Impact of Debt on Financial Health of Select Companies

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ABSTRACT:

Indian firms are highly leveraged. In this paper, we examine the effect of debt structure on several dimensions of the strategic behavior of firms and on their performance of the Indian Economy, which is one of the largest and most important economies of the world today. To understand how companies finance their operations, it is necessary to examine the determinants of their financing or capital structure decisions. Company financingdecision involves a wide range of policy issues. Therefore, the present study focuses on investigate the capital structure patterns of the selected companies under the selected 4industries and to test the extent of variations among industries as also among individual's firms companies with in the same industry.

Key Words:

Debt, Profitability, Capital Structure, Leverage, Industry.

INTRODUCTION:

Capital structure and company's growth is important for any firm because a company success depends on its growth and required capital. In competitive market growth shows strength and stability of firm and profitable continuation in long run. Firm required funds which could be arranged either by debt or by issuing equity which is called capital structure of the company. Every organization has different policies to set their capital structure and managers make their policies according to size and nature of the company. Usually debt portion is lower than equity portion because firm wants to minimize its risk as well as to avoid bankruptcy. Debt capacity is the ability to borrow. It deals with the amount of fund that a company can borrow. There is no set pattern to set the portion of debt in the capital structure. The choice of debt for the fund is the crucial issue in the corporate financial policy.

There are different factors to consider before taking any decision regarding its debt. Taxes are deductable expense therefore are favorable for the firms when the tax rates are high, companies move to debt to reduce the burden of taxes. Management styles either conservative or aggressive may also be a reason which can support company to determine its debt level. Generally firms with conservative style use less debt and prefer equity and firms with aggressive style use more debt. Some times company prefers to borrow fund when company is not in a position to issue more equity. When the firms projected earnings are not reflected in stock prices so firms prefer to finance with debt than higher earnings are reflected in stock prices and when the firm is financially strong it increases money from the equity but when the firm is not financially strong it arranges more from debt. Organizations do not have ability to borrow money as much as they want in some cases. Many factors are involved which stops them to borrow but the main factor is the growth of the company because if the companies growth is on the track their debt level would be high and the company growth level is not on track then their debt level would be low. For maximizing firm's value, the important point for every financing decision made by the management of the company to increases their debt capacity than on the other side they are going to increase the risk factor if they do not get proper return as expected or forecasted then it becomes very risky for company can move to liquidation or bankruptcy.

DEBT STRUCTURES IN INDIA- AN ANALYTICAL FRAMEWORK:

Debt has two key characteristics that make it distinctive from equity. Firstly, debt holders have the right to a fixed income stream from the issuers of debt. Secondly, debt holders have the right to repossess collateral, which are often the tangible operational assets of the enterprise. If the actions of managers take the firm to bankruptcy if are not assured of a fixed income stream and do not have the right to repossess collateral.

Instead, equity holders can vote out managers and directors, who represent intangible organizational assets of the enterprise, who they believe are not acting in their best interests .The exercise of these rights, however, depends on history, the formal rules of the jurisdiction in which the equity and debt holders are located, and the manner in which these rules are implemented. This implies that the way in which the firm's debt composition and equity structure may impact its diversification strategies will depend to a large extent on the institutional context of the economy where the firms are located. Much of the corporate governance literature has concerned itself with the implications of the different rights that debt and equity holders have for the firm's choice of capital structure and for its strategic behavior and outcomes. An important strand of the literature has argued that the presence of debt in the firm's capital structure can play a discipline role on the managers of the firm. However, debt is itself not a homogenous entity and different types of debts have different characteristics that may have different implications for the strategic choices and behavioral outcomes of the firm.

Indian firms typically borrow using five types of debt instruments: (1) short-term unsecured borrowings from commercial banks; (2) long-term secured borrowings from term-lending institutions; (3) secured long-term borrowings in the form of debentures; (4) unsecured long-term borrowings in the form of fixed deposits, and finally (5) a residual category called 'other borrowing' which includes trade credit and other funds accessed from the inter-corporate market. Ignoring the residual category, the five types of borrowings have three sets of characteristics that may have implications for the firm's strategic behavior .Bank borrowings are the most important source of borrowing for firms in Indian industry at an average level of 39.7 percent of total borrowing, followed by borrowings from other financial institutions at 29.7 percent. Debentures and fixed deposits comprise 11.6 and 5.8 per cent of total borrowing respectively, while other borrowing comprises 13.1 per cent of total borrowings.

REVIEW OF LITERATURE:

The following are the studies have been carried out by the academicians, scholars, practitioners and professionals on the impact of debt on the financial health of select companies.

AnisJarboui and HamadiFakhfakh(2011) argued that the impact of banks on the adoption of specific investment in French non-financial companies through broad representation and ownership stakes. The theoretical principles suggest that the banks refuse the financing of this investment. Therefore , the level of banking debt has a negative effect changes according to the contribution of bankers in the corporate governance system.AtharIqbal et. al (2012) concluded that the financial choice of the debt capacity as the source of capital and its impact on growth of the firm. The results reveals a significant positive relation between the debt to asset ratio and market to book ratio. Jyothi   K (2012) Observed that the proportion of both long -term and short-term debt in capital structure firms under cement, pharmaceutical and IT sectors differ significantly across the levels of operating risk tend to use more long-term relative to total assets compared to firms at moderate and high level of risk.KaushikChakraborty (2012) conclude that the extent of relationship between efficiency of cash management and profitability, between efficiency of debtors management and profitability   of the selected companies and and to compare the said matters of the multinational companies with that of domestic companies in Indian Pharmaceutical sector.

