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Financial Performance Analysis of PT XYZ and Compliance Of Financial Loan Covenant Toward Debt Repayment Capability

Adinda Nur Azizah[1], Acip Sutardi[2]
School of Business and Management, Institut Teknologi Bandung, Indonesia[1,2]
Email: adinda_nurazizah@sbm-itb.ac.id

Abstract

In 2022, PT XYZ faced a decline in net sales of -16.42%. At the same time, Indonesia's furniture industry also faced a decline in export value. This research analyses PT XYZ's financial performance from 2018 to 2022, specifically regarding its debt repayment capability. Financial ratios from several aspects, such as profitability, liquidity, activity, and solvency ratios, will be generated to reflect the firm's performance and trend in the past five years. Other than evaluating the firm's financial ratios, this research will also evaluate the firm's compliance with financial loan covenants in existing bank loans and bond issuance. From the financial ratio analysis, the firm's performance plummeted in 2022, mainly due to the decline in sales experienced by PT XYZ. There may be some issues regarding the firm's liquidity performance. However, it can be seen from the solvency ratios such as DSCR and Interest Coverage Ratio that the firm can still meet its obligations in paying its debt interest and principal payments. Compliance with financial loan covenants indicates a covenant breach in the debt-to-EBITDA ratio, which is applied as a financial loan covenant by Bank DEF and Bank JKL. However, the firm can still pay its debt principal and even pay off the credit facilities. The research found that the decline in sales faced by the firm significantly impacted the firm's weakened financial performance in 2022. Regarding compliance with financial loan covenants from bank loans and bond issuance, the covenant breach does not affect the firm's capability in debt repayments.

Keywords: Bank Loans; Bond Issuance; Financial Loan Covenants; Financial Performance Analysis; Financial Ratio.

A. INTRODUCTION

Financial performance is a subjective measure of how well a firm can use its assets from its primary business mode and generate revenues (Kenton, 2023). The company's financial statements can reflect the firm's financial performance and health and are often utilized as data in financial performance analysis. In conducting a financial performance analysis, various methods can be utilized according to the purpose of the use, time criteria, the character of information, or the degree of algorithm development (Myšková & Hajek, 2017). One of the ways to assess a firm's financial performance is by utilizing ratio analysis; according to (Gitman & Zutter, 2015), a ratio analysis is done by calculating financial ratios and interpreting them to analyze and monitor the firm's performance. Generating financial ratios has helped to understand financial statements such as income statements, balance sheets, and cash flow statements in measuring the firm's business performance (Rashid, 2018).

In most loan agreements, there are a few restrictive notes known as loan covenants made by lenders directed for the firm to agree upon and comply with in obtaining loans. The loan covenants have been beneficial to ensure that the borrower's actions throughout the loan term align with the lender's interest (Zhang, 2010). Loan covenants are essential for firms to comply with when obtaining loans since they may affect the lender's decisions on the disbursement of credit facilities or loans. A covenant breach, the term for a violation of the covenants, may cause the lenders to tighten the covenants and increase loan spread in which the lenders get stricter in the disbursement of the subsequent loan issuance to the firm who has violated the covenant (Freudenberg et al., 2017). However, firms with social purposes that violate the covenants in the loan agreement tend to get penalized less severely than those without social purposes (Austin et al., 2022). A financial loan covenant, in particular, consists of a few sets of financial ratios that the firm, as the borrower, must maintain. Determinants in selecting financial ratios used in the financial loan covenant are associated with the borrower's underlying credit risk (Demerjian, 2007). Demerjian then further supports the previous statement with his dissertation paper "Financial Covenants, Credit Risk, and the Resolution of Uncertainty," where he finds that the selection of financial covenants is aligned with the firm's financial performance mainly leverage and earning performance and that the inclusion of financial covenants can determine the firm's risk of default (Demerjian, 2010). Therefore, the financial loan covenant set

* Corresponding author

up towards the firms as borrowers specifically pertained to the firm's financial performance and metrics and effectively evaluated the firm's credit risk.

In this case, PT XYZ has obtained several short-term and long-term loans from multiple banks and financial institutions. In their existing bank loans that the firm has obtained, a few of the banks set up a financial loan covenant for the firm to comply as agreed upon in the credit agreements. Therefore, the firm needs to be able to maintain its financial performance in order to be able to meet its obligations in time and comply with compliance in order to mitigate its credit risk. In 2022, PT XYZ experienced a decline of -16.42% in total net sales. PT XYZ stated in their annual report that the decline in sales was caused mainly due to the decrease in demand from the US market as the current mortgage rate is rising and inflation is high. The decline in total net sales in 2022 may affect their overall financial performance, especially towards generating adequate cash flows to meet their obligations for the year. If the firm's financial performance is decreasing, there can be a possibility that the firm may not be able to maintain the performance of its financial ratio. Thus, the firm might be experiencing an indication of a financial loan covenant breach.

