Effect of Political Risk on Profitability Mediated by Capital Structure in Real Estate Development Companies of ASEAN-5

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ABSTRACT

The aim of this study is to investigate the effect of political risk on profitability with capital structure as mediator in real estate development companies of ASEAN-5 that is 268 companies total in population. The type of research is quantitative and the datas are collected from companies' financial statements period 2012-2016. The analysis is conducted on partial least square. The result of partial least square shows that capital structure is not significant as mediator. However, political risk to profitability is significant. This proves that politics also determine the survivability of real estate development companies in the scope of finance. Afterwards, the outcomes may guide investors while considerating to invest in own country or in other ASEAN-5 countries which have different characteristics including political risk.

Keywords: Political risk, capital structure, profitability, real estate development companies, ASEAN-5, 2012-2016.

1. INTRODUCTION

Southeast Asian nations attracted foreign interest relatively low because of the lack of transparency and also government restrictions (Hughes, 2015). Investors tend to associate Southeast Asia with political and economic volatility (Bhalla, Harris, Khanna, Wu, & Dolya, 2012). While the current economic problems dominate the mindset of investors, political risk also remains as an important consideration (World Bank Group, 2013). In the scope of the country can be seen that countries in Southeast Asia have different performance. Specifically, in this study within the scope of ASEAN-5 namely Indonesia, Malaysia, Philippines, Singapore and Thailand because among all ASEAN member countries in Southeast Asia, these 5 countries are the most prominent (Tan & Tang, 2016). Based on 12 pillars measured by the Global Competitiveness Index, Singapore has the highest competitiveness in ASEAN-5 followed by Malaysia, Thailand, Indonesia and Philippines respectively (World Economic Forum, 2015)

In terms of sector, Ling & Archer (2013) wrote that real estate plays a key role in shaping the economic conditions of individuals, families, and companies. Real estate has been estimated to represent about half of the world's total economic wealth. In addition, real estate is an industry that has a high level of volatility. Historically, real estate development is volatile because of the prices and real estate costs tend to be unstable. In addition, real estate is associated with very large and very competitive market share (Brueggeman & Fisher, 2011). Next, when considering a cross-country project, there are some steps that followed by developers. One of the most important is financing. The company's financing decision involves various policy issues. One of the policies is the capital structure policy. The capital structure consists of debt and equity or personal capital.

Furthermore, based on previous studies, capital structure negatively affects profitability (Chen, Chen, Liao, & Chen, 2009; Hussain, 2015). This implies that the company has a higher profit rate when the equity ratio increases or the ratio of reserves to liabilities or debt

decreases. Since, if the debt increases aggressively, it will has negative impact on profitability (Chisti, Ali, & Sangmi, 2013). On the other hand, still there is positive relationship of capital structure to profitability (Gill, Biger, & Mathur, 2011; Semuel & Widjojo, 2016). The results of the study suggest that the debate continues in the company's financial theory of the optimal capital structure, which is how companies choose and adapt the most strategic securities mix. The relationship between capital structure and profitability can not be ignored because increased profitability is required for long-term survival (Gill et al., 2011). To sum up, profitability is the most important goal in business dealings (Hagel, Brown, & Lang, 2010).

2. LITERATURE REVIEW

POLITICAL RISK

Political risk refers to the risk that government policy will negatively impact the cash flows of companies that make international investments (Bekaert, Harvey, Lundblad, & Siegel, 2015). Political risk for a particular country is the actions or authorities of the government from the executive, legislative, or judicial branch of the country that negatively affecting the value of investments in that country. The company has expressed greater concern about macroeconomic instability as an obstacle to foreign investment plans rather than political risk. However, the company continues to recognize the importance of political risk not only in investment intentions but also its impact on business that is likely to suffer financial loss (World Bank *Group*, 2013).

