

## *Factors behind The Early Signs of Financial Distress in An Indonesian Medical Device Company During Covid-19: A Case Study of PT Cakra Medika Utama*

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### **ABSTRAK**

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Tujuan dari penelitian ini adalah untuk menyelidiki fenomena anomali penurunan kinerja keuangan sebagai tanda awal dari kesulitan keuangan di sebuah perusahaan alat kesehatan di Indonesia, PT Cakra Medika Utama ("CMU") untuk periode 2020-2021, di saat pertumbuhan sektor industri alat kesehatan nasional secara agregat meningkat. Studi eksplanatori ini menggunakan pendekatan metode campuran yang menganalisis data kuantitatif dan kualitatif yang dikumpulkan melalui wawancara semi-terstruktur yang mendalam dengan CEO dan karyawan, observasi, dokumentasi, dan studi literatur. Hasil dari penelitian ini menemukan bahwa penurunan kinerja keuangan disebabkan oleh kesalahan pengelolaan hutang dan piutang, kurang memanfaatkan momentum penjualan, ketergantungan yang tinggi pada pemasok asing, dan model bisnis yang lemah. Penelitian ini memberikan kontribusi kepada perusahaan, industri alat kesehatan, dan literatur yang ada dalam memahami penyebab dan faktor-faktor yang berkontribusi di balik penurunan kinerja keuangan CMU, termasuk beberapa strategi untuk mencegah terjadinya kesulitan keuangan.

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### **ABSTRACT**

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*The objective of this study is to investigate anomalous phenomena of declining financial performance as early signs of financial distress in an Indonesian medical device company, PT Cakra Medika Utama ("CMU") for the period of 2020-2021, whereas the growth of nationwide medical device industry sector has been escalating aggregately. This explanatory study adopts mixed methods approach which analyzes quantitative and qualitative data collected through in-depth semi-structured interviews with the CEOs and its employee, observation, documentation, and literature studies. The results of this study discover that the declining financial performance were caused by mismanagement of payable and receivable, underutilizing the sales momentum, high dependency on foreign suppliers, and a weak business model. This research contributes to the company, the medical device industry, and the existing literature in understanding the causes and contributing factors behind the sinking financial performance of CMU, including some strategies to prevent the financial distress from truly happening.*



## INTRODUCTION

The aim of this paper is to scrutinize the conflicting phenomenon between net income and operating cash flows along with the anomalous downfall of sales growth of an Indonesian medical device company, PT Cakra Medika Utama ("CMU"), during the Covid-19 crisis. This company is a part of Health and Social Activities Sector, an industry sector which constantly made the highest Gross Domestic Product ("GDP") growth in the country and did not get affected – even benefitted by the pandemic.

Firms could not survive in the market if they do not make stable profit, hence management of the firm should try all possible actions related to the economic resources in generating income (Lim & Rokhim, 2020). The main reason is that continuance of a firm mainly relies on its capability to function profitably and maintain the cash outflows (Lee et al., 2017). As the Covid-19 arose, many people in multiple countries were impacted profoundly and economic core was knocked on both the demand and supply side (Fang et al., 2023). However, the effect actually differed from one industry to another.

Indonesian Central Bureau of Statistics noted that the cumulative economic growth of Indonesia declined 2,07% by 2020 and grew 3,69% by 2021. During these periods, the GDP of Health and Social Activities Sector flew up at 11,6% and 12,16% in 2020 and 2021 respectively. The growth domination was caused by the surging demand of medical devices and pharmaceuticals during this outbreak. Considering the condition, the Indonesian Government even decided on investing heavily in medical research programs and stockpiling immune-boosting vitamins, supplements, and drugs, as well as prioritized the medical devices and pharmaceuticals sector in "Making Indonesia 4.0" (Badan Koordinasi Penanaman Modal, 2022). This urgency of Industry 4.0 adoption was also recognized by governments around the world to slow down the spread and to treat the infected cases (Lepore et al., 2022).

The euphoria of flooding demand and skyrocketing cost of sales at the beginning of the pandemic was also experienced by CMU. As of 2020, the company earned a net profit of IDR 4,2 billion or an increase of 17% from 2019, while the operating cash flow decreased by 66% to IDR 2,9 billion. This inverse condition was primarily caused by the multiplying cost of sales as in payments to suppliers and additional investment in the form of fixed assets. In this case, timing difference becomes one thing that causes the contrast position between profit and cash flow. This situation got worst in 2021, where CMU faced a fall of 94% in net profit to IDR 245 million with a decline of 7% in operating cash flow to IDR 2,7 billion.

