

# Firm Value and Firm Performance with Political Connections

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**Abstract-** *This study aims to determine whether there is an empirical study of the effect of political connection and ownership structure on the company's financial performance and its impact on firm value where the long-term goal of the company is to maximize firm value. The population of this study comes from the financial statements of LQ-45 companies listed on the Indonesia Stock Exchange in 2014-2018. The sampling method used in this study was a purposive sampling method. The data analysis used is panel data regression through the model selection test, and the indirect effect is processed using the Sobel Test.*

*The results show that political connection, ownership structure has a significant negative effect on the company's financial performance. Company financial performance, political connection, ownership structure has a significant positive effect on firm value. The political connection has an insignificant negative effect, ownership structure has a significant negative effect on firm value through company's financial performance.*

**Indexed Terms-** *Political Connection, Ownership Structure, Firm Performance, Firm Value.*

## I. INTRODUCTION

Firm value is an investor's view of the level of success of a company that is often associated with the market (Putu, et al., 2014; Nuradawiyah & Susilawati, 2020; Fatma & Chouaibi, 2021). High stock prices make the company highly valued and affect market confidence in the company's current performance and the company's prospects in the future. So, the firm value is the main goal of the company that can reflect the welfare of the shareholders (Ceryta et al., 2018).

The growth rate of shares of manufacturing companies listed on the Indonesia Stock Exchange has fluctuated in recent years due to the continuous development of

the global economy. With these fluctuations, stock prices as a representation of firm performance and firm value are the point concern of shareholders. Several phenomena related to stock market prices on the Indonesia Stock Exchange based on closing prices have increased and decreased, like TOTO's share price had dropped from Rp. 396.66 at the end of 2014 to Rp. 348.00 at the end of 2018. BATA's share price also decreased from Rp 1,105.00 at the end of 2014 to Rp. 600.00 at the end of 2018. Furthermore, ULTJ's share price increased from Rp. 930.00 at the end of 2014 to Rp. 1,350.00 at the end of 2018 (Sudiyatno et al., 2020). In 2017, thirty-two shares, recorded in the Indonesia Stock Exchange, were suspended and there was no transaction for a month. Eight shares were inactive for a month, one of them is PT. Mitrabara Adi Perkasa Tbk (MBAP). The condition of the shares of PT. Mitrabara Adi Perkasa Tbk was not active, even though at that time its performance was positive because it managed to record sales of US\$ 203.61 and a net profit of US\$ 54.84. It could be said that inactive shares do not always have bad financial performances. Meanwhile, eighteen shares were recorded inactive for 2-10 months (Susilawati & Suryaningsih, 2020).

Firm performance is the total value that can be created by the company through its activities in generating profits (Harrison and Wicks, 2013). The company's performance as a barometer of the company's success will be a benchmark for investors to invest their funds. The company's high performance will encourage an increase in the company's stock market price. Thus, investors will give a good signal and respond positively. Therefore, firm performance is a factor that will determine the firm's value through an increase in stock prices. (Sudiyatno et al., 2012)

The success of a company cannot be separated from the influence of the environment in which the company is founded. one of them is politics. Political connections like are a double-edged sword, as they can

jeopardize the firm value if government officials and bureaucrats exert political pressure to engage in rent-seeking behavior (Facio, 2006; Chen, et al., 2017). On the other hand, companies that have good political connections are considered can improve firm performance (Idris et al., 2020). In developing countries, political connections play an important role in increasing the firm value. Indonesia as a developing country with such complex problems is very visible in its political connections. Companies that have close ties to the authorities will easily get projects from the government, permits, and even tax evasion. Apart from the positive benefits, political relations can also harm the company. Some researchers have found that there is a negative impact from political connections, the companies that have directors and commissioners who come from people closest to the apparatus or have political ties had the potential to commit acts of corruption and nepotism (Bandiyono, 2019).