To measure political risk, the International Country Risk Guide (ICRG) by PRS Group is used (Bekaert et al., 2014; Bekaert, Harvey, Lundblad, & Siegel, 2015; Kesternich & Schnitzer, 2010). The ICRG's political risk indicators are designed to assess the political stability of the covered countries, combining information from twelve subcomponents including government stability measures, socioeconomic conditions, investment profiles, internal conflicts, external conflicts, corruption, military in politics, religious tensions, law and order, ethnic tensions, democratic accountability, and bureaucratic quality (Bekaert et al., 2015). If the subcomponents are grouped then the first three subcomponents concern about the quality of institutions in a country which is law and order, bureaucratic quality, and corruption. The next group that has the label "conflict" includes four subcomponents that measure the existence or risk of political turmoil that is internal conflict, external conflict (which includes economic disputes such as trade embargoes), tensions, and ethnic tensions. The next group of democratic tendencies that measure a country's democratic tendencies includes two subcomponents of military in politics and democratic accountability. The latter group is called government action that includes government stability and socioeconomic conditions in which this last subcomponent attempts to measure public satisfaction or dissatisfaction with government economic policy. This grouping also includes potential and highly relevant subcomponents of investment profile. This component includes the risk of expropriation or contractility, taxation, and repatriation. It is therefore highly relevant for multinational corporations (Bekaert et al., 2014).

The ICRG indicator is the best choice for three reasons: First, it considers the various dimensions of political risk such as corruption, bureaucratic quality, and ethnic and religious tensions as well as socioeconomic conditions. Second, while many indicators provide only information about selective country samples, ICRG indicators cover more than 140 countries. Third, the ICRG indicators vary over time and provide information for all the years required in the study (Kesternich & Schnitzer, 2010).

CAPITAL STRUCTURE

The term capital structure of an enterprise is actually a combination of equity shares, preferred stock and long-term debt (Al-Najjar & Taylor, 2012). Debt is sometimes associated as something to avoid when running a business but debt is not bad at all. On the other hand, analysts and investors want companies to use debt smarter to finance their businesses (Gallo,

2018). The company may issue several bonds and use the funds to repurchase some shares, thus increasing the debt-equity ratio. Alternatively, a company can issue shares and use the money to pay off some debts, thereby reducing the debt to equity ratio.

Capital structure decisions can have important implications for company value and capital costs. An important element of capital structure decisions is easily recognizable, but the exact size of these elements can not generally be obtained. As a result, it can only provide incomplete answers to questions about the best capital structure for a particular company at any given time (Ross, Westerfield, & Jordan, 2008). This causes the debt to equity ratio to be important. This ratio is a simple measure of how much debt is used to run a business. DER (debt to equity ratio) is called leverage ratio which allows to see how and how large the company uses debt. As a joint note, each company has debt to equity ratio and any company that wishes to borrow money or interact with investors should pay attention to it (Gallo, 2018).

In its history, there are several theories of capital structure as the development progresses as follows. First, the Modigliani-Miller (MM) theory suggests that in a taxeless world, the value of the levered company is equal to the value of an unlevered company. In other words, the choice of debt to equity ratio is not important here. MM theory also suggests that in a world with taxes, the value of a company increases with leverage, which implies that the company must bear as much debt as possible. But these results leave a number of questions such as whether this is perfect and whether financial managers really set a debt-to-company ratio of close to 100 percent while many companies are using lower debt (Wester, Westerfield, & Jaffe, 2013). Second, trade-off theory is the optimal debt ratio of companies seen from the exchange between the cost and the profitability of the loan. Third, pecking-order theory is an alternative theory of trade-offs. A key element in pecking-order theory is when a company prefers to use internal financing whenever possible. If a company is very profitable, it probably will not require external financing so it will end up with little or no debt (Mohapatra, 1999).

PROFITABILITY

Profitability is benchmark of the company's overall financial system (Semuel & Widjojo, 2016). Most analysts and investors on Wall Street tend to focus on return on equity (ROE) as a key measure of company performance. Many executives are very focused on this measure by realizing that ROE is one of the biggest concerns of the investor community. This is because ROE focuses on returns to shareholders of the company. From the standpoint of shareholders themselves, ROE is a fast and easy to understand (Hagel et al., 2010). ROE provides information on how much percentage of profit is generated for each dollar of equity invested in a company. This is an important ratio regardless of what industry it belongs to, and more relevant than return on assets (ROA) for some businesses. For example, the bank gets its maximum savings and then lends it with a higher return. In general, the return on assets is so small and does not really relate to how to make money but basically every company has equity. ROE is calculated by net profit after tax divided by total shareholders' equity (Gallo, 2016)

