Research Paper

Volume : 4 | Issue : 12 | December 2015 • ISSN No 2277 - 8179

Impact of Value of the Company Due to the Changes in Debt-Equity Mix (Selected Company)

Management

KEYWORDS : Capital structure, Debt, Equity, Risk, Parameters

N.Nadanamoorthy — Assistant Professor, Department of Management Studies, Gnanamani Educational Institutions,NH-7,A.K.Samuthiram,Pachal(Po), Namakkal-637018, Tamilnadu,India

S.Dhachanamoorthy — Assistant professor, Department of Management Studies, SreeSastha Institute of Engineering and Technology, Chennai – Bangalore Highway, Chembarambakkam, Chennai-600123, Tamilnadu, India.

ABSTRACT

The choice of debt and equity in financing the assets of corporate firms assumes vital significance in corporate financial management due to their influence both on return and risk of the shareholders. Corporate enterprises generally are inclined to use more debt in financing their assets. The major reasons are: (i) debt is a cheaper source of finance in view of tax advantage on interest payments, (ii) it does not lead to the problem of dilution of control from its existing owners and (iii) it magnifies the rate of return to its equity-holders. However, the corporate managers are to guard themselves against the excessive use of debt as it may endanger the very survival of the corporate firms. The primary objective of the study is to enumerate the capital structure practices followed by the private corporate enterprises in India during 2010-15. Besides, the study also aims at comparing the capital structure practices of foreign controlled companies in India with the domestic companies. The study, inter-alia, examines the constituents of debt, risk characteristics of the corporate firms, the existence of pecking order hypothesis (firms follow a preferred hierarchy in raising funds, internal to external; if external, debt to equity) in India and some of the major design parameters of capital structure. The present endeavour also seeks corporate finance managers' opinion on factors affecting capital structure decisions and the changes,if any, in the wake of globalisation in India.

1.1. Introduction

To carry out each and every normal business activities, an industrial organization must have adequate amount of capital at its disposal. The capital is regarded as the lifeblood of an organization. It is available in a limited quantity, the industrial organization must acquire and spend the same in a planned and systematic manner. The planning of the capital structure is one of the important decisions taken by a finance manager in the current corporate world. As the shareholder value maximization is the new mantra for the long term sustainance, organizations across various industrial categories provide due weight age to the debt-equity mix decisions.

The optimum capital structure is one that minimizes the overall cost capital of the firm and maximizes the value of the firm with an optimum debt-equity mix, the cost of capital is minimum and the market price per share is maximum.

The capital structure can affect the value of the company either by its expected earnings or by the cost of capital or by the both. The capital structure/ financial leverage cannot affect the total earnings of firm, as they are determined by the investment decision but it can affect the share of earnings that belong to the ordinary shareholders. In practice it is difficult to design an optimum capital structure. There may be significant variations among industries and among individual companies within the same industry in respect of capital structure decision. This is due to the quantitative and qualitative factors which determine the capital structure of a company. Therefore, there should be an attempt to design an appropriate capital structure which maximizes the value of the firm. The company should plan its capital structure for an organization; the financial manager should aim at maximizing the long term market price per share.

1.2. Statement of the problem

Capital structure decisions assume vital significance in the corporate financial management due to their influence both on the return and the risk of the shareholders. In this industrial organizations have propensity of making a lavish use of borrowed money without considering its earning potential. Such a policy can spell disaster for the enterprise leading to failure and bankruptcy in the long run. Another policy often adopted by the industrial undertaking is the unplanned and indiscriminate use of borrowed money and the other modes of financing which totally distort their capital structure. The ultimate implications of such policies on the financial position of an industrial organization can be very unsatisfactory both in the short run and in the long run. Thus it is very much imperative that every successful industrial organization must pay adequate consideration to the vital question of financial leverage and cost of capital.

The crucial problem that is faced by the companies while raising the funds is whether to raise debt or equity. There has been inconclusive debate on the issue of association between financing decision and the valuation of the firm. A judicious mixture of debt and equity is the never ending task of the financial executives who are wedded to the objective of maximizing market value of the firm.

1.3. Review of previous studies

In order to make the present study more consistent and more amenable and to infuse the element of vitality, an acute understanding of the past studies is necessary. The following studies are closely related to the present study and have provided a considerable amount of information to the present study.

