Capital Structure Practices of Public Limited Companies in India

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Abstract: *In Capital Structure Debt and equity is the two important source of finance for the firms. Basically capital structure of the firm revolves around the judicious mix of the debt and equity. Upon Debt and equity mix much research has been done and many have designed the capital structure in a very different manner. The main objective of this paper is to analyse the capital structure practices in India, particularly concerning the problem of Debt-Equity ratio analysis of public limited companies. In capital structure Debt-Equity ratio plays an important role to take decision towards wealth maximization of a particular company. It will reveal that how debt-equity ratio is changing from industry to industry and also company to company. However, standard debt-equity ratio is 2:1 but is all the companies are following the standard D/E ratio or not? Is a big question. So this study will focus on Debt -Equity ratio practices of Indian firms. In analyzing Capital structure practices of public limited companies in India; this paper has been divided into five parts. In the first part Introduction, Second part theoretical background, third part review of literature; fourth part Capital structure policies in practice and in the last part conclusion. The source of data is secondary. The conclusion is except a few industries, remaining industries are not at all using cheap source of debt capital. In the past, Indian companies were maximum based on debt , but now the debt usage is declined because of the availability of financial resources or improved financial climate in India. The capital structure is different from industry to industry and within industry different structures used by companies.*

Key words: *Capital Structure, Debt-Equity Ratio, Cost of Capital*

1. INTRODUCTION:

Capital structure (also known as financial structure) refers to the compensation of long-term funds such as debentures, long-borrowings, preference shares, equity shares (including retained earnings) in the capitalization of a company. The essence of capital structure decision is to determine the relative proportion of equity and debt. Equity here in broader sense means owner's funds which can be raised by issue of equity shares and preference shares and by retained earnings. Debt can be raised by issuing debentures/bonds or by taking long-term borrowings [1]. Capital structure refers to the mix or proportion of different sources of finance (debt and equity) to total capitalization. A firm should select such a financing-mix which maximises its value /the shareholder's wealth (or minimises its overall cost of capital). Such a capital structure is referred to as the optimum capital structure. Capital structure theories explain the theoretical relationship between capital structure, overall cost of capital and valuation [2].

2. THEORIES OF CAPITAL STRUCTURE:

The Net Income approach says that the average cost of funds declines as the leverage ratio increases. The Net operating income approach holds that the cost of capital remains unchanged when the leverage ratio varies. The traditional approach argues that the cost of capital decreases as the leverage ratio increases, up to a point, but

thereafter the cost of capital increases with the leverage ratio. The Modigliani and Miller position(MM) is similar to the net operating income approach. The MM position is stated in terms of two basic propositions. MM's first proposition is that the value of a firm is equal to its expected operating income divided by the discount rate appropriate to its risk class: V=D+E. MM's second proposition says that the expected return on equity is equal to the expected return on assets, plus a premium. The leverage irrelevance hypothesis of MM is valid i the perfect market assumptions underlying their analysis are satisfied. The real world, however, is characterised by imperfections such as taxes, bankruptcy costs, agency cost, and informational asymmetry. The issue of optimal debt policy was answered in a novel, though controversial, manner by Merton Miller. He argued that while there is an optimal debt-equity ratio for the economy as a whole, no single firm can benefit by varying its own debt-equity ratio. The greater the level of debt, the higher the probability of financial distress. There are direct and indirect costs associated with financial distress. There is an agency relationship between shareholders and creditors of firms that have substantial sums of debt. According to tradeoff theory, the optimal debt-equity ratio of a firm depends on the tradeoff between the tax advantage of debt on the one hand and the financial distress and agency costs on the other hand. In the real world firms seem to follow a pecking order of financing which goes as follows : internal finance, debt finance, and external equity finance. Myers proposed a new theory called the signalling, or asymmetric information theory to explain the pecking order or financing. Because of the problem of asymmetric information, firms would do well a maintain reserve borrowing power. [3]