HYPOTHESIS

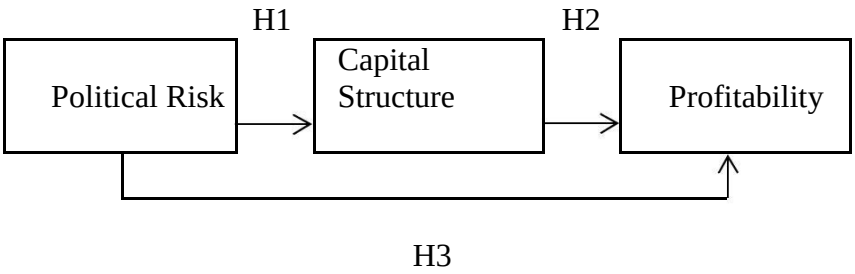

Figure 1 Research Model

H1: Political risk significantly affects capital structure in real estate development companies of ASEAN-5

H2: Capital structure significantly affects profitability in real estate development companies of ASEAN-5

H3: Political risk significantly affects profitability in real estate development companies of ASEAN-5

3. METHODOLOGY

TYPE OF RESEARCH

This research is quantitative research. Quantitative research is a research that uses mathematical methods and data processing must be in numerical form (Muijs, 2004). This research uses secondary data that is the issued financial statements by the sample companies.

POPULATION AND SAMPLE

The population in this study is companies in the property owners & developer sector that listed in Indonesia Stock Exchange (IDX) totaling 42 companies, listed in Philippines Stock Exchange (PSE) totaling 42 companies, listed in Bursa Malaysia (BM) totaling 42 companies, listed in The Stock Exchange of Thailand (SET) totaling 49 companies, and listed in Singapore Exchange (SGX) totaling 58 companies. Thus, the total population is 268 companies.

In this study non-probability or non-random sampling technique is used. This technique is a sampling technique that is not based on random mechanism or random. In this research, purposive sampling sampling technique that based on certain intention and criterion is also used. The criteria of the companies that will be sampled in this study include companies that have issued reports and financial data required during 2012 to 2016, the company did not experience delisting and did not merge with other companies during the study period.

VARIABLES

Here is the operational definition of each variable in this study. The International Country Risk Guide (ICRG) Indicators by PRS Group to measure political risk (POL), DER (Debt to Equity Ratio) to measure capital structure (CAPS), and ROE (Return on Equity) to measure profitability (PROF).

Political Risk (POL)

The political risk rating of the International Country Risk Guide (ICRG) is designed to reflect only political risk because the ICRG has separate ratings on economic and financial risks. The political risk rating of the ICRG represents a significant difference in the probability of realizing future political risk. The overall ICRG political risk indicator is an information center on various aspects of political risk and some components that may be more predictive of future risks than others. In summary, there is evidence that the deterioration in the political risk rating of the ICRG has predictive power for political risk insurance claims as well as political risk events as measured by news coverage (Bekaert et al., 2014).

The ICRG's political risk indicators are designed to assess the political stability of the countries covered, combining information from twelve subcomponents including government stability measures, socioeconomic conditions, investment profiles, internal conflicts, external conflicts, corruption, military in politics, religious tensions, law and order, ethnic tensions,

democratic accountability, and bureaucratic quality (Bekaert et al., 2015). Of the many subcomponents grouped by the PRS Group up to 6 components and for inclusion in the data analysis, the six components can be searched the average so the output will be a number that represents one country within the period of study as applied by Kesternich & Schnitzer (2010). The frequency of determining political risk is every month since 1984 and is shown in scores per year. Then, in the ICRG's political risk indicators if the political risk rating of 0.0% to 49.9% indicates Very High Risk; 50.0% to 59.9% High Risk; 60.0% to 69.9% Medium Risk; 70.0% to 79.9% Low Risk; and 80.0% or more Very Low Risk (ICRG, 2016).