D. Hackbarth and D. Mauer (2012) in his study has stated that, through the judicious use of debt and equity, a firm can reduce its overall cost of capital and thereby increase its total value. The use of debt beyond the acceptable limit of leverage, on the contrary causes cost of capital to increase. His proposition therefore is that an optimum capital structure exists and the cost of capital is a function of leverage of the firm.

Patrik, B(2004) in his article on the pattern of corporate financial structure finds that there is direct evidence on the companies with high proportion of fixed costs tending t use more long term debt. He also finds using IRs data that all type of classes in all industries and the profitable firms have lower book value leverage.

Fischer, Heinkel and Zechnar(1992) stated that, the problems that result from using leverage ratios for to investigate how firms determine their capital structure. They model the impact of the cost to adjust leverage and explain how empirical tests that use year and debt ratios are biased since observed leverage ratios depend on past operations.

1.4 Objectives of the study

The following are the main objectives of the present study:

1. The analyze the capital structure practices used by the select companies.
2. To study the factors that influences the capital structure decision.
3. To study the impact of the capital structure decisions on corporate performance.
4. To study the trend in leverage ratios affecting the capital structure decision.

1.5 Collections of data

The present study is based on the secondary data. Such data were collect from the various annual reports of company's journals, magazines, books, newspapers, various thesis, dissertation, website and the like.

1.6 Tools for analysis

The collected secondary data were analyzed by using meaningful tools like, EBIT – EPS analysis, Net Income Approach method and Ratio analysis

2. IMPACT ON DEBT EQUITY MIX-AN OVERVIEW

2.1 Capital structure / Leverage

When a firm expands it needed capital that capital may come from debt or equity. The equity consists of paid up share capital, share premium, reserves and surplus and preference share capital. Debt consists of term loans and debentures. Given the objective of the firm to maximize the value of equity shares, the firm should select such a financing mix / capital structure / financial leverage which will help in achieving the objective of financial management. A judicious combination of the debt and the equity affects the cost of capital as also the total value of the company.

The capital structure refers to the composition of the long term sources of funds. As a proportion of different long term sources of funds the total capitalization of the company, it is also called leverage. Financial leverage refers to the debt in the capital structure. It multiplies the effectiveness of equity invested in a business enterprise but adds risk. Under favorable economic considerations, the earnings per share increase with leverage. But leverage also increases the financial risk of the shareholders. As a result, it cannot be stated definitely whether or not the value of the firm will increase with leverage.

If leverage affects the cost of capital and the value of firm, an optimum capital would be obtained at the combination of debt and equity that maximizes the total value of the firm or minimizes the weighted average cost of capital.

2.2 Capital Structure Practice in Automobile Industry

The debt / equity ratio also depends on the industry in which the company operates. Capital intensive Industries such as auto manufacturing tend to have a debt / equity ratio above 2 companies with less business risk and more stable operating cashflows can take on more debt. The automobile Industries do not have an internal debt – equity norm.

2.3 Information Technology Industry – An Overview

India's IT industry can be divided into five main components, viz. Software Products, IT services, Engineering and R&D services, ITES/BPO (IT-enabled services/Business Process Outsourcing) and Hardware. Export revenues, primarily on project based IT Services continue to drive growth with IT Services. This accounts for 54.2% of total revenues followed by BPO and Engineering services at 19.5%, Software Products at 15.3% and hardware at 11%. Multi-year annuity based outsourcing agreements continue to increase at a steady rate. In terms of total export and domestic revenues, Application Development and Maintenance (ADM) still continue to be the bread and butter for Indian IT companies; however traditional services have become increasingly commoditised.

2.4 Capital Structure Practices in IT Industry

In technology business where the markets tend to be volatile and the business risk tends to be high, it may be necessary to reduce financial risk by having a large proportion of equity knowledge intensive industries such as IT companies have a debt / equity under 0.5.