This research evaluates PT XYZ's financial performance and determines whether or not the company indicated a loan covenant breach. Through this analysis, the author can give recommendations to PT XYZ regarding the company's financial performance, specifically regarding debt repayment capability.

B. RESEARCH METHOD

The methodology used in this research is the quantitative descriptive method. (Williams, 2007) stated that a quantitative research method requires a numeric or statistical approach to the research design method. Additionally, (Sukamolson, 2007) stated that quantitative research is about gathering numerical data to elaborate a certain phenomenon further. Thus, a quantitative approach in research could be defined as a method that requires certain numerical data or a statistical approach toward problem-solving and/or describing a certain occurrence. In particular, the descriptive research approach in the quantitative research method looks further into the situation or problem as it exists in the exact moment or state (Williams, 2007). Using figures, statistics, and other quantifiable tools, a quantitative approach gathers factual and numerical data to express concepts.

To conduct this research, data collection was done by collecting secondary data, which was obtained from PT XYZ's Annual Report and Financial Statement from the year 2018 to 2022. The data will then be processed into financial ratios from profitability, liquidity, activity, and solvency. Instead of solely relying on financial ratios for the analysis, the research also analyzes PT XYZ's compliance in financial loan covenant from the credit agreement that banks determine in the credit agreement or the bond trustee sets from the issuance of bonds and sukuk mudharabah. The compliance evaluation in financial loan covenants is then further analyzed towards the firm's debt repayment capability. Through the result of financial performance analysis through generating ratios and analyzing the firm's compliance towards the financial loan covenants, the research can evaluate and develop recommendations on PT XYZ's overall financial performance and debt repayment capability.

C. RESULTS AND DISCUSSION

1. Financial Ratio Analysis

The data analyzed is obtained through PT XYZ's annual reports and financial statements from 2018 to 2022. It will be further analyzed by generating financial ratios to evaluate the firm's financial performance in several aspects, such as profitability, liquidity, activity, and solvency.

1.1. Profitability Aspects

Table 1. Profitability Ratio

Ratio	2018	2019	2020	2021	2022
Gross Profit Margin	35.17%	34.82%	33.65%	35.39%	31.10%
Operating Profit Margin	22.53%	22.95%	22.67%	17.74%	9.57%
Net Profit Margin	25.25%	11.87%	11.23%	10.08%	4.11%

Source: Processed Data, 2023

In terms of profitability, it can be seen from the ratios that there has been a declining trend in the past five years. The sales decline in 2022, as stated in the problem statement, affects the overall performance of profitability in 2022, in which the margins generated have plummeted compared to the previous year. The Gross Profit Margin shows growth in 2021 and a decline in 2022. In 2021, the firm generated a much higher revenue, as we can see that the Gross Profit Margin in 2021 has increased.

Meanwhile, the decline in 2022 is primarily caused by the decline in sales and increasing COGS depreciation. The Operating Profit Margin generated a significant decrease in 2022.

Compared to the previous year, the revenue generated is lower, and the operating expenses keep increasing. Therefore, the Operating Profit Margin experienced a significant drop in 2022. In the end, the Net Profit Margin Generated in 2022 has plummeted from 10.08% in 2021 to 4.11% in 2022. The firm's profitability faced a major decline in 2022 with lower revenue, increasing expenses, and depreciation. Despite the decline in sales and worsened profitability performance in 2022, the firm can still generate profit and meet product demands in the export market.

1.2 Liquidity Aspects

Table 2. Liquidity Ratio

Ratio	2018	2019	2020	2021	2022
Current Ratio	1.29	1.28	1.35	2.07	2.43
Quick ratio	0.29	0.41	0.29	0.39	0.34

Source: Processed Data, 2023

Liquidity ratios measure the company's capacity to meet its short-term obligations (current liabilities). The current ratio shows a significant increase each year, with a current ratio of 2.4x in 2022, indicating that the company's current assets are sufficient to meet its current obligations. However, the firm's quick ratio shows that its most liquid assets, such as cash, cash equivalents, marketable securities, and trade/account receivables, are inadequate to pay its short-term obligations as its current assets consist mostly of their inventories.

1.3 Activity Aspects

Table 3. Activity Ratio

Ratio	2018	2019	2020	2021	2022
Average Collection Period	80	159	86	48	28
Average Age of Inventory	405	486	404	278	303

Source: Processed Data, 2023

The activity ratio aspects are shown in days to determine how long it took for a certain activity to generate cash. From the average collection period, we can see that the accounts receivable collection has improved within the past five years, with the average collection period being 48 days in 2021 and 28 days in 2022. This was due to the decrease in accounts receivable in 2022; meanwhile, the improvements in account receivable collection in 2021 were due to the increasing net sales. Subsequently, the average inventory age has fluctuated over the past five years. It took approximately a year for the firm to generate cash from the sales of its inventories. A long average age of inventory and the low quick ratio results from the table could lead to a liquidity issue if the firm cannot generate adequate cash fast enough to pay its current liabilities.

