%
Implied Growth Rate	7.37%		
Enterprise value	173,581,303	174,883,942	1,302,639
Value/share	4,510.00	4,544.15	34.15

Based on the cost of capital simulation result, 10% debt to capital ratio results in the optimal capital structure for the company with weighted average cost of capital at 11.52%. The projected optimal capital structure result shows a lower rate compared to the current cost of capital of 11.55%. Another consideration of the optimal capital structure is the firm value generated. It can be seen that the firm value is increasing to Rp 174,883,942 million compared to the current firm value.

D. Sensitivity Analysis

Sensitivity analysis is performed to gain a comprehensive analysis by considering drop in EBIT factor. Data for the last 10 years was obtained to calculate the changes in EBIT each year. Standard deviation was calculated to obtain the spread of EBIT changes as a basis to do a sensitivity analysis. The standard deviation of EBIT for the past 10 years is 14.34% which represents the dispersion of EBIT data to the mean. Thus, sensitivity analysis is performed until the 15% drop in EBIT to gain more precise analysis.

Table 3 - SENSITIVITY ANALYSIS

	Optimal	EBIT (-15%)
EBIT	7,679,451	6,527,533
Debt to capital	10%	10%
Cost of capital	11.52%	11.53%

According to the calculation, the result shows that even though EBIT dropped 15%, the optimal capital structure is still 10% of debt composition. However, when EBIT drops 15%, the cost of capital will increase by 0.01%.

E. Takeover Target

To determine whether a firm is a takeover target or not, several financial measurements will be used. According to the previous research by Meghouar and Ibrahimi (2020), several financial characteristics that have a significant possibility of the firm becoming a takeover target include firm size, economic value added (EVA), and liquidity [18]. The research result shows that the takeover firms tend to have lower performance in terms of these ratios compared to the control group firms.

Table 4 - TAKEOVER TARGET POSSIBILITY

Measures		UNVR	Average Industry
Firm size	Market capitalization	173,906,500	117,142,912
EVA	NOPAT - (invested capital * cost of capital)	5,071,473	1,261,034
Liquidity	Quick ratio	0.42	1.18

considering the firm size and EVA factors, it is assumed that is not a takeover target.

F. Investment Quality

Based on the previous result, it can be concluded that UNVR was not a takeover target. Thus, the next step is to determine the good project availability for the firm. If there is a good project, the company can consider taking the projects and use debt financing. If there are no good investments, the company should consider their shareholders preference in dividend. To determine whether the company has a good investment or not, return on equity and return on capital is measured as summarized in Table V.

Table 5 - ROE & ROC CALCULATING

Return on Equity		Return on Capital	
Net income	5,758,148	EBIT (1-T)	5,989,972
BV equity	4,629,319	Invested capital	7,061,819
ROE	124%	ROC	84.82%
Cost of equity	11.60%	Cost of capital	11.55%

Return on equity calculation shows a result at 124% with net income of Rp 5,758,148 million and equity book value of Rp 4,629,319 million. The return on equity is greater than the cost of equity which indicates that the company could generate a higher return compared to its equity.

Return on capital calculation with EBIT Rp 5,989,972 million, invested capital Rp 7,061,819 million, and tax rate at 22% resulted in 84.82% return on capital. This also has a greater ratio compared to the cost of capital which indicates the company effectively generates income that above the average cost paid for its debt and equity capital. Thus, the company could consider taking new projects with debt as a financing decision.

G. Implementing Changes in Financing Mix

It has been identified that UNVR was under-levered as the current debt ratio is lower than the optimal debt ratio. The optimal debt ratio based on the optimal capital structure is 10%, which represents that there is excess of debt. UNVR's optimal debt is approximately at Rp 17,390,650 million, indicating that the firm needs to issue additional debt amounting to Rp 15,540,560 million.

According to the paths for changing financing mix, under-levered firms can change the financing mix by increasing their leverage. If the firms need to increase leverage quickly, they can borrow money and do stock buyback. Based on the framework, UNVR investment quality is considered good as the return on capital and return on equity are higher than the discount rate. Hence, the firm can consider taking new investment with debt financing to increase their leverage.

Beside increasing the leverage amount by borrowing money, the firm also needs to reduce equity amount in order to make a considerable decrease in debt ratio. Thus, the firm also needs to do stock buyback to reduce equity and eventually will increase debt ratio.