The capital structure decision is a significant financial decision since it affects the shareholders' return and risk, and consequently, the market value of shares. The use of the 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 shareholders' return. A firm determines the advantage of financial leverage by calculating its impact on Earnings per share (EPS) or Return on equity (ROE). For a 100 per cent equity financed company, EPS is calculated as EPS = [EBIT(1-T)] / N. For a company that employs both debt and equity then EPS = [(EBIT-INT)(1-T)] / N. If the firm's overall profitability is more than interest rate, EPS increases with debt. With increasing EBIT, EPS increases faster with more debt. The percentage change in EPS occurring due to a given percentage change in EBIT is referred to as the degree of financial leverage (DFL). EBIT depends on sales. A change in sales will affect EBIT. The variability in EBIT due to a change in sales is affected by the composition of fixed and variable costs. The percentage change in EBIT occurring due to a given percentage change in sales is referred to as the degree of operating leverage (DOL). DOL and DFL can be combined to see the effect of total leverage on EPS. Financial leverage, on the one hand, increases shareholders' return and on the other, it also increases their risk. For a given level of EBIT, EPS varies more with more debt. In the extreme situation if the firm is unable to pay interest and principal, its solvency is threatened. In the insolvency, shareholders are the worst sufferers. Thus, we find that financial leverage is a double-edged sword. It increases return as well as risk. A trade-off of between return and risk will have to be struck to determine the appropriate amount of debt. [4]

FACTORS DETERMINING CAPITAL STRUCTURE:

The following factors affect capital structure. They are Personal Tax, Bankruptcy, Agency Costs, Corporate Governance, Signalling , Ownership Structure, Macro Economic Variables, Floatation and other Direct Costs, Government and other regulations, Corporate Tax etc.

Financial structure indicates the amount of debt and equity used in financing a firm. For any financial structure , debt is always a less expensive form of capital than equity because the cost of debt is tax deductible and because in the case of bankruptcy debt holders have priority over equity holders. However, debt also comes with fixed explicit costs. Every dollar of debt increases the risk of the firm and the cost of all financing. With too much debt and wavering business conditions, a firm may be forced into bankruptcy. [5]

3. REVIEW OF LITERATURE:

In Indian context, few studies have been done so far on capital structure theory. Chakraborty (1977) who has made an early study on capital structure where he found that age, profitability and retained earnings have a negative impact while capital intensity and total assets have a positive impact on the capital structure[6]. A number of companies in practice prefer to borrow for the following reasons: Tax deductibility of of interest, Higher return to shareholders due to gearing, Complicated procedure for raising equity capital, No dilution of ownership and control, Equity results in a permanent commitment than debt. There are however, managers whose choice of financing depends on internal and external factors. The internal factors include: purpose of financing, company's earning capacity, Existing capital structure, cash flow ability, investment plans, etc. The external factors are: capital and market conditions, debt-equity stipulations followed by financiers, restrictions, imposed etc. In practice, it may not be possible for a company to borrow whenever it wants. Lenders may analyze a number of characteristics of the borrower before they decide to lend. What factors do borrowers think are considered by lenders? Borrowing firms' managers perceive the following factors in order of importance being considered by lenders: (i) profitability (ii) quality of management, (iii) security , (iv) liquidity, (v) existing debt-equity ratio, (vi) sales growth, (vii) net worth, (viii) reserve position , and (ix) fluctuations in profits.[7]

Titman and Wessels (1988) have used six measures of financial leverage for their study. They took long term debt, short term debt, and convertible debt over book value and market value of the equity. In their theory, they took different types of debt for the study because each and every kind of debt has different implications and at the same time they used book value and market value of the equity for their model[8]. In another study, Singh and Hamid (1992) observed that Indian firms are more depending upon the outsider's fund than on the internal funds. The reason behind is that Indian capital markets are not enough matured, so the firms are finding it hard to raise funds from the equity market[9]. While Kakani (1999) in his study used short term debt, long term debt and total debt as measure of capital structure for the model[10].

Indian corporate employ substantial amount of debt in their capital structure in terms of the debt-equity ratio as well as total debt to total assets ratio. Nonetheless, the foreign controlled companies in India use less debt than the domestic companies. The dependence of the Indian corporate sector on debt as source of finance has over the years declined particularly since the mid-nineties. The

