Does A Highly Leveraged Capital Structure Of A Firm Influence Its Performance? - A Comparative Study Of High And Low Leveraged FMCG Companies In India

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INTRODUCTION

Business solvency is the ability of an entity to pay its debts with available cash. Solvency can also be described as the ability of a corporation to meet its long-term fixed expenses and to accomplish long-term expansion and growth. The better a company's solvency, the better it is financially. When a company is insolvent, it means that it can no longer operate and is undergoing bankruptcy. Solvency is a different concept from profitability, which refers to the ability to earn a profit. Businesses can be profitable without being solvent (e.g. when they are expanding rapidly). Businesses can be solvent even while losing money (e.g. when they spend future cash flows, like selling accounts receivable). A business is bankrupt when it is unprofitable and insolvent.

The FMCG Sector is one of the most important sectors of any Economy. It plays a vital role in the economy as FMCGs are a necessity and are inelastic products which touch every life in one or the other aspect. India's FMCG sector is the 4^{th} largest sector in the economy and creates employment for more than three million people in downstream activities. There is a huge growth potential for all the FMCG companies, as the per capita consumption of almost all products in the country is amongst the lowest in the world. According to CRISIL anticipation, the FMCG sector could be over INR 140,000 crores by 2015.As the market for FMCG products is forecasted to have vibrant growth, expansion and acquisitions are bound to happen. Capital would be sourced for financing these ventures. Debt servicing definitely has an impact on the profitability of the company.

In this study, an attempt is made to analyze the capital structuring that helps the company to maintain adequate solvency and profitability. An application of researched solvency management practices would definitely help this sector to perform with better profitability.

RESEARCH OBJECTIVES

The study was conducted with the following objectives in mind :

1. To study FMCG companies - Britannia Industries Ltd. (low leverage) and Marico Industries Ltd. (high leverage) on the basis of their performance & short & long-term liabilities, over past five years (FY2008-09 to 2004-05).

2. To Analyze the various financial statements including Solvency Ratio.

3. Based on the analysis, to comment on the Management's Solvency Practices.

PLAN OF ANALYSIS

1. CAGR of Sales, Profit, Expenses;

2. Debt equity;

3. Degree of Leverage;

4. ROE & EPS.

RESEARCH METHODOLOGY

It is an exploratory and analytical study. For the purpose of research, secondary sources of data were used. Data was collected from Annual reports of FMCG Companies, Company websites.*The analysis is based on two companies, one low leveraged (Britannia Industries Ltd.) and one high leveraged (Marico Ltd.)*

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RESEARCH HYPOTHESES

1. There exists a relationship between capital structure and solvency of the company.

2. There is no significant influence of capital structure on the performance of the company.

3. The performance of the company does not depend entirely on capital structure. There are many other factors such as elasticity of the product, price, market penetration, marketing strategy etc.

LITERATURE REVIEW

☸**Ratio Analysis** is the study undertaken to evaluate the financial strength or weakness of a company and its operating trend.

Solvency Ratio = (After Tax Net Profit + Depreciation) / (Long Term Liabilities + Short Term Liabilities)

There are two commonly used ratios relating to servicing long-term debt. One measures ability to pay interest, the other, the ability to repay the principal.

Interest Coverage or Times Interest Earned is the ratio that compares the amount of income available for paying interest with the amount of the interest expense. The amount of income available for paying interest is simply earnings before interest and before income taxes. The Earnings before interest and taxes is known as EBIT.

Interest Coverage or

Times Interest Earned = EBIT/Interest Expense

= (Net Income + Interest Expense + Income Tax Expense) / Interest Expense

The long-term capital structure of a firm is made up principally of two types of financing:

1) Long-term debt **2)** Owner's equity.

Some hybrid forms of financing mix characteristics of debt and equity, but usually can be classified as mainly debt or equity in nature.

