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A STUDY ON CAPITAL STRUCTURE AND ITS IMPACT ON PROFITABILITY

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ABSTRACT

The project report of "capital structure and its impact on profitability". The research includes study and analysis of current market, identification of the problem and its features. The work is basically concentrated on perception towards performance, what will be its effect on the market. Which factors it should concentrate on and what are the different servicing methods used to improve service quality.

The assets of a company can be financed either by increasing the owners claim or the Creditors claim. The owner's claims increase when the form raises funds by issuing ordinary shares or by retaining the earnings, the creditors' claims increase by borrowing. The various means of financing represents the "financial structure" of an enterprise.the financial structure of an enterprise is shown by the left hand side (liabilities plus equity) of the balance sheet. Traditionally, short-term borrowings are excluded from the list of methods of financing the firm's capital expenditure, and therefore, the long term claims are said to form the capital structure of the enterprise the capital structure is used to represent the proportionate relationship between debt and equity, it includes paid-up share capital, share premium and reserves and surplus. The financing or capital structure decision is a significant managerial decision .it influences the shareholders returns and risk consequently; the market value of share may be affected by the capital structure decision.

INTRODUCTION

Financial management is that managerial activity which is concerned with planning and controlling of firms financial resources. It was branch of economics till 1890, and as a separate discipline, it is of recent origin. Still, it has known unique body of knowledge of its own, and draws heavily on economic for its theoretical concepts event today.

The subject financial management is of immense interest in both academicians and practicing managers. It is of great interest to academicians because the subject is still developing, and there are still certain areas where controversies exit for which no unanimous solutions have been reached as yet. Practicing managers are interested in this subject because among the most crucial decisions of the firm are those which relate to finance, and an understanding of the theory of financial management provides them with conceptual and analytical insights to make those decisions skillfully.

Given the capital budgeting decision of a firm, it has to decide the way in which the capital projects will be financed. Every time the firm makes an investment decision, it is at the same time making a financing decision also. For example, a decision to build a new plant or to buy a new machine implies specific way of financing that project.

OBJECTIVES:

the project is an attempt to seek an insight into the aspects that are involved in the capital structuring and financial decisions of the company. This project endeavors to achieve the following objectives.

- To study the capital structure and its impact on profitability **s** through ebit-eps analysis
- Study effectiveness of financing decision on eps and ebit of the firm.
- Examining leverage analysis of **ramco cements**.
- Examining the financing trends in the **ramco cements**. For the period of **2021-24**
- Study debt/equity ratio of **ramco cements** for **2021-24**

SCOPE:

a study of the capital structure involves an examination of long term as well as short term sources that a company taps in order to meet its requirements of finance. The scope of the study is confined to the sources that **ramco cements** tapped over the years under study i.e. **2021-24**

NEED FOR STUDY:

the value of the firm depends upon its expected earnings stream and the rate used to discount this stream. The rate used to discount earnings stream it's the firm's required rate of return or the cost of capital. Thus, the capital structure decision can affect the value of the firm either by changing the expected earnings of the firm, but it can affect the reside earnings of the shareholders. The effect of leverage on the cost of capital is not very clear. Conflicting opinions have been expressed on this issue. In fact, this issue is one of the most continuous areas in the theory of finance, and perhaps more theoretical and empirical work has been done on this subject than any other.

if leverage affects the cost of capital and the value of the firm, an optimum capital structure would be obtained at that combination of debt and equity that maximizes the total value of the firm or minimizes the weighted average cost of capital. The question of the existence of optimum use of leverage has been put very succinctly by ezra solomon in the following words.

given that a firm has certain structure of assets, which offers net operating earnings of given size and quality, and given a certain structure of rates in the capital markets, is there some specific degree of financial leverage at which the market value of the firm's securities will be higher than at other degrees of leverage?

the existence of an optimum capital structure is not accepted by all. These exists two extreme views and middle position. David durand identified the two extreme views the net income and net operating approaches.

RESEARCH METHODOLOGY AND DATA ANALYSIS

Data relating to **ramco** cements. Has been collected through

SECONDARY SOURCES:

Published annual reports of the company for the year 2021-24

DATA ANALYSIS:

The collected data has been processed using the tools of

- Ratio analysis
- Graphical analysis
- Year-year analysis

These tools access in the interpretation and understanding of the existing scenario of the capital structure.