This research contributes to the existing knowledge in several ways. First, the gap between the nationwide industry growth and CMU earnings growth itself has become a big question and a great challenge for the company. Second, literature study is conducted to get the idea on determinants affecting the declining financial performance as the early signs of financial distress. Third, this study collects secondary data of CMU like financial statement, as well as primary data deriving from some interviews with the persons in charge. Fourth, a

descriptive study is carried out to convey the causes of the downfall of CMU's financial performance. Fifth, the results are summarized and concluded.

The remaining parts of this paper are arranged in the following sections. Section 2 describes the methods of data collection and data analysis. Section 3 provides the results of this research that elaborate the reasons and causes of the declining financial performance faced by CMU. Section 4 is the conclusion of all findings and management recommendations for CMU.

## LITERATURE REVIEW

### DuPont System

DuPont analysis is a structure for analyzing the basic performance of a company popularized by DuPont Corporation. The formula was originally developed by DuPont employee, F. Donaldson Brown in 1914, where he combined income, investment, and working capital into a single figure called return on investment ("ROI"). DuPont analysis is also useful for separating the financial activity component from return on equity ("ROE") (Hargrave, 2022).

Harrison et al. (2013) on the other hand explained that DuPont analysis is a detailed study of return on total assets ("ROA") and ROE. The ultimate mission of DuPont analysis is to explain ROE in detail by dividing it into three elements: return on sales, asset turnover, and leverage. The combination of the first two elements is useful to derive the rate of return on total assets (ROA). When the last element (leverage) is incorporated into the DuPont model, it forms the return on common shareholders' equity (ROE).

The application of the DuPont System can be used to compare the operational efficiency of two similar companies and to determine a company's strengths and weaknesses (Hargrave, 2022). There are three things that affect ROE (Ross et al., 2016):

1. Operating efficiency, which is calculated by profit margin and shows the company's ability to manage its expenses to maximize profits.
2. Asset use efficiency, which is calculated by total asset turnover and shows the company's ability to manage its assets to generate profits.
3. Financial leverage, which is calculated by equity multiplier and reflects the use of debt in funding the company's assets.

### Porter's Five Forces

Based on Rothaermel (2021), the Five Forces model was proposed by Michael Porter to assist in understanding the potential advantages of various industries and how to position one's own company to achieve and maintain competitive advantage. Porter's five forces model is based on two important observations:

1. Competition is seen in a broader context, ie. from buyers, suppliers, potential entry of other competitors, and threats from substitute companies.

2. Five competitive forces affect profit potential, ie. the threat of new entrants, supplier power, buyer power, threat of substitutes, and competition among existing firms.

As a rule of thumb, the stronger the five forces, the lower the profit potential of the industry. Conversely, the weaker the five forces, the greater the industry's profit potential (Rothaermel, 2021). These five forces consist of (Porter, 2008):

1. The threat of new entrants entering the industry, which can pressure the industry in two ways. First, it reduces overall industry profits. Second, it increases the expenditures of surviving firms. However, this threat can be mitigated by entry barriers such as economies of scale, customer switching costs, capital requirements, and government policies.
2. Supplier power, which reduces a firm's ability to earn profits because first, strong suppliers can increase production costs by demanding higher input prices or by reducing the quality of input factors provided. Secondly, strong suppliers are a threat to the firm as they reduce the profit potential of the industry by taking away part of the economic value created.
3. Buyer power, where the pressure from customers can exert affects sellers' margins by demanding lower prices or higher product quality. Therefore, strong buyers can reduce potential industry profits and corporate profits.
4. Threat of substitutes, where available products or services from outside of a particular industry can fulfill or replace current customer needs. The threat of substitute products is high when substitute products provide attractive price and performance trade-offs, as well as low costs incurred by buyers to switch to substitute products.
5. Competition among existing competitors. The higher the strength, the higher the expected intensity of competition, which will ultimately limit the potential profitability of the industry. Competitors may lower prices or use value-adds (such as product features and design, quality, promotion, service) to attract customers away from their competitors.

