CHAPTER I
INTRODUCTION
# CHAPTER - I

**INTRODUCTION**

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CHAPTER - 1

INTRODUCTION

1.1 INTRODUCTION

Every business needs capital. The may run the business with own capital alone or with loan capital also. When mixed capitals are used, there is a possibility for leverage. There are two types of leverages - Financial leverage and Operating leverage. The capital structure should be arranged in such a way to get the advantage of leverages. The dividend policy of a concern also depends on capital structure. A detailed study over these aspects and their effects on profit are made.

1.2. CAPITAL STRUCTURE AND LEVERAGE

The choice of a firm’s capital structure depends upon allocation of cash flows towards meeting debt capital obligations and rewarding the equity shareholders.

Since the objective of financial management is to maximize shareholder wealth, the key issue is towards the capital structure decision. Some says that there is no relationship between capital structure and financial leverage, some others say it has a positive effect on firm value, up to a point and negative effect thereafter; still others contend that, other things being equal, greater the leverage would increase greater the value of the firm.

Capital structure decision is of tremendous significance for the management, since it influences the debt-equity mix of the company, which ultimately affects shareholders' return and risk. The risk of the shareholders increases in case there is a high proportion of a borrowed fund in the total capital structure of the company. In a
situation where the proportion of the shareholders' funds is more than the proportion of the borrowed funds, the return as well as the risk of the shareholders will be much less. The concept of leverage helps in examining this aspect.

1.3. DIVIDEND POLICY:

The dividend policy of a firm determines what proportion of earnings is paid to shareholders by way of dividends and what proportion is ploughed back in the firm for reinvestment purposes. The dividend policy has a bearing on the choice of financing. On the other hand; if a firm's capital budgeting decision is dependent on its dividend decision, a higher dividend payment will cause shrinkage of its capital budget and vice versa. In such a case, the dividend policy has a bearing on the capital budgeting.

A firm's dividend payout ratio obviously depends on how earnings are measured. For the sake of simplicity, we look at the accounting measure of earnings. Of course, we are aware that accounting earnings often diverge from economic earnings and do not truly reflect a firm's capacity to pay dividends.

The objective of corporate financial management is to maximize the market value of equity shares. We can see the same by seeing relationship between dividend policy and market price of equity shares.

The wealth of owners is reflected in the market value of shares. So wealth maximization implies the maximization of the market price of shares.
Leverage, Capital structure and Dividend policies are the important decision areas in financial management. The study concentrates on the leverage, Capital structure and dividend policies and practices of SAMBANDAM SPINNING MILLS LIMITED over a period of 1997-1998 to 2003-2004.

1.4. BACKGROUND OF STUDY:

As the shareholders value and the enterprise value depends how well the concern is managed with proper capital mix, leverage is carried on and how the profits are distributed, a proper analysis is the need of the hour for every one.

Generally, shareholders wealth is measured by the returns they receive on their investments in the form of dividends and in the form of capital appreciation, reflected in market value of shares. Hence, Capital Structure, Leverage and dividend policy are the important decision areas in financial management.

The management has to consider the proper capital mix to enjoy the benefit from leverages. The following impact we arise due to leverage and dividend distribution:

1. A high degree of leverage will indicate that the company is working under a Very high risky situation.

2. Too low leverage will indicate that the company is observing extra conservatism at the cost of equity shareholders.

3. While taking dividend decision, the management will obviously take into account the effect of the decision on the maximization of the shareholders' wealth.

Therefore, the concentration of study over these areas would benefit the company.
1.5. SIGNIFICANCE OF CAPITAL STRUCTURE

Capital structure is an appropriate mixture of own capital and loan capital as per the tastes of the concerns. A company should plan its capital Structure to get maximum advantage. The financial manager should make a compromise between the following guiding principles while framing their capital structure.

|-------------------|------------------|---------------------|-------------------------|-------------------|

The capital structure may be of any of the following four patterns:

1. Capital structure with equity shares only
2. Capital structure with both equity and preference shares.
3. Capital structure with equity shares and debentures.
4. Capital structure with equity shares, preference shares and debentures.

The capital structure pattern should minimize the cost of capital and maximize the value of stocks. Appropriate Capital Structure should have the following features:


The capital structure should be flexible so as to meet the changing conditions. The company should provide funds whenever needed to finance its profitable activities.

1.6 LEVERAGE:

Every Financial manager has to consider the following leverages in taking decisions:

1. Operating leverage 2. Financial leverage and 3. Composite leverage
1. Operating leverage:

It is closely related with the **business risk**, which is viewed as the uncertainty inherent in estimates of future operating income. If the degree of operating leverage is high break-even point is relatively higher and thus, changes in the sales level have a magnified or leverage effect on profits.

The firm is said to have a high degree of operating leverage if it employs a greater amount of fixed costs and a smaller amount of variable costs. This leverage is related to volume or capacity of operation of a concern.

2. Financial leverage:

The use of the fixed-charges sources of funds, such as debt and preference capital along with the owners' equity in the capital structure, is described as financial leverage. Financial leverage magnifies the volatility of returns whether measured by net income or return on equity or earnings per share. Financial Leverage magnifies the risk of bankruptcy i.e. financial risk. High degree of FL brings about a higher magnification of equity earnings.

3. Composite Leverage:

It is computed by considering both the financial and operating leverages. It is given as

Composite leverage = Operative leverage × Financial leverage
1.7 DIVIDEND POLICY:

Any distribution of accumulated profits whether capitalized or not, if such distribution entails a release of the assets or part thereof. Dividends are generally paid in cash. Dividends can be classified into different categories depending upon the form in which they are paid. The various forms of dividend that may be considered by the management are:

|-------------------|------------------|----------------------|

Dividend policy concerns quantum of profits to be distributed by way of dividend.

Most of the firms pursue three types of policies:

1. Generous Dividend and Bonus Policy:

Firms, which follow this policy, reward shareholders generously by stepping up total dividend payment over time. Typically, these firms maintain the dividend rate at a certain level (15 to 25 per cent) and issue bonus shares when the reserves position and earnings potential permit. Such firms naturally have a strong shareholder orientation.

2. More or Less Fixed Dividend Policy:

Some firms have a target dividend rate which is usually in the range 10 per cent to 20 per cent which they consider as a reasonable compensation to equity shareholders. Such firms normally do not issue bonus shares. Infrequently, may be once in few years, the dividend rate may be raised slightly to provide somewhat higher
compensation to equity shareholders to match the higher returns from other forms of investment.

3. Erratic Dividend Policy:

Firms which follow this dividend policy seem to be indifferent to the welfare of equity shareholders. Dividends are paid erratically whenever the management believes that it will not strain its resources.

1.8 BENEFITS FROM OPTIMUM CAPITAL STRUCTURE, LEVERAGE AND DIVIDEND POLICY:

1. The most profitable capital structure tends to minimum cost of financing and maximize earning per equity share.

2. The capital structure should be such that it can be easily maneuvered to meet the requirements of changing conditions.

3. The optimum capital structure involves minimum risk of loss of control of the company.

4. The financial leverage helps to magnify the shareholders' return under favorable economic conditions.

5. Combined leverage helps in finding out the resulting percentage change in taxable income on account of percentage change in sales.

6. The dividend policy determines the amount of profit to be distributed among shareholders.

7. The better dividend policy planning the long-term growth of the company.
1.9 STATEMENT OF THE PROBLEM:

The capital structure is a significant managerial decision. It influences the shareholders return and risk. Consequently, the market value of the share may be affected by the capital structure decision.

The dividend decision is also a financing decision. The company's policy to retain or distribute earnings affects the owners' claims. Shareholders' equity position is strengthened by retention of earnings. Thus, the dividend decision has a bearing on the capital structure of the company. The objective of dividend policy should be maximizing the shareholder's return so that the value of his investment is maximized. A high payout policy means more current dividends and less retained earnings, which may consequently result in slower growth and perhaps lower market price per share. Low payout policy means less current dividends, more retained earnings and higher capital gains and perhaps higher market price per share.

The study concentrates on the findings of the capital structure of the company, leverage used and dividend policy framed and maintained.

1.10 THE OBJECTIVES OF THE STUDY:

The study has been carried out with the following objectives in view:

1. To study the operating, financial and combined leverage of SAMBANDAM SPINNING MILLS LIMITED.
2. To understand the capital structure policies and practices in SAMBANDAM SPINNING MILLS LIMITED.
3. To know about the dividend policy of the company and its influence on Price-Earning (P/E) and MPS.
1.11. HYPOTHESES

The study is based on the finding of Capital Structure, Leverage and dividend policy of the company for the stated period.

Hypotheses have been suitably formulated to test the validity with the available data for appropriate analysis.

HYPOTHESIS 1

There is no significant relationship between Debt-Equity ratio and interest coverage ratio and average market price.

In this, Average market price has been taken as dependent variable and others as independent variable.

Multiple regression analysis is used to test the Hypothesis. The test shows that the Null Hypothesis is rejected.

HYPOTHESIS 2

There is no significant relationship between changes in EBIT, changes in sales and Degree of Operating Leverage.

In this, changes in EBIT have been taken as dependent variable and others as independent variable.

Multiple regression analysis is used to test the Hypothesis. The test shows that the Null Hypothesis is accepted.
HYPOTHESIS 3

There is no significant relationship between the degree of financial leverage and EPS.

In this, EPS has been taken as dependent variable and the other is independent variable.

Simple regression analysis is used to test the Hypothesis. The test shows that the Null Hypothesis is rejected.

HYPOTHESIS 4

There is no significant relationship between D.O.L and D.F.L and D.C.L

In this, D.C.L has been taken as dependent variable and the others as independent variable.

Multiple regression analysis is used to test the Hypothesis. The test shows that the Null Hypothesis is rejected.

HYPOTHESIS 5

Profit is not influenced by the capital structure

In this, profit has been taken as dependent variable and the capital structure as the independent variable.

Simple regression analysis is used to test the Hypothesis. The test shows that the Null Hypothesis is rejected.
HYPOTHESIS 6

Market price is not influenced by dividend distributed.

Here we take the market Price as the dependent variable and dividend distributed as independent variable.

Simple regression analysis is used to test the Hypothesis. The test shows that the Null Hypothesis is accepted.

HYPOTHESIS 7

Price -Earnings is not influenced by dividend distributed per share.

Here we take the Price Earnings as the dependent variable and DPS as independent variable.

Simple regression analysis is used to test the Hypothesis. The test shows that the Null Hypothesis is accepted.

1.12 PLAN OF ANALYSIS

The capital structure, leverage and dividend policy are very significant areas as it would influences the overall performance of the company.

In this study overall performance of the Company is made by giving due importance to capital structure, leverage and dividend distribution.

Firstly the performance of the Company has been tabulated for different years.

Secondly the capital structure of the company for different years is arrived.
Thirdly the leverages are calculated or different years.

Fourthly dividend distribution for the year under the study is arrived for highlighting the Dividend Policy followed.

Fifthly various statistical analyses is used to find the relationship between capital structure, leverage and dividend policy of the company.

1.13 METHODOLOGY

The unit selected for this study is THE SAMBANDAM SPINNING MILLS LTD., SALEM, which is within the city limits of Salem City.

The basic data required for the study have been collected from the secondary data.

The secondary data were adequately drawn from the published annual reports. The sources of secondary data are noted at appropriate pages.

The bibliography at the end of the thesis presents a comprehensive list of books and periodicals from which the method of computation and the understanding of the concept of the capital structure, leverage and dividend policy has been referred.

1.14 PERIOD OF STUDY:

This study is confined to relatively a shorter period of 7 years from 1997-98 to 2003-2004.

The period can also be extended depending on the availability of data related to the company.
1.15 TECHNIQUES OF ANALYSIS

The data related to the Company's performance for the 7 years have been collected from the annual reports of the Company and arranged in a form convenient for analysis. To make the study more scientific tools like Regression analysis, correlation Analysis and ANOVA are used.

1.16 PRESENTATION AND INTERPRETATION OF DATA:

The collected data have been classified and tabulated in such a way to make it useful for analysis and interpretation. Wherever necessary charts, and graphs have also been prepared to present the information in a more effective way. The effective presentation of the data has made the interpretation as very easy.

1.17 LIMITATION OF THE STUDY:

The capital structure decision and its impact on the leverage and dividend policy are very much important for every organization as it affects the value of the firm. The board of directors give due importance to the expectations of shareholders in the matter of dividend decision. The combined concept of the capital structure, leverage and dividend policy is subject to various factors.

It is always a challenge for every concern over deciding the optimal capital structure and getting the benefits of leverages and dividend distribution. The capital structure process is a continuous one. Dividend policy varies as per the taste of the shareholder and retainment for future growth of the company. Therefore the limitation
of this study depends upon the factors that affecting the company's capital structure, leverage and dividend policy and information received for our study purpose.

1.18 SCOPE OF THE STUDY:

In order to find out the capital structure, leverage and dividend policy for different periods and its trend, the performances of the Sambandam Spinning Mills Ltd., Salem, shown in the Annual Reports has been considered. The results and findings of the studies are interpreted for improving the capital structure, leverage and dividend policy in the near future.

1.19 ARRANGEMENT OF CHAPTERS:

The study is divided into SIX chapters.

The First Chapter is an introductory and starts with the brief review of background of studying capital structure, leverage and dividend policy, and significance of capital structure, leverage and dividend policy. It is followed by the objectives of the study, the scope of the study, the methodology adopted for finding the capital structure, leverage and dividend policy and testing of Hypothesis. The chapter closes with the limitation of the study.

The Second chapter deals with the concept, scope and significance of the capital structure, leverage and dividend policy.

The Third chapter deals the review of literature.

The Fourth chapter describes the working and progress of Sambandam Spinning Mills Limited.
The Fifth chapter deals with the data analysis and computation of the capital structure, leverage and dividend policy.

The Sixth chapter contains a very brief summary of the previous six chapters. Finally the findings and suggestions are listed in the concluding part of the last chapter.