CHAPTER – 5

CONCLUSIONS

AND

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The basic objective of the study was to find out how Indian companies determine their optimal capital structures and the relationship between cost of capital, capital structure and value of the firm. But owing to the facts that they operate in an imperfect market and have no specific model or mechanism to determine an optimal capital structure, the present study aimed at finding out whether an optimal capital structure existed at both micro and macro level. In a perfect market there is no optimal capital structure as the value of the firm is independent of its capital structure. But when various market imperfections viz., personal taxes, corporate taxes, bankruptcy and agency problems are taken into account, value of the firm is no more invariant to its capital structure. During the last years a lot of work has been done on the problem of optimal capital structure and by now it has been well established that in an imperfect capital market, an optimal capital structure does exist. It is determined by the trade-off between tax advantages of debt and the disadvantages associated with it. But till date, no model has been developed which can establish an exact relationship between capital structure and market value of the firm.

Various financial practitioners, consultants and academicians, hae not been able to develop a mechanism for measuring (i) bankruptcy and agency costs; (ii) their effect on EBIT of a firm; (iii) their significance to value of the firm; (iv) the exact relationship between interest rates and leverage; (v) the precise effects of personal taxes and; (vi) the expected future earnings. So in the light of these problems it is not possible to develop a model which can show the exact effects of changes in capital structure on the value of a firm. In the absence of any such model, all the previous studies done on capital structure, cost of capital and value of the firm have used correlation and regression techniques to find the degree and nature of relationship among them. In this study also, we have used bivariate correlation to establish the relationship between capital structure and value of the firm.

Besides this main objective, the present study has some sub-objectives which are as follows:

(i) To determine the existing capital structure of different companies.
(ii) To test the significance of differences in capital structures of different companies and to find the determinants of capital structure.
(iii) To find the determinants of share price and market value of a company.
To determine the factors that affect the capital structure decisions.

To conduct the study, a sample of 30 companies listed on Bombay Stock Exchange index was taken. Thus the sample was not homogeneous. This was a multiperiod study covering the period 2001-02 to 2010-2011. Primary data, obtained through questionnaire, was used to supplement the empirical results.

The main conclusions drawn on the basis of results obtained, are as follow:

1. Except Jindal steel and power ltd., average values of debt to total capital (D/C) ratio for other sample companies ranged from 0.05 to 0.4. So none of the companies was found to be excessively leveraged. For Jindal steel and power ltd., value of this ratio was 0.56

2. The difference in capital structure of different companies whether they belong to the same industry group or different groups, was found to be statistically significant. This is because of the fact that qualitative values of the determinants of capital structure and their effect on value of the firm vary from company to company. The main determinants were (i) cost of capital, (ii) dividend payout ratio, (iii) capital market conditions, (iv) earning stability, (v) nature of industry, (vi) government rules and regulations, (vii) size of the company, (viii) restrictions by financial institutions, (ix) industry norm and (x) management decisions and policies.

3. At micro level, no significant and definite relationship was found between capital structure and value of the firm, out of 23 companies, under study, 18 companies showed a negative relationship, while 6 companies showed a positive relationship. The relationship was statistically significant in case of 10 companies only (2 showing positive and 8 showing negative). These differences in degree and nature of relationship could not be explained even in the light of business risk, size and growth of a company. This is because of the fact value of a firm is affected by a multiplicity of causes (capital structure being one of them). Many of these factors like reputation of promoters, management of the company, economic and political conditions, roles of bulls and bears in the stock market, government policies etc. are not measureable as they are qualitative in nature. Further, it is not possible to segregate the effects of all factors, so an exact relationship could not be established.
4. At macro level, the relationship between capital structure and value of the firm was found to be highly positive. The external factors shown above may result in overvaluation or undervaluation of shares at micro level, but at macro level their positive and negative effects neutralize each other. So the share prices are closely approximate to true indices of the aggregate financial and operating results. Thus we get a high degree of positive correlation between the two. Thus the results advocate that at macro level an optimal capital structure, i.e., D/C ratio do exist which is definitely higher than 0.25 because up to this level the value of ‘r’ was found to be 0.79 which is statistically significant. So issuance of additional debt will increase the value of the firm. But the question, “How long will the value increases with increase in leverage”? remains unanswered as it is not possible to estimate the value of a firm beyond the existing level of D/C ratio.