Based on research found by Wati et al. (2016) stated that the market capitalization value of conglomerates increased significantly post-election either in 2009 or 2014. The increase in company stock prices shows that entrepreneurs and corporate leaders in developing countries such as Indonesia, with still higher levels of corruption, it is believed that political relations make it easy to achieve company goals, so they make significant efforts to encourage political relations to achieve company growth, they realize that political relations are a very valuable resource for companies (Li et al., 2012; Wati, et al., 2016).

The relationship between ownership structure and firm performance be able to evaluate by examining the performance of companies with changes in ownership structure over several years. Studies on the influence of ownership structure on firm value are also often associated with agency problems (Jensen and Meckling, 1976) which highlight the concerns of agents in making several decisions, where most decisions are contrary to the goal of maximizing shareholder wealth (Alipour, 2013; Vintila & Gherghina, 2015).

Several previous studies have found that ownership structure has a positive effect on firm performance (Mollah et al., 2012; Fauzi & Locke, 2012; Bentivogli & Mirenda, 2017; Hanafi et al., 2018; Rashid, 2020),

and structure ownership is positively related to firm performance (Kao et al., 2018). Ongore (2011); Lestari & Julianto (2017), found that ownership structure has a negative effect on company performance. Other researchers use several measurements on ownership structure. Other researchers use several measurements on ownership structure, such as Shyu (2013), finding that ownership structure has a positive and negative relationship. Likewise, Alipour (2013); Elvin & Hamid (2016); Yeh (2019), found that ownership structure has different effects. Research by Wu et al. (2012) and Wong & Hooy (2018) found different results regarding the influence of political connections on firm performance. Bencheikh & Taktak (2017) found that political connections had a positive and significant effect on firm performance. Wang et al. (2018) found that political connections had a positive and unrelated influence on firm performance. Osamwonyi (2013) found that no significant positive relationship between board political connection and firm performance.

## II. LITERATURE REVIEW

### A. Agency Theory

This theory may provide information on the relationship between the company, stakeholder, and its financial resource equity (Susilawati & Murwaningsari, 2021). Agency Theory Agency theory addresses the differences in interests between owners and managers, and they act in their self-interest. Agency theory (Jansen and Mackling, 1976) states that the company is a legal contractual relationship between shareholders (principal) and management (agent). In linking the ownership structure and the company's financial performance, there is one thing that cannot be separated from the achievement of company goals and performance, namely finance. Unbalanced information needs between managers and investors are caused by the unequal distribution of information between principals and agents. This causes a lack of transparency in the financial performance of agents and can lead to manipulation by agents. The contractual relationship between the two parties can lead to manipulation to increase the utility of each very likely to occur (Jansen and Meckling, 1976).

*B. Signalling Theory*

Signal theory explains how the information owner gives a signal in the form of information related to the current and future condition of the company to other parties. This information is also one of the efforts of the management to carry out their duties to realize the wishes of the stakeholders. These signals can also trigger the investments that investors make in the company. With a positive signal that is conveyed, it shows an increase in investment made by investors so that it increases the firm value.

*C. Firm Value*

In Brigham and Joel (2014), firm value is defined as market value because if the company value continues to increase, it can provide maximum prosperity for shareholders. The higher the firm value of a company, the higher the investor confidence in the company and consider the company can to provide welfare to stakeholders (Bandiyono, 2019; Bandiyono and Murwaningsari, 2019). Measurement of firm value using Tobin's, where Tobin's itself is an indicator to measure the company's financial performance, especially company value, which shows a management performance in managing company assets.

$$\text{Tobin's } Q = \frac{\{(CP \times \text{Number of Companies}) + TL + I - CA\}}{TA}$$

Where: CP -- closing price, TL-- total liabilities, I- inventory, CA -- current asset, TA -- total assets.

*D. Firm Performance*

In measuring company performance, this study focuses on the company's financial performance by using return on assets (ROA). Obtained from net income divided by total assets.