Debt / Equity Ratio = LT Debt / Share Holder's Equity

Long term Debt ratio = (LT Debt) / LT Debt and Share holder equity

A high debt/equity ratio generally means that a company has been aggressive in financing its growth with debt. This can result in volatile earnings as a result of the additional interest expense. If a lot of debt is used to finance increased operations (high debt to equity), the company could potentially generate more earnings than it would have without this outside financing. If this were to increase earnings by a greater amount than the debt cost (interest), then the shareholders benefit as more earnings are being spread among the same amount of shareholders. However, the cost of this debt financing may outweigh the return that the company generates on the debt through investment and business activities and becomes too much for the company to handle. This can lead to bankruptcy, which would leave shareholders with nothing.

Long-term debt and preferred stock is divided by common stock equity. This relates securities with fixed charges to those without fixed charges.

Long-Term Debt is obligations such as bonds and notes, which have maturities greater than one year, would be considered long-term debt. Other securities such as T-bills and commercial papers would not be long-term debt because their maturities are typically shorter than one year.

Degree Of Financial Leverage = Total Liabilities/ Total Stockholders' Equity.

It indicates what proportion of equity and debt the company is using to finance its assets.

☸**Profitability** is the lifeblood of a business. Businesses that earn incomes can survive, grow, and prosper. Businesses that incur losses cannot stay in operation, and will last only until their cash runs out. Therefore, in order to assess business viability, it is important to analyze profitability.

When analyzing profitability, it is usually done in two phases, which are:

1. Profitability in relation to sales.

2. Profitability in relation to investment.

The objective of profitability relates to a company's ability to earn a satisfactory profit so that the investors and shareholders will continue to provide capital to it. A company's profitability is linked to its liquidity because earnings ultimately produce cash flow. For these reasons, ratios are important to both investors and shareholders.

When calculating profitability ratios, we always use Profit on ordinary activities before taxation because there might be unusual variations in the tax charge from year to year, which would not affect the underlying profitability of the company's operation. Another important profit figure used should be the Profit before interest and tax (operating profit) which represents the profit generated by the entity through its normal business operations.

❁**Return On Capital Employed (ROCE) :** A ratio that indicates the efficiency and profitability of a company's capital investments.

ROCE = EBIT / (Total Assets - Current Liabilities)

It is impossible to assess profits or profit growth properly without relating them to the amount of funds (capital) that were employed in making profits. The rate for ROCE should be compared with ROCE of the previous year, ROCE being earned by other companies within the same industry if the information is available, ROCE with the current market borrowing rates. What would be the cost of extra borrowing to the company if it needed more loans, and is it earning a ROCE that suggests that it could make profits to make such borrowing worthwhile? Is the company making a ROCE which suggests that it is getting value for money from its current borrowings?

❁**Return on Equity (ROE)** measures again return on investment but targets ordinary shareholders. This ratio is specifically for shareholders and is aimed at measuring a corporation's profitability by revealing how much profit a company generates with the money shareholders have invested.

ROE = (Net Income - Preferred Dividends) / Average Common Equity

ROE = Profit Margin x Turnover x Leverage

***Leverage = Assets / Shareholder's Equity**

The amount of net income returned as a percentage of shareholders equity.

❁**Gross profit margin and Net profit percentage** are ratios used to measure the financial performance of the business. The ratios show how aggressive the entity was in its sales promotion.

BRITANNIA INDUSTRIES LIMITED

❁**Products Group: (i)** Biscuits and high protein food, **(ii)** Bread and Suji toast, **(iii)** Cake.

❁**Major Brands:** Britannia, Marie Gold, Tiger, Good Day, Bourbon, Treat, 50-50, MilkBikis, Nutrichoice, MilkMan, Time Pass, Nice Time, Little Hearts, 50-50, Daily Fresh, Britannia Shubh Kamanaye, Overseas Brand - Nutro.