Debt to Equity Ratio (DER)

This ratio is called leverage ratio which allows to see how and how large the company uses debt. As a joint note, each company has a debt-to-equity ratio and any company that wishes to borrow money or interact with investors should pay attention to it. DER is then calculated by dividing the total debt of the company against total equity. Then the equation is Total Debt / Total Equity (Gallo, 2018).

Return on Equity (ROE)

The usefulness of the ROE is to measure the company's successful rate of return on its equity. If the company has a high profitability then this ROE variable will also show a high number (Semuel & Widjojo, 2016). ROE is measured by dividing net income by total equity. Then the equation is Net Income / Total Equity (Wester et al., 2013).

DATA COLLECTION TECHNIC

The data of the simple companies is in the form of published annual financial statements such as income statement, cash flow statement, balance sheet and political risk data for the period 2012-2016. These secondary data related to population and research sample are obtained from Indonesia Stock Exchange (BEI) website www.idx.co.id, Philippines Stock Exchange www.pse.com.ph, Bursa Malaysia (BM) www.bursamalaysia.com, Singapore Exchange (SGX) www.sgx.com, The Stock Exchange of Thailand (SET) www.set.or.th, and / or the Petra Christian University Bloomberg laboratory for the financial statements of the company. Political risk data is obtained from International Country Risk Guide (ICRG) through the PRS Group in collaboration with the World Bank https://info.worldbank.org/governance/wgi/pdf/prs.xlsx.

DATA ANALYSIS TECHNIC

This research uses the PLS (partial least square) technique with SmartPLS software. Partial least squares has flexibility that makes it possible to be used in situations where the use of conventional multivariate methods is very limited, as when there are fewer observations than predictor variables. Furthermore, partial least square regression can be used as an exploratory analysis tool to select the appropriate predictor variables and to identify the segregation before analyzing the linear regression (de Jong, 1993; Statsoft, 2018).

FINDINGS

DESCRIPTIVE ANALYSIS

The sample unit in this study is real estate development companies in ASEAN-5, which originated from Indonesia, Philippines, Malaysia, Singapore, and Thailand. The initial sample is 286 companies, with 42 companies from Indonesia, 42 from Philippines, 77 from Malaysia, 58 from Singapore, and 49 from Thailand.

The result of data collection shows there are some companies whose data are not available completely, so researchers done the filtering by only include a sample unit of the company whose value of each variable is available completely. The result of the screening

shows 21 companies (7.8%) whose data variables are not available completely, while the remaining 247 companies (92.2%) data of each variable is complete. Thus the sample in this study is as many as 247 companies, with details as follows.

Table 1
Number of Research Sample

Country	Targeted Company in Number	%
Indonesia	40	16,2
philippine	32	13,0
Malaysia	73	29,6
Singapore	56	22,7
Thailand	46	18,6
Total	247	100,0

This shows that the real estate development companies in ASEAN-5 which is sampled in this research is mostly from Malaysia, which is 73 companies or 29.6%. The least sample is from the Philippines that is 32 companies or 13.0%. The sample of real estate development companies originating from Indonesia amounted to 40 companies or 16.2%.

OUTER MODEL EVALUATION

Convergent Validity

The first evaluation of the outer model is convergent validity. Convergent validity is measured by looking at the outer loading value of each indicator. An indicator is said to meet convergent validity if it has an outer loading value of ≥ 0.50. Here is the value of outer loading of each indicator on the research variables.

Table 2
Outer Loading Value

Indicators	Political Risk	Capital Structure	Profitability
POL	1,00		
DER		1,00	
ROA			1,00

Based on the outer loading value, it is known that the outer loading value for each indicator on the variable of political risk, capital structure, and profitability all have value more than 0.50. This means that the POL, DER, and ROA indicators used to measure each variable of political risk, capital structure, and profitability have met convergent validity.

Discriminat Validity

A second evaluation of the outer model is discriminant validity. Discriminant validity is measured using cross loading. An indicator is said to meet the discriminant validity if the value of cross loading indicator to the variable is the largest compared to other variables. The value of cross loading in this study is presented in the table below.

