

Leverage Capital Structure and Dividend Policy Practices in Indian Corporate – A Case Study

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Abstract

A proper blend of debt and equity is a significant financial decision of the corporate firm from the perspective of its shareholders and other stakeholders. The excessive use of debt may endanger the survival of a corporate firm while the conservative policy may deprive the advantage of cheaper debt. An appropriate capital mix influences both the return and risk of the shareholders. The proper and efficient management of capital structure yields two advantages: (i) maximization of profit and wealth of shareholders, and (ii) minimization of cost of capital. Therefore, the financial manager is confronted with the task of determining determinants of a capital structure of the firm, which on the one hand maximizes the wealth of the owners and on the other hand minimizes the cost of funds. The present study examines the practices being followed in Indian corporate.

Key Words



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Leverage, Capital Structure, Dividend, Solvency, and Debt-Equity Ratio

Introduction:

The main objective of financial management in any management organization is value maximization. The value maximization criteria is based on the concept of cash flows generated by the investment decision and also the value maximization is used in terms of worth to the owners i.e. ordinary shareholders. The wealth of owners is reflected in the market value of shares. So wealth maximization implies the maximization of the market price of shares. Leverage, Capital structure and Dividend policies are the important decision areas in financial management. This paper concentrates on these three areas, due to its impact on the solvency and financial performance of the firm. This paper mainly studies the leverage, Capital structure and dividend policies and practices of Coromandel Fertilizers Limited, an Indo-American joint venture over a period i.e. 2003-2009.

Coromandel Fertilizers limited is a project with, an initial cost of Rs. 50 Crores. Murugappa Group of Companies holds 78.31 % share capital while the Indian Financial Institutions holds about 12.62% and Indian public holds the balance 9%.

Review of literature

Narasimhan and Vijayalakshmi (2002) analyze the influence of ownership structure on dividend payout of 186 manufacturing firms. Regression analysis shows that promoters' holding as of September 2001 has no influence on average dividend payout for the period 1997-2001. Oza (2004) study on thirty non financial Indian companies dividend behaviour, finds that current earnings is the most influencing factor while deciding on dividend policy followed by pattern of past dividends.

Reddy (2004) has examined the dividend behaviour of Indian corporate firms over the period 1990-2001 of companies listed on NSE and BSE. He concluded that dividend changes are impacted more by contemporaneous and lagged earnings performance rather than by future earnings performance. Sur (2005) has tried to study the dividend payout trends of Colgate Palmolive Ltd. And concluded there was a significant deviation between actual DPR and estimated DPR.

George and Kumudha (2005) has tested Linter Model in Hindustan Construction Co. Ltd. and finds that current year's dividend per share is positively related to current year's earnings per share and previous year's dividend per share. A Study of Dividend Policy of Indian Companies was carried out by Singhanian (2007) on the 590 listed Manufacturing firm of India over the period of 1992-2004. She finds that average dividend per share increased significantly during the study period. Bhayani (2008) has conducted a study on the dividend policy behaviour of BSE 30 companies of India for the period of 1996-97 to 2004-05. He finds that the firm under study follows the linter model of dividend. Mishra and Narender (1996) analyze the dividend policies of 39 state-owned enterprises (SOE) in India for the period 1984-85 to 1993-94. They find that earnings per share (EPS) are a major factor in determining the dividend payout.

Objectives:

- To study the operating, financial and combined leverage of Coromandel Fertilizers Limited (CFL) during the period 2003- 2009 and to know about the impact of fixed charges on Earning Before Interest and Taxes (EBIT) and Earnings Per Share (EPS).
- To understand the capital structure policies and practices in Coromandel Fertilizers Limited (CFL) and its impact on Market Price per Share (MPS)
- To know about the dividend policy of the company and its influence on Price - Earning (P / E) and MPS.

Research Methodology:

Primary data are collected from several managerial and executive personnel of CFL, Visakhapatnam. Secondary data mainly from annual reports, brochures of CFL, magazines, Bombay Stock Indexes and web site from internet which belongs to the organization. The average market price of share is calculated on the basis of monthly high/low average closing prices of the company quoted in BSE. For computation of operating and financial leverage, 2003 is taken as base year.

Capital structure, debt equity ratio, interest coverage ratios are calculated. D/E ratio is compared with market price for analysis and interpretation. For studying the

dividend policy, ratios like dividend per share, earnings per share, dividend yield, earnings yield and P/E ratio have been computed with the help of appropriate formulas.

Analysis of leverage of CFL:

In financial management, the term leverage is used to describe the firm's ability to use fixed cost of assets or funds to increase return to its owners i.e. equity share holders. It provides the framework for financing decisions of a firm. Leverages are of three types (1) Operating Leverage (2) Financial Leverage and (3) Combined Leverage.

Operating leverage (OL)

Operating leverage refers to the use of fixed costs in the operations of a firm. It studies the sensitivity of EBIT to sales. From safety point of view, the operating leverage should be rather low.