corporate enterprises in India seem to prefer long-term borrowings over short-term borrowings. Over the years they seem to have substituted short-term debt for long-term debt. The foreign controlled companies use more long-term loans relatively to the domestic companies. As a result of debt-dominated capital structure, the Indian corporate are exposed to a very high degree of total risk as reflected in high degree of operating leverage and financial leverage and, consequently, are subject to a high cost of financial distress which includes a broad spectrum of problems ranging from relatively minor liquidity shortages to extreme cases of bankruptcy. The foreign controlled companies, however, are exposed to lower overall risk as well as financial risk. The debt service capacity of the a sizeable segment of the corporate borrower as measured by (i) interest coverage ratio and (ii) debt service coverage ratio is inadequate and unsatisfactory. Retained earnings are the most favoured source of finance. There is significant difference in the use of internally generated funds by the highly profitable corporate relative to the low profitable firms. The low profitable firms use different form of debt funds more than the high profitable firms. Loan from financial institutions and private placement of debt are the next most widely used source of finance. The large firms are more likely to issue bonds in the market than small corporates. The hybrid securities are the least popular source of finance amongst corporate India. They are more likely to be used by low growth firms. Preference shares are used more by public sectors units and low growth corporate. Equity capital as a source of funds is not preferred across the board[11].

Mazur (2007) took total debt to total assets for their study. As previously many researchers depicted the measure of capital structure in a number of ways but in this study we have taken total debt over total assets as the measure of capital structure. Here debt ratio has been designated as the representative of the capital structure. Debt Ratio = Total debt / Total Assets Debt ratio explains about the debt portion used to finance the total assets of the company. We have considered the book value of the long term and short term debt for total debt category and non-current and current assets are considered for the total assets category in our study[12]. Small sized companies relies more on debt capital as compared to large sized companies. The average debt-equity ratio of small sized companies were found to be more than 3:1 whereas in case of large sized companies it is 1:1. This shows that the large sized companies followed a strict conservative policy while deciding the debt equity mix. The average debt-equity ratios of manufacturing companies were more than double of the average debt-equity ratio of service sector companies. It indicates that service sector companies relies more on the equity and less on the debt, and vice-versa in case of manufacturing companies[13].

Anurag Pahuja and Anu Sahi analysed the factors determining the capital structure of the Indian companies. This analysis grounded on agency theory and pecking order theory. The paper takes into consideration dependent variable debt equity ratio and independent variables viz. size, growth, profitability and tangibility. The two major determinants are found to be growth and liquidity according to the study[14]. *Ram chandra das and Nikhil Bhusan dey* in their study examined the Capital Structure of the selected companies of Petroleum industry in India(PII). It is found that all the selected companies of PII are running with low debt fund[15]. Rakesh H M, in his study identified the impact between Capital Structure and Companies Performance, taking into consideration the level of Companies Financial Performance. The analysis has been made on the capital structure

and its impact on Financial Performance capacity during 2009 to 2012 (03 years) financial year of Business companies in India. The results show the relationship between the capital structure and financial performance is having a negative association. It reflects the insignificant level of the Business Companies in India. Hence Business companies mostly depend on the debt capital. Therefore, they have to pay interest expenses much[16].

Anshu Handoo and Kapil Sharma concluded in their study observed that factors such as profitability, growth, asset tangibility, size, cost of debt, tax rate, and debt serving capacity have significant impact on the leverage structure chosen by firms in the Indian context[17].

Neha Poddar and Manish Mittal in their paper observed that the borrowing pattern of the five Indian companies of steel sector with respect to the Size, profitability, Liquidity and interest coverage were studied, applying panel data analysis techniques. Larger firms will more easily attract a debt analyst to provide information to the public about the debt issue. Banks are more willing to lend their funds to larger firms partly because they are more diversified and partly because larger firms usually request larger amounts of debt capital than smaller firms. As a consequence, larger firms are usually able to reduce transaction costs associated with long-term debt issuance and can arrange a lower interest rate[18].

According to K. Bhagya Lakshmi et al, observed that the results are insignificant level performance of listed companies in India by using more debt capital for business[19]. B.D.Panda et. al in their study, eight explanatory variables are taken into consideration and we found that explanatory variables like profitability, risk and growth are playing a significant role in explaining the debt ratio of the Indian steel companies. Hence steel companies need to reduce their cost or to improve their efficiency level in order to increase their profitability. Another important factor that companies need to reduce is the risk factor, if the risk factor will be high then automatically lenders will move away and may not be willing to put their money is risky business. Other explanatory variables are like size, asset structure, non debt tax shield, liquidity and uniqueness are not significant here [20].

4. CAPITAL STRUCTURE POLICIES IN PRACTICE:

To learn about the capital structure policies of business firms, Prasanna Chandra [21] asked the chief finance officers of twenty large-sized business undertakings, representing a wide cross-section of industries, the following question: What is your capital structure policy? The responses obtained are reproduced below (the lengthier ones have been paraphrased).