MARICO INDUSTRIES LIMITED

❁**Product Group**: **(i)** Hair Oil **(ii)** Skin Care Products, **(iii)** Edible Oil **(iv)** Rice, Wheat Flour, Salt, Shampoos, Clothes Cleaner.

❁**Major Brands**: Parachute, Nihar, Kaya Skin Clinic, Saffola, Revive, Hair Code, Parachute Jasmine, Shanti Amla, Hair & Care, Mediker, Black Chic, Swekar, Sil, Silk-n-Shine.

DATA COLLECTION

❁**Objective 1:** Study about the Britannia Industries and Marico Industries' performance and about the Short & Long-Term liabilities, over past 5 years (FY2008-09 to 2004-05).

Fig.1(i): BIL Sales Turn-Over: CAGR of 18%

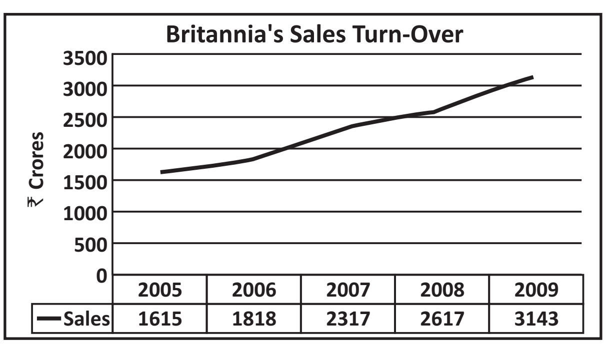


Fig.1(ii):MIL Sales Turn-Over: CAGR of 19%

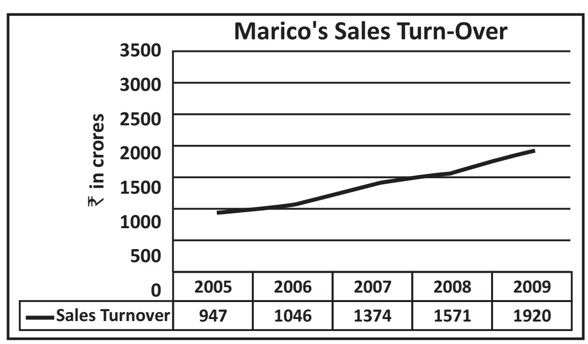
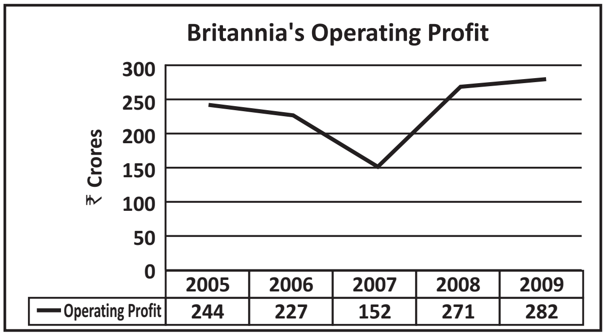
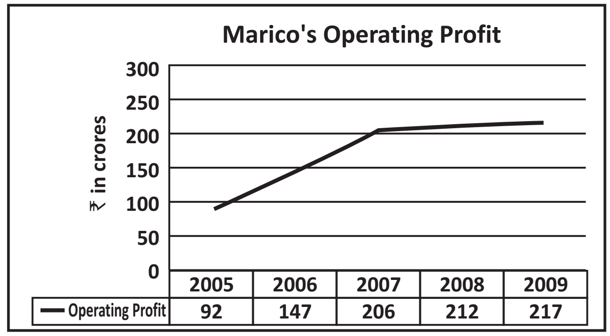


