CHAPTER I

INTRODUCTION

1.1. Background of The Study

The manufacturing industry is an important engine of Indonesia's economic growth. According to (Yogatama, 2024), this industry has consistently demonstrated positive growth and contributes significantly to the nation's GDP. Faced with rising competition both domestically and internationally, manufacturing companies must adopt effective financial strategies to ensure future profitability and sustainability. As the economy expands, manufacturing activity intensifies, requiring substantial financing to sustain growth. Consequently, many companies in this sector rely on financing instruments such as leverage to support both operational activities and expansion efforts.

Leverage is a financial strategy used by companies to increase capital by utilizing debt, with the hope of increasing profit potential. Leverage can increase profits, but it also creates financial risks (Vecernikova et al., 2020). In the context of manufacturing enterprises that are listed on the Indonesia Stock Exchange (IDX), leverage is often used to finance operational expansion, purchase of new assets, or increase production capacity. The use of debt can provide quick access to the necessary funds without having to rely on the company's internal equity. The impact of leverage on profitability largely depends on how efficiently borrowed funds are used. Challenges arise when firms fail to manage debt effectively, increasing the risk of bankruptcy, and lowering profitability (Lamba & Atahau, 2022).

The evaluation of a corporation's financial performance heavily depends on its profitability, especially in assessing its capacity to generate earnings from its assets. Profitability had measured use indicators like Return on Equity (ROE) and Return on Asset (ROA), which show how efficiently the corporation uses its assets or equity to make profits (Ikram & Zainul, 2023). Maintaining steady profitability presents a significant challenge for industrial companies listed on the *Bursa Efek Indonesia*, as they are influenced by worldwide market changes, variations in raw material costs, and significant investments needed to improve production capability.

Leverage or use of debt to finance business expansion, is often the main strategy used by companies to increase profitability. Proper leverage can increase profitability if the funds obtained from loans are used productively in profitable operations. However, excessive leverage can have an effect on profitability. When the interest expense exceeds the profit earned by the investment, profitability is reduced, limiting the company's capacity to use its assets efficiently (Sari et al., 2021). As a result, company management must strike a balance between using leverage to boost profit potential and mitigating the financial dangers that may occur.

Table 1. 1 Research Phenomenon

Company Name	Code	Year	Leverage	Profitability
PT. Unggul Indah Cahaya Tbk	UNIC	2019	0.247	0.056
		2020	0.219	0.114
		2021	0.216	0.199
		2022	0.155	0.121
		2023	0.154	0.067
PT. Delta Djakarta Tbk	DLTA	2019	0.175	0.223
		2020	0.202	0.101
		2021	0.296	0.144
		2022	0.306	0.176
		2023	0.293	0.165

Table 1. 1 Research Phenomenon (Continue)

Company Name	Code	Year	Leverage	Profitability
PT. Mulia Industrindo Tbk	MLIA	2019	1.273	0.022
		2020	1.145	0.010
		2021	0.761	0.107
		2022	0.518	0.125
		2023	0.415	0.080

Prepared by: Author (2024)

Over the past few years, there has been a noticeable trend in Indonesian manufacturing companies when it comes to the leverage phenomenon and its impact on profitability. Leverage, commonly assessed through the debt to equity ratio (DER), has frequently utilized as means to facilitate business expansion, particularly within the capital-intensive manufacturing industry. Nevertheless, elevated levels of debt do not always result in favorable outcomes for profitability, as indicated by the return on assets . Analysis of data from various manufacturing firms listed on the IDX, including PT. Unggul Indah Cahaya Tbk (UNIC), PT. Delta Djakarta Tbk (DLTA), and PT. Mulia Industrindo (MLIA), reveals that fluctuations in DER do not consistently align with changes in ROA.

For instance, in the case of PT. Unggul Indah Cahaya Tbk (UNIC), DER declined from 0.247 in 2019 to 0.154 in 2023. This reduction in DER initially coincided with an increase in ROA, from 0.056 in 2019 to 0.199 in 2021, suggesting that reduced leverage can support higher profitability. However, after 2021, even though DER remained low (at 0.154 in 2023), ROA dropped significantly to 0.067. This indicates that a low DER does not always guarantee improved profitability, as other factors may also influence the company's performance.

Meanwhile, at PT. Delta Djakarta Tbk (DLTA), DER rose from 0.175 in 2019 to 0.306 in 2022, then slightly decreased to 0.293 in 2023. Initially, this increase in DER was accompanied by a drop in ROA, from 0.223 in 2019 to 0.101 in 2020, indicating that higher leverage can weigh down profitability. However, in the subsequent years, as DER peaked at 0.306 in 2022, ROA actually improved to 0.176, only slightly dipping to 0.165 in 2023. This suggests that DLTA may have managed to utilize its leverage more effectively in recent years, thus sustaining or even enhancing its profitability.

As for PT. Mulia Industrindo Tbk (MLIA), DER saw a sharp decline from 1.273 in 2019 to 0.415 in 2023. Initially, the company experienced very low ROA, at 0.022 in 2019, which dropped further to 0.010 in 2020, likely due to the high debt burden. However, as DER dropped significantly, ROA started to increase, reaching 0.125 in 2022, though it slightly declined to 0.080 in 2023. This major drop in DER seems to have provided the company with space to improve its profitability.