Stock Buyback

The result shows that the firm value will increase if they are increasing debt to optimal level and do stock buyback. The firm can issue new debt to obtain funds in order to purchase its stock. In this analysis, it is assumed that the expected buyback price is the same with the current market price. However, it is possible for the firm to reduce the stock price before the buyback. The value per share after stock buyback is increasing from Rp 4,510 to Rp 4,547 which also indicates the increase in firm value. Debt ratio after stock buyback is moving towards optimal to 10%.

Table 6 - STOCK AND PRICE BUYBACK EFFECT

Current Stock price	4,510
# Shares outstanding before buyback	38,150
Expected buyback price	4,510
Current Debt	1,850,000
Debt at Optimal	17,390,650
New Debt issued	15,540,650
# Shares bought back	3,446
Shares outstanding after buyback	34,704
Enterprise value after buyback	174,883,942
+ Cash	325,197
- Debt	17,390,650
Equity value after buyback	157,818,489
/ Number of shares after buyback	34,704
Value per share for remaining shares	**4,548**
Debt ratio	**10%**

Designing Debt

Choosing the right financing instruments for the firm is important as it will determine the debt characteristic of the firm. According to Damodaran (2014:680), a quantitative approach can be used to design debt by estimating the firm's sensitivity to changes in several macroeconomic variables which are 10-year government bond interest rates, GDP growth, inflation rate, and currency exchange.

Table VII illustrates the sector estimates where the firm's business operates. UNVR operates two business divisions which are Home and Personal Care (HPC) and Foods and Refreshment (FNR). The estimations are obtained from the average of all firm's value for each year during 10 years backwards. The regression analysis is performed to analyze the sensitivity of firm value against the macroeconomic variables.

Table 7 - SECTOR ESTIMATES

Div.	Weight	Duration	Cyclical	Inflation	Currency
HPC	66.70%	-3.967	0.184	0.149	0.574
FNR	33.30%	-2.618	0.088	0.177	0.083
Firm	**100.00%**	**-3.518**	**0.152**	**0.158**	**0.410**

Based on the regression sector estimates result, the debt duration for the firm is around 3 to 4 years. The cyclicality, inflation, and currency sensitivity show similar results with historical data regression, where the firm value fluctuation moves according to the movement of these variables.

H. Debt Design Conclusion

Based on the analysis of the firm value and operating income sensitivity, the summary of UNVR's debt should be:

1. The firm could issue a long-term debt which has a duration approximately 3 to 4 years. This is also reflecting the firm's asset life for machinery and equipment which are between 3 to 5 years.

2. The firm can use floating rate debt since the firm's operating income is increasing along with interest rates.

3. UNVR's firm value and operating income sensitivity show that the fluctuation is in line with the currency movement. Thus, debt should be in rupiah currency as the firm might be benefited as the rupiah strengthens. In addition, it also matched with the majority of revenue generated which is 93.18% revenue generated from domestic sales.

Currently, UNVR has Rp 1,850,000 million bank borrowing with fixed rate with all borrowings denominated in Rupiah currency. If the firm is planning to move into optimal capital structure and accepts the debt design recommendation, UNVR can swap its existing fixed rate with floating rate to reduce the risk of interest rate arises from borrowings.

IV. CONCLUSION

UNVR shows a decreasing financial performance with net income of Rp 5,758,148 million, decreasing for -19.62% from previous year which caused a decrease in firm value. According to the debt to capital ratio, UNVR financing has been almost all equity financing with a debt ratio of 1.06% in 2021 that resulted in high cost of capital. This contributes to the low firm value which might be seen as unattractive by investors.

Based on the optimal capital structure simulation, the optimal debt to capital ratio at 10% resulted in minimum weighted average cost of capital at 11.52%. The optimal capital structure can generate the maximum of the firm value which is Rp 174,883,942 million, an increase for Rp

1,302,639 million from Rp 173,581,303 million.

This was in accordance with the optimal capital structure theory where the company needs to minimize the cost of capital in order to maximize the firm value (Gitman and Zutter, 2015:587). This is because the present value of future cash flows will be maximized if the cost of capital as a discount rate is minimised, thus generating a high firm value.

To increase the debt ratio into the optimal capital structure, UNVR can issue new debt with long-term duration between 3 to 4 years, floating rate interest, and denominated in Rupiah currency. It is also preferred for the firm to issue banks than bonds since issuing bonds is more difficult and costly as the firm needs to provide all information to the rating agency.