Fig.2 (i):BIL Operating Profit: CAGR of 4%



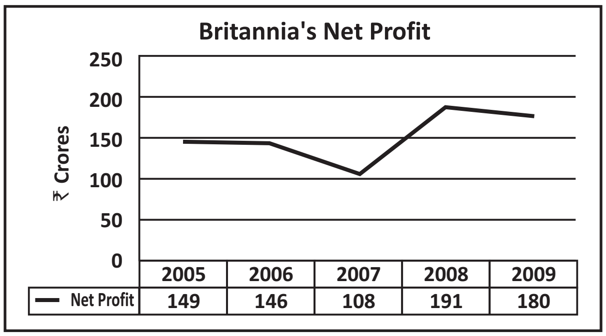
	2005	2006	2007	2008	2009
Operating Profit	244	227	152	271	282

Fig.2 (ii):MIL Operating Profit: CAGR of 24%



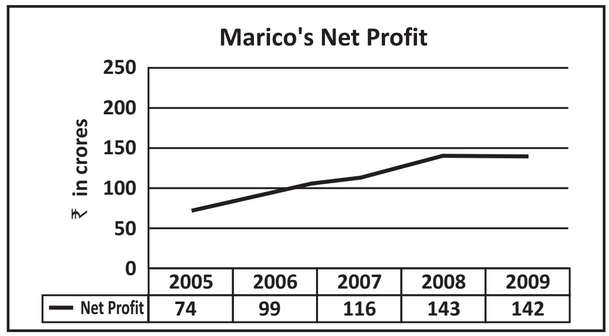
	2005	2006	2007	2008	2009
Operating Profit	92	147	206	212	217

Fig.3 (i): BIL Net Profit: CAGR of 5%



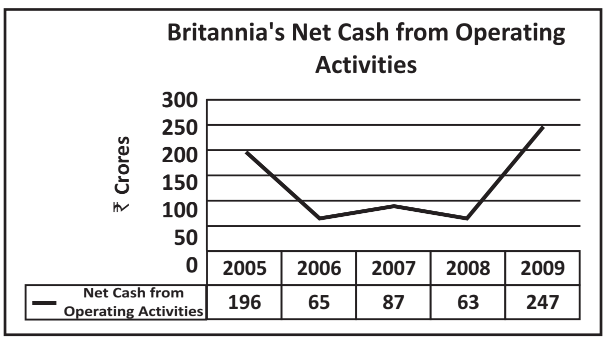
	2005	2006	2007	2008	2009
Net Profit	149	146	108	191	180

Fig.3 (ii): MIL Net Profit: CAGR of 18%



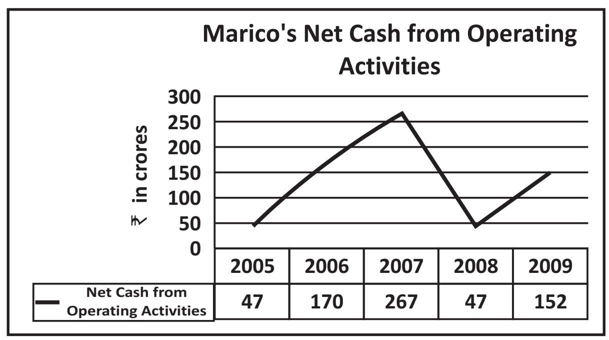
	2005	2006	2007	2008	2009
Net Profit	74	99	116	143	142

Fig.4 (i): BIL Operating Cash Flow: CAGR of 6%



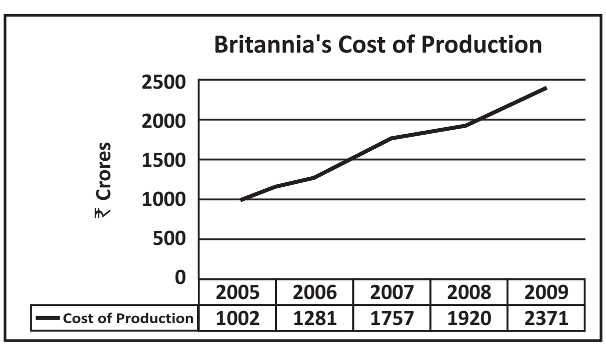
	2005	2006	2007	2008	2009
Net Cash from Operating Activities	196	65	87	63	247