3. ANALYSIS OF VALUE OF FIRM DUE TO CHANGE IN DEBT AND EQUITY MIX

Table 1.1

Capital gearing ratio – TCS

(Rupees in crores)

Year	Fixed Interest bearing Funds	Equity Shareholders Funds	CGR
2010 – 11	174.8	24404.81	0.007
2011 – 12	215.37	29479.23	0.007
2012 – 13	230.98	38545.73	0.006
2013 – 14	227.26	49194.61	0.005
2014 – 15	114.27	50634.76	0.002

(Source: http://www.tcs.com/investors/financial_info/Pages/default.aspx)

The capital gearing ratio of the TCS is low (0.002) in the year 2014-15. The financial risk of the company is lower and the earnings available to the equity shareholders is less vulnerable.

Table 1.2

Capital gearing ratio – M & M Ltd

(Rupees in crores)

Year	Fixed Interest bearing Funds	Equity Shareholders Funds	CGR
2010 – 11	17068.08	14250.11	1.198
2011 – 12	16039.86	16770.21	0.956
2012 – 13	19860.26	19960.7	0.995
2013 – 14	25491.75	23306.86	1.093
2014 – 15	22327.03	25856.38	0.863

(Source:www.**mahindra**.com/resources/pdf/listed.../**Annual-Report**-FY14-15.pdf)

The above table shows that capital gearing ratio of the capital gearing ratio of Mahindra & Mahindra (0.68) in the year 2014-15. It indicates the changes in the benefits accruing to the equity shareholders by changing the levels of fixed interest bearing funds in the organisation.

Proprietary ratio

Table 1.3

Proprietary Ratio – Tata Motors

(Rupees in crores)

Year	Share holders net worth	Total assets	Proprietary Ratio
2010 – 11	20013.30	40099.84	0.499
2011 – 12	19626.01	40548.01	0.484
2012 – 13	19134.84	42049.81	0.455
2013 – 14	19176.65	42995.36	0.446
2014 – 15	14862.59	41370.20	0.360

(Source: http://www.tatamotors.com/investors/financials/70-ar-html/ind-auditors-report.html)

Volume : 4 | Issue : 12 | December 2015 • ISSN No 2277 - 8179

Table 1.4
Return on Equity – Wipro Ltd
(Rupees in crores)

Year	Profit after tax	Shareholders Net worth	ROE
2010 – 11	4843.7	21320.9	0.227
2011 – 12	4685.1	24352.5	0.192
2012 – 13	5650.2	24229.5	0.233
2013 – 14	7387.4	29355.9	0.251
2014 – 15	8193.1	34261.6	0.240

(Source: http://www.wipro.com/investors/financial-information/annual-reports/)

The above tables predict that the Return on equity of Tata motors is high (0.49) in the year 2010-11. The Return on equity of Wipro Ltd is high (2.51) in the year 2013-14.

It shows that the rate of return on the funds employed by the equity shareholders in the Tata motors is high in the year 2010-11 when compared to other years.

Tabe: 1.5
Return on Equity – Mahindra & Mahindra
(Rupees in crores)

Year	Profit after tax	Shareholders Net worth	ROE
2010 – 11	7286.18	10313.39	0.706
2011 – 12	2878.89	12171.09	0.236
2012 – 13	3352.82	14658.92	0.229
2013 – 14	3758.35	16791.19	0.224
2014 – 15	3321.11	19255.09	0.172

(Source: www.**mahindra**.com/resources/pdf/listed.../**Annual-Report**-FY14-15.pdf)

The tables explain that ROE of Mahindra & Mahindra is low (0.17) in the year 2014-15 It indicates the equity shareholders does not earn adequate of return on their funds employed because of low profit after tax when compared to previous years if company uses more debt than equity, it might increase the company's profit.And Return on equity of Mahindra & Mahindra is stable for last years. Five it shows that the steady growth in the profit after for last five years.

Table: 1.6
Debt Coverage Ratio - TCS
(Rupees in crores)

Year	Creditors fund	Total assets	Debt Coverage Ratio
2010 – 11	41.12	19689.93	0.002
2011 – 12	96.23	17723.02	0.005
2012 – 13	83.10	19503.50	0.004
2013 – 14	89.69	22769.38	0.003
2014 – 15	64.71	22635.16	0.003

(Source: http://www.tcs.com/investors/financial_info/Pages/default.aspx)

Table 1.6 shows that the debt coverage ratio of the TCS is high is the year 2011-12 and it comes to low in the year 2010-11.