V. IMPLEMENTATION PLAN

According to the Damodaran framework, UNVR is under levered since the current actual debt ratio is 1.06%, meanwhile the optimal debt ratio is 10%. In implementing the financing mix, the company can consider new investment opportunities and use debt as financing. If there is no good investment, the company should determine whether to pay additional dividends or do stock buyback.

Based on the overall research process, UNVR could invest in new projects to enhance its firm value. By investing in new projects or products, the company could obtain a new revenue stream from their new products, thus increasing the free cash flow to the firm.

According to the capital structure strategy analyzed in the previous chapter, it is recommended for the company to invest in new projects using the debt as financing to increase the debt ratio into the optimal capital structure. This could assist the company in increasing the firm value by reducing the cost of capital as the company will use more debt capital compared to the equity capital.

In addition, the company capital structure will also be in accordance with the Pecking Order Theory where the hierarchy of financing begins from the internal retained earnings, followed by debt, and stock issuance. Thus, the company could increase the firm value by investing in new projects using debt as financing to minimize the cost of capital.

ACKNOWLEDGMENT

The author would like to express a greatest gratitude to her parents and sister for their support and encouragement, and also to Dr. Erman Sumirat, S.E., M.Buss., Ak., as a thesis advisor who gives guidance and support. Big appreciation to the lecturers who have given the valuable knowledge sincerely, and staffs of MBA ITB for the support during courses.

REFERENCES

1. PT Unilever Indonesia Tbk. (2021). Annual Report 2021. Tangerang: PT Unilever Indonesia Tbk.
2. PT Unilever Indonesia Tbk. (2021). Annual Financial Statement 31 December 2021. Tangerang: PT Unilever Indonesia Tbk
3. Indonesia Stock Exchange. (2021). IDX Statistic 2021. Jakarta: Indonesia Stock Exchange.
4. Sukesti, F., Ghozali, I., Fuad, F., Almasyahri, A.K., & Nurcahyono, N. (2021). Factors Affecting the Stock Price: The Role of Firm Performance. Journal of Asian Finance, Economic and Business, Vol. 8, No. 2 (2021), pp. 165 – 173.
5. Bank Indonesia. (2021). Consumer Expectation Survey December 2021. Jakarta: Bank Indonesia.
6. Nugroho, D.S. (2021). The Effect of Financial Condition of Firm Value: A Comparative Study. Jurnal Ilmiah Akuntansi dan Bisnis, Vol. 16, No. 2 (July 2021), pp. 199 - 217.
7. Gitman, L. J., & Zutter, C.J. (2015). Principles of Managerial Finance. 14th ed. Harlow: Pearson Education Limited.
8. Deloitte. (2021). Deloitte Consumer Insights: Adapting to the new normal in Indonesia. Deloitte Southeast Asia.
9. Deloitte. (2021). Realising the potential of Indonesia's digital economy. Jakarta: Deloitte Indonesia
10. Bank Indonesia. (2021). Rise and Be Optimistic: Synergy and Innovation for Economy Recovery. Jakarta: Bank Indonesia.
11. LPEM FEB Universitas Indonesia. (2021). Macroeconomic Analysis Series: Indonesia Economic Outlook 2022. Jakarta: LPEM FEB Universitas Indonesia.
12. Damodaran, A. (2014). Applied Corporate Finance. 4th ed. New Jersey: John Wiley & Sons, Inc.
13. Damodaran, A. (2022). Capital Structure Spreadsheet. https://pages.stern.nyu.edu/~adamodar/New_Home_Page/spreadsh.htm.

14. Pefindo. (2022). Pefindo Beta Stock. https://pefindo.com/fileman/file/1169.

15. Penilai Harga Efek Indonesia (PHEI). (2022). Indonesia Bond Indexes. https://www.phei.co.id/

16. Damodaran, A. (2022). Country Default Spreads and Risk Premiums. https://pages.stern.nyu.edu/~adamodar/New_Home_Page/datafile/ctryprem.html.

17. Damodaran, A. (2022). Ratings, Interest Coverage Ratios and Default Spread. https://pages.stern.nyu.edu/~adamodar/New_Home_Page/datafile/ratings.html

18. Meghouar, H., and Ibrahimi, M. (2020). Financial Characteristics of Takeover Targets: French empirical evidence. EuroMed Journal of Business, Emerlad Publishing Limited.