LIMITATION:

eps is one of the mostly widely used measures of the company's performance in practice. As a result of this, in choosing between debt and equity in practice, sometimes too much attention is paid on eps, which however, has serious limitations as a financing-decision criterion.

the major short coming of the eps as a financing-decision criterion is that it does not consider risk; it ignores variability about the expected value of eps. The belief that investors would be just concerned with the expected eps is not well founded. Investors in valuing the shares of the company consider both expected value and variability.

REVIEW OF LITERATURE

Modigliani and miller (1958) in their original work prove that under a restrictive set of assumptions, capital structure is irrelevant. This was advocated in modigliani and miller's (mm) proposition i which says that the

value of a firm in the absence of taxes is independent of its leverage. Mm also advocated under proposition ii which says that the cost of equity of a levered firm increases in proportion to the increase in debt-equity ratio expressed in market values. The cost of equity increases when leverage increases as the cost of equity increases with leverage (ross, stephen, randolph, & jaffe, 1993). Equity risk increases because the remaining shareholders have to bear more of the firm's business risk as more debt is used. When taxes are included, the value of a levered firm under proposition i increases by the amount of the tax shield which is equal to the corporate tax rate (t) multiplied by 7 the amount of debt used. With taxes, according to proposition ii, a levered firm's cost of equity rises in proportion to the debt-equity ratio multiplied by (1-t). Since (1-t) is less than 1, corporate taxes cause the cost of equity to rise less rapidly with leverage than when there are no taxes (brigham, eugene, louis, & michael, 1999).

Myers (1984) gave an explanation about two options in capital structure. Firstly, the static tradeoff hypotheses argues that firms trade off the tax benefits of debt financing against the costs of borrowing by substituting debt for equity or vice-versa until the value of the firm is maximized at an optimal capital structure point. Beyond this point bankruptcy-related costs exceeded the tax benefits and the costs of financial distress increase. The second way of thinking is the pecking order theory which says that firms prefer internal finance (myers & stewart, 1984). If external finance is needed, firms issue the safest security first, starting with debt, then possibly hybrid securities and finally equity as a last resort. This is because managers often have asymmetric information about their firms' prospects and prefer to issue debt to equity when their inside information is favorable. They will prefer equity to debt only when prospects are favorable.

Fama and french (1998), inspired ordinary least square (ols) specification with the first large sample attempting to empirically estimating modigliani and miller (1963). They empirically regressing firm value with interest expense (their proxy for debt) with controls for vu. They use the excess of market value over book value assets as the proxy for vl. Their controls include earnings, r&d expenditures and dividends. They found that the coefficient of interest is generally negative or insignificant in their regressions which they attribute to either non-existence of tax benefits, or inadequate controls for future profitability (jayaraman, 2006).

Modigliani and miller (1958) theory is developed with the assumptions of a perfect and complete markets, which the only imperfections explicitly modeled in mm is the tax deduction of interest expense. Nevertheless, while empirically estimating relationship between firm value and debt, one has to take into account real-world imperfections such as agency and asymmetric information that has been assumed away by modigliani and miller (jayaraman, 2006). Miller (1988) states that "… price reactions to dividend announcement were not really refutations (of the mm hypotheses). They were better seen as failures of one of the key assumptions of both 9 leverage and dividend models, namely, that all capital market participants, inside and outside investors, alike, have the same information about the firm's cash flows" (jayaraman, 2006).

Stiglitz (1988) states that once informational asymmetries are incorporated, firm's choice of capital structure conveys information on the firm's prospects to lenders and purchaser of equity. On the other hand debt-equity ratios serve to signal management's private information about the firm's future profits (ross s. , 1977). When outstanding debt matures after firm's investment option expires, firms with high levels or growth opportunities issues less debts, which evidence that a firm's growth options did have influences on its debt level (myers s. ,

1977). The markettiming literatures argue that firms take advantage of their share pricing while making capital structure decision.

