

CHAPTER VI

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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 of an organisation is structured. Of all these factors, the attitude of management plays an important role in shaping of the capital structure.

When the management strongly desires for assured and exclusive control, preference will 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 financial risk, it will not prefer issuing of bonds or debentures which may plunge the company into greater risks 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 considered 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 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.

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. A sample of 100 companies among the identified population of South Indian Enterprises and another 100 samples of North Indian Enterprises from the identified population of that segment were selected by using the proportionate stratified random sampling technique. Ratio analysis and variables related to capital structure like weighted

average cost of capital and value of firm were used in this study as tools of analysis of capital structure and financial performance of the sample companies.

Systematic research works comparing capital structure of companies based on their geographical location are not yet available. However there are research works on capital structure and the factors influencing the capital structure. To his best of knowledge, the Researcher had gone through all such research works carried out in India and a few works done abroad. The methodology and findings of these research works had been carefully studied by the Researcher. Useful hints were drawn from these studies which helped in putting the present research work in a proper perspective. The gist of a few related research studies on capital structure were presented in the second Chapter. The literature, relevant to the present study and surveyed by the Researcher, were concerned with one or the other aspects of capital structure and with different corporate sectors. The present study significantly differs from the earlier studies as it compares organisations located in two different regions of the country, North and South and verifies the popular myth that the South Indian Enterprises are conservatives while their counterparts in the North are dynamic.

A random sample of 100 SIE was analysed by looking at the selective indicators, in the third Chapter. Individual analysis were presented in this chapter for all the seven categories of SIE. The South Indian Automobile Industry (SIAI)

had recorded high degree of capital gearing and debt equity ratio. During the five year period of study the debt equity ratio of SIAI varied from Rs.3.59 to R.4.50. The fixed assets created for every rupee of long term debt employed by the sample units of SIAI were also very low and varied from Re.0.75 to 0.92 registering an average of Re.0.80.

Every rupee of debt in South Indian Cement Industry (SICI) had an equity of Rs.9.75. In contrast the debt equity ratio of SICI registered a continuous fall during the study period from Rs.3.52 in 1990 to 60 paise in the year 1994. The ratio of reserve to equity capital was fluctuating within a range of Rs.2.68 in the year 1990 to Rs.7.56 in 1992. The average ratio of fixed assets to long term debt was Rs.7.35. the solvency ratios indicated that the SICI was conservative in its financial management during the study period. The earning power ratio was increasing upto 1992 but stabilised at 15 per cent afterwards. The earnings per share and return on capital employed were also increasing upto the year 1992 but decreasing afterwards. The book value per share registered an increase from Rs.143.63 to Rs.288.25. The dividend yield ratio had also been fluctuating from 2.63 per cent to 3.37 per cent. The payout ratio was moderate considering the earnings per share registered.

South Indian Chemical Industry (SICHI) had reduced equity by Rs.1.51 for every one rupee of debt during the period of study. The debt component in the

capital structure was also decreased by Rs.1.27 for every rupee of equity between 1991 and 1994. But the reserve amount was doubled from Rs.1.59 in 1990 to Rs.3.02 in 1994. The continuous reduction of fixed assets to long term debt ratio shows that the SICHI had been using long term debt capital to augment its working capital.

The earnings available to equity shareholders of SICHI is raised from Rs.4.34 in the year 1990 to Rs.8.68 in the year 1994. The average earning power of the industry was 16.2 per cent during the study period. The book value per share which was Rs.25.57 in 1990 was increasing year after year and ended in Rs.42.49 in the year 1994. The Dividend yield ratio of SICHI was in a fluctuating trend. The average pay out ratio during the study period was 27.60 per cent. The SICHI maintained its pay out ratio more or less uniformly from 1990 to 1993.

Every one rupee of debt in South Indian Engineering Industry (SIEI) had a equity of Rs.1.63 on an average during the study period. The debt equity ratio of this group of companies was stabilised around Rs.1.91 which was the average debt equity ratio during the period. The SIEI had been appropriating higher allocations to reserve. Every one rupee of debt in SIEI had a fixed asset of Rs.1.12 in 1990 which fluctuated over the study period and settled at Rs.2.27 in 1994. The EPS of SIEI increased by Rs.14 per share from 1990 to 1994.