### **Early Signs of Financial Distress**

Generally, the essence of financial distress is a downturn in financial efficiency marked by a cash deficit (Karugu et al., 2018). In a similar way, financial stress exists when operating cash flow is insufficient to settle up liabilities. Consequently, a financially distressed firm that is able to generate a positive operating cash flow will be seen as low risk and can endure financial problems (Lee et al., 2017). Further, it is also reported that investors are more worried with the accessibility of operating cash flow for the company than earnings in a financially distressed firm. In the case of CMU, the operating cash flow keeps on decreasing from 2020 until recently, causing concern for management and shareholders.

Company that struggles with financial distress is caused by three reasons. First, high cash disbursement to pay interest from loan. Second, low cash receipt due to inferior operational efficiency compared to other companies in industry. Last, a declining industry (Setyawati & Amelia, 2018). Point one and two is relevant to CMU case, as the firm paid large amount of investment credit for the new buildings and its operational performance declined during Covid-19 pandemic. This is coherent with preceding papers which identified internal and external factors of financial distress; internal factor such as weak management performance and external factor such as financial crisis or a pandemic (ElDeeb & Ramadan, 2020; Karugu et al., 2018).

Financial distress or declining financial performance can be caused by poor operating performance and high financial leverage, lack of technological innovation, liquidity and funding shocks, relatively high rate of formation of new businesses in certain periods, deregulation of major industries, and unforeseen liabilities (Altman et al., 2019). When a firm is severely short of internal cash due to high external financing, the firm's investment becomes more sensitive to its cash flow (Beladi et al., 2021).

Bukhori et al. (2022) further explained that the high level of sales will increase the potential profit that will be obtained by the company and has the potential to raise cash so that the company can meet the burden of its obligations to reduce the occurrence of financial distress. In dealing with the symptoms of declining financial performance and preventing financial distress, companies can take several actions such as: (1) selling main assets, (2) merging with other companies, (3) reducing capital expenditures and research and development, (4) issuing new shares, (5) negotiating with banks and other creditors, (6) exchanging debt for equity, or (7) filing bankruptcy (Ross et al., 2015).

## METHODS

The object of this study is PT Cakra Medika Utama ("CMU"), a company associated in the medical device industry sector. Although established in 2007, CMU started its business by selling clinical laboratory consumer products under the name Thermalindo Jaya in 1998. CMU currently has 3 (three) main parts in its business: in- vitro diagnostics (IVD), medical devices, and endo-surgery.

Referring to De Massis & Kotlar (2014), this study is an explanatory case study type, which aims to understand why and how a phenomenon can occur. Furthermore, this study is classified as a single case study, which is generally chosen because the case studied is an unusual or extreme example or because it has access to unusual research (De Massis & Kotlar, 2014). This case was chosen for these two reasons. First, the condition of CMU became an anomaly amidst the peak growth in the health sector. Second, there is a high level of access to the company for research.

Data collection techniques represent a fundamental part of a research because they have the main mission of obtaining data (Sugiyono, 2019). This research combines secondary data in the form of CMU's financial reports 2020-2021 and primary data from interviews in confirming things that presumably

cause the declining financial performance. The semi-structured interviews are carried out with 25 open questions to 3 (three) informants in finding out and analyzing what factors influenced the inclining financial performance of CMU during Covid-19 pandemic.

The data collected is then analyzed based on some theories and results of previous studies. Furthermore, this method can assist researchers in understanding the best strategy for CMU in dealing with the risk of declining operating profits and cash flow.

## RESULTS

CMU, as a medical device distributor company, experienced positive and constant sales growth from year to year, as well as in terms of net profit for 5 (five) years before the Covid-19 pandemic occurred. The decrease in operating cash flow only occurred in 2016, due to the purchase of 2 (two) warehouse buildings worth IDR 9.3 billion. Other than 2016, the operating cash flow continued to experience constant growth.

This supports the fact that CMU's performance before the Covid-19 pandemic throughout 2015-2019 was indeed better than the performance during the pandemic in 2020-2021. Therefore, the study aims to investigate the causes and determinants that result in CMU's early signs of financial distress during the pandemic. This condition is an anomaly considering that in aggregate, the market size of the medical device industry has escalated during the Covid-19 pandemic due to increased public needs and demand.