Fig.4 (ii):MIL Operating Cash Flow: CAGR of 34%



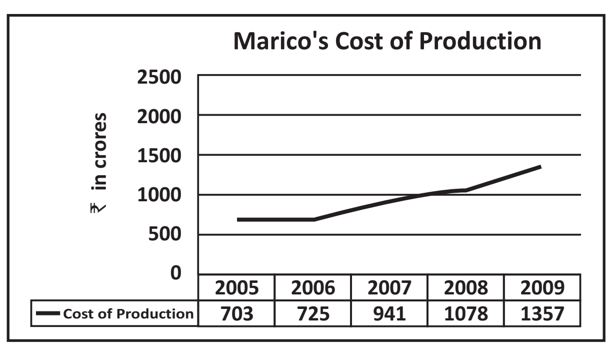
	2005	2006	2007	2008	2009
Net Cash from Operating Activities	47	170	267	47	152

Fig5 (i): BIL Cost of Production: CAGR of 24%



	2005	2006	2007	2008	2009
Cost of Production	1002	1281	1757	1920	2371

Fig.5 (ii): MIL Cost of Production: CAGR of 18%



	2005	2006	2007	2008	2009
Cost of Production	703	725	941	1078	1357

Fig.6(i): BIL Selling Cost: CAGR of 29%

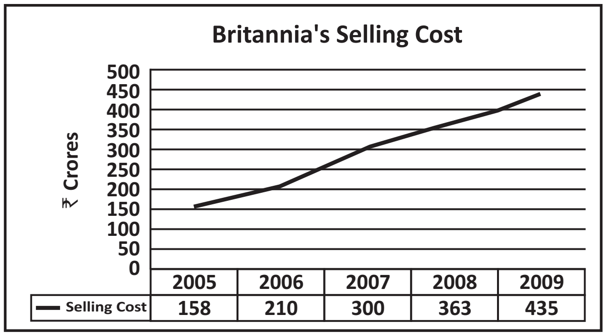


Fig.6(ii): MIL Selling Cost: CAGR of 19%

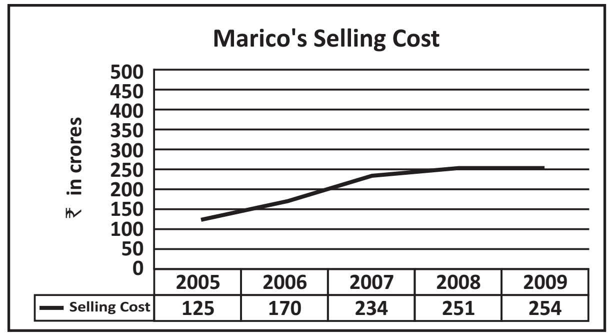


Fig.7(i): BIL Net worth: CAGR of 17%

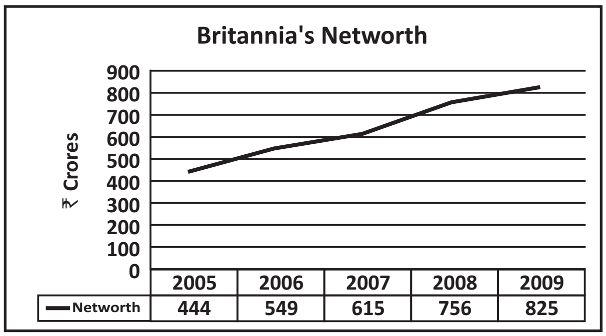
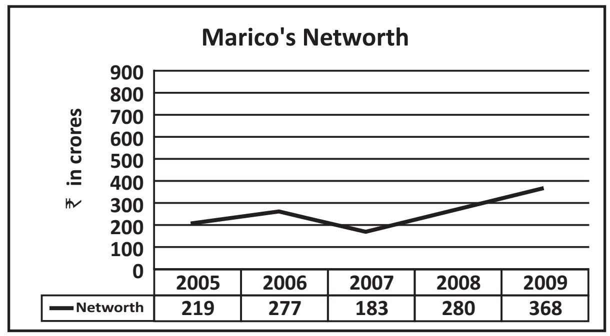


Fig.7(ii): MIL Net worth: CAGR of 14%



☸**Objective 2:** To analyze the financial statements of Britannia Industries Ltd. and Marico Industries Ltd.

