CHAPTER – I

INTRODUCTION

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1.1 INTRODUCTION:

Financial management is the area of business administration devoted to planning and control of firm's financial resources. The three important activities of business firm are: finance, production and marketing. The important finance functions are: investment, financing and dividend.

In financial management, the primary purpose of the operation of a firm is the maximization of the owners' wealth as represented by the value of the business. Financial management involves the solution of the three major decisions. Together, they determine the value of the firm to its shareholders. Assuming that firm's objective is to maximize this value, the firm should strive for an optimal combination of the three interrelated decisions, solved jointly. The decision to invest in a new capital project necessitates financing the investment. The financing decision, in turn influences and is influenced by the dividend decision. The retained earning which is used as internal financing represents dividends forgone by stockholders. The main thing is that the finance manager relates each decision to its effect on the valuation of the firm.

The investment decision is referred to as capital budgeting decision. This relates to the allocation of capital and involves decisions to commit funds to long-term assets, which would yield benefits in future. This involves estimation of profit on account of investment. As the future is uncertain, capital budgeting involves risk. Thus the projected profitability as well as the risk factors are to be taken into consideration to decide the viability of the investment. Various techniques have emerged over a period of time for capital budgeting decision, viz, Pay Back Period, Accounting Rate of Return, Net Present Value, Internal Rate of Return, Benefit Cost Ratio, etc. The first two belongs to non-discounted approach. The later belongs to discounted approach. This implies that while applying first two techniques, the projected cash flows or profit are taken as it is without considering the time value of money, whereas, in the later approach, time value of money is taken into consideration. For this purpose discounting is to be applied. The question arising at this juncture is regarding the rate of discount. This discount rate is necessarily dependent on the cost of capital, as it indicates the return expected by the stakeholders. This necessarily leads to the intricacies of the financing decision. The cost of capital depends on various sources of finance. The optimum combination of various sources of finance is to be determined by the finance manager. The proportions of equity, debt, term loan etc, are to be determined with caution by the finance manager. The higher proportion of equity with wide number of shareholders affects to control of the organisation. The higher proportion of equity also increases the cost of capital, as the equity has higher cost, being risky source of finance for investors. The higher proportion of debt will be risky from the point of view of organisation as it involves compulsory payment of interest. This may directly affect to solvency aspect of the organisation. The finance manager will have to strike a proper balance between return and risk. When the shareholder's return is maximized with minimum risk, the market value per share will be maximum and firm's capital structure would be optimum. In addition to meeting with the capital budgeting needs, funds are also required for the working capital. The part of the working capital requirement is permanent in nature and partly they are fluctuating. Thus over and above the capital structure decision for the firm, it is essential for the finance manager to have funds available for day-to-day requirement. This calls for examination of the overall financial structure. The financial structure has effect on both profitability and liquidity of organisation. These both are very important for any firm.

The third important decision for finance manager is the dividend decision. The finance manager must decide whether the firm should distribute all profits or retain all or distribute a portion and retain the balance. The dividend policy should be determined in terms of its impact on shareholders' wealth. The optimum dividend policy is the one, which maximizes the market value per share. Thus, if the shareholders are not indifferent to the firm's dividend policy, the finance manager must determine the optimum dividend payout ratio. The aspects to be considered here are dividend stability, stock dividend and cash dividends.

As seen above the viability of capital budgeting decision is dependent on cost of capital. The cost of capital is dependent on the capital structure. The capital structure is in turn affected by the dividend policy. Thus capital structure turns out to be the central theme of effective financial management. It is with this background that the present study intends to examine the various aspects of the capital structure, financial structure of Chemical and Pharmaceutical Companies in India.

At present, chemical and pharmaceutical companies are of small scale and large-scale units in our country. The demand for chemicals and pharmaceuticals is increasing by leaps and bounds. Thus, analysis of financial structure of Chemical and Pharmaceutical industry is very important.

Chemical products have made a significant contribution towards arranging food production by supplying fertilizers and pesticides. Chemicals of one type or the other are required in almost all industries like textiles, paper, sugar, pharmaceuticals, plastics, man-made fibers and so on. Chemical products are substituting other materials in practically every sector of the free economy. They have also played some part in conservation of water resources, development of improved construction material to substitute metals and in meeting the needs of the health of the population. The chemical industry includes organic chemicals, inorganic chemicals, petrochemicals, pharmaceuticals and drugs, dyestuffs, fertilizers, agro-chemicals and many others which produce products like paints, varnishes and so on. Gujarat and Maharashtra are the two main states for the production of chemical and pharmaceutical items in India. For any country's economic development, chemical industry should be given a priority, because this industry improves the economic condition of a nation. Also to meet the needs of growing population of India, production of chemical products should be increased.