The earning power of SIEI was 28 per cent in 1990 which was the same 28 per cent in 1994. The return on capital employed was between 28 per cent and 68 per cent from 1990 to 1994. The book value per share was Rs.52.28 in 1990 which increased to Rs.122.30 in 1994. The price earning ratio of this group of sample had been decreasing during the five year of the present study. The times interest earned ratio had been continuously increasing during the study period. It started at 4.43 times in 1990 and ended at 8.94 times in 1994, making an average of 5.75 times. The average dividend yield was 2.20 per cent. It shows that the investors in SIEI received a fair amount of dividend from 1990 to 1994. The payout ratio of SIEI was 84.04 per cent in 1990 which decreased to 24.90 per cent in 1994.

The fact that the South Indian Paper Industry (SIPI) had been conservative in respect of its financial management is better reflected in the solvency ratios. The capital gearing ratio which indicates the quantum of equity employed for every rupee of debt, had been increasing from Rs.1.13 in the year 1990 to Rs.2.24 in 1994. The debt equity ratio which shows the quantum of debt employed in relation to the equity, had been decreasing from Rs.1.27 to Re.0.46. These two ratios show that the SIPI preferred a higher proportion of equity rather than debt. Similarly the value of fixed assets built up in relation to the debt employed had been increasing year after year from Rs.1.83 in 1990 to Rs.2.76 in 1994. The earning power of SIPI in 1990 was 42 per cent and was

decreased to 12 per cent in 1994. The average return on capital was 24.40 per cent during the study period. The book value per share was fluctuating every year. The price earning ratio and times interest earned ratio were also fluctuating during the study period. The dividend yield of SIPI was 1.44 per cent in 1990 which increased to 2.61 per cent in 1994. The SIPI distributed 40 per cent of its earnings on an average during the study period.

The proportion of equity by the South Indian Sugar Industry (SISI) in relation to the debt capital has been kept at a lower level. This has shown the desire of the industry to make leverage benefits. The debt equity ratio had been increasing year after year during the study period. The increasing debt component in the capital structure is also evident from the fixed assets to long term debt ratio which had been decreasing over the five years of the study. The ratio of reserve to equity capital had been in an increasing trend. It started at Rs.4.42 in the year 1990 and ended at Rs. 9.04 in the year 1994, making an average of Rs.6.97. The EPS of the SISI was also in an increasing trend. The average EPS during the study period was Rs.8.08. The earning power of the assets of SISI was highly fluctuating during the study period. The range of fluctuation was from 10 per cent to 48 per cent. The return on capital employed was fluctuating with a range of 16 per cent to 33 per cent. The times interest earned ratio shows that SISI has been in a good position, so far as serving the debt was concerned. The average times interest earned ratio during the period of study was 3.24, times. That the

SISI had been declaring a sumptuous rate of dividend over the study period was evident from the fact of higher payout ratio registered during the study period.

That the South Indian Textile Industry (SITI) had been using a higher proportion of debt in relation to equity in its capital structure was evident from the capital gearing ratio and debt equity ratio. The ratio of reserve to equity capital of SITI was doubled from 1990 to 1994. SITI could not maintain any trend in fixed assets to long term debt ratio. It recorded marginal fluctuation in the range of Rs.1.21 and Rs.1.52. The SITI had largely been managed by a few members of the promoters family who are known to be conservatives and hence the solvency ratios relating to fixed assets to long term debt and reserve to equity reflect that conservatism.

The averages of earning power (39.2 per cent) and times interest earned ratio (4.44 times) were favourable to SITI during the study period. Going by the averages of EPS and return on capital employed, which worked out to be Rs.45.36 and 24.8 per cent respectively, it can be said that the financial management of SITI was efficient during the study period. The book value per share was Rs.182.96 in the year 1990 and was increased to Rs.246.82 during the last year of the study. The dividend yield ratio varied from 6.22 per cent to 8.17 per cent. The range of variation in payout ratio had been 28.27 per cent and 55.56 per cent. However the averages of dividend yield ratio and payout

ratio (7.54 per cent and 40.89 per cent respectively) show that the SITI was declaring dividend at highly satisfactory rates.