Table 1: Analysis Of Financial Statements Of Britannia Industries Ltd.

Britannia Industries Ltd. (Curr: ₹ in Cr.)	**200903**	**200803**	**200703**	**200603**	**200503**
Networth or Shareholders funds	824.54	755.81	614.82	549.09	443.52
Capital Employed	849.71	861.91	619.6	558.45	449.66
Total Debt	25.17	106.1	4.78	9.36	6.14
%Internal Financing	97	88	99	98	99
%External Financing	3	12	1	2	1
Long term debt Ratio	0.02	0	0.01	0.01	0
Debt equity ratio	0.08	0.08	0.01	0.02	0.05
Interest Cover ratio	15.52	24.86	14.29	40.42	28.86
PBIT	248.41	241.87	127.18	205.75	225.24
PAT	180.4	191	107.65	146.43	148.77
EPS (annualised) (Unit Curr)	68.71	76.89	42.51	59.19	60.31
Depreciation	33.46	29.08	25.27	21.72	18.97
Degree of financial leverage	-3.93	0.90	0.74	0.21	
ROCE (%)	29.9	33.76	22.38	42.96	35.41
ROE(%)	22.83	27.87	18.5	29.5	22.32
Solvency Ratio	**8.50**	**2.07**	**27.81**	**17.96**	**27.32**

Table 2: Analysis Of Financial Statements Of Marico Industries Ltd.

Marico Industries Ltd (Curr: Rs in Cr.)	200903	200803	200703	200603	200503
Networth or Shareholders funds	367.68	280.23	183.49	277.36	218.55
Capital Employed	676.21	585.82	350.74	500.73	282.58
Total Debt	308.53	305.59	167.25	223.37	64.03
%Internal Financing	54	48	52	55	77
%External Financing	46	52	48	45	23
Debt equity ratio	0.95	1.02	0.85	0.58	0.18
Long term debt Ratio	0.34	0.24	0.43	0.4	0
Interest Cover ratio	8.57	9.77	8.54	25.55	26.69
PBIT	199.93	193.02	170.79	113.99	80.61
PAT	142.1	143.41	116.16	98.86	73.79
EPS (annualised) (Unit Curr)	2.22	2.24	1.79	16.18	12.01
Depreciation	17.03	18.93	35.19	33.23	11.6
Degree of financial leverage	-0.26	1.80	0.35	0.82	
ROCE (%)	39.29	41.22	40.12	32.74	34.16
ROE(%)	54.32	61.85	49.7	44.97	37.04
Solvency Ratio	**0.52**	**0.53**	**0.90**	**0.59**	**1.33**

☸**Objective 3**: Comment on the Management's Solvency Practices, based on the analysis.

BRITANNIA INDUSTRIES LIMITED

Under the execution of MD, Vinita Bali & under the guidance of Chairman Nusli N. Wadia , the company has been very proactive in conducting the business. The company has its corporate office in Bangalore & presence in Pan-India with Global presence in Mauritius, New Zealand, Dubai & Oman.

The efforts of the management in the right direction has made BIL outpace market growth & Britannia brands continue to lead the market in every category and the company was also ranked second among FMCG companies in the "Business World's Most Respected Company Survey , 2006."