Baker and wurgler (2002) found that when share prices are high, managers prefer to issue equity instead of debt, which decreases the debt ratio (jayaraman, 2006). The hausman test is used in applied economic work as a test of misspecification. It is most commonly thought of (wrongly some would say) as a test of whether one or more explanatory variables in a regression model are endogenous (chmelarova, 2007). Jayaraman (2006) used the hausman test in two stages. In stage one, the suspected endogenous variable is regressed on an instrument and the other related exogenous variables from the primary equation. He added that in second stage, the predicted regression residual from the first stage is used as an additional explanatory 10 variable in the primary regression. He argue that if the residual is statistically significant, then the suspected endogenous variable is indeed endogenous (beaver, macnally, & stinson, 1997)

Jensen & meckling (1976) stated that managers with substantial free cash flow are able to increase dividends or repurchase stock and thereby pay current cash that would otherwise be invested in low-return project or wasted. They added that the fact that capital markets punish dividend cuts with large stock price reductions is consistent with the agency cost of free cash flow.

Debt can be effective substitute for dividend, something that is not recognizing in the corporate finance. By issuing debt in exchange for stock, managers are bonding their promise to pay out future cash flows in a way that cannot be accomplished by simple dividend increase (jensen & meckling, 1976). Thus debt reduces the agency cost of free cash flow by reducing the cash available for spending at the discretion of managers. These control effects of debt are a potential determinant of capital structure.

Cash flow and liquidity can affect the cost of borrowings. Myers s. (1977) notes that the pervasive empirical capital structure regularity is the inverse relation between debt usage and profitability. The effect of liquidity and profitability can be offset by free cash flow consideration. Jensen m. (1986) theorizes that managers of firms with free cash flows might lack discipline. The implication of this argument is that firms should issue debt which committing to distribute free cash flows as interest payments to discipline management into working efficiently.

DATA ANALYSIS
&
INTERPRETATION

YEAR 2018-2019

Performance of company (Amount in Rs.'000s)

Gross Revenue	773919	Total Expenditure	743342
Profit (Loss) before tax	30577	Profit after tax	29077
Earnings per share Rs.	1.79	Dividend ratio	10%

YEAR 2019-2020

Performance of company (Amount in Rs.'000s)

Gross Revenue	742200	Total Expenditure	711921
Profit (Loss) before tax	30279	Profit after tax	27450
Earnings per share Rs.	1.69	Dividend ratio	10%

YEAR 2020-2121

PERFORMANCE OF COMPANY (AMOUNT IN RS.'000S)

Gross Revenue	726774	Total Expenditure	715556
Profit (Loss) before tax	11218	Profit after tax	10412
Earnings per share Rs.	0.64	Dividend ratio	5%

YEAR 2021-2022

PERFORMANCE OF COMPANY (AMOUNT IN RS.'000S)

Gross Revenue	726774	Total Expenditure	715556
Profit (Loss) before tax	11218	Profit after tax	10412
Earnings per share Rs.	0.64	Dividend ratio	5%

YEAR 2022-2023

PERFORMANCE OF COMPANY (AMOUNT IN RS.'000S)

Gross Revenue	924313	Total Expenditure	872511
Profit (Loss) before tax	51802	Profit after tax	25219
Earnings per share Rs.	1.55	Dividend ratio	10%

YEAR 2023-2024

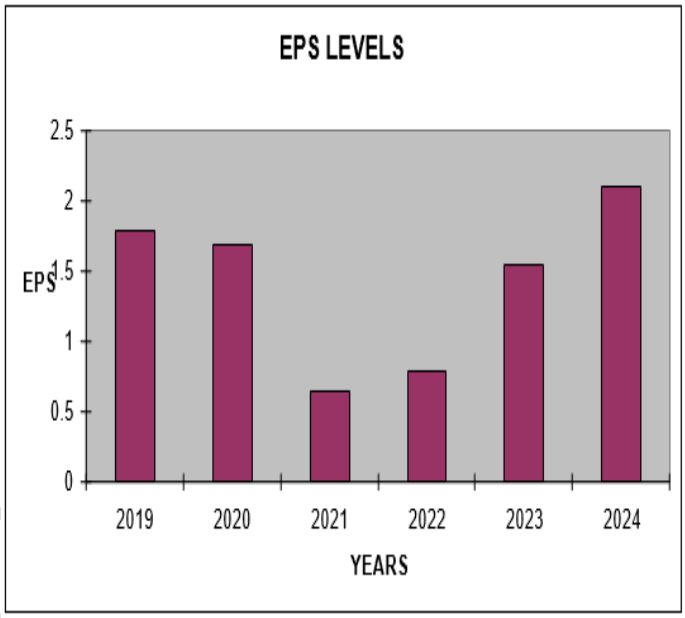
PERFORMANCE OF COMPANY (AMOUNT IN RS.'000S)