Moreover, chemical and pharmaceutical companies also play a very vital role in the business and society. It serves a vital social need and is an industrial asset. The wide spread use of chemical is made in varieties of products which are useful to our people. Similarly, the pharmaceutical may provide wealthy health to the people. Our lives are touched at several points by its products.

1.2 RATIONALE OF THE STUDY:

Finance is considered to be the lifeblood of the business. A business needs funds at every stage. It is hardly possible to think of a business activity without finance. It is necessary from inception of the business. Finance is required for inventory, fixed assets, working capital, repayment of liabilities, expansion of the business, modernization of activities, development of new technology, etc. It depends on the super structure frame by the finance manager. The business firms use different sources of funds for their growth. The business firms could prosper and build a sound financial base only if it gets adequate finance and that too at a minimum or reasonable cost. Getting funds at the cheapest cost in proper sum is the main function of finance manager. However, the process does not end with the intent of making the most appropriate use of it that have been acquired. It is the responsibility of the finance manager to manage the same efficiently. The financial structure of the organization plays a vital role for the success of the firm.

The financial structure is frequently voluminous, cumbersome and detailed, to the point where they are almost useless to top management, because it becomes very tedious job for them. The analysis and interpretations of the financial structure results in the presentation of information that will aid in decision making by business managers, investors, creditors, and other groups who are interested in the financial status and operating result of a business. However, the analysis of financial structure can not give an absolute answer to every question of doubt. It may throw light and can point to the direction in which further inquiries should be made. The importance of the study is emphasized by the fact that the success or failure of any organization depends largely on how efficiently decisions relating to procurement (acquire) and allocation of funds, cash flow estimates, controls of current performance utilization of funds, etc, are made.

A company should have the right kind and amount of assets to run in each and every conditions. Some companies do not plan their capital structure and it develops as a result of the financial decisions taken by the financial manager without any formal planning. These companies may prosper in the short-run, but ultimately they may suffer considerable difficulties in raising funds to finance their activities without planning of capital structure. The liabilities and shareholders' equity of a business as the sources of its assets constitutes its financial structure. Therefore the financial manager should plan an optimum capital structure of his company. The optimum capital structure is obtained when the market value per share is maximum. The determination of an optimum capital structure is a difficult job and one has to go beyond the theory. The manager should keep the objectives of sound liability and equity management in his mind. There are significant variations among industries and among individual companies, within an industry in terms of capital structure. There are many circumstances and number of influencing factors in the decisions of capital structure. At that time the judgment of the person making the capital structure decision plays a vital role. From various combinations of amounts and types of liabilities and equity items, decision maker has to decide the best combination to the circumstances and other conditions of the individual company. Firstly, they have to decide on what proportion of the assets can appropriately be sought from creditors and the remaining proportion, therefore must be obtained from shareholders equity. Further decisions are necessary on the proportions that should be sought for short-term and long-term respectively. Finally, the decisions are needed about the extent to which equity contributions by way of accumulation of profits can or should be depended on.

Considering the significant role played by the capital structure in success of the firm, it is considered to be an area of interest for research. Varieties of research work are carried out in the said area. Based on literature survey, it is observed that there are varieties of factors affecting in determination of capital structure. The determinants of capital structure may relate to the asset structure of the firm, it may relate to profitability of the firm, it may also relate to size of the firm. Many studies are carried out considering these factors to find the impact of the same on capital structure. However, in the course of literature survey it is observed that there is pancity of the studies carried out taking either long span for study, or taking more indicators of capital structure, etc.

In the light of this it is found interesting to carry out research in the area of "Analysis of Financial Structure of Chemical and Pharmaceutical Companies in India".

1.3 OBJECTIVES OF THE STUDY:

In the light of above background, the main objective of the study is to carry out detailed analysis of financial structure of the Chemical and Pharmaceutical companies in India. This can be precisely put as follows:

1. To analyse the financial structure of Chemical and Pharmaceutical companies of India for the period under consideration.
2. To examine the theory followed by the company, viz, Pecking order or Trade-off theory.
3. To examine the impact of asset structure on financial structure.
4. To examine the impact of profitability on financial structure.
5. To examine the impact of size on financial structure.
6. To examine, difference, if any, of the impact of asset structure, profitability and size of firm in pre and post reform era.