MihaelaDragota and AndreeaSemenescu(2009) identified that there are four explanatory variables are selected for analysis of the capital structure determinants based on linear multiple regression model in the Central and Eastern European Countries.Nishi Sharma and GurumailSingh(2014) diagnoses the impact of eight independent variables over leverage through pooled, fixed effect and random effect regression analysis. The results divulged that leverage is positively related with size, tangibility and growth whereas it has negative relation with tax rate.Sumit K. Majumdar and KunalSen (2010) examined that the consequences of the important role that debt plays in the capital structure of Indian corporate firms. The study that effects of debt structure of firm's strategic behavior such as diversification, advertising and outsourcing.VijayaLaxmi B et. al (2013) argued that the telecom sector plays a crucial role in the economy and has undergone major reforms and restructuring for better financial viability and providing better services to customers.YaminiAgarwal, K et. al (2009) observed that the extense of multiple consideration/goal perceived by a decision maker in Capital Structure Decision. They also found that the firm specific and time variant of capital structure.

Use of equity was more predominant than debt and Indian CEO were found to be more conservative.YaminiAgarwalet. al (2011) found that the macro economic factors were found to have less significant influence over the capital structure in India. Indurstry dynamics has been observed to play a significant role. The Indian Capital Structure as per the balance sheet values appears robust and less susceptible to bankruptcy.

NEED AND IMPORTANCE OF THE STUDY:

A company determines the proper limitation of borrowing, i.e., the appraisal of risk associated with debt financing and the establishment of borrowing limits. It will show how successful industrial corporations make the choice between debt and equity as the source of long-term capital. The determination of debt capacity is the appropriate limit to the amount of long-term debt outstanding at any point of time. Therefore, there is a need and importance about "Impact of Debt on Financial Health of Select Companies". This study will help companies to maintain their debt portion and their growth. This study is addresses that how debt capacity and firm growth are linked and how company can change its debt portion while maintaining its growth level.

OBJECTIVES OF THE STUDY:

The main objective of proposed study is to examine the cause and effect of debt on financial health of select companies. The following are the sub objectives of the study:
1.To study the significance of debt management.
2.To identify the debt management practices in Indian corporate sector.
3.To analyze the impact of debt on financing and investment pattern of select companies.

4.To examine the impact of leverage on the profitability and liquidity of select companies.
5.To evaluate the impact of debt management on the financial health of the select companies.

HYPOTHESIS OF THE STUDY:

On the basis of above objectives, the following hypotheses will be formulated.
H1: There is no significant relation among the debt management practices of select companies.
H2: There is no impact of leverage and the investment pattern of select companies.
H3: There is no impact of leverage on the profitability.
H4: There is no impact of leverage on the liquidity.
H5: The value of the sample firm is independent from the financing decision.

RESEARCH METHODOLOGY:

Data Sources: The study isexamine the impact of debt on financial health of select companies as a whole. The relevant data will be collected from the secondary sources comprising of published monthly and annual reports of select companies. In addition, official websites of SEBI, RBI, NSE, BSE and CMIE, various reputed journals, magazines will be referred.

Sample Design: The data that will be used in this study are the financial reports of 20 companies, 5 each from Cement, Pharmaceutical, Steel and Telecommunication for the years from 2002-03 to 2012-2013. The target companies are identified using stratified sampling techniques based on size, based on ten years' data availability and if the total assets value of the company were more than Rs.100 crore.The following are the companies of select study.

CEMENT INDUSTRY	PHARMACEUTICAL INDUSTRY	STEEL INDUSTRY	TELECOMMUNICATION INDUSTRY
ACC	CIPLA	TATA	BSNL
ULTRATECH	RANBAXY	SAIL	RELIANCE
BIRLA	Dr. REDDY	JINDAL	AIRTEL
AMBUJA	AURABINDO	JSW STEEL	VODAFONE
KESORAM	LUPIN	BAJAJ	IDEA

Period of the study:

The present study will cover the period of 10 years i.e., from 2002-2003 to 2012-13; more specifically, the period subsequent to the initiation of liberalization measures.

LIMITATIONS OF THE STUDY:

Though the present study is very compressive in nature, following limitations are subject to the study:

1.The study is purely based on secondary sources of information.

2.The study is restricted to only the select companies from Cement, Pharmaceutical, Steel and Telecommunication industries.

3.The study is limited to the period from 2002-03 to 2012-2013.

4.The target companies are identified using stratified sampling techniques based on size to identify the target companies.

DATA ANALYSIS:

The sample contains a company that has an equity base of Rs. 4,000.00 crores and a small equity base of mere Rs. 15 crores . On an average most companies have an equity value in each firm which defined the stake of the owners of the company.