Table 3
Cross Loading Value

Indicators	Political Risk	Capital Structure	Profitability
POL	1,000	0,006	-0,137
DER	0,006	1,000	-0,158
ROE	-0,137	-0,158	1,000

Based on the value of cross loading, it can be seen that all the indicators that make up each variable of political risk, capital structure, and profitability have met the discriminant validity because it has the largest outer loading value for the variables it formed but small on other variables . Thus all indicators of variable political risk, capital structure, and profitability have met the discriminant validity. Another method that can be used to determine discriminant validity is to compare the value of the AVE root (average variance extracted) of each variable with a correlation involving the corresponding variable with the other variable in the model. If the value of the AVE root is greater than the correlations that occur then the variable, then it can be said variables meet the discriminant validity. Here is the discriminant validity test using a comparison between AVE root and the correlation between variables.

Table 4
Discriminant Validity Test Results

Variable	AVE	Square Root of AVE	Correlation between Variables			
				POL	DER	ROE
(POL)	1,000	1,000	POL	1		
(DER)	1,000	1,000	DER	0,006	1	
(ROE)	1,000	1,000	ROE	-0,137	-0,158	1

Based on the discriminant validity test result it is known that the AVE root value for each variable is of greater value when compared to the correlation value between the variables themselves and the other variables in the model, so it can be concluded that the variable of political risk, capital structure, and profitability have good discriminant validity.

Composite Reliability

The last evaluation of the outer model is composite reliability. Composite reliability tests the consistency of indicators in measuring a construct. A construct or variable is said to meet composite reliability if it has composite reliability value of ≥ 0.70. Here is the value of composite reliability of each variable of political risk, capital structure, and profitability.

Table 5
Composite Reliability

Variabel	***Composite Reliability***
Political Risk	1,000
Capital Structure	1,000
Profitability	1,000

Composite reliability test results show that the value of composite reliability of each research variable has a value greater than 0.70. Thus it can be concluded that each variable of political risk, capital structure, and profitability have met the composite reliability.

INNER MODEL EVALUATION

R-Square

The first evaluation of the inner model is seen from the value of R-Square or coefficient of determination. Based on data processing with PLS, R-Square value is generated as follows.

Table 6
R-Square Value

Variabel	**R-** ***Square***
Political Risk	-
Capital Structure	0,000038
Profitability	0,043381

The R-Square value for capital structure is 0,000038, meaning that the percentage of political risk effect to capital structure is 0.0038%, while the rest is 99.9962% explained by other variables. While the value of R-Square for profitability is 0.043381, meaning that the percentage of magnitude of political risk and capital structure to profitability is 4.3381%, while the rest is 95.6619% explained by other variables.

In the PLS model, the assessment of goodness of fit is known from the value of Q2. The value of Q2 has the same meaning as the coefficient of determination (R-Square) on regression analysis, where the higher R-Square, then the model can be said more fit with the data. From above results then the value of Q2 is generated as follows: $Q^2 = 1 – (1 – 0,000038) \times (1 – 0,043381) = 0,043417$

Q^2 means the amount of diversity of research data which can be explained by structural model developed in this research is equal to 4,3417%. Based on these results indicate there are many other variables that also affect the profitability.

Hypothesis Testing with Inner Weight

Testing of research hypothesis by using PLS analysis done by using inner weight table. The research hypothesis can be accepted if t count (t-statistic) ≥ t table at the error rate

(α) 5% is 1.96. Here is the value of the path coefficient (original sample estimate) and t value (t-statistic) on the inner model.

Table 7
Hypothesis Test Results

Hyp.	Scheme of Effect	Direction	Path Coefficient	T-stat	Explanation
H1	Political Risk→Capital Structure	+	0,006169	0,078301	Not significant
H2	Capital Structure → Profitability	-	-0,157268	1,134288	Not significant
H3	Political Risk → Profitability	-	-0,135590	2,009609	Significant

The value of path coefficient of political risk to capital structure is 0,006169 with T-stat equal to 0,078301 (smaller than t table value of 1,96), it shows no significant effect of political risk to capital structure. Based on this result, the research hypothesis which suspects there is effect of political risk on capital structure at real estate development companies in ASEAN-5, is unacceptable (H1 is rejected).

