The Effect of Capital Structure on Company's Profitability:

A Case of LG Electronics European Shared Service Center B.V.

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PREFACE

This thesis is submitted to INHolland University of Applied Sciences in partial satisfaction of the requirements for the degree of Bachelor of Business Administration. The thesis was constructed based on a study conducted by the author on LG Electronics European Shared Service Center.

The author is a double degree student from Petra Christian University in Surabaya, Indonesia. Currently, the author is doing his final year at INHolland University of Applied Sciences in Diemen, The Netherlands.

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ABSTRACT

This thesis investigates the effect of capital structure to the profitability of LG Electronics European Shared Service Center (LGESC). Theoretically, capital structure decision of a company affects the value of that company. Since profit is one of the widely followed variables affecting the value of a company, it is interesting to examine whether capital structure affects LGESC's profitability. Besides, the results of previous academic studies are conflicting, it is not safe to simply assume the relationship between the two variables in LGESC.

In this thesis, the relationship between the two variables is investigated quantitatively with Pearson Correlation analysis and regression analysis. As the metric of capital structure, debt to equity ratio is chosen. Meanwhile, return on equity (ROE), return on assets (ROA), and net profit margin (NPM) are used as the metrics of profitability. Both the Pearson Correlation analysis and the regression analysis are conducted with a confidence interval of 95 per cent.

The findings suggest that capital structure affects profitability negatively. The Pearson Correlation analysis between debt to equity ratio to all three profitability ratios result in a moderate inverse relationship. Meanwhile, based on the regression analysis, it is confirmed that capital structure affects LGESC's profitability negatively. The findings shall help the management of LGESC to evaluate its capital structure and give insight into determining the company's optimum capital structure.

CHAPTER 1
INTRODUCTION

1.1. Introduction

Companies have two sources of capital: debt capital and equity capital. Debt capital can be obtained by taking out a loan, while equity capital can be obtained by issuing shares. Debt holders generally have a higher priority of claims to a company's assets over the shareholders and can exert legal pressure against the company to make payment (Gitman & Zutter, 2012). In certain cases, a company can even be declared bankrupt and have their assets liquidated to fulfil its obligations to the debt holders. Then, why do companies use debts when having debts can be risky?

While there are risks in using debt, it does not mean that it is harmful for a company to use debt financing. Indeed, it is possible for a company to obtain finance by issuing shares to raise equity. However, cost of debt financing is generally lower than the cost of equity financing because debt is a less risky investment compare to equity. As risk and return principle says, an investor who invests in a riskier investment will be more likely to demand higher return than an investor who invests in a less risky investment. With debt, companies are obliged and liable contractually to make payment of interest and repay the principle amount at certain date. The contractual obligation and the prioritized claims over company's asset make debt holders bear less risk compare to equity holders, whose claims are residual in nature and not prioritized. Therefore, equity holders will demand higher return compare to debt holders. However, it should also be remembered that having too much debt will cause problems when a company cannot meet all its obligations to the debt holders. A proper balance between debt and equity is needed, so the company is able to enjoy the benefits of debt without damaging the company. This is when the capital structure decision comes into place.

Capital structure is defined as the way companies finance itself through debt and equity (Velnampy & Niresh, 2012). It can also be defined as the mix of debt and equity used in a company's operation (Shubita & Alsawalhah, 2012). According to the theory, the goal of capital structure decision is to determine the financial leverage that maximizes the value of the company (Clayman, Fridson, & Troughton, 2008). However, many researchers are also trying to find out the effect of capital structure on the profitability of a company. This interest is driven by the fact that profit, which represents the returns earned on behalf of shareholders, is one of the widely followed variables affecting the value of a company (Gitman & Zutter, 2012).

Despite the fact that focusing on earnings ignores risk which is also other key variable affecting company's value, it is interesting to explore whether capital structure affects company profitability. Based on empirical studies conducted by the researchers in the past, there are many differences in results. For example, Berger and Bonaccorsi (2006) found out that lower equity capital ratio is associated with higher profitability. On the other hand, it was concluded by Velnampy and Niresh (2012) that debt is negatively correlated to the net profit. Meanwhile, Kebewar and Shah (2012) concluded that debt has no influence on profitability in either linear or non-linear relationship.

In this thesis, the effect of capital structure on company's profitability will be studied. The study, however, is not based on a certain industry or geographical location like how the previous researchers had conducted their studies. In this thesis, capital structure will be evaluated based on a subsidiary of a Korean electronics company located in The Netherland, LG Electronics European Shared Service Center B.V. (LGESC). It is important to keep in mind that capital structure is not the only variables affecting the profitability of a company since in practice many factors are also affecting profitability, e.g. macroeconomic environment, degree of rivalry, price of raw materials, currency fluctuation, and other managerial aspects.

