Profile of Textile Industries and Determinants of Capital Structure
CHAPTER III
PROFILE OF TEXTILE INDUSTRY

3.1. INTRODUCTION

Textile Industry plays a