Gross Revenue	1275243	Total Expenditure	1203680
Profit (Loss) before tax	71313	Profit after tax	34078
Earnings per share Rs.	2.10	Dividend ratio	15%

PERFORMANCE

EPS ANALYSIS

Particulars	2019	2020	2021	2022	2023	2024
Profit After Tax	29077000	2745000	10412001	30569000	32806000	34078000
Less: Preference Dividend	-	-	-	-	-	-
Amount of Equity share holder	29077000	27450000	10412001	12857000	25219000	34093133
No. OF equity share of Rs.10/- each	16234825	16234825	16234825	16234825	16234825	16234825
EPS	**1.79**	**1.69**	**0.64**	**0.79**	**1.55**	**2.1**



Interpretation

The pat is in an increasing trend from **2021- 22** because of increase in sale prices and also decreases in the cost of manufacturing. In **2023** and **2024** even the cost of manufacturing has increased by 5% because of higher sales volume pat has increased considerably, which leads to higher eps, which is at 9.36 in **2024**.

FINDINGS, SUGGESTIONS AND CONCLUSION

FINDINGS:

1. Sales in **2021- 22** are at 7267.74 and in **2023**- 2024 12752.43 lakh those in a decreasing trend to the extent of 20% every year. On the other hand manufacturing expenses are at 8725.11 lakh from **2022**- 2023. There has been significant increase in cost of production during **2022**- 2023 because of increase in royalty.

2.the interest charges were 492.21 in **2022** and 357.07in **2023** and 522.56 respectively shows that the company redeemed fixed interest bearing funds from time to time out of profit from **2021- 22**.debantures were partly redeemed with the help of debenture redemption reserve and other references.

3. The pat (profit after tax) in **2023**- 2024 is at 340.78 lakh. The pat has increased in prices in whole cement industry during the above period. The profit has increased almost 15% during the period **2021**- 2024.

4. Debentures were redeemed by transfers to d.r.r. In **2022**- 2023.

5. A steady transfer for dividend during **2021- 22** from p&l appropriation but in **2021** there is no adequate dividend equity shareholders.

6. The share capital of the company remained in charge during the three-year period because of no public issues made by the company.

7. The secured loans have decreased consistently from **2021- 22** and slight increase in **2024**.

8. The ensured loans have increased from **2023**- 2024. All the secured and an insecure loan obtained by the company to optimize the leverage financially have some set books. Because of non-payment of dividends to share holders. Because of less profit made during the period.

SUGGESTIONS

1. The company has to maintain the optimal capital structure and leverage so that in coming years it can contribute to the wealth of the shareholders.

2. The mining loyalty contracts should be revised so that it will decrease the direct in the production

3. The company has to exercise control over its outside purchases and overheads which have effect on the profitability of the company.

4. As the interest rates in pubic financial institutions are in a decreasing trend after globalization the company going on searching for loan funds at a less rate of interest as in the case of uco bank.
5. Efficiency and competency in managing the affairs of the company should be maintained.

6. The reserves of the company steadily increase from **2021** to **2024**. Because of less transfer in p&l appropriation a/c and transfer to differed tax. Thus marginalizing the equity interest net worth of the company.

CONCLUSIONS

1) Sales in **2021- 22** are at 7267.74 and in **2023**- 2024 12752.43 lakh those in a decreasing trend to the extent of 20% every year. On the other hand manufacturing expenses are at 8725.11 lakh from **2022**- 2023. There has been significant increase in cost of production during **2022**- 2023 because of increase in royalty.

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