*E. Political Connection*

Faccio (2006) defines political connections by "A company is defined as connected with a politician if at least one of its large shareholders (anyone controlling at least 10 percent of voting shares) or one of its top directors (CEO, president, vice president, or secretary) is a member of parliament or a minister, or is closely related to a top politician or party. Close relationships can be through friendship, former heads of state or prime ministers, past directorships held, foreign politicians, or longstanding relationships with political

parties". Measurement using dummy variables, 1 for political connections, and 0 otherwise.

*F. Ownership Structure*

institutional ownership is the company's proportion of the total number of outstanding shares owned by all institutional investors at the end of the year. Measured by dividing institutional shares by the number of outstanding shares, multiplied by 100%.

III. RESEARCH HYPOTHESES

Sometimes companies compete not only in business but also for political power because politics provides access to the economy and the possibility to set the rules of the game, the strong political connections can be considered as one of the most important intangible assets of every company (Osamwonyi, 2013). And, sometimes companies compete not only in business but also for political power. Because politics provides access to the economy and the possibility to set the rules of the game, strong political connections can be considered as one of the most important intangible assets of any company. Wang, et al. (2018) provides evidence that the influence of political connections is strong even in the absence of political corruption, the findings suggest that political corruption is not a prerequisite or the only factor that makes political connections very valuable. in line with the research of Wong & Hooy (2018) and Osamwonyi (2013) that political connections affect firm performance. Based on the description above, the hypothesis is:

H1: Political connections have a positive effect on firm performance.

Principal and agent problems often arise in the spheres of economic activity (Jensen and Meckling, 1976). In general, the agent will carry out his duties in the company contrary to the main objectives of the company and will harm the principal. However, when there is an alignment of equity ownership between the interests of managers and shareholders, then if the contract between the principal and agent is results-based, the agent or manager will be more likely to behave in the interests of the principal (Elvin & Hamid, 2015). In addition, investors seek to maintain the ownership structure that allows them to oversee the actions of managers to reduce agency problems which will contribute to improving the firm performance

(Rashid, 2020). Based on the description above, the hypothesis is:

H2: Ownership structure have a positive effect on firm performance.

Firm value is the total wealth of investors and shareholders, which is indicated by the total value of the company's assets. The high firm performance will encourage an increase in the company's stock market price because investors will respond positively to these conditions as a signal to invest their funds in the company. As a representation of the value of the company, the increase in the stock market price indicates that the firm value also increases (Sudiyatno et al., 2012). Based on the description above, the hypothesis is:

H3: Firm performance have a positive effect on firm value.

In developing countries, political connections play a very important role in increasing the firm value. Politically connected companies will take advantage of political closeness/connections, which are more inclined to the interests of the company itself (Susilawati & Murwaningsari, 2021). The company will easily get projects from the government, permits, and even tax evasion. This politics can be done in several ways, to do the relationship between the board of commissioners from the leadership of the ruling political party, retired officials, or have ownership in the company. In Faccio (2006) it is explained that political connections make it easier for companies to get credit with extendable lines of credit because lenders also receive direct economic support from the government to which the company is connected and there is an assurance from the government that politically connected borrowers and politically connected lenders will be given bailout funds when they experience a financial crisis (Bandiyono, 2019). Based on the description above, the hypothesis is:

H4: Political connection have a positive effect on firm value.

The ownership structure describes the composition of share ownership between the government, institutional, public, foreign, family, or managerial sectors. With the proportion in the ownership structure, there is optimal supervision of the activities carried out by managers, so that it is believed to be able

to influence the course of firm performance to maximize firm value (Soewarno & Ramadhan, 2020). For example, the existence of a highly concentrated ownership structure can allow insiders to exercise effective control over their companies (Conelly et al., 2012). Based on the description above, the hypothesis is:

H5: Ownership structure have a positive effect on firm value.

