

# **CHAPTER 1**

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## **INTRODUCTION**

# CHAPTER I

## INTRODUCTION

Financial authorities and experts differ in their views on composition of funds in capital structure. While some believe that the capital structure tantamounts to the financial structure and hence, they say that the structure includes funds mobilised from both long term and short term sources. According to Richard C. Osborn<sup>1</sup>, 'the term capital structure is used to mean the financial plan according to which all assets of a corporation are furnished. This capital is supplied by long and short term borrowings, the sale of preferred and common stock and the reinvestment of earnings'. He further states that, 'in analysing the capital structure of an enterprise, short term debt is often excluded from consideration'. Many others include only long term sources of funds under the capital structure. Harry.G. Guthmann and Herbert E.Dougall state that 'the phrase Capital Structure may be used to cover the total combined investment of the bond holders, and the total stock holders investment including retained earnings as well as original investment'<sup>2</sup>. Both the concepts of capital structure have their own merits and demerits. The latter concept is more popular and widely accepted and hence the present study takes that view for explaining the composition of capital structure.

The capital structure of a company may be either simple, compound or complex. A simple capital structure is composed of the single security base, for example the equity share capital issued by a company. A compound capital structure indicates a combination of two security base in the form of equity and preference share capital. The complex capital structure is made up of a multi-security base, consisting of equity, preference share capital and a series of debentures or bonds and loans from other sources.

One of the most important phases of promoting a new business is the determination of the capital structure. Many businesses fail, particularly in their early years, because of an unbalanced capital structure. The capital structure of these companies might be deficient because the amount of funds raised from permanent sources were insufficient for the requirements of the business or because the sources used involved too much risk.

Most promoters are naturally optimistic and tend to over-estimate income and under-estimate expenses. Such a situation may result in failure within a short time. In working out the capital structure, therefore, it is imperative that it provide for sufficient money to enable the company to carry on operations. Although the estimate of the capital that will be needed may turn out to be substantially correct, an error may be made in the determination of how this capital should be mobilised. Generally speaking a stock issue will not cause a company to fail, but

a bond issue may do so. The company is not obligated to pay dividends on the stock or to repay the principal. But both the interest and principal of the bonds must be paid regardless of the earnings or else bond holders may take legal steps to foreclose the enterprise.

An important item added to the capital of a going concern is retained earnings. Companies which have been in existence for many years can make the same kinds of errors in determining their capital structures as can the promoters of a new and untried business. Generally speaking most firms are found to become more conservative in their capital structure as they mature. This is due primarily to the build-up of retained earnings.

Different factors like the state of capital market, the nature of business, technology adopted, stability of earnings, credit standing and the attitude of the management influence the way in which capital is structured. Of all these factors, the attitude of management plays an important role in shaping the capital structure. When the firm has strong desire for assured and exclusive control, preference will have to be given to borrowing for mobilising capital in order to be assured of continued control. On the contrary, if the firm does not want to assume risk it will not prefer issuing of bonds or debentures which may plunge the company into greater risk, and endanger its position. The experienced firms which feel relatively secured and believe in the leverage principle will resort to

higher level of borrowing in an attempt to improve the firms' earnings.

The attitude of management towards capital structure vary from region to region. It is often said that the South Indian Enterprises (SIE) are conservatives and are very particular about their total control over their enterprises. And hence they very sparingly issue additional equity for fear of losing control. At the same time they also use a lesser debt capital as they don't want to assume the risks associated with borrowing. They follow a conservative policy of dividend disbursement to enable the retained earnings to build-up over the years.

In contrast, the North Indian Enterprises (NIE) are believed to be dynamic and highly professional. They are not that much control conscious and are prepared to go for frequent public issues of equity. At the same time they are also prepared to take a higher degree of financial risk and mobilise a higher proportion of debt. To attract more number of investors in the company, they follow a liberal policy of dividend disbursement.

The corporate scene in the country is undergoing many changes after the liberalisation of Indian economy. Aggressive new faces are surging ahead. The new breed is willing to grab opportunities where they exist. But the established industrial houses of the south are still conservative. The SIE are snuffed; the big deals are passing them by. They don't exploit the opportunities

around while the rest of the country is surging ahead.'<sup>3</sup>

Geographically the big industrial houses of the south are concentrated in Tamilnadu, one of the earliest states to industrialise. Andhra Pradesh, is at a transitory stage where landowners are gradually moving into industry. The major players in the south are TVS, Amalgamations, TTK, TI, Lakshmi and SPIC. These are all financially sound groups with excellent reputation, good marketing and dealer networks and proven management capabilities. Yet they fight shy of realising their full potential. They appear to be terrified of moving out of their narrow grooves. Given a choice, the SIE would rather think and remain small, and a Rs.100 crore project proposal gives them sleepless nights'<sup>4</sup>.