Analysis

If the firm is operating with high leverage a proportionate change in sales will bring a more than proportionate change in EBIT. In the above table in 2004 the firm is operating with moderate operating leverage. In 2005 it is very high as a result a little change in sales i.e. 8.82% increase, brought 94.47% increase in EBIT. The same thing happened in 2007 also. However, when the firm is operating with high leverage if sales decrease, EBIT also decreases with more than proportionate change in sales.

2004 is being taken as base year. Leverage is calculated by taking the difference between the values in 2004 and 2003.

To be clear except in 2009 the company has maintained, more or less, high degree of operating leverage. But during all these years the company has recorded an increasing trend in its sales. So the adverse effects of high operating leverage can't hit its earnings. At the same time it is observed from the table -that the company is not particular about its operating leverage. Because throughout the period' operating leverage has more ups and downs. From safety point it is suggested that the firm should maintain with low operating leverage as it has done in 2009.

(T a b l e - 1)

Analysis of Leverages with reference to Coromandel Fertilizers Limited (CFL)**Computation of EBIT**

Year	2003	2004	2005	2006	2007	2008	2009
	28,203	31,183	30,691	35,903	34,534	41,360	42,746
EBT +	1449	2701	4081	4857	6717	7155	7038
Interest	1625	1626	1960	1718	1813	1999	2155
EBIT	3074	4327	5978	6575	8530	9154	9193
EPS	6.35	9.61	12.01	14.13	19.29	24.70	27.18

Source: Annual Report 2010

(T a b l e - 2)

Degree of Operating Leverage (DOL)

	2004	2005	2006	2007	2008	2009
% change in EBIT	40.76	94.47	113.90	177.49	197.97	199.06
% change in sales	10.57	8.82	27.30	22.45	46.65	51.56
DOL	3.86	10.71	4.17	7.91	4.24	1.92

(T a b l e - 3)

Degree of Financial Leverage (DFL)

Year	2003	2004	2005	2006	2007	2008	2009
EBIT	3074	4327	5978	6575	8530	9154	9193
EBT	1449	2701	4018	4857	6717	7155	7038
DPL	2.12	1.60	1.48	1.35	1.26	1.28	1.31
D/E	1.37	0.94	1.01	0.82	0.68	0.75	0.85
EPS	6.35	9.61	12.01	14.13	19.27	24.70	27.18

Financial Leverage (FL)

The use of fixed charges capital like debt with equity capital in the capital structure is described as financial leverage or trading on equity. The main reason for using financial leverage is to increase the return of equity shareholders. Thus financial leverage studies the sensitivity of

EPS to EBIT.

Analysis:

It is very clear from the table that the degree of financial leverage and the debt-equity ratio of company are positively correlated. In 2003 the debt equity ratio (1.37) is very high during these 7 year period. Similarly DFL is also very high (2.12) in that year. Later debt-equity ratio declined in 2004. Similarly DFL also declined.

The debt equity ratio is low in 2007. DFL is also low in 2007 compared to other financial years. This trend can be clearly understood with the help of the table. On an average the company is following a stable financial leverage which is in between 1.25 to 1.6. So the company didn't have the problem of servicing its debt because the EPS of the company has been growing steadily.

Financial Leverage:

$$\text{Financial Leverage} = \frac{\text{EBIT}}{\text{EBIT-I or EBT}}$$

Another interesting point is that there is no considerable relationship between the degree of financial leverage and Earning Per Share (EPS) as the debt equity ratio is more or less stable, and sales are increasing year by year, the EPS is also increasing irrespective of the changes in financial leverage. That means the effect of fixed charges sources of funds on EPS is very less. But it is a general tendency in financial management to employ high financial leverage as long as the cost of debt is less than the return on assets and the firm can service its debt even in adverse conditions. Higher the financial leverage the better since it will mean more than proportionate profit for equity funds. Thus the wealth of shareholders is being maximized.

Combined leverage:

Both financial and operating leverages magnify the revenue of the firm. The Degree of Operating Leverage (DOL) and Degree of Financial Leverage (DFL) can be combined to see the effect of total leverage on Earnings Per Share (EPS) associated with a given change in sales. Financial leverage of CFL is not fluctuating widely like DOL during these years. As the DFL is more or

less stable, the DCL is highly depends on DOL. In 2005 DCL is very high because DOL is also very high in that year. Similarly DCL is very low in 2009 at 2.52 because DOL is also very low in that year at 1.92.

Combined Leverage

(Table - 4)
Degree of Combined Leverage (DCL)

	2004	2005	2006	2007	2008	2009
DOL	3.86	10.71	4.17	7.91	4.24	1.92
DFL	1.60	1.48	1.35	1.26	1.28	1.31
DCL	6.18	15.85	5.63	9.97	5.43	2.52

Capital Structure:

The two principle sources of finance available to every concern are equity and debt. The capital structure of a firm should be planned in such a way that the cost of servicing the debt should be minimum and the return should be maximum. While developing an appropriate capital structure, the financial manager should aim at maximizing the market value of the share. Such a capital structure can be determined empirically.