The political umbrella is proven to have a positive impact on the firm value because with its political power the company is given leeway for several difficulties including licensing issues or credit loans, and others. Political connections can be considered as intangible assets (Osamwonyi, 2013) which can indirectly help improve firm performance which in turn increases firm value which is marked by an increase in profits or sustainable company growth. Not only with political connections, but a good ownership structure also allows for better supervision from shareholders so that it will lead to an increase in firm performance and firm value. Based on the description above, the hypothesis is:

H6: Political connection affects firm value through the firm performance.

H7: Ownership structure affects firm value through the firm performance

#### IV. RESEARCH METHODE

This type of research is causality. the unit of analysis is the organization (company). The population of this study was LQ-45 companies listed on the Indonesia Stock Exchange in 2014 - 2018. The sampling method used in this study was a purposive sampling method so that from 45 companies 26 companies were selected, with the amount of observation data being 130 annual data.

This research was made into two research models, namely:

Model 1

$$FP = \alpha_0 + \beta_1 PC + \beta_2 OS + \epsilon_1$$

Model 2

$$FV = \alpha_1 + \beta_3 FP + \beta_4 PC + \beta_5 OS + \beta_6 PC\_FP + \beta_7 OS\_FP + \epsilon_2$$

Where: FP -- Firm performance as measured by company financial performance proxy, obtained from return on assets (ROA); FV – firm value, using tobin's q; PC – Political connection, using a dummy variable, namely: 1 = if politically connected, and 0 = otherwise; OC – Ownership structure is measured using institutional ownership proxies. namely dividing institutional shares by the number of outstanding shares, multiplied by 100%; ε: error

V. RESULT

Table I. Descriptive Statistics

Variables	N=130			
	Min	Max	Mean	St. Dev
Tobin's Q	0.094843203	23.28575098	3.010419123	4.010974737
PC	0	1	0.923076923	0.26750188
OS	0.011754111	0.849918414	0.580254895	0.129153591
FP	0.005249849	2.321796673	0.15605384	0.231910681

Tobin's Q is 4.010974737, with the average value of Tobin's Q owned by LQ-45 companies for the 2014-2018 period being 3.010419123. The lowest value is owned by PT. Bumi Serpong Damai Tbk. in 2018, and the highest is PT. Unilever Indonesia Tbk in 2017. Tobin's Q which has a value of more than one means that the company can generate profits with a return rate that is by following the acquisition price of its assets. The minimum value for political connections is 0 and the maximum is 1. Meanwhile, the average value for political connections is 0.923076923 and the standard deviation value is 0.267500188.

• Hypothesis Test

Based on the feasibility test of the model, the chosen one is the common effect model. Where before it is used, the classical assumption test is carried out first.

Tabel II. Test Results, Model 1

$$FP = 0,31159 - 0,065913PC - 0,181581OS.....(1)$$

Variables	Prediction	Main Model	Prob.	Statement
Constant		0.31159		
Political Connection	+	-0.065913	0.3790	Unsupported
		-0.882857		
Ownership Structure	+	-0.181581	0.0000*	Unsupported
		-7.077487		
R <sup>2</sup>		0.287927		
Ajusted R <sup>2</sup>		0.276713		
F-Statistik		25.67623		

\*Sign 0,05 (5%)

Based on table II, it can be explained that:

1. The regression coefficient obtained from the influence of the Political Connection on Financial Performance is -0.065913 with a statistic value of -0.882857 < 1.96 at a significant level = 0.05 (5%) with a significant value of 0.3790 > 0.05 which states that there is a negative and insignificant effect between political connection with financial performance. That is, if the political connection increases by one unit, the financial performance decreases by -0.065913. Thus, the first hypothesis (H1) is rejected.
2. The regression coefficient obtained from the influence of the Ownership Structure on the Company's Financial Performance is -0.181581 with a statistic value of -7.077487 > 1.96 at a significant level = 0.05 (5%) with a significant value of 0.0000 < 0.05 which means states that there is a negative and significant effect between ownership structure and financial performance. These results indicate that the higher the value of the ownership structure, the lower the financial

performance by -0.181581. Thus, the second hypothesis (H2) is rejected.