Industry	*Nature of Response*
Electrical	"We try to maintain a debt-equity ratio of less than 2:1 because this is the governmental norm."*
Chemicals	"Ours is a very conservative debt policy. We borrowed funds only in recent years for some expansion projects."
Tea	"We have ample internally generated funds. So we never had to think about debt."
Fertiliser	"We don't have a specific debt-equity policy-it depends. Few years ago we relied mostly on internal accruals. Now we are considering some term finance."
Toothpaste	"Our internal accruals are enough for our modest capital investments. We

	would depend only on equity resources."
Aluminium	"Our goal is to maintain the debt-equity ratio within a certain level which, of course, is kept confidential."
Chemical	"We have good projects. We would like to increase our dependence on debt-how far we will go, time alone will say."
Automobile	"We don't have an internal debt-equity norm. Since the government permits a 2 : 1 ratio, we will remain within it. Of course, we will keep a cushion for bad times."
Shipping	"The risk of our business has increased. So, we have deliberately decided to follow a conservative financing plan in relation to shipping industry norms. We try to cover debt service burden by our depreciation charges."
Leasing	"We will borrow as much debt as we can. After all money is our raw material."
Diversified	"We have a very conservative financing policy. We have depended mostly on internally generated funds-except for two rights issues. We would like to set a limit of 1 : 1 for our debt equity ratio."
Diversified	"Till 1970 we had no long-term debt except for a foreign currency loan taken in 1963. From 1970 onward we have depended more on loans, less on internal accruals. We really don't have a long-term capital structure policy as such. Even if the government allows a 2 : 1 ratio, we may not be able to service it."
Truck	"The capital structure of the company is carefully planned for optimum financial leverage, while the following corporate objectives for a stable funding pattern are retained: (i) All fixed assets to be funded only by long term funds, i.e. equity + long-term borrowings. (ii) At least 50 percent of working capital to be funded only by long-term funds, i.e., equity + long term borrowings. (iii) Total debt to equity not to exceed 1:1."
Pharmaceuticals	"Traditionally we had a very conservative capital structure. We are now levering ourselves and have set a debt-equity norm of 1.7: 1. This will give us some margin, given the governmental norm of 2:1,"
Diversified	"We finance on a project-by-project basis. There is no long range capital structure in mind."
Textiles	"You see it is like this. We go by the project. If it is good, finances will come — the shareholders will give, the institutions will give. What is the point in talking of a hypothetical capital structure."
Storage Batteries	"We have not borrowed funds. We don't want to borrow. We don't want external interference in our business."
Diversified	"We have very promising projects on the anvil which require massive investments. We will borrow as much as we can. It costs us less. After all, we have serviced our debt well in the past."
Consumer Electronics	"Our focus was on technology and production. Finances didn't pose much of a problem. We have frankly speaking not thought of a capital structure policy."
Diversified	"Before the cement project our debt equity ratio was 0.1 to 1.0. With the borrowings of the cement unit it went upto 1.15 to 1.0. Since this appeared quite safe, we never defined any policy in this respect."

* This survey was done when the general debt-equity norm followed by financial institutions was 2 : 1.

Some Observations:

On the basis of the above comments, we may make the following observations:

While some firms have been able to articulate their capital structure policy, others have still to do so. The reasons why many firms have not been able to define their capital structure policy with definitiveness seem to be as follows:

(a) *Widening of the Instruments of Financing:* The range of the instruments of financing has widened over the years. Convertible debentures which were relatively unknown in yesteryears have assumed great significance in recent years. Likewise, leasing and hire purchase are becoming important. In addition, some new instruments like cumulative convertible preference shares and cumulative convertible debentures have been introduced or are likely to be introduced.

(b) *Lack of Long Experience with Debt :* Before the emergence of term-lending financial institutions most of the firms relied largely, almost exclusively, on internal accruals. Hence, debt-equity ratios were very low. With the easier availability of term finance from the sixties and debenture finance in more recent years many firms have resorted to substantial debt finance to support their ever-increasing capital investment programmes. The experience of these firms with debt finance is apparently not sufficiently long to provide a sound basis for delineating their capital structure policies definitively.

(c) *Changing Complexion of Business Risk:* The pace of change in the Indian industry has quickened with the introduction of new products and services, adoption of modern.