Based on the data collected, there are 4 (four) major reasons of the declining financial performance as explained further below.

### **Mismanagement of Payables and Receivables**

Based on Table 1, CMU's receivable and payable turnovers are quite high, they show that CMU was actually fast in paying off its payables and receivables. However, if we look further, the payable turnover ratio is much higher than the receivable turnover ratio in both 2020 and 2021. This indicates that CMU paid debts much faster than receiving receivable payments and therefore, cash flow would automatically be disrupted. At the beginning of the Covid-19 period in 2020, CMU experienced 47.59% sales growth, but experienced a 66% decrease in operating cash flow. This contrasting phenomenon was caused by purchasing inventory from vendors with full payment terms in advance before the goods were delivered.

Based on management confirmation, CMU did pay debts quickly in accordance with the credit terms given by suppliers and creditors. Not only trade debts, but also long-term debts. The aim is to maintain credibility and obtain funding from banks easily. For uncollectible trade receivables, CMU has conducted regular follow-ups to customers. However, CMU cannot accelerate the term of payment due to strong customer concentration in this industry, so

customers will easily switch to competitors if CMU provides a short payment term.

**Table 1. Financial Ratios of CMU (2020-2021)**

Rasio		CMU	
		2021	2020
A.	Sales current year	43.072.919.685	58.430.963.604
	Sales previous year	58.430.963.604	39.589.990.998
	<b>Sales growth</b>	<b>-26,28%</b>	<b>47,59%</b>
B.	Net sales	244.676.365	4.195.569.902
	Sales	43.072.919.685	58.430.963.604
	<b>Net profit margin</b>	<b>0,57%</b>	<b>7,18%</b>
C.	Net sales	244.676.365	4.195.569.902
	Sales	43.072.919.685	58.430.963.604
	Total assets	57.194.031.503	54.839.703.902
	Total equity	27.654.105.230	29.596.690.898
	<b>Asset turnover</b>	<b>0,75</b>	<b>1,07</b>
	<b>Equity multiplier</b>	<b>2,07</b>	<b>1,85</b>
D.	Total liabilities	29.539.926.273	25.243.013.004
	Total equity	27.654.105.230	29.596.690.898
	<b>Debt-equity ratio</b>	<b>1,068</b>	<b>0,853</b>
E.	Cash and equivalents	78.532.639	467.219.530
	<b>Current liabilities</b>	<b>18.428.085.506</b>	<b>16.206.633.251</b>
	<b>Cash ratio</b>	<b>0,004</b>	<b>0,029</b>
F.	Cost of sales	27.521.861.833	35.906.430.215
	Inventory current year	14.772.736.560	14.416.930.408
	Inventory previous year	14.416.930.408	11.124.881.557
	<b>Inventory turnover</b>	<b>1,886</b>	<b>2,812</b>
G.	Sales	43.072.919.685	58.430.963.604
	Receivable current year	3.676.010.569	8.540.163.927
	Receivable previous year	8.540.163.927	5.715.569.222
	<b>Receivable turnover</b>	<b>7,052</b>	<b>8,198</b>
H.	Purchase	27.877.667.985	39.198.479.066
	Utang usaha tahun ini	1.859.314.225	2.570.655.242
	Utang usaha tahun sebelum	2.570.655.242	1.967.569.607
	<b>Payable turnover</b>	<b>12,586</b>	<b>17,275</b>

Source: Financial Statement of CMU 2020-2021, processed

There are several actions that CMU can take to improve company's payables and receivables management:

- Evaluate customer payment terms. For customers who pay debts more than the specified period, late fees can be applied.
- Determine the maximum limit of the percentage of uncollectible receivables from total purchases for each customer. If it has exceeded the maximum limit, CMU can restrict the sale of goods to that customer, unless the customer wants to make cash purchases.
- Evaluate inventory purchases. CMU can reduce the quantity of inventory purchases by ordering inventory stock for a shorter period. For example, previously CMU used quarterly sales averages to estimate inventory purchases for the next 9 months. Now, CMU can purchase inventory with an estimated inventory for the next 6 months, to reduce purchases and balance payable turnover and receivable turnover.
- Negotiate with suppliers for a payment-by-term policy. This negotiation was done to prevent full payment upfront, so that cash flow is better maintained.