Based on table III, it can be explained that:

1. The regression coefficient obtained from the influence of the Company's Financial Performance variable on Firm Value is 3.477732 with a statistic value of 5.716054 > 1.96 at a significant level = 0.05 (5%) with a significant value of 0.000 < 0.05 which states that there is a positive and significant influence between performance Corporate Finance with Company Value. These results indicate that the higher the financial performance, the value of the company also increases by 3,477732. Thus, the third hypothesis (H3) is accepted.

Tabel III. Test Results, Model 2

$$FV = -2,139449 + 3,477732FP + 1,419517PC + 4,24514OS..... (2)$$

Variables	Predicti on	Main Model	Prob.	Stateme nt
Constant		- 2.1394 49		
Firm Performa nce	+	3.4777 32	0.000 0*	Support ed
		5.7160 54		
		1.4195 17		
Political Connecti on	+	7.4273 32	0.000 0*	Support ed
Ownersh ip Structure	+	4.2451 4	0.000 1*	Support ed
		4.0712 0		

Indirect Testing

Variabl es	Predicti on	Sobel Test	Prob	Stateme nt
PC-FP	+	- 0.87244 32	0.190 0	Rejecte d
OS-FP	+	- 4.44652 65	0.000 0*	Rejecte d
R <sup>2</sup>		0.36287		
Adjuste d R <sup>2</sup>		0.33746 2		
F- Statisti k		0.0000		

\*Sign 0,05 (5%)

PC = Political Connection; FP = Firm Performance; OS= Ownership Structure

2. The regression coefficient obtained from the influence of the Political Connection variable on Company Value is 1.419517 with a statistic value of 7.427332 > 1.96 at a significant level = 0.05 (5%) with a significant value of 0.0000 < 0.05 which states that there is a positive and significant effect between political connection and firm value. These results indicate that the higher the value of political connection, the firm's value will increase by 1,419517. The results of this study support. Thus, the second hypothesis (H4) is accepted.
3. The regression coefficient obtained from the influence of the Ownership Structure variable on Firm Value is 4.24514 with a statistic value of 4.071201 > 1.96 at a significant level = 0.05 (5%) with a significant value of 0.0001 < 0.05 which states that there is a positive and significant effect between ownership structure and firm value. These results indicate that the higher the value of the ownership structure, the firm's value will increase by 4,24514. The results of this study support. Thus, the second hypothesis (H5) is accepted.
4. To test the hypothesis using the intervening variable, it can be done with the procedure developed by Sobel (1982) and known as the Sobel Test. Sobel test is done by testing the strength of the indirect effect of exogenous variables on endogenous variables through intervening variables.

5. t-value of the indirect effect of political connection on firm value through financial performance is  $-0.87244319 < 1.96$  at the significance level = 0.05 (5%), so the sixth hypothesis (H6) is rejected. It means that there is no significant effect of political connection on firm value through financial performance.
6. t-value of the indirect effect of ownership structure on firm value through the company's financial performance is  $-4.44652 > 1.96$  at a significance level of = 0.05 (5%), so the seventh hypothesis (H7) is rejected. It means there is a significant negative effect of ownership structure on firm value through the company's financial performance.

## VI. DISCUSSION

The first hypothesis shows that political connection has a negative but not significant effect on the company's financial performance. This negative correlation is in line with the research of Saeed et al. (2016) which states that political connections have a negative influence on firm performance. He said that companies with political connections had lower returns on assets than those without political connections. The first hypothesis does not show a statistically significant effect, in line with his research by Osamwonyi (2015) which shows that there is no significant influence of political connections on firm performance. This happens because the main goal of any business organization is to generate profits for the survival of the company in the business environment and also determine how seriously the company will be taken by investors. Given these factors, companies are looking for other ways to improve their performance. One of them is to look for credible and experienced individuals who are aware of events in the business environment to occupy important positions and also to make important decisions that will affect the future of the company, so political connections are not the only asset and way that can improve firm performance.