The fourth Chapter analysed the capital structure and financial performance of sample North Indian Enterprises. The analysis was presented for every category of the group viz., NIE as done in the case of SIE.

The capital gearing ratio of North Indian Automobile Industry (NIAI) had an increasing trend during the five years of the study. A constant growth of debt during the study period in NIAI was evidenced by debt equity ratio. The ratio of fixed assets to long term debt of NIAI over the five year period indicates that the incremental debt employed by NIAI was converted into long term fixed assets. Baring the initial declining the ratio of reserve to equity had an increasing trend indicating the prosperity of NIAI. From the lowest Rs.6.42 in the year 1991, it increased to Rs.8.12 in the year 1994. The average of reserve to every rupee of equity in NIAI was Rs.7.37.

NIAI were in a comfortable position as the average times interest earned ratio was 7.21 times. The per centage of earnings in relation to the total assets was in a decreasing trend as it went down to 12 per cent in the year 1994 from 20 per cent in the initial year of the study. Return on capital employed and EPS were highly fluctuating and were not able to set any trend. The book value per

share was coming down initially but started to increase from the year 1992. From Rs.89.28 of 1990, it decreased to Rs.64.11 in the year 1992 but had a hike and stood at Rs.81.06 in the final year of the study. The three important ratios price earning ratio, dividend yield ratio and pay out ratio were in a decreasing trend during the study period.

The capital gearing ratio and debt equity ratio of North Indian Cement Industry (NICI) reveal that the cement industry in North India employed higher proportion of debt in their capital structure. The ratio of reserve to equity of NICI had experienced continuous hike during the period of study. It was only 17 paise for every rupee of equity in the first year, but thereafter it went up sharply and settled at Rs.3.58 during 1994. It is interesting to know that the ratio of fixed assets to long term debt was stable during the five years of study. The average of this ratio worked out to be 85 paise for every rupee of long term debt.

The times interest earned ratio and earning power ratio of NICI which represent the earning power of the industry were rising initially but declining afterwards. The return on capital had not established any trend during the study period. The EPS in the year 1990 was Rs.4.84. It increased remarkably to Rs.41.38 in the year 1992, but the increased EPS could not be sustained afterwards. The industry maintained a fair rate of dividend^{ry} which is evidenced by pay out ratio. The average pay out ratio of NICI was 35.07 per cent during the

study period. The book value per share had established a clear increasing trend throughout the study period.

The capital gearing ratio of North Indian Chemical Industry rate of equity to debt had been maintained without much fluctuation by the industry. The debt equity ratio increased from Rs.1.44 in the year 1990 to Rs.1.72 in the year 1992, but it decreased to Rs.1.36 in the year 1994. The ratio of reserve to equity capital of NICHl has reported an increasing trend over the study period with Rs.3.16 in the year 1990 to Rs.5.29 in the year 1994. A greater stability had been maintained in the ratio of fixed assets to long term debt by NICHl. The average of this ratio was 98 paise.

The times interest earned ratio and earning power ratio of NICHl did not set either upward or downward trend. The average return on capital employed for the period was 21.6 per cent. EPS increased from Rs.16.54 in the year 1990, it increased to Rs.26.27 in the year 1994. The book value per share was increased by about 100 per cent during the period of study. The pay out ratio of NICHl was decreasing contrary to the trend set by earnings per share. The price earning ratio of NICHl was increasing in the first part of the study period, but latter was decreasing.

The North Indian Engineering Industry, (NIEI) had an equity of Rs.1.31 for every rupee of debt during the study period. The average of debt-equity ratio of NIEI was Rs.1.23 during the study period. The ratio of reserve to equity capital had not witnessed any particular trend. It increased in one year and decreased in the next. NIEI had the ratio of fixed assets to long term debt lesser than Re. 1. during the study period.