Analysis of Capital structure of CFL:

The company is following conservative debt policy except in 2003 its debt equity ratio is around 1:1. The debt equity ratio varies between 0.75 and 1 during this period. If we observe the past three or four years the management doesn't allow its debt equity ratio to fluctuate more. The debt equity ratio is very high at 1.35 in 2003 later it touched 1.01 in 2005. In remaining years it lies below 1.

If we observe the table, it is very clear that the debt equity ratio and interest coverage are negatively correlated. As the debt decreases the interest coverage improves and vice versa. The conservative debt policy of the company is reflected in its interest coverage also. The interest coverage ratio is around 4 times during the last four years. Prior to that high D/E and less EBIT resulted low interest coverage. Still the company has a large reserve debt

capacity providing it with financial capability to easily fund its diversification and expansion programs.

It is significant to note that inspite of the ups and downs in debt-equity ratio and interest coverage ratio, the average market price is not affected by these policies. Thus the debt equity and average market price of CFL are not closely related.

(T a b l e - 5)

Analysis of Capital Structure in Coromondal Fertilisers Limited**Capital Structure and debt service**

Year	Debt in	Net worth	D/E	EBIT in lakhs	Int. in lakhs	Interest coverage (no. of times)
2003	10,957	8,022	1.37	3074	1625	1.89
2004	9,814	10,431	0.94	4327	1626	2.66
2005	12,768	12,685	1.01	5978	1960	3.05
2006	12,560	15,319	0.82	6575	1718	3.83
2007	12,904	18,926	0.68	8530	1813	4.70
2008	14,633	19,471	0.75	9154	1999	4.58
2009	19,862	23,382	0.85	9193	2155	4.27

Source: Annual reports of CFL

D/E = Total Debt/Net Worth, Interest Coverage = EBIT / Interest

(T a b l e - 6)

Effect of interest on EBIT and sales

Year	Sales in lakhs (Rs.)	Interest in lakhs (Rs.)	Interest as % on sales	Interest coverage (no. of times)
2003	28,203	1625	5.76	1.89
2004	31,183	1626	5.26	2.66
2005	30,691	1960	6.39	3.05
2006	35,903	1718	4.78	3.83
2007	34,534	1813	5.25	4.70
2008	41,360	1999	4.83	4.58
2009	42,746	2155	5.04	4.27

Dividend Policy and Practices:

Shareholders of every company expect two forms of returns, dividend and capital gains. A major decision in financial management is the dividend decision in the sense that the firm has to choose between distributing the profits to the shareholders and plugging them back to the business. Dividend policy determines what portion of earnings will be paid out to stockholders and what portion will be retained in the business to finance long-term growth. Both dividends and growth are desirable but are conflicting to each other. This situation is an existing challenge for the financial manager and necessitates the need to establish an optimum dividend policy that has no adverse effects on the future progress of the firm.

Analysis:

The EPS of the company has been steadily growing during these 7 years period. So also DPS has been growing steadily with EPS. The company has been steadily increasing its DPS. The dividend payout of the company is also rising. Almost in all the years the proportionate increase in DPS is more than that of in EPS except 2008 and 2009. As a consequence payout ratio has been steadily increasing year by year till 2007 after that it has declined in 2008 and 2009.

(Table-7)
Capital Structure and Market Price

Year	D/E	Average Market Price
2003	1.37	40.00
2004	0.94	54.50
2005	1.01	36.65
2006	0.82	46.03
2007	0.68	45.25
2008	0.75	62.65
2009	0.85	51.05

Source: Annual Reports of CFL and BSE Stock prices

(Table-8)
Retention policy and its impact

Year	EPS (Rs)	DPS (Rs)	Average Mkt Price	Payout %	DY %	EY %	P/E
2003	5.96	1.0	40.00	0.17	2.5	14.9	6.7
2004	9.61	2.0	54.50	0.21	3.67	17.63	5.67
2005	12.01	2.5	36.65	0.21	6.82	32.77	3.05
2006	14.13	3.0	46.03	0.21	6.82	30.70	3.26
2007	19.27	5.0	45.25	0.26	11.05	42.58	2.35
2008	22.79	5.5	62.65	0.24	8.78	36.38	2.74
2009	28.00	6.5	51.05	0.23	12.73	54.84	1.82

Source: Annual Reports of CFL and BSE Stock prices

The average market price of the share of CFL, except some fluctuations, has recorded a satisfactory growth during this period. Perhaps shareholders like the company's dividend policy. Though the company has been following a stable growth dividend policy, its effect on the market price of the share is not very clear. It is very difficult to establish a relationship between DPS and MPS. The fluctuations in the share prices may cause due to economic conditions, Government policy, prospects of fertilizer industry and the most important one is the activities of market forces.

Conclusion

Coromandel Fertilizers Ltd. has abundant internal resources. It is following a stable debt equity ratio. It has been maintaining an increased trend in its dividend payout. Operating leverage of the company has more ups and down. But the financial leverage is more or less stable. The fluctuations in the market price of the share are related to the capital structure decisions and dividend decisions to some extent.

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