The second hypothesis shows that the ownership structure has a negative and significant effect on the company's financial performance. This is in line with Lestari & Jualiarto (2017) showing the results that ownership concentration has a significant effect on firm performance in a negative direction. This is

because, in countries that have weak regulations such as Indonesia, majority shareholders can easily take advantage of their interests at the expense of minority shareholders which has an impact on the company's performance decline. In addition, the majority shareholder will maintain his position by choosing a trusted successor to the company even though he does not have the competence to do so, which makes the company's performance decline.

The third hypothesis shows that the company's financial performance has a positive and significant effect on firm value. A good company's financial performance indicates a good company condition, so it will show an increase in stock prices. High stock prices make the company highly valued and affect market confidence in the company's performance because investors respond positively to deciding to invest in the company. This result is by the signalling theory which states that if the information related to the company's performance is positive, it means that investors will respond positively and be able to distinguish between quality companies and those that are not so that the stock price will increase and directly increase the firm value. This is in line with Soewarno & Ramadhan (2020).

The fourth hypothesis shows that the political connection has a positive and significant effect on firm value. This is in line with the research of Ang et al. (2013), that politically connected firms can benefit through easier access to debt financing, lower taxes, and stronger market power (Faccio 2006).

The fifth hypothesis shows that the ownership structure has a positive and significant effect on firm value. This is in line with the research of Soemarno & Ramadhan (2020) that ownership structure has a positive influence on firm value. With the ownership structure, in this case, institutional ownership, they will optimally supervise the activities of company managers to secure their investments in the company. This supervision can help the company run according to the expectation of the owners of capital without any conflicting activities from managers. That way, the company can provide the best performance and result in a sustainable increase in firm value.

The seventh hypothesis shows that the ownership structure has a negative and significant effect on firm value through the firm's financial performance. The proportion of ownership structure can help increase supervision over the activities of managers in the company. This supervision directly limits the deviant behavior of managers so that the firm performance will always be a priority in the implementation of its business. Increasing the firm performance can give a positive signal to investors and thus can increase the firm value. However, institutional supervisors do not always play a role as they should in the company, they do not have more time to control the company so they are often exploited by managers and majority shareholders which can harm minority shareholders. With this interest gap, the firm performance will decline and have an impact on the decline in firm value. The proportion of ownership structure can help increase supervision over the activities of managers in the company. This supervision directly limits the deviant behavior of managers so that the firm performance will always be a priority in the implementation of its business. Increasing the firm's performance can give a positive signal to investors and thus can increase the firm's value.

#### CONCLUSION

The political connection has a significant negative effect on the company's financial performance. The higher the political connection, the lower the company's financial performance.

The ownership structure with institutional ownership on financial performance has a significant negative result. This is because there is an agency conflict and the proportion of shares owned by the board of directors and commissioners is very small. That way it will be difficult for institutions to hold control and control over the company's strategic decisions. In addition, the majority of companies in Indonesia are still dominated by family ownership, so this will encourage corrupt practices, collusion, and nepotism which will ultimately reduce the firm value.

Financial performance with firm value shows significant positive results. This is because the increasing financial performance of the company can lead to a positive firm value.

Political connection to the value of the company has a significant positive result. This is because companies that build connections with politicians can increase the firm value.

Ownership structure on firm value has a significant positive result. This is because the increasing number of shares owned by institutions can increase the firm value.

Political connection to firm value through financial performance shows no effect. This is because the presence or absence of political relations does not make the firm value through financial performance increase and political connections cannot mediate directly. Ownership structure on firm value through financial performance shows significant negative results. This is due to the increasing number of shares owned by institutions, the lower the firm value through financial performance.

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