Sundaram Clayton Ltd, was established to manufacture automotive air brakes and went into moped manufacture in 1983. Sundaram Clayton promoted TVS Suzuki in collaboration with Suzuki of Japan to manufacture two wheelers. Two projects in electronics (Rs.78 crores) and appliances (Rs. 32 crores) that Sundaram Clayton had subsequently taken up were considered extremely daring ventures by South standards. The Lakshmi Machine Works (part of the Lakshmi Group) put up a machine tool plant at a cost of Rs.30 crores. The Sakthi group had expanded its sugar capacity at a cost of Rs.28 crores and set up an integrated soya project of Rs.21 crores.

'All very conservative sums and sizes. L. Lakshman, of the Rane group of Madras (manufacturers of auto ancillaries), an unabashed believer in good old fashioned conservatism says, "I don't believe that one has to launch a big project to demonstrate that one is doing a big job. We are well aware of our strengths and weaknesses and believe in sticking to our knitting." N.Sankar of the Sankar group feels the same way, "Growth for growth's sake is not necessarily a good thing, ultimately it's the bottomline that is important. I would rather have a Rs.50 crore turnover and Rs.5 crore profit than be large and shaky."

'The considerations perhaps go deeper. The fear of size stems from the obsession with retaining shareholding and an unwillingness to expose themselves to a wider pattern of shareholding. The SIE are perturbed of losing control. They're terribly cautious, no doubt. The hectic activity in the capital markets has created few ripples in the South. Between January and December 1988, public issues worth Rs.1528 crores were made country wide. Of this, South based issues amounted to Rs 18 crores, a figure smaller than that of a single medium sized issue in Bombay. "Then there is the tendency to stick fanatically to the home ground. The industrialist in Coimbatore do not want to venture into Madras and those who are based in Madras feel that they have travelled far when they cross the borders to neighbouring Andhra or Karnataka", says a source from a financial institution. The NIE do not share these inhibitions. The investment opportunities are limited in the south business houses, since they are circumscribing themselves

with unwillingness to expand their geographical horizons. They would shudder at the very thought.

Ironically, almost all major SIE were industrial pioneers. The sixties was their decade. The TI group was the first to manufacture bicycles and Enfield motor cycles. Standard Motors dared to make automobiles from a tiny base. The automobile component industry was concentrated largely in Tamil Nadu. At one time Madras was known as the Detroit of India. The textile industry flourished in Coimbatore. But today, although 30 per cent of the country's cotton spinning capacity is in Coimbatore, there are no well known branded textiles from the South. Nor has Coimbatore moved away from cotton spinning. From none of the big houses has emerged a giant Indian Company.<sup>15</sup>

The present research work was taken up to verify and to provide factual information on the myth that the South Indian Enterprises conservatively design their capital structure and the North Indian Enterprises look at their capital structure professionally. The present research work is the result of such an articulation and it attempts to unveil the myth.

### **Objectives of the Study**

- The study was undertaken with the specific objectives of
- a. analysing the capital structure and financial performance of industrial enterprises in south India,
  - b. analysing the capital structure and financial performance of industrial enterprises in north India,
  - c. finding out variation between SIE and NIE in terms of capital structure and financial performance, and
  - d. verifying the myth that the SIE are conservative.

### **Scope of the Study**

The study had been undertaken to unveil the myths about the attitudes of SIE and NIE towards capital structure. The myths primarily concerned about the quantum of equity, quantum of debt and dividend policy of both SIE and NIE. While the SIE were believed to employ lesser quantum of equity, fearing loss of control; lesser quantum of debt fearing financial risk and a conservative dividend policy to build-up cost-free retained earnings. The NIE were believed to have a capital structure policy exactly opposite to that of SIE. The scope of this study is limited to verify these myths. For the purpose of such a verification, data on capital structure and financial performance of sample enterprises were collected for a period of 5 years from 1989 - 90 to 1993 - 94. This period is significant for the business and industrial enterprises in the country due to the changes

witnessed after the liberalisation of the Indian economy.