### **Underutilizing the Sales Momentum**

Referring to Table 1, CMU has a fairly low inventory turnover. The small number of this ratio indicates that the movement of inventory from the beginning of the purchase until it is finally sold is quite slow. This situation indicates CMU's poor supply chain efficiency due to management not taking advantage of the momentum of medical device sales during the Covid-19 period. When some countries were hit by this new virus in late 2019, the management was still hesitant to invest in Covid-19 products and still focused on stocking in-vitro diagnostics laboratory equipment, medical devices, and endo-surgery.

The early Covid-19 pandemic era became a valuable momentum for medical device companies to sell the stock of medical devices related to Covid-19, such as medical masks, antigen swabs, PCR swabs, and personal protective equipment - where the demand was high, supply was limited and the price was multiplying. As a result of focusing on laboratory equipment stock instead of stocking up the Covid-19 devices, CMU also lost the opportunity to sell its inventories when market prices were at the highest.

In the case of CMU, antigen swab were acquired when prices were soaring and led to high inventory values. Unfortunately, CMU did not manage to sell the entire stocks of mask and antigen swab when prices were still soaring. As a result, CMU now has to sell the remaining masks and antigen swabs at low prices due to the fallen market price of masks and antigen swabs. This causes cash inflows to not offset cash outflows when purchases occur, and ultimately results in losses to CMU.

Furthermore, inventory turnover in a supply chain is inversely related to product expiration. The slower an inventory item moves, the faster it will move towards its expiration date. Conversely, when an inventory item moves quickly in the supply chain, the remaining expiration time of the item will be longer. As explained earlier, the Covid-19 pandemic restriction policy has resulted in reduced demand for laboratory tests and endo-surgery.

People had a fear of going to the hospital for a general check-up or laboratory test if they do not have the urge to. Before Covid, many companies held annual medical check-ups ("MCUs"), but during Covid, no companies conducted MCUs anymore. This condition made the stock of laboratory equipment accumulated during Covid-19 and caused many equipment to expire. This contributed to losses in CMU's financial statements.

To improve inventory turnover, CMU can implement the following ways:

- Conduct inventory forecasting based on past transactions so as not to accumulate inventory in the warehouse. CMU can reduce inventory purchase quantity by ordering inventory stock for a shorter period. For example, previously CMU ordered inventory stock for the next 9 months. Now, CMU can reduce purchases by ordering supplies for the next 6 months.
- Improve product marketing that is right on target, by making discount promos if buying in certain quantities and also implementing loyalty programs.



### **High Dependency on Foreign Suppliers**

10 out of 12 CMU's suppliers are foreign companies. During the pandemic, it is known that the supply chain changed completely, especially when lockdowns occurred in various countries. This condition certainly affects the import transaction of goods, where there are no flights and shipping between countries, as well as the lack of slots if any transportation is operating. As a result, airfreight prices have become very expensive, in 2020 soaring to 30% of Freight on Board ("FOB") while before Covid it was only around 5-7% of FOB. Nonetheless, CMU was not able to increase the price straight away because there was a price contract with each customer. Thus, it is known that CMU absorbed any losses on the increase in shipping cost.

Another factor is foreign exchange losses. As 83% of CMU's suppliers are foreign companies, CMU imports goods in United States Dollars ("USD") currency, which are then resold to the Indonesian market in Indonesian Rupiah ("IDR") currency. When the IDR weakens as the goods are sold, it will cause foreign exchange loss that will be absorbed by CMU. As mentioned before, CMU could not change the selling price to customers who have previously had contracts.

To protect itself from the danger of fluctuating currency prices, a company that has partnered with businesses abroad should begin to consider hedging. CMU can use forward contracts to lock in import prices in the future to anticipate the impact of foreign exchange losses due to dependence on foreign suppliers. In this case, the use of forward contracts is to hedge the risk of exchange rate fluctuations, so that CMU can lock in the company's profits.

In addition to shipping costs and exchange rate differences, the dependence on imports from foreign suppliers is also related to the implementation of government policies related to the Domestic Component Level ("TKDN"), which requires at least 60% of locally produced medical device. This also has an impact on CMU's sales to the government institutions which are hampered because most of the products sold by CMU are foreign imported products. The reason why CMU does not attract domestic suppliers is that management sees that the domestic products are actually repackaged foreign products and the margins provided by domestic suppliers are too small. The management considers that most of local medical devices are not suitable for the society. For example, imported syringes are more comfortable to use than local syringes because the needles are thinner. This point was considered risky by management as it could disrupt the company's sales and cash flow. Therefore, CMU decided to build a factory to produce its own higher quality medical devices.