The times interest earned ratio of NIEI was more or less stable during the study period. The return on capital employed was also stable at 20 per cent during the study period. The earnings per share varied widely from the first part of the study period (Rs.15) to the second part (Rs.11). The book value per share was increasing at a constant rate from Rs.70.07 in 1990 to Rs.98.27 in the year 1994. The average of pay out ratio of NIEI was 36.53 per cent for the five year period of study. The price earning ratio and dividend yield ratio had not seen any considerable movement during the study period.

North Indian Paper Industry (NIPI) had maintained an average gearing of 81 paise for the study period. On an average every rupee of equity in NIAI had a debt of Rs.2.08 with a variation ranging from Rs.1.71 to Rs.2.68 Retained earnings in relation to equity capital of NIPI was in an increasing trend during the study period. The ratio of fixed assets to long term debt was more or less stable at around Rs.1.15 during the first four years of the study.

The operating profits in relation to interest charges of NIPI was decreasing year after year. The earning power of NIPI was highly fluctuating during the study period from 7 per cent to 28 per cent. Return on capital employed and earnings per share moved in tandem with each other during the period of study. The pay out ratio, dividend yield ratio and price earning ratio were highly fluctuating during the study period. The book value per share was kept increasing from Rs.31.86 in the year 1990 to Rs.52.87 in the year 1994.

The capital gearing ratio and debt equity ratio of North Indian Sugar Industry over the study period show that the industry used a high proportion of debt to equity during the study period. In the year 1990, every one rupee of debt in the financial structure had an equity support of Rs.1.11. But it went sharply down to 53 paise during the last year of observation, i.e. 1994. Where as the debt equity ratio shows that the proportion of debt to equity of NISI during the study period went up from Rs.1.45 in 1990 to Rs.2.99, in 1994. Both these ratios indicate that the NISI used a higher degree of leverage to get its benefits.

During the study period, the NISI could not maintained a uniform times interest earned ratio. The earning power of the assets employed by the NISI kept fluctuating from year to year. The average earning per share for the five year of the study was Rs.22.11. The book value per share was Rs.83.70 in the year 1994, an increase of more than 50 per cent from Rs.53.26 of 1990. The price

earning ratio and pay out ratio were fluctuating, but dividend yield ratio was more or less constant with minor variation. The average pay out ratio for the period was 54.12 per cent shows that the NISI followed a liberal dividend policy in order to attract and retain the shareholders.

The capital gearing ratio and debt equity ratio of North Indian Textile Industry (NITI) show that the debt component of the capital structure of the industry has been reducing over the study period. The ratio of reserve to equity was only Rs. 4.18 in the initial year, it experienced continuous increase and settled at Rs.6.86 in the year 1994. The ratio of fixed assets to long term debt was more or less constant at 96 paise. The fluctuation in the times interest earned ratio of NITI during the study period was not wide and averaged 2.26 times. The earning capacity of the assets of the industry has also remained more or less constant with an average of 14.8 per cent, for the study period. There was wide fluctuation in the earnings per share of NITI during the study period. NITI had an increasing trend in the book value per share from Rs.56.93 in the year 1990 to Rs.77.94 in the year 1994. The pay out ratio of the industry shows that the industry gave much importance to the expectations of the shareholders by either maintaining the rate of dividend or by increasing it even when the return on capital employed was declining. No particular trend could be observed in the case of both price earning ratio and dividend yield ratio.

An attempt was made in the fifth Chapter to compare the capital structure and financial performance of South Indian Enterprises with that of North Indian Enterprises. All the seven categories of industries were taken and averages of the various ratios over the study period for each industry group were taken as the base. Averages of the identified ratios of all the samples from both the regions viz., North and south were also calculated at the end of the Chapter and compared with each other in order to verify the myths about the approach to capital structure.