1.4 RESEARCH METHODOLOGY:

a. DATA:

For the purpose of our study, period selected is 1981-1999, which includes both pre and post reform period. The data are collected from Bombay Stock Exchange Official Directory, Bombay.

The present study includes Public Limited Chemical and Pharmaceutical Companies, which are listed in Bombay Stock Exchange of India. There are about 250 companies, which are working and listed in the Bombay Stock Exchange of India. The number of companies under analysis are limited, on account of period of analysis, which is intended to be from 1981-1999. For 28 companies data are available for all 19 years and for other 17 companies data are available for 1981-1996. Till 31ST January 2001, the data of year ending March 1999 of remaining 17 companies were not available from Bombay Stock Exchange Official Directory, Bombay.

The companies have been selected by taking following factors into consideration:

1. Only those companies, which are registered with the Bombay Stock Exchange, Bombay as on 31st March 1999, are selected.
2. The companies for which data for the entire period of study (i.e. from the year 1981 to 1996 and from 1981 to 1999) are available, are only considered.
3. The selected companies should represent the companies of different size, fixed assets, equity capital and net sales.

B. METHODOLOGY:

For the purpose of analysis of data it is a prerequisite that they should be comparable. While going through the data it was observed that the year ending for different companies is different. Moreover, it was also observed that the companies have changed their year ending, during the period under study. Hence, to make data comparable, and to carry out systematic analysis, data are adjusted for 12 months period for having uniform year ending, viz, 31st March.

For the purpose of analysis of financial structure to begin with various ratios are computed for period under consideration. Based on computed ratios taking all companies together yearwise averages are derived. Taking all years together for each company average is derived. Based on both these grand average is also derived. Moreover, as a measure of dispersion, standard deviations and coefficient of variations are also derived for all companies, between the years and for all years between the companies. In the next step detailed analysis is carried out for capital structure. After identifying various ratios indicating capital structure, an attempt is made to examine the impact of asset structure, profitability and size on capital structure. It is worth mentioning here that 4 ratios are identified, as indicator of capital structure, viz, D/E ratio, LTD/TA ratio, TD/TA ratio and TE/TA ratio. Moreover, as indicators of asset structure GFA/TGA, NFA/TNA, are selected, as indicator of profitability OPI/TGA, OPI/Sale and PBT/TNA are selected, and as indicator of size, average asset size is selected. These factors are selected based on existing available literature. For the purpose of examining the impact of these independent variables on variables indicating capital structure, simple regression selecting each variables independently are carried out. Moreover, to examine the combined effect of selected variables, multiple regressions are also carried out.

To examine the level of significance of effect of independent variables on selected dependent variables, t-test is applied and to examine fitness of model F-test is applied.

In addition to above study, it was also an area of concern to examine the changes in impact of various variables in pre reform and post reform era. For this purpose pre reform era is considered from 1981-1991 and 1992-1999 is considered as post reform era. To examine this, use of dummy variables is made in the regression model.

1.5 CHAPTER SCHEME:

The study is divided into 7 chapters.

Chapter one is "Introduction". It discusses background of the study, rationale of the study, objectives of the study and methodology of the study.

The second chapter "Survey of Existing Literature" carries out survey of the available literature on the given subject.

The third chapter "Theory of Financial and Capital Structure" discusses meaning of financial structure and capital structure, features of an appropriate capital structure, determinants of capital structure, optimum capital structure, Modigliani

Miller's hypothesis, financial distress and approaches to establish appropriate capital structure. The chapter also discusses in detail Pecking order and Trade-off theory.

The chapter four "Determinants of Financial and Capital Structure" explains various ratios used for the purpose of study, alongwith its meaning, significance and method of derivation.

Chapter five "Analysis of Financial and Capital Structure" analyses the financial structure of selected sample companies for selected years. For the purpose of analysis ratios indicating financial structure, profitability and asset structure are derived. After derivation of ratios for selected period their average, standard deviations and coefficient of variations are also derived to have an overall idea.

In the next chapter six, "Analysis of Capital Structure", an attempt is made to examine the impact of asset structure, profitability and size on the capital structure, taking all years under study together, as well as taking each year separately. Moreover, to scan the effect of reforms, the analysis is also made to examine the extent of change in the impact of independent variables on capital structure.

Chapter seven gives brief summaries of each chapter alongwith findings of analysis. This is followed by bibliography.