☸**Brand Investment :** BIL has many Power Brands & does regular Brand Investment. *It strongly believes in leveraging the three growth vectors of brand, geography and channel.* The key themes pursued by the company has helped increase brand relevance & differentiation, improve availability, structurally building capability & efficiencies to be cost competitive. The company has set its focus on product innovation and development based on new opportunities for positioning existing brands in the overall consumption repertoire of food products. 2005-06 witnessed a boost in product innovation and as many as six new launches were executed and were well received in the market.BIL continuously introduces several new renovated offerings in Tiger, Good Day, Treat and Marie Gold. Innovation in Bread, Cake and Rusk portfolio was brought with vitamins & minerals, thus positioning them firmly as the healthy start. This innovation combined with relevant consumer activation in key markets has brought 30%+ growth in FY2007-08. Emphasis has been always there on expanding distribution reach, 50% of Tiger sales now come from rural markets. New products are launched on a regular basis like Treat-duet, Tiger Orange Cream etc.

☸**Manufacturing Operations & Acquisitions :** Considering the buoyant demand for BIL products, a new factory was set-up in the state of Uttarakhand in April 2005 to enhance the capacities in existing manufacturing base. To ensure that a cost effective and efficient supply chain supports the business, KPMG was hired in FY2004-05, which resulted in the savings of ₹ 202 mn, thus establishing best in class process improvements.With a view to optimize capacities and manufacturing cost, the company, in April 2008, offered a VRS to workmen at its Chennai unit. As part of its growth strategy, in March 2007, the company acquired (in the same business space) significant stake in the middle-east companies like Strategic Food International (Dubai), Al Sallan Food Industries Company (Oman) etc & believes in many more such acquisitions.

☸**Quality Standards :** The high quality standards for all "Britannia" brands are the hallmark of the quality policy. Continuous efforts are always on to improve product and pack quality based on product testing and consumer feedback. All factories follow the well proven quality assurance systems such as ISO 9001-2000, HACCP & Stringent ISO 22000 standards for implementation of Food Safety Management Systems. The quality organizations of BIL ensure strict adherence to these systems through regular audits and visits to the various manufacturing locations and stocking depots. An independent management structure reporting directly to CEO was created for quality management in the year 2005-06, so as to strengthen focus on Quality.

☸**Information Technology :** The company continues to have thrust in technology investment and in FY2004-05 had connected and integrated all depots and production centres with the centralized SAP data centre. To improve the speed of communication between all Britannia offices, vendors, suppliers and manufacturing units, the company has upgraded the communication software. The company created a centralized set-up for payable processing, accounting and MIS systems in the Corporate office, and this has significantly improved turnaround time and overall efficiency of back-end systems, thereby improving customer satisfaction to suppliers and channel partners.

☸**Corporate Governance :** Field Marshal Sam Manekshaw was on Board of Directors and renowned members like Dr. Vijay Kelkar, Mr. Nimesh Kampani etc have provided the leadership to BIL.

☸The company adheres to the guidelines of Stock Exchanges.

☸The Company paid regular dividends (in the period of study i.e 2004-2009) of 140%, 150%, 150%, 180% & 400% respectively.

☸ The company has kept a high solvency ratio from the year 2005 to 2007 (27, 18, & 28 respectively). It leveraged its performance in 2008 for a few acquisitions, as part of the growth strategy, thus reducing the solvency ratio to 2.

☸Throughout the period of the study, the company kept its debt at a very low level and was not aggressive in raising the same, except in 2008.

☸They regularly add to their capacities either by adding to existing capacities or by setting up new capacities (BIL set up a new factory in Uttarakhand in 2005).

☸Interest coverage ratio has been on an average at around 25%, which is very safe.Networth has also grown consistently at 17%.

☸The increase in the raw material cost has been transferred to consumers, thus protecting margins.

☸The net cash from operating activities has substantially increased to ₹ 247 crores vis-a-vis ₹ 63 crores of 2008; this was possible only because of steps taken for efficient supply chain management (role of KPMG, as mentioned in analysis), interface of Information Technology and cost-cutting measure like VRS.

Looking at the solvency ratios, we strongly believe that Britannia is averse to risk taking and going further, it can surely leverage aggressively.