One can easily say that South Indian Automobile Industry (SIAI) was more dynamic than their counterpart in North India, if the quantum of debt alone is taken as the criterion. The average of capital gearing ratio of automobile industry during the study period reveals that for every rupee of debt, the SIAI had an equity of only 23 paise, while NIAI had Rs.1.21 similarly the average of debt equity ratio shows that for every rupee of equity, the South Indian Enterprises had more debt of Rs.3.94 from North Indian Enterprises which had only Rs.2.69. The reserve to equity ratio shows that the SIAI had only 70 paise for every rupee of equity, while NIAI had Rs.7.37. Lastly for every one rupee of long term debt the SIAI had fixed assets with 80 paise. The excessive debt component in the capital structure of SIAI was due to the continuous losses suffered by the sample units of SIAI over the study period. These sample units seems to have been trapped in a vicious cycle of operating losses and increasing debt. Hence the use

of a higher rate of debt by SIAI cannot be taken as an indicator of dynamism in the approach to capital structure. A real comparison of SIAI based on the profitability ratios was not possible because of the continued losses suffered by the SIAI over the study period.

There was a wide gap between SICI and NICI in terms of capital gearing ratio. While the SICI recorded Rs.9.75 equity for every rupee of debt, the NICI had a thin cushion of only 28 paise. This is because of the higher quantum of retained earnings accounted for by SICI than NICI. The ratio of fixed assets to equity capital was Rs.7.35 for SICI and 85 paise for NICI. The higher quantum of ratio of fixed assets to equity capital in SICI was due to the heavy investment made by the sample units of SICI during the study period.

The heavy investments made by SICI either in modernisation or expansion enabled them to save huge amount of income tax which had resulted in a higher earning per share of Rs.53.53 than the Rs.24.42 of NICI. The higher times interest earned ratio of SICI has helped them in registering a higher return on capital employed of 21.6 per cent, which compares well with the 12.6 per cent of NICI and has resulted in a magnificent book value per share of Rs.248.97. However the assets of NICI proved to be more efficient than SICI in terms of their earning power. The earning power ratio of NICI was 18.40 per cent while it was only 17.02 per cent in the case of SICI. Though SICI recorded a higher

earning per share than NICI, the SICI was a bit conservative in rewarding the shareholders. The pay out ratio of SICI was 22.50 per cent, while it was 35.07 per cent in the case of NICI.

It could be safely said that there was no major difference between SICI and NICI in terms of both capital gearing ratio and debt equity ratio, because the differences between the two groups of the industry with respect to these two ratios were only marginal.

All the important indicators of profitability viz., earning power ratio, earning per share, return on capital employed and book value per share of NICI were higher than SICI. the lesser dividend yield ratio recorded by NICI might be due to a higher market value per share influenced by earning per share and book value per share.

Excepting the ratio of reserve to equity capital, the other ratios viz., capital gearing ratio, debt equity ratio and ratio of fixed assets to long term debt of the two regions of engineering industry recorded only marginal differences. Therefore any worthwhile interpretation of their approaches to capital structure could not be made. In spite of the higher debt component used by SICI, it has registered a higher times interest earned ratio (5.75) than NICI (3.28). The earning power of the South Indian group was larger than NICI. The larger earning power ratio

(26.8 per cent) has resulted in a higher return on capital employed and earning per share Rs.19.81 and 38 per cent respectively. The SIEI was liberal in rewarding the shareholders; the pay out ratio of this group was 39.75 per cent, while Northern group recorded 36.53 per cent.

The capital gearing ratio and debt equity ratio clearly indicated that the paper industry in North India used a higher proportion of debt in their capital structure. Every rupee of equity in NIPI had a debt of Rs.2.08, while it was only Rs.1.01 in the case of SIPI. Capital gearing ratio shows that the SIPI had engaged a higher quantum of equity (Rs.1.39) in comparison with the NIPI (Rs.0.81) It appears, as data show, that the SIPI was conservative towards its capital structure and that the NIPI was dynamic.

Though the SIPI was appeared to be conservative as show earlier, it was liberal in its dividend policy as the pay out ratio was 40.81 per cent. The pay out ratio of the other group was only 20 per cent. Perhaps due to the higher degree of financial leverage tried by the NIPI, the times interest earned ratio, earning per share and the book value per share of NIPI were higher than that of the SIPI.