Table 1.6 shows that the debt equity ratio of the TCS is less than the standard equity ratio of 2.1. In indicates that the company is using too much of equity funds instead of borrowing. But it is not good for the investors, because the EPS gets deleted with an increase in equity capital.

4. SUMMARY OF FINDINGS AND CONCLUSION

4.1 Summary of Findings

- Unplanned and indiscriminate use of borrowed money and other modes of financing totally distort the company's capital structure.
- The proportion of debt and equity in the capital structure varies according to the industry and marketing situation in which the company is operating.
- Astute use of leverage (debt) increases the amount of financial resources available to a company for growth and expansion. The assumption is that management can earn more on borrowed funds than it pays for interest expenses and fees on these funds.
- If return on investment is higher than the fixed cost of funds, the company should prefer to raise funds having a fixed cost such as debentures, loans and preference share capital.
- Rapidly growing firms need to rely more on debt because the financial requirement of such firms are high and cannot be met adequately from the internal sources.
- The company with higher profitability will have low reliance on the outside debt and it will meet its additional requirement through internal generation.
- By selling secured assets, firms increase the value of that equity by expropriating wealth from their existing unsecured creditors.
- The long term projects of the company are financed through long term sources and these are in the form of equity. The short term projects are financed by the issue of debt instruments and by raising term loans from the banks and the financial institutions.
- .Tables 1.4 and 1.5 show that equity ratio of the shareholders of both the auto industry companies is stable. It reveals that the unsecured creditors are well protected against loss in the event of liquidation.
- Tables 1.3 and 1.4 shows that both the Auto Industry companies maintain low financial leverage. It reveals that knowledge intensive companies like to minimized their financial risk inorder to ensure high liquidity.
- Tables 1.4 and 1.5 predict that both the auto Industry companies should change their financing mix according to the economic conditions. Otherwise the market price of equity share will decrease.
- A decrease in leverage or use of debt will cause an increase in the overall cost of capital and a decline both in the value of the firm as well as the market price of equity shares.
- A high debt ratio raises the threat of bankruptcy, which carries a cost but wich also forces managers to be more careful and less wasteful with the money shareholders.
- The firms should maintain a reserve borrowing capacity so that they can always issue debt on reasonable terms rather than to issue new equity at the wrong time.

4.2 CONCLUSION

Given the objective of the firm to maximize the value of the equity shares, the firm should select a financing mix which will help in achieving the objective of Financial Management. Identifying the precise percentage of debt that will maximize price per share is almost impossible. But however, it is possible to determine the approximate proportion of debt to use in the financial plan in conformity with the objective of maximizing share prices.Establishing the right capital structure is an imprecise process at best, and it should be based on both the informed judgment and the quantitative analysis.

REFERENCE

1. D. Hackbarth and D. Mauer. Optimal priority structure, capital structure, and investment. Review of Financial Studies, 25(3):748–796, 2012. 2. J. Annaert, M. De Ceuster Marc, P. Van Roy, and C. Vespro. What determines Euro area bank CDS spreads? Journal of International Money and Finance, 32(1):444–461, 2013. 3. H. Bhamra, A. Fisher, and L.-A.Kuehn.Monetary policy and corporate default. Journal of Monetary Economics, 58(5):480–494, 2011. 4. Cosh, Andrew, Douglas Cumming and Alan Hughes, 2008. "Outside Entrepreneurial Capital," forthcoming, Economic Journal. 5. Peterson, Mitchell and RaghuramRajan, 2000. "Does distance still matter? The information revolution in small business lending," NBER Working Paper #7685. 6.Patrik, B. 2004. Determinants of Capital Structure Empirical Evidence from the Czech Republic, Czech Journal of Economics and Finance, 54, 2004, a. 1-2. 7. Rajan, R.G., &Zingales, L. 1995. Is There An Optimum Capital Structure? Some Evidence from International Data.The Journal of Finance, 50, 1421- 60. 8. http://www.tcs.com/investors/financial_info/Pages/default.aspx 9. http://www.tatamotors.com/investors/financials/70-ar-html/ind-auditors-report.html 10. www.mahindra.com/resources/pdf/listed.../Annual-Report-FY14-15.pdf 11. http://www.wipro.com/investors/financial-information/annual-reports/