MARICO INDUSTRIES LIMITED

Marico, under the leadership of Chairman & MD, Mr. Harsh Mariwala has given consistent returns to investors. Every month, over 70 Million consumer packs from Marico reach approximately 130 Million consumers in about 23 Million households, through a widespread distribution network of more than 33 lakh retail outlets in India and abroad.

☸**Manufacturing Operations And Acquisitions :** Since 2004, throughout the period of analysis, MIL has continuously invested in acquiring and expanding its business. It acquired the brand 'Nihar' from Hindustan Lever Ltd. (HLL), diversified into manufacturing beauty products with the launch of 'Silk n Shine', acquired brand Aromatic, bath soap brand 'Manjal' from Oriental, and also entered the Bangladeshi and Egyptian markets.

☸**Brand Investment, Innovation & Extension :** Many of its successful products like 'Saffola' were re-launched with the help of a fresh campaign. Also, the product was launched with innovated combinations that lower the cholesterol level of the oil. R&D efforts have resulted in innovation in existing products like 'Mediker' shampoo that increased the market share of the company.

☸**Quality :** The Total Quality Movement within the Company was started in 1996 and now embraces virtually all locations. The Company has acquired a formidable reputation for its HR practices and has been recognized by the

National HRD Network in the recent past. The company has also been awarded many accolades for its quality standards and innovative efforts in giving a variety and good quality products to its customers.

☸**Technology :** Presently, all the establishments are covered by information technology and are networked with the Corporate Office.

☸**Corporate Governance & Corporate Social Responsibility :** Marico Jalgaon was awarded the CII National Water Management Award. Marico was ranked 2nd in Sourcing Platform Benchmarking Program 2009.

☸Asia Pacific Quality Organization (APQO) : Marico won the 'Best in Class' Award (Second highest) for the Large Manufacturing category.

☸Marico won the Greentech Environment Excellence Award 2009 in the Silver Category in FMC.Harsh Mariwala was awarded the Ernst & Young 'Entrepreneur of the Year Award' 2009 in the Manufacturing category.

☸Marico thus follows Corporate Governance Practices around the following philosophical cornerstones:

☸Generative Transparency and Openness in Information sharing, Constructive Separation of Ownership and Management, Accountability, Discipline, Responsibility, Fairness, Social Awareness, Value-adding Checks & Balances and Board / Committee Proceedings.

☸Marico was also voted one of the most Innovative Companies by the Business Today in 2008.

CONCLUSION

☸From the above analysis, we observe that both the companies - BIL & MIL, over a period of time, have maintained as well as expanded their market share by introducing product differentiation, product innovation and also invested in Brand Awareness. Acquisitions have been their policy to spread risk. Both the companies have been ever expanding their markets outside India too. They have invested in Quality Control and technology to reduce Cost of Production. The roles and responsibilities of incorporating Corporate Governance practices have been assigned to renowned professionals who have helped the companies to plan their strategies that helped in long term solvency and profitability of the companies.

☸The difference lies in the source of financing of these two companies for their expansion projects. BIL has low degree of leverage and MIL has comparatively higher degree of leverage.

☸Though solvency ratio of MIL is low, being comparatively high leveraged, but the company's Return on Equity is higher to BIL. It has availed tax benefits on interest payments, thus having better Returns on Equity.

☸Though profitability of the company is not entirely dependent on the source of financing, but the return to equity holders vary according to the source of capital funding adopted by the company.

☸A high leverage firm gives better returns to equity shareholders than a low leveraged firm.

☸The primary objective of any firm is to enhance the value of its equity stakeholders and maintain solvency. To achieve both these objectives, restoring to debt rather than equity is a profitable option.

Thus, we can infer from the above analysis that though there was substantial difference in the capital structure of BIL & Marico, but the Sales performance of both the companies has been almost same with CAGR of at 18% & 19% respectively. Both the companies have invested in the Best Management Practices to bring-in positive results.

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