1.4 Solvency Aspects

Table 4. Solvency Ratio

Ratio	2018	2019	2020	2021	2022
Debt-to-Equity	0.88	1.05	0.98	0.87	0.85
Debt-to-EBITDA	3.28	4.03	3.26	2.53	5.64
Interest Coverage Ratio	3.46	2.76	3.24	4.12	2.31
Debt Service Coverage Ratio (DSCR)	3.46	2.22	1.95	2.36	1.59

Source: Processed Data, 2023

The firm's Debt-to-Equity ratio has remained similar throughout the past five years. The ratios generated throughout the years are mostly <1, indicating that the firm relies mostly on equity financing, although the proportions of debt and equity financing used are almost equal since the ratios are close to 1. Banks often include the debt-to-EBITDA ratio in loan covenants for bank loans because it can determine whether the firm's EBITDA earnings can pay its debts (Kenton, 2020). The Debt-to-EBITDA ratio seems to be fluctuating, and although the Debt-to-EBITDA ratio improved in 2021, it then worsened in 2022 due to lower EBITDA earnings for the year in comparison to the previous year and the firm's increasing long-term and short-term debts. From the coverage ratios, such as Interest Coverage Ratio and DSCR, the company shows good effort in repayment capability and can meet its financial obligations.

The Interest Coverage Ratio shows that the firm can pay the interest due on the outstanding debt from the EBITDA proceeds. The Debt Service Coverage Ratio (DSCR) of >1 indicates that the firm has adequate cash flow from EBITDA to pay off its debt payments. Although the DSCR and Interest Coverage Ratio plummeted in 2022, they can still generate enough cash flow from EBITDA to pay their debts and interest due.

2. Compliance with Financial Loan Covenants

Subsequently, this section will analyze the ratios generated towards the firm's compliance with financial loan covenants from existing bank loans and bond issuance. The result will then determine whether or not the firm indicates a loan covenant breach, which may affect the firm's debt repayment capability.

2.1 Bank ABC Loan Covenants

Table 5. Bank ABC Loan Covenants

Ratios	Threshold	Firm's Performance (2022)	Evaluation Breach Indication
Current Ratio	Min. 1x	2.43	Maintained
DSCR	Min. 1x	1.59	Maintained
Debt-to-Equity	Max. 2.5x	0.85	Maintained

Source: Processed Data, 2023

The firm has managed to maintain all of the ratios applied by Bank ABC. As seen in the table, the firm can maintain and even surpass the threshold applied by the bank. As stated on the financial statements, the firm has paid the principal installments of long-term debt amounting to Rp 66,875,000,000 in 2022 and Rp 9,843,750,000 in 2021, which means it can still pay its obligations towards Bank ABC.

2.1 Bank DEF Loan Covenants

Table 6. Bank DEF Loan Covenants

Ratios	Threshold	Firm's Performance (2022)	Evaluation Breach Indication
Current Ratio	Min. 1x	2.43	Maintained
Debt-to-EBITDA	Max. 4.5x	5.64	Breach
Interest Coverage Ratio (EBITDA-to-Interest)	Min 1.25x	2.31	Maintained

Source: Processed Data, 2023

As seen in Table 6, there has been an indication of a financial loan covenant breach in the Debt-to-EBITDA ratio. The company's performance of debt-to-EBITDA ratio in 2022 is 5.64x; meanwhile, the threshold applied by Bank DEF in the financial loan covenant is 4.5x. This could happen as, in 2022, the decline in sales affected the company's financial performance, as reflected in ratios, to be worsened. The earnings from EBITDA decreased; meanwhile, the company has obtained more debt. Therefore, with the increase of debt and decreasing EBITDA earnings, the debt-to-EBITDA ratio weakened, leading to a breach in the debt-to-EBITDA ratio in the financial loan covenant. The firm needs to be able to increase its earnings and optimize allocations of cash in the next period in order to maintain the financial loan covenant thresholds in Debt-to-EBITDA ratio by cutting several operating expenses, such as selling expenses that are increasing as well as converting their inventories into cash more effectively. Unfortunately, no information is mentioned regarding the payment of principal installments for Bank DEF. However, the "Compliance to Loan Covenants" section of the financial statement states that the company has acquired the waivers as necessary in terms of a covenant breach.