Furthermore, sales of medical devices to the government must also go through E-Catalog, where medical device companies register themselves and their products in one government portal. In that portal, companies are required to enter the invoice price, the PIB price from the manufacturer, and the landed cost price (the total cost that covers the purchase process until the goods arrive

at our place). Generally, the Ministry of Health requests a price of 35% of the landed cost, which will be the price before VAT. To address this issue, CMU is currently building a factory for domestic production of medical devices, which is expected to increase sales, especially to the government. Thus, CMU can produce its own medical devices with the desired quality size and can avoid losses due to increased shipping costs and exchange rate fluctuations.

### **Weak Business Model**

Based on the interview results with CMU management, the company often incurs training costs and product demos to many hospitals. Product demos are carried out as a form of marketing strategy so that the target market recognizes the products marketed by CMU. However, many hospitals ended up not buying the products offered by CMU. In improving the effectiveness of training and product demos, CMU can consider to create interesting and attractive product demos, such as animations of products explanations, demos, and procedures for the medical devices offered. This method can help CMU in terms of providing better understanding and reducing training time and costs. Thus, CMU can reduce sales costs and increase revenue.

On the other hand, CMU should only provide training to customers who have purchased the medical devices offered, not the other way around. If a potential customer requests CMU to provide training, CMU should make a contractual agreement that requires the recipient of the training to purchase the equipment used during the training. This is to avoid deficits due to training costs incurred.

In terms of customer segments, CMU's current customers include private hospitals, government hospitals and sub-distributors. Until 2021, CMU has not made any sales to the government other than to the Regional General Hospital ("RSUD"). The management realizes that doing business transactions with government agencies is not an easy thing, especially if there is no internal channel or access. Despite the sales to government organizations through E-Catalog, CMU has not had the opportunity to make large transactions directly to government institutions such as the Ministry of Health or PMI.

In terms of products, the medical devices offered by CMU are less diverse when compared to its competitors. Based on the results of interviews with CMU management, it is known that CMU does not diversify sales products into vitamins/supplements or vaccine coolers because the sale of vitamins requires a distribution license that is different from medical devices, and the submission of licenses to the Food and Drug Administration. The application is considered very complicated and not worth it, considering CMU's core business is not in the direction of medicine. Meanwhile, CMU does not sell vaccine coolers considering that vaccine coolers are slow moving items, where one hospital usually only buys 1-2 devices within 5 (five) years.

The tense competition in the medical device industry makes CMU should remain creative and innovative in developing and marketing the products. CMU needs to set a strategy to survive in this industry. If the cost leadership strategy

cannot be implemented, then CMU can carry out a differentiation strategy by highlighting unique and different values from its competitors, or a combination of both strategies. Currently, CMU is producing its own new laboratory test kit that covers many diseases at a low price, which will be the first of its kind in the Indonesian market. CMU should also implement a combination of cost leadership and differentiation strategies for in-house manufactured products.

## CONCLUSION AND SUGGESTION

The results of this study concluded that the decline in CMU's financial performance was not entirely caused by the pandemic, but was also caused by several internal factors, namely:

- Mismanagement of payables and receivables, where the period of payment of trade payables is shorter than the period of receipt of customer receivables. The high level of long-term debt such as working capital loans and investment loans resulted in increased interest costs borne by CMU.
- Underutilizing the sales momentum during the peak of the Covid-19 pandemic, so now CMU has to sell at a loss the accumulated inventory.
- High dependence on foreign suppliers resulting in increased shipping costs and foreign exchange losses, and a reduced portion of sales to the government. Changes in suppliers led to reduced regular sales to repeat customers.
- Weak business model, with CMU spending on ineffective training and product demos to many hospitals. In addition, human resources lacking expertise was also one of the problems at CMU.

Future studies are encouraged to further explore literature and previous research relevant to factors behind a declining financial performance or the early signs of financial distress. Additionally, it is recommended for the future research to deeper analyze the unidentified problems and its causes by conducting follow-up interviews.

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