The value of path coefficient of capital structure to profitability is equal to -0.157268 with T-stat equal to 1,134288 (smaller than t table value of 1,96), this shows there is no significant effect of capital structure to profitability. Based on this result, the research hypothesis which suspects there is effect of capital structure on profitability at real estate development companies in ASEAN-5, is unacceptable (H2 is rejected).

The value of path coefficient of political risk to profitability is -0.135590 with T-stat equal to 2,009609 (bigger than t table value of 1.96), it shows there is significant effect of political risk to profitability. The direction of effect between political risk and profitability is negative, indicating the lower the political risk the profitability will tend to decrease. Based on this result, the research hypothesis which suspect there is effect of political risk to profitability at real estate development companies in ASEAN-5, is acceptable (H3 is accepted).

4. RESULT AND DISCUSSION

The results show that political risk has no significant effect on capital structure on real estate development companies in ASEAN-5. This result is consistent with the results of Rurangangabo (2013) study which found that political risk has no significant effect on the size of capital or the ability to mobilize capital for the project as well as the capital structure. Because, from the perspective of debt, leverage of ASEAN companies is still very low, not only compared to China but to the whole world. The average corporate debt for the six largest ASEAN countries (Indonesia, Malaysia, Philippines, Singapore, Thailand and Vietnam) is almost 100% in total debt to equity when 177% in China and 176% globally. The debt structure is also more sustainable, with only 56% of total debt classified as short-term debt (maturing in one year), compared to 68% in China.

At the same time, ASEAN economies are substantially affected by foreign conditions such as trade, given the openness in ASEAN for both trade and financial flows. Impacts on sector and country level also depend on exposure to external factors such as external demand for goods, commodity prices and US federal policies. In addition to external factors, ASEAN economy also depends also on varying domestic demand based on the strengths of each economic cycle and the real credit of ASEAN countries themselves (Herrero, 2017).

The results also show insignificant capital structure on profitability in real estate development companies of ASEAN-5. This is in line with Nduku (2015) study which found that the influence of capital structure on the profitability of real estate companies in

insignificant. Thus the profitability of these companies is a function of other factors than the choice between equity and debt financing. This result will tend to support the pecking order theory which holds that there is no optimal leverage for the company. Recommendations for managers are they do not need to focus on maintaining certain leverage ratios but they must let the actual capital structure be determined by the business needs (Mwangi & Birundu, 2015).

The results then show that political risk has no significant effect on capital structure and capital structure to profitability on real estate development companies in ASEAN-5. It can be concluded that capital structure does not give significant influence as mediator.

On the other hand, the results of the study show that political risk has significant effect on profitability in real estate development companies in ASEAN-5. Because basically, politics create uncertainty about future policy, which in turn affects the level of economic activity (growth) and expected profitability through its impact on investment, taxes, consumer and business confidence, and the price and availability of credit (Eurasia Group & Nikko Asset Management, 2015).

If paying attention at the direction, the higher the political risk of a country, the higher the profitability of the company. According to Cashman, Harrison, & Zinc (2015), higher observed earnings rates may be the result of investing in risky businesses that demand a higher rate of return. In addition, investors with good on-the-ground knowledge can often enjoy above-normal returns compared to highly transparent markets (Liang, 2015). So it can be concluded, political risks are able to provide high profit opportunities while others avoid such risks.

5. CONCLUSION

Political risk has insignificant effect on capital structure of the real estate development companies in ASEAN-5. For the proportion of debt ASEAN companies are still very low. In addition, the capital structure is also influenced by foreign conditions such as global free trade because of the openness of ASEAN to investors.

The capital structure has insignificant effect on profitability of the real estate development companies in ASEAN-5. Thus the profitability of real estate developers is influenced by factors other than the choice between equity and debt financing. This has an impact on the company's capital structure policy that managers do not need to focus on maintaining certain compositions to achieve expected profitability because the actual capital structure is determined by the needs of each business.

The higher the political risk the higher the profitability. This caused by 4 out of 5 countries in ASEAN-5 are developing countries and political risk in developing countries tend to be higher than developed countries but regardless of the risk, some investors are aware of the risks and seize the opportunity to gain profit while others avoid it.

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