



Do Borrowings Necessarily Have To Destory The Raison D’etre of A Company?

Abstract

When a company involves debt in its capital structure, it has to bear fixed charges and this has deep impact on the company's profitability and liquidity. This paper focuses on the relationship between leverage and profitability in West Coast Pharma Limited. The financial statements of West Coast Pharma Limited have been collected over a period of 7 years (from 2009-10 through 2015-16). Various tools and techniques employed reveal that the degree of operating leverage is found to have statistically significant positive correlation with the ROI as also that the degree of financial leverage is positively correlated with the ROI. It is suggested that West Coast Pharma Limited should revamp its capital structure such that it should include the optimum blend of equity and borrowed funds so that it has positive impact on Return on Investment. Furthermore, degree of combined leverage is positively correlated with ROI of West Coast Pharma. It follows that West Coast Pharma has not significantly resorted to the use of debt funds which also deprives it of the benefits of financial leverage.

Keywords: Combined Leverage, Financial Leverage, Operating Leverage, Profitability and ROI

1. Introduction

Leverage is employment of debt fund or borrowed capital. Although leverage is purely a financial tool, it is used immensely by managers involved in the decision-making processes related to capital structuring decisions, mergers and acquisitions, ascertainment of cost of capital etc. The management of a company goes through many brain storming sessions before deciding on a particular capital structure- Equity dominated or Debt-dominated or trade-off between the two etc.

2. Literature Review

Financial Leverage has always been a favourite topic with the business community as well as the academia. It evokes a full gamut of responses from both the teaching community and the business community. To fully gauge this diversity of opinion and body of work, several books, journals and articles were reviewed. In this study utmost care has been taken to include as diverse literature as possible on the theoretical aspect of the topic and findings and exploratory studies. Dilip D. Kare (2003) published a survey of Corporate practices with regard to employment of Financial Leverage, in which he said that while different industries may exhibit widely differing capital structure, firms in the same industry choose the same level of leverage composition...this means that intra industry leverage differences were fairly negligible". Brent A. Gloy, Baker (2002) have discussed the risk-taking and risk-aversion behaviour of various companies and the reasons thereof. They opined "the problem of choice among risk-management strategies is addressed with the dominance of a risk-free asset criterion. This allows for strategies with less business risk, less expected return and greater leverage to dominate strategies...". Carole E. Scott (1998) in a working paper described Financial leverage as " name given to

the impact on returns of a change in the extent to which the firm's assets are financed with borrowed money". Louis Chaillet (2010) in his book has stated that the prospective investors should first look at the quality of assets acquired by the leveraged firm. This, they say, is a decisive factor in projecting the future prospects of getting a reasonable rate of return. CA Sachchidanand Pachori and Dr. Navindra Totala (2012) made an attempt to study the influence of financial leverage on the shareholders' return and market capitalisation of automotive cluster companies of Pithampur, Madhyapraesh, India. They have observed that shareholders of the firms with risk-laden debt will invest only when or up to the point at which, the expected return on investment is at least as great as the promised payment to bondholders. They imply that if the expected return is less than the promised payment, the shareholders invest less than the optimal amount or do not invest at all. Then, the firm value declines resulting in restricted use of debt. Their findings indicate that even if the rate of return on equity is high but if the amount of financial leverage is very high the shareholder will ask for premium to cover the added risk. They conclude that financial leverage is a speculative technique and that there are special risks and costs involved with financial leverage and there is no guarantee that financial leverage strategy will be successful during any period in which it is employed.

3. Rational Of The Study

In India, there have been significant changes in the capital market over the last few decades. The government rules and regulations have also been changing from time to time. Hence, the expectations of the investing community have also changed in keeping with the aforementioned changes. How the corporates raise funds and utilise the same has become a make or break point so far as the financial performance of the corporate world is concerned. Leverage has always been and continues to be the buzz-word for the corporates and the investors as well as other stakeholders. Employing leverage has its pros under a particular set of financial circumstances and also its cons in a different set of financial circumstances. West Coast Pharma Limited, an Ahmedabad-based company, has continued its steady march to growth and prosperity even in the face of changing vicissitudes at the stock market. West Coast Pharma Limited has been growing by leaps and bounds in recent years and being a home-grown company it naturally arouses curiosity in the academia.

4. Objectives Of The Study

- To analyse the Financial Performance of West Coast Pharma Ltd.
- To carry out Leverage Analysis of West Coast Pharma Ltd.
- To examine the relationship between Leverage and Profitability in West Coast Pharma Ltd.

5. Research Methodology :

Considering the nature of study only secondary financial data have been used. The secondary data have been collected from the online data sources.

Null Hypotheses

H1: There is no significant positive correlation between Operating Leverage and Profitability of West Coast Pharma Ltd.

H2: There is no significant positive correlation between Financial Leverage and Profitability of West Coast Pharma Ltd

H3: There is no significant positive correlation between combined Leverage and Profitability of West Coast Pharma Ltd.

Methodology

- Various profitability ratios, liquidity ratios, and leverage ratios have been used to analyse the financial performance of West Coast Pharma Ltd. for the period from 2009-10 to 2015-16.
 - Operating **Leverage**, **Financial Leverage** and **Combined Leverage** have been computed to gauge leverage.
- Degree of Operating Leverage (DOL)** has been computed as under:
Percentage change in EBIT / Percentage change in sales
 - Degree of Financial Leverage (DFL)** been computed as under:
% change in EPS / % change in EBIT
 - Degree of Combined Leverage (DCL)**
The Degree of Combined Leverage (DCL) is the leverage ratio that sums up the combined effect of the Degree of Operating Leverage (DOL) and the Degree of Financial Leverage (DFL) has on the Earning per share or EPS given a particular change in sales. This ratio helps in ascertaining the best possible financial and operational leverage that is to be used in any firm or business.
- The Leverage and Profitability relationship has been analysed through statistical tools such as Pearson coefficient of correlation.

Tools of data analysis:

The collected data have also been also analysed using Ratio Analysis Technique & statistical software such as SPSS.

6. Data Analysis

Table -1: Degree of Operating Leverage

Year	Sales	Operation profit	%EBIT	%Sales	DOL
2009-10	879.06	57.37	----	----	----
2010-11	955.89	72.25	25.93	12.56	2.06
2011-12	1080.98	102.48	78.62	28.41	2.76
2012-13	1104.97	147.3	156.75	42.19	3.43
2013-14	1558.76	181.8	216.89	63.18	3.43
2014-15	1840.64	247.95	332.19	99.83	3.326
2015-16	2037.88	274.43	378.35	138.40	2.73

Table -2: Degree of Financial Leverage

Year	EPS(Rs)	Operation Profit (Rs.Cr)	%EPS	%EBIT	Financial Leverage
2009-10	6.25	57.37	----	----	----
2010-11	7.38	72.25	18.08	25.93	0.69
2011-12	9.45	102.48	51.2	78.62	0.65
2012-13	10.46	147.3	67.36	156.75	0.42
2013-14	14.84	181.8	137.44	216.89	0.63
2014-15	35.14	247.95	462.24	332.19	1.39
2015-16	26.7	274.43	327.2	378.35	0.86

Table-3: Degree of Combined Leverage

Year	% change in EPS	% Change in Sales	DOL	DFL	DCL = DOL*DFL
2009-10	----	----	----	----	-----
2010-11	18.08	12.56	2.06	0.69	1.42
2011-12	51.2	28.41	2.76	0.65	1.79
2012-13	67.36	42.19	3.43	0.42	1.44
2013-14	137.44	63.18	3.43	0.63	2.16
2014-15	462.24	99.83	3.326	1.39	4.62
2015-16	327.2	138.40	2.73	0.86	2.35

Table -4 : Current Ratio

Year	Current Ratio
2009-10	1.70
2010-11	1.71
2011-12	1.68
2012-13	1.10
2013-14	1.10
2014-15	1.72
2015-16	1.97

Table -5: Quick Ratio

Year	Quick Ratio
2009-10	0.14
2010-11	0.18
2011-12	0.18
2012-13	0.22
2013-14	0.14
2014-15	0.20
2015-16	0.66

Table -6: Debt -Equity Ratio

Year	Total debt (Rs.Cr)	Net worth (Rs.Cr)	Debt-equity ratio
2009-10	480.33	2120	0.22
2010-11	510.8	2510.38	0.20
2011-12	440.63	2910.15	0.15
2012-13	250.05	3347.28	0.07
2013-14	138.77	3988.24	0.04
2014-15	1905.4	5749.3	0.30
2015-16	0.00	7000.33	0.00

Table -7: Total Assets Turnover Ratio (TATR)

Year	Sales(Rs.Cr)	Total Assets(Rs.Cr)	TATR
2009-10	770.93	266.31	2.89
2010-11	867.76	303.19	2.86
2011-12	989.96	335.8	2.94
2012-13	1096.21	359.33	3.05
2013-14	1258.08	412.01	3.05
2014-15	1540	593.72	2.62
2015-16	1837.97	700.33	2.62

Table -8: Working Capital Turnover Ratio

Year	Sales (Rs.Cr)	Working capital (Rs.Cr)	WCTR
2009-10	770.93	124.42	6.19
2010-11	867.76	142.01	6.11
2011-12	989.96	132.56	7.46
2012-13	1096.21	126.8	8.64
2013-14	1258.08	32.07	39.22
2014-15	1540.59	186.4	8.20
2015-16	1837.97	343.54	5.35

**Table -9:
Rate of Return**

Year	ROI (%)
2009-10	19.31
2010-11	20.30
2011-12	18.34
2012-13	25.16
2013-14	26.11
2014-15	29.41
2015-16	29.07

RELATIONSHIP BWTWEEN LEVERAGE AND PROFITABILITY

It is imperative to understand the relationship between leverage on the one hand and profitability on the other. In that, correlation is a statistical technique measuring an association or relationship between two or more variables. There can be a simple correlation or multiple correlation. An association between two variables is called simple correlation whereas an association among several variables (more than two variables) is called multiple correlation. If two variables are negatively correlated, such a correlation is called negative correlation and the Karl Pearson coefficient of correlation is negative. It may be pertinent to note here that the Karl Pearson coefficient of correlation varies from -1 to +1. When two variables are positively correlated then the correlation is called positive correlation and the Karl Pearson coefficient of correlation is positive. If there is no correlation between two variables, it is called zero correlation and the Karl Pearson coefficient of correlation is zero. However, when the correlation coefficient -1 then there exists perfect negative correlation and it turns out to be +1, it indicates perfect positive correlation.

Table -10: Correlation Coefficient b/w DOL and ROI (SPSS)			
	Variables	DOL	ROI
DOL	Pearson Correlation	1	.946**
	Sig. (2-tailed)		.004
	N	6	6
ROI	Pearson Correlation	.946**	1
	Sig. (2-tailed)	.004	
	N	6	6

The table-10 shows that the correlation coefficient between DOL (Degree of Leverage) and ROI (Return on Investment) is 0.946 which is statistically significant at 0.01 level of significant as significant level (p value =0.004) less than 0.01. Therefore, it is observed that degree of operating leverage is significant positively correlated with the ROI. It means that degree of operating leverage of West Coast Pharma was at a desirable level or in a good position. It is suggested to West Coast Pharma to continue its present operating leverage practice in future also.

	Variables	DFL	ROI
DFL	Pearson Correlation	1	.195
	Sig. (2-tailed)		.712
	N	6	6
ROI	Pearson Correlation	.195	1
	Sig. (2-tailed)	.712	
	N	6	6

As can be observed from the table-11, the correlation coefficient between DFL (Degree of Financial Leverage) and ROI (Return on Investment) is 0.195 which is statistically not significant at 0.01 level of significant as significant level (p value =0.712) more than 0.05. Therefore, it is implied that the (DFL) degree of financial leverage is positively correlated with the return on investment. West Coast Pharma Ltd. can be said to not have been optimally levered as suggested by DFL. West Coast Pharma Ltd. is advised to review and recast its present capital structure so that there is judicious mix of equity and borrowed funds to experience the positive impact of leverage on ROI.

	Variables	ROI	DCL
ROI	Pearson Correlation	1	.469
	Sig. (2-tailed)		.349
	N	6	6
DCL	Pearson Correlation	.469	1
	Sig. (2-tailed)	.349	
	N	6	6

A glance at table-12 divulges that the correlation coefficient between DCL (Degree of Financial Leverage) and ROI (Return on Investment) is 0.469 which is statistically not significant at level of significant as significant level (p value =0.349) more than 0.01. Therefore, it is observed that degree of combined leverage is positively correlated with the ROI but not significant statistically. It means that degree of combined effect of leverage of West Coast Pharma Ltd. was not profound or at an optimum level. The key to augment ROI is effective management of debt. Again the company is advised to tweak its capital structure to have the desired effects of leverage.

CONCLUSION

West Coast Pharma Ltd is not maintaining optimum financial leverage. As a natural corollary, the average degree of combined leverage is also not optimum. Everything in moderation is desirable.

The company is tilting on the “inadequate leverage” side. This lopsided disarray of capital structure should be corrected by administering greater dose of leverage to augment profitability as well liquidity. In the context of liquidity, the company is not sufficiently liquid as reflected in the average of current ratio of just 1.5 which is less than the standard norm of 2.1, reflecting the “not-so-satisfactory” liquidity position of the company. It may not be able to meet or even worse, default on its short-term obligations. The exact same truth is brought out by the quick ratio with the average quick ratio being 0.25 against the standard norm of 1. West Coast Pharma Ltd has an average total debt capital employed which is merely 8.43 percent of total capital employed. That leads to the conclusion that the company is heavily banking on shareholders’ funds, 91 % of its capital requirements and borrowed funds to the extent of just 8.43 %. This inadequate use of debt has failed to unlock the company’s potential to create wealth for its shareholders. The same fact is corroborated by the averaged out debt equity ratio (at 0.12) of West Coast Pharma Ltd. and that is why the advantages of leverage are negated to the company. Total Assets turnover Ratio maintained of West Coast Pharma Ltd. is 2.86 which again shows that total assets have not been used productively to achieve greater amount of sales. It indicates that firm’s management efficiency was not superior. However, the company is efficient when it comes to using its fixed assets as reflected in average of fixed Asset Turnover Ratio which come to 8.11 times. It can be said the fixed assets with the company have been effectively engaged in generating higher sales. The average of Working Capital turnover ratio maintained by West Coast Pharma Ltd. is 11.6 times indicating firm’s superior management efficiency.

As far as profitability goes, the average ROI maintained by West Coast Pharma was 34.35 % during the study period which can be taken as satisfactory. Moreover, when profitability and leverage are considered together, it can be stated that the degree of operating leverage is significant positively correlated with the ROI. The degree of financial leverage is positively correlated with the ROI. The degree of combined leverage is positively correlated with the ROI although not significant statistically, implying that the degree of combined effect of leverage was not at an optimum level. This again brings home the point that the company must introduce a greater dose of leverage to achieve greater profitability and liquidity and even the cherished objective of shareholders’ wealth creation can also be accomplished.

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