This thesis comprises of five chapters including this introductory chapter and it is organized as follows. Chapter 1 introduces the problems discussed in this study and lays down the purpose of this study. Chapter 2 gives the literature review from the earlier works and findings in the area of capital structure and its relationship with company's profitability. Chapter 3 explains the methodological approach that has been chosen to answer the research questions presented in Chapter 1. Chapter 4 presents and analyzes the result of this study. Finally, Chapter 5 discusses the findings and compares it with the findings from previous academic studies. Recommendation based on the findings discussed in the previous chapter will also be presented in this chapter.

1.2. Problem Statement

As the results of previous academic studies are conflicting, it is not safe to assume the relationship between capital structure and profitability of LGESC. Making the assumption that there is a relationship between the two while actually there is no relationship can be a waste of resources and time for the management. On the other hand, making the assumption that there is a positive relationship while actually the relationship is negative can also cause incorrect decision. Knowing whether there is a relationship between LGESC's capital

structure to its profitability is the very first step toward estimating the company's best combination of debt and equity in relation to the profitability.

1.3. Purpose of the Study

One of the main goals of this study is to examine the effect of capital structure on the profitability of LGESC. Previous studies are examining the relationship on industry or country level, so it is always interesting to see if the result of previous studies is confirmed on corporate level. Another goal of this study is to find out the direction of the relationship, which shall assist the management of LGESC to evaluate the company's capital structure.

1.4. Aims of the Study

Since maximizing profit is one of the aims of companies in general, LGESC needs to constantly investigate areas that affect its profitability. Obviously, the attempt to increase the number of sales and cost reduction will help to earn more profit. However, from management perspective, good and right managerial decision can also help a company to be more profitable. Based on the theories in financial management, there is an indication that capital structure affects profitability, which is also supported by the previous empirical studies. This study aims to give insight to LGESC management team into the relationship between capital structure and the company's profitability. The knowledge of whether or not capital structure affects profitability and the direction of the relationship can be used as the basis to evaluate the company's capital structure. In addition, finding the relationship shall be the very first step to estimate the optimum capital structure.

1.5. Research Questions

The central research questions investigated in this study is as follows:

"How is capital structure affecting LG Electronics European Shared Service Center's profitability?"

The sub-research questions investigated in this study are defined as follows:

- **i.** What is the correlation between LGESC's capital structure and its profitability?
- **ii.** How significant is LGESC's capital structure at explaining its profitability?
- **iii.** To what extent does LGESC's capital structure affect its profitability?

1.6. Company Background

LG Electronics, Inc. is one of the world's largest electronics company and operates in four business sectors and product categories, which are home entertainment, mobile

communications, home appliance, and air conditioning and energy solution. With a vision to become the market leading company with broad market recognition, LG focuses itself on three core capabilities, which are product leadership, market leadership, and people leadership.

LG has at least 114 subsidiaries across the globe and LG Electronics European Shared Service Center (LGESC) is one of them. LGESC was established on 31 December 2005, following a demerger of LG electronics Services Europe into LG Electronics European Shared Service Center (LGESC), LG Electronics Logistics and Services (LGELS), and LG Electronics Benelux Sales (LGEBN).

In 1 January 2012, LGELS merged with LGESC and since then LGESC consists of three divisions, which are Shared Service Center, Logistics & Services, and Supply Chain Management division. The sole shareholder of the company is the LG Electronics European Holding B.V. (LGEEH) and the company is part of the LG Electronics European Holdings group of companies. The head of this group is none other than the LG Electronics Inc. in Seoul, Korea, which is also the ultimate parent company of the group. LGESC's activities mainly comprise of:

i. Providing concentrated shared services regarding treasury, tax, credit insurance, legal, IT services, and compliance (standard center), and other auxiliary services to marketing and sales entities within the LG Electronics European Holdings B.V. group of companies;
ii. Sales and distribution of consumer electronics and information technology equipment to group companies and third parties, purchased from other group production companies located in China and Korea and other regions; and
iii. Purchasing and distribution of electronics equipment items and parts of service group companies and third parties.

Regarding its capital structure, LGESC is relying heavily on debt to finance its assets. In the previous end of fiscal year (December 2013), LGESC reported total liability of around EUR 717 million and total assets of around EUR 736 million. That means, at least 97.5 per cent of assets owned by LGESC are financed by debt. Historically, LGESC debt to equity ratio has always been very high since 2009, with the lowest of 29.01 in August 2013 and the highest of 560.6 in June 2011.