### **METHODOLOGY**

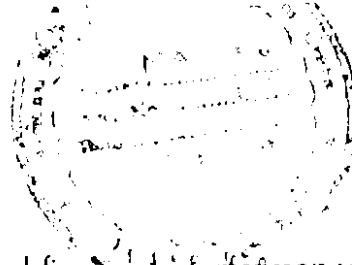
For the purpose of the present study business enterprises were broadly classified into two categories, North Indian Enterprises and South Indian Enterprises. Each classification was further categorised into seven groups, viz., automobile industry, cement industry, chemical industry, engineering industry, paper industry, sugar industry, and textile industry. Companies registered in Tamil Nadu, Kerala, Karnataka, Andhra Pradesh and Pondichery and listed in Madras Stock Exchange were taken as South Indian Enterprises. Since Maharashtra and Gujarat had the largest registration of companies, those registered in these two states and listed in Bombay Stock Exchange were taken as North Indian Enterprises. As the prime objective of this study was to analyse the attitude of business enterprises towards the capital structure and as there was a belief that attitude differed from one person to another person based on their regional affiliation, extreme care was taken in finalising the samples for the purpose of the study. Companies promoted and managed by North Indians but registered in South India were excluded from the category of South Indian Enterprises. Similar companies promoted and managed by South Indians but registered in North India were excluded from the category of North Indian Enterprises. The population for the purpose of the present study was identified after exercising this care. A sample of 100 companies among the short-listed population of South

Indian Enterprises and another 100 samples of North Indian Enterprises from the short-listed population of that segment were selected by using the proportionate stratified random sampling technique. The randomness of the samples were ensured by adopting the procedure of selecting the kth item from the population with a random start. The number of identified population and selected samples are given in Table 1.1.

**Table 1.1**

**Size of the Population and Samples**

Sl.No.	Industry group	North Indian Enterprises		South Indian Enterprises	
		Population	Sample	Population	Sample
1	Automobile Industry	8	3	9	4
2	Cement Industry	16	6	13	6
3	Chemical Industry	83	33	51	24
4	Engineering Industry	57	23	50	24
5	Paper Industry	20	8	8	4
6	Sugar Industry	8	3	18	9
7	Textile Industry	61	24	61	29
Total		253	100	210	100



76  
313

**Collection of Data**

Data on capital structure and financial performance were collected from secondary sources like the directories of Bombay and Madras Stock Exchanges, Reports of Centre for Monitoring Indian Economy, and the Data Bank of Institute of Financial Management and Research. Appropriate information on the samples were also collected from other secondary sources like financial journals, Business magazines and books. Report of Financial Performance Analyses carried out by Reserve Bank of India and Development Banks like IDBI, ICICI and IFC were also extensively sourced. The Researcher also had fruitful and comprehensive discussions with senior faculty members of Indian Institute of Technology, Madras; Institute of Financial Management and Research, Madras; University of Madras; Bharathiyar University, Coimbatore; and Bharathidasan University, Tiruchirapalli which helped the researcher to widen his knowledge on the problem and to perfect the methodology.

Ratio analysis and variables related to capital structure like weighted average cost of capital and value of firm, were applied to analyse the capital structure and financial performance of the sample companies. The formulae used for analysing the collected data are given in Appendix I. Seven sets of hypotheses were framed and tested to verify the myths about the attitudes of SIE towards capital structure decisions. The details of the framed hypotheses and model applied for testing the hypotheses are given in Chapter V.

### **Importance of the Study**

The findings of the study are hoped to throw more light on the influence of management attitude on capital structure. The study is also hoped to provide an indepth understanding of capital structure decisions by comparing South Indian Enterprises (SIE) with North Indian Enterprises (NIE). The study gains its importance from the spread of equity cult and the rapid development of Indian Capital Market.

### **Limitations of the Study**

The researcher had taken all the necessary steps to carry out the research flawlessly. However, the data and information published by various organisations, which were collected and used for this study, might have some defects in it. The Researcher had no facility to identify and remove the defects in the published data.

The Researcher could not meet or contact the executives of sample organisations to get to know more about their style of decision making on matters relating to capital structure due to time constraints. Had this been done, the results of this study would have been still more useful.

### **Chapter Scheme**

The report of the study is organised into six Chapters including the present first Chapter which presents the objectives of the study, methodology, scope, importance and limitations of the study. A review of the relevant empirical studies is presented in the Second Chapter. The Third Chapter contains the analysis of capital structure and financial performance of South Indian Enterprises. An analysis of capital structure and financial performance of North Indian Enterprises is presented in the Fourth Chapter.

The Fifth Chapter compares the capital structure and financial performance of South Indian Enterprises with that of North Indian Enterprises. The hypotheses framed on the myths are tested and interpreted in this Chapter. A summary of conclusions is presented in the Sixth and final Chapter.

## REFERENCES

1. Richard, C. Osborn. 1959. *Corporation Finance*. New York: Harper and Brothers. p.140.
2. Guthmann, Harry. G. and Herbert, E. Dougall. 1955. *Corporate Financial Policy*. New Jersey: Prentice Hall Inc. p.76.
3. Sushila Ravindranath. 1989. *Is the South lagging behind?*. Business India. January 1989. p.50.
4. *Ibid.* p.51.
5. *Ibid.* p.52.