This phenomenon highlights the varied influence of leverage on profitability among Indonesian manufacturing companies. Factors such as debt management strategies and operational efficiency play a significant role in how leverage affects profitability. Thus, additional research into the influence of leverage on profitability in the manufacturing industry should provide significant insights for businesses aiming to optimize debt utilization as a funding source without losing profitability.

A comprehensive comprehension of leverage is essential, as it not only enhances profit margins but also fortifies a company's ability to withstand unexpected market fluctuations. By integrating effective financial practices with proper asset management, businesses can increase profitability, particularly in terms of leverage, which is an important factor in business operations. The academy has previously conducted research on the influence of debt on profitability, with a particular focus on manufacturing companies listed on the *Bursa efek Indonesia (BEI)*.

According to (Fransisca & Widjaja, 2019), leverage, together with liquidity and company size, significantly improves profitability, demonstrated by Return on Assets. This topic is related to another topic (Kurrahmaniah et al., 2021), which discusses the close relationship between firm size, leverage and profitability in the food and beverage sector. Additionally, (Pasaribu et al., 2021) revealed that liquidity ratios, company size, and managerial ownership all play a role in shaping profitability, adding complexity to the analysis of ROA. In essence, these studies underscore that leverage is not the sole determinant of profitability, emphasizing the importance of a holistic approach to financial management.

Building on this understanding, the research by (Susilawati & Purnomo, 2023) expands the discussion by highlighting the use of leverage as a potential factor for enhancing profitability, provided it is managed with measured precision. This underscores that while leverage can increase Return on Assets (ROA), financial decision-making must be approached carefully to mitigate financial risks. On the other hand, (Hayati et al., 2021) provide insight into the importance of various ratios related to finances, such as the liquidity (current ratio) and leverage (debt-to-equity ratio), as crucial components in profitability studies. The focus is not solely on leverage and liquidity; (Tirtanata & Yanti, 2021) and (Trisnayanti & Wiagustini, 2022) further emphasize that working capital is also a critical determinant of profitability in the consumer goods sector. Different from previous researchers, this research examines a broader range of variables in relation to ROA, illustrating the need to design a comprehensive financial strategy. Consequently, the varying approaches and contexts of companies in earlier studies provide a foundation for the current research to delve deeper into how leverage and other specific variables contribute to profitability.

This study will concentrate on manufacturing companies, acknowledging the critical role this sector plays in the national economy and the major influence leverage has on their operational activities. The choice of these companies for the study is driven by the availability of accurate and verified data through regularly published financial reports, as well as the high diversity in their capital structures, which can provide richer insights into the effects of leverage. The research population consists of all manufacturing enterprises listed on the *Bursa Efek Indonesia* that have regularly reported positive net income during the last five years. This criterion assures that the research subjects have enough financial stability to conduct a thorough analysis of leverage.

From this population, the sample will be selected using purposive sampling, which aims to identify companies that not only meet the positive net income criterion but also possess complete data on the leverage and profitability components required for the analysis. This method is chosen to ensure that the findings are relevant and representative of the industry as a whole, considering the diversity in financial reports may pose challenges for valid comparative analysis. Thus, determining the research area, population, and sample is likely to have a substantial influence on the validity and reliability of the data produced, laying a solid foundation for the practical and theoretical recommendations that will emerge from this study.

Based on the phenomenon and prior study, the researcher is eager to delve deeper into the complex relationship on leverage and profitability in manufacturing organizations. As a result, the researcher plans to do future study on the subject. "**THE IMPACT OF LEVERAGE ON PROFITABILITY**".

1.2. Problem Formulation

Given the context provided in the background fo study, the problem formulation could be rephrased as follows:

1. What is the impact of leverage on the profitability of manufacturing companies?

1.3. Objective of the Research

The problem explanation above forms the basis for this research to get solid evidence of the stated objectives, which are as follows:

1. To ascertain how leverage affects a manufacturing company's profitability listed on *Bursa Efek Indonesia (BEI)*.

1.4. Benefit of The Research

1.4.1. Theoretical Benefits

The purpose of this study is to contribute to the advancement of financial theory on the influence of debt on the profitability of manufacturing firms. By investigating the relationship between leverage and profitability, this study hopes to improve our understanding of the elements that influence a company's financial performance. The findings of this study are intended to serve as a guide for future researchers investigating hypotheses connected to leverage and profitability.

1.4.2. Practical Benefits

This research has major practical implications for practitioners and decision-makers in manufacturing companies. Understanding the impact of leverage on profitability allows financial managers to make better decisions about debt management. Furthermore, the insights can help investors and shareholders evaluate the company's financial performance, which may impact their investment decisions. As a result, this study is projected to make a significantly contribution to increasing the performance and value of manufacturing companies that listed on the *Bursa Efek Indonesia*.

1.5. Problem Limitation

To make the range of the topics discussed in this work affordable, the research restrictions are as follows:

1. This study's independent variables are confined to leverage. Other control variables that could be employed include the liquidity, efficiency, firm size, and firm age.
2. Profitability is the main dependent variable in this research.

3. Manufacturing firms registered on the *Bursa Efek Indonesia (BEI)* will be the main subject of the study.
4. The research uses secondary data from 2019–2023 financial statements of businesses registered on the Indonesia Stock Exchange.