Table I			
Industry Composition of 20 Companies			
S. No	Industry Sector Composition	Number of Companies in each industry	Percentage of the industry in Sample Survey
1	Cement Industry	5	25%
2	Pharmaceutical Industry	5	25%
3	Steel Industry	5	25%
4	Communication Industry	5	25%
	Total	20	100%

(Souce: Self Structured)

Variations in the Leverage positions :

The average, maximum, minimum and range values for the industries are given in the Table II and average position is highlighted. The minimin long-term debt ratio was observed in Telecommunication Industry (0.54) andminimax position was observed in Cement Industry (2.67). The maximin position of long term debt to equity ratio was observed in Cement Industry and maximax position was observed in Pharmaceutical Industry.

The other leverage ratio which was considered to understand the leverage positions in the Indian firm as suggested on the review of the study sample was the total debt to equity ratio which is given in Table III and its descriptive statistics is presented .The ascending order of the total debt to equity ratio in reference to the industry in the sample was as follows- Pharmaceutical, Cement, Steel and Telecommunication Industries.highest leverage was still observed in the 2006 (2.68)and the lowest in the 2003 (0.40).

The total debt to equity ratio on year -to –year basis had an erratic movement or trend and lacked consistency to exhibit any specific trend. For instance the ascending order of the total debt to equity ratio with respect to the years in the sample was as follows-2010, 2003, 2004, 2006, 2008, 2005, 2009, 2011, 2012 and 2013.

CONCLUSION:

The present study concludes that a firm withlow leverage will have the ability to raise greater levels of subsequent debt, and this possibility will enable it to engage in contemporary aggressive strategic behaviour that leads to product market success. Similarly , a firm with higher leverage or other financial constraints can be vulnerable to the predatory or the aggressive behaviour their rivals to weaken them financially by aggressive strategic behaviour and these firms cannot respond with similar strategies since the financial outcomes can become ruinous.

Since firms with high debt levels are monitered and require periodic re- financing , negative financial parameters can lead to denial of re financing or loan recall. Finally, this study concludes that the firm high leveraged will behave passively in terms of competitive strategies.

Table II

Table II Industry Wise Long Term Debt to Equity Ratio

Industry	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	Min	Max	Range	Avg.
Cement Industry	1.95	2.13	2.14	2.17	2.61	2.22	2.63	2.64	2.67	2.66	1.85	1.85	2.67	0.82	2.16
Pharma ceutical Industry	3.66	3.22	3.16	3.22	3.17	3.21	3.02	3.69	2.66	2.11	1.95	1.95	3.69	1.74	3.01
Steel Industry	3.59	1.24	0.92	2.48	1.36	2.22	2.12	2.61	2.39	2.15	2.60	0.92	3.59	2.67	2.15
Communi cation Industry	2.02	1.36	0.56	0.54	0.66	1.51	1.33	2.15	2.22	2.66	2.10	0.54	2.66	2.12	1.56
Min	1.95	1.24	0.56	0.54	0.66	1.51	1.33	2.15	2.22	2.11	1.85				
Max	3.66	3.22	3.16	3.22	3.17	3.21	3.02	3.69	2.67	2.66	2.60				
Range	0.44	1.98	2.60	2.68	2.51	1.70	1.69	1.54	0.45	0.55	0.75				
Avg.	2.80	1.99	1.66	2.10	1.95	2.29	2.28	2.78	2.48	2.39	2.12				

(Source:www.moneycontol.com)

Table III

Industry Wise Total Debt to Equity Ratio

Industry	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	Min	Max	Range	Avg.
Cement Industry	4.13	2.16	4.04	5.03	3.05	2.09	0.90	2.95	0.39	0.21	2.35	0.21	4.13	3.92	2.48
Pharma ceutical Industry	3.66	1.89	2.03	2.50	3.15	3.25	3.39	5.02	3.02	3.33	2.75	1.89	3.66	1.77	3.09
Steel Industry	3.57	1.50	1.16	1.96	1.29	2.50	2.50	2.70	2.89	2.88	2.66	1.16	3.57	2.41	2.33
Communi cation Industry	2.80	1.42	0.60	0.64	0.80	2.31	2.45	2.66	2.75	2.01	1.92	0.64	2.80	2.16	1.85
Min	2.80	1.42	0.60	0.64	0.80	2.09	0.90	2.66	0.39	0.21	1.92				
Max	4.13	2.16	4.04	5.03	3.15	3.25	3.39	5.02	3.02	3.33	2.75				
Range	1.33	0.74	3.44	4.39	2.35	1.16	2.49	2.36	2.63	3.12	0.83				
Avg.	3.54	1.74	1.96	2.53	1.87	2.54	2.31	3.33	2.26	2.10	2.42				
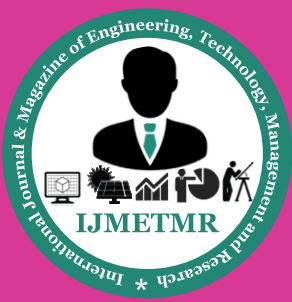
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