The Industry standard according to Reserve bank of India which is available in it's website (attached in Table-1) shows in the name of Financial ratios of Selected Public Limited Companies-Industry wise in detailed. As the recent data is not available, the information is compared with the same. From this table one can see the Capital Structure practices of different industries in India. Except a few Industries, remaining industries are not at all using cheap source of debt capital.

5. CONCLUSIONS:

From the above reviews and observations we can conclude that except a few

Industries, remaining industries are not at all using cheap source of debt capital. In the past, Indian companies were maximum based on debt, but now the debt usage is declined because of the availability of financial resources or improved financial climate in India. The capital structure is different from industry to industry and within industry different structures used by companies.

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TABLE:1 Debt to Equity Ratio of Selected Public Limited Companies-industry Wise

(Figures in Per cent)

Industry / Year--> Year->	2007-08	2006-07	2005-06	2004-05	2003-04	2002-03	2001-02	2000-01	1999-00
All Industries	46.20	49.80	48.70	55.20	56.30	69.00	75.30	71.90	73.80
Apparel	32.20	28.50	22.40	27.50					
basic chemical	56.10	73.60	96.90	98.00	95.40	310.90	320.00	153.20	121.20
cement and cement products	72.10	88.20	105.70	111.30	107.40	178.30	179.00	170.10	166.90
Ceramics	53.50	66.40	75.30	78.40					
chemical fertilizer and pesticides	39.30	58.60	57.00	67.70	59.90	80.60	85.90	84.40	86.00
chemicals and chemical products	37.70	46.70	48.50	52.90	44.90	54.50	62.60	64.90	66.10
computer and related activities	31.40	45.10	76.50	337.60	5.80	10.10	13.30	18.80	21.20
computer and related activities	13.80	6.90	5.40	3.40					
construction	46.10	57.30	42.60	46.70	83.20	54.40	44.30	95.00	89.30
cotton textiles	163.50	132.00	116.30	126.50	138.70	97.70	110.50	77.20	70.30
Diversified						39.90	53.70	41.20	50.30
Edible Oils and Oilcakes	50.10	46.90	58.80	94.20	61.30	147.70	110.90	62.10	61.80
electrical machinery and apparatus	26.80	24.90	31.10	36.90	40.50	52.40	64.30	44.70	50.70
Electricity generation and Supply						56.80	64.40	59.70	77.90
Fabricated Metal products except Machinery and equipments	54.10	72.40	82.00	60.40	103.00	421.80	236.60	195.90	155.00
food products and beverages	66.40	63.30	62.60	67.00	65.30	106.90	92.10	50.90	55.50
Hotels and Restaurants	68.10	60.90	70.70	97.40	115.90	73.40	68.70	47.30	48.30
iron and steel	84.10	108.80	105.60	175.90	129.00	462.70	399.90	169.10	153.60
machinery and machine tools	23.50	21.80	18.90	24.90	37.70	31.60	31.90	39.00	42.30
man- made textiles	220.70	171.70	143.70	132.00	108.20	178.40	186.30	268.20	179.60
mining and quarrying	86.10	96.60	94.60	89.20	133.50	228.80	221.50	203.20	167.40
motor vehicles and other transport	32.80	32.00	30.70	31.80	27.40	39.70	49.70	40.70	37.50
paints and varnishes	21.30	18.40	22.00	17.40	23.90	33.00	37.30	43.20	39.40
Paper and Paper Products	74.90	80.90	63.60	73.70	91.70	130.30	146.10	85.50	96.90
pharmaceuticals and medicines	30.40	35.30	33.10	31.80	30.50	36.00	43.10	20.10	22.10
plastic products	62.00	64.90	70.70	80.40	92.00	106.20	111.90	98.70	97.00

Radio, Television, Communication Equipments and apparatus	81.00	62.60	65.10	120.50	154.40			78.00	76.10
rubber and plastic products	53.90	59.20	69.40	70.20	78.70	80.30	94.90	86.40	85.40
Sugar	115.40	84.90	86.60	115.50	94.40	153.90	119.50	66.30	70.10
tea plantations	21.40	16.00	23.30	43.00	31.30	36.60	23.00	26.40	24.50
transport, storage and communication	149.60	122.30	93.20	89.10	95.60	58.50	55.20	82.50	103.50
tyres and tubes	44.40	55.30	73.10	55.50	67.10				
wholesale and retail	43.70	54.80	37.20	31.50	27.00	7.30	8.60	26.10	23.00

Source: Reserve Bank of India