2.2 Bank GHI Loan Covenants

Table 7. Bank GHI Loan Covenants

Ratios	Threshold	Firm's Performance (2022)	Evaluation Breach Indication
Current Ratio	Min. 1x	2.43	Maintained
DSCR	Min. 1.25x	1.59	Maintained
Debt-to-Equity	Max. 1x	0.85	Maintained

Source: Processed Data, 2023

The firm and its subsidiaries can still maintain the financial ratios per the threshold set by Bank GHI. As mentioned in the financial report, it is mentioned that the firm has paid Rp 8,000,000,000 in 2022

and 2022 towards the principal installments. It is also stipulated in the "Subsequent Events" section of the annual report that on January 2, 2023, the firm managed to pay off the revolving time loan credit facility. Both events indicate that the firm can still repay the debt towards Bank GHI.

2.3 Bank JKL Loan Covenants

Table 8. Bank JKL Loan Covenants

Ratios	Threshold	Firm's Performance (2022)	Evaluation Breach Indication
Debt-to-EBITDA	Max. 3.5x	5.64	Breach
Inventory Turnover	Max. 500 days	303 days	Maintained
Trade Receivables Turnover	Max. 120 days	28 days	Maintained
DSCR	Min. 1.25x	1.59	Maintained

Source: Processed Data, 2023

The table shows a loan covenant breach in the debt-to-EBITDA ratio. The firm's debt-to-EBITDA ratio in 2022 reached 5.64x, whereas the threshold of debt-to-EBITDA ratio applied by Bank JKL in the financial loan covenant is 3.5x. Similarly to the covenant breach in compliance with Bank JKL loan covenants, the breach in the Debt-to-EBITDA ratio was due to the weakened financial performance where the amount of debt obtained increased while their EBITDA earnings decreased. The firm needs to maintain its performance in debt-to-EBITDA by increasing its earnings and optimizing its cash allocations. Despite the covenant breach in debt-to-EBITDA ratios, the firm has paid principal installments of Rp 13,333,333,334 in 2022 and Rp 12,975,984,174 in 2021. Additionally, as stipulated in the "Subsequent Events" section of the annual report, it is mentioned that the firm has paid off credit facilities from Bank JKL. By paying off the credit facilities obtained, it can be concluded that the firm can more than meet the debts from Bank JKL.

2.4 Bank MNO Loan Covenants

Table 9. Bank MNO Loan Covenants

Ratios	Threshold	Firm's Performance (2022)	Evaluation Breach Indication
Interest Coverage Ratio (EBITDA-to-Interest)	Min. 1.25x	2.31	Maintained
Debt-to-Equity	Max. 3x	0.85	Maintained

Source: Processed Data, 2023

As the trustee in issuing bonds and sukuk mudharabah, Bank MNO applied a financial loan covenant for the firm to comply. Based on the table, the firm has managed to maintain all financial loan covenants from Bank MNO in issuing bonds and sukuk mudharabah. The current maturities in 2021 for Bonds and Sukuk Mudharabah are Rp 42,180,000,000 and Rp 52,500,000,000, respectively. Subsequently, the outstanding balance of interest expense at the year-end for 2022 is Rp 12,005,833,333 and Rp 13,236,120,833 for 2021.

D. CONCLUSION

The research found that the decline in sales in 2022 affects the firm's overall financial performance in 2022, as reflected by the ratios that show that it weakened and plummeted in 2022. In terms of profitability, there seems to be a declining trend over the past five years. However, the firm is still able to generate profit. The firm may also face a liquidity issue; from the current ratio, its current assets can still meet its current liabilities. However, remember that the firm's current assets consist mostly of its inventories; therefore, the quick ratio shows that its most liquid assets, such as cash and cash equivalents, are insufficient to cover its current liabilities. It also took a long time for the firm to generate cash from activities of inventory sales.

Regarding solvency, the debt-to-EBITDA ratio plummeted in 2022 due to decreasing earnings and increasing debt. Although the firm's solvency performance plummeted in 2022, the firm shows good performance in repayment capability, as seen from Interest Coverage Ratio and DSCR. From the evaluation of compliance to loan covenants applied by banks and evaluation of debt principal payments, it can be said that even though there is an indication of a covenant breach, the firm can still pay off its obligations in the payment of debt principal and its interest.

The firm needs to improve its financial performance, especially earnings, in the upcoming period since it needs to pay more obligations, such as for the maturity of loans, bonds, and sukuk mudharabah, as the sales decline has affected the overall financial performance. Creditors of PT XYZ, on the other hand, need to be able to monitor further and evaluate the firm's financial performance. In the event of a financial loan covenant breach, creditors must be able to evaluate the covenant breach to determine the firm's risk. Creditors tend to raise interest rates and impose stricter loan covenants in newly issued loans following a loan covenant violation in the previous credit agreement (Demiroglu & James, 2010).

For future research, it is wise to be able to analyze the firm's financial performance in the upcoming year, as the firm's performance may improve or even weaken. It is also interesting to see how compliance with financial loan covenants may affect other variables, such as interest rates applied by banks as debtors and the change in credit facilities or the outstanding limit of the credit facilities.

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