The solvency ratios pertaining to the South Indian and North Indian sugar industries do not give any signal to indicate the approaches of the two groups towards their capital structure. There is no significant difference between the two

groups in terms of capital gearing ratio and ratio of fixed assets to long term debt. The times interest earned ratio, return on capital employed and book value per share were higher in the case of SISI than NISI. The earning power of the assets of NISI was 47.80 per cent which is nearly 20 per cent more than SISI.

There is no significant difference between the two regions in terms of capital gearing ratio of North and South Indian Textile Industries. Debt equity ratio shows that the NITI had engaged a higher debt (Rs.1.73) for every rupee of equity.

The profitability ratios indicate clearly that the SITI was more efficient than NITI in making surpluses. All the profitability indicators like times interest earned ratio (4.44) earning power ratio (39.2 per cent) earnings per share (Rs.45.36) and return on capital employed (24.8 per cent) were far higher than that NITI.

The data presented in the fifth Chapter indicate that the optimum capital structure of the South Indian Enterprises was achieved in the ^{year} 1994. The overall cost of capital of SIE in the year 1994 was the lowest during the five years of the study and the average value of firm was the highest during 1994. During this year the overall cost of capital was only 6.93 per cent but the average value of a firm was Rs.3 crores, indicating that the capital structure was optimum. The debt equity ratio of SIE during the year 1994, when the optimum capital structure was

achieved was 1.66. The average overall cost of capital was the least (6.45 per cent) in the year 1993 for NIE. The average value of firm was the highest (Rs.11.59 crores) in the same year. As the average overall cost of capital was at its minimum and the average value of firm was at its maximum in the year 1993, the capital structure of NIE in that year can be described as the optimum structure. The optimum capital structure of NIE was achieved at a debt equity ratio of 2.23.

The ratio analysis of the capital structure and financial performance of the 200 random samples did not either clearly confirm or reject the myths about the approach of SIE towards capital structure. Hence the Researcher framed seven sets of hypotheses, each set comprising a null hypothesis and an alternative hypothesis, and statistically verified them. These hypotheses were framed and tested to enable a proper interpretation of collected data.

Out of the seven sets of hypotheses, the first three sets relate to capital structure decisions. The fourth, fifth and sixth sets of hypotheses are concerned about the impact of capital structure on the financial performance of the companies. The last set relates to dividend policy. As the seven sets of hypotheses reflect the different dimensions of capital structure decision and their impact on financial performance, it was hoped that verification of the statistical

validity of these hypotheses would confirm or reject the myths.

All the three null hypotheses pertaining to capital gearing, debt equity combination and quantum of earnings retained were statistically accepted. This indicates that there had been no significant difference between SIE and NIE in terms of their approach towards the three important dimensions of capital structure decision. This has shattered the popular myth that the SIE were conservatives towards their capital structure decisions and that the NIE were dynamic. It is also interesting to note that the seventh null hypothesis relating to dividend policy was also accepted indicating that there was no significant statistical difference between SIE and NIE in terms of their approach towards dividend policy. Here also the myth that the SIE were conservatives in rewarding the shareholders and that the NIE were liberal had been broken. The fact that the fifth and sixth null hypotheses relating to earning per share and book value per share respectively were also accepted shows that there was no significant statistical difference between SIE and NIE in terms of the impact of capital structure decision on financial performance. Though the fourth null hypothesis relating to return on capital employed had been rejected, there is no reason to believe the myths. In fact, the SIE were performing well with an average return on capital employed of 20.88 per centage which is higher than the 17.46 per centage of NIE.

Since six null hypotheses out of the seven relating to the important dimensions of capital structure decision were accepted, it can be safely concluded that there is no statistical evidence to prove that the South Indian Enterprises were conservatives with regard to capital structure decision. Further, rejection of the fourth null hypothesis indicates that the South Indian Enterprises performed more efficiently than their counterparts in the North. Both these two findings, one relating to the capital structure and the other relating to financial performance, are highly significant as they break the existing popular myths against South Indian Enterprises.