5. The companies, under study, in general have no scientific and systematic mechanism to determine the target capital structure and if a company has set a target capital structure, it has no specific plans to achieve it.

6. Co-efficient of correlation between cost of capital and capital structure was found to be negative. The results support the view that increase in leverage decreases the cost of capital because debt is a cheaper source than equity. But the results are not statistically significant. This is because this relationship is affected by a number of factors, both quantitative and qualitative, whose effect on this relationship could not be isolated. Further the interest rates in India are much higher than those prevailing in the developed countries where, in the previous studies, significant relationship had been established. At macro level, the value of r was found to be -0.36.

Besides these main results, some other results have also emerged from this study, which are as follows: -

(i) Indian companies have no specific model to compute the cost of specific components of capital, particularly the cost of equity capital and average cost of capital.
(ii) Outside shareholders are not consulted in taking capital structure and dividend decisions. This situation can result in an agency problem because the decisions taken by the managers may be not be in the best interest of the shareholders. The individual shareholders, holding a very small proportion of the total share capital, are not in a position to influence or change the decisions taken by the managers.

(iii) The capital structure decisions generally made by the Indian companies are based on: (i) funds requirement (ii) cost of capital (iii) existing and target capital structure (iv) existing earning level (v) capital market conditions (vi) level of retained earnings (distribution in form of bonus issue) (viii) control of the management and (ix) value of the firm. Though a company can take any number of factors into account, but the decisions on what factors to consider are taken as per situation prevailing at the time of decision-making.

To conclude we can say that the results support the current view that in an imperfect-market like ours, an optimal capital structure does exist, but the problem in developing a proper model lies in the fact that market price of share and value of a firm are affected by a number of factors, quantitative as well as qualitative and external as well as internal, many of which can’t be measured and their effects can’t be segregated. These factors coupled with other factors also effect the relationship of capital structure with cost of capital. So an exact relationship among them can’t be established. In Indian industries an optimal capital structure does exist at macro level which has positive relationship with value of the firm and negative relationship with cost of capital.

SUGGESTIONS

The present study was undertaken to determine an optimal capital structure in Indian private sector companies which operate in an imperfect market. No assumptions were used in the study. The results obtained can be improved, if the suggestions mentioned below are taken into account by Indian companies, researchers and the government:

1. Indian companies should develop some scientific models or mechanisms for computing costs of capital and by incorporating future uncertainty taking capital structure decision. These steps will improve the functioning of the financial
management thus achieving the objective of wealth maximization more efficiently. Further, they will also help in evaluating the project investment opportunities and appraising the financing decisions in a better way.

2. Indian stock market should be made more efficient, i.e., the stock prices should act as true indices of a company’s performance because one. Then it may be possible to determine an optimal capital structure at micro level. The government has also recognized this problem and constituted Securities Exchange Board of India (SEBI) in 1992 with the main objective of streamlining the working of the stock markets. But still a lot of work has to be done in this direction.

3. Interest rates in Indian debt-market are quite high as compared to the rates prevailing in the debt market of developed countries. That’s why, whereas the studies in the west have established significant relationship, our study failed to show any significant results at micro level. So, suggestion interest rates should be restructured so as to make them compatible to the rates in the international financial markets.

4. Indian companies should make efforts to win the confidence of the investors. For this it is necessary that working of the companies be made more transparent and open. They should encourage participation of equity holders and bond holders in decision making process. Further the companies should try to introduce innovative security instruments in the stock market. All these steps will help significantly in increasing the value of the company.

At this area is under researched in India, so the researcher feels that a good number of further researches could be carried out on this and other related issues like developing an efficient stock market in India, effect of financing and dividend decisions on the value of a firm segregating the effects of factors which influence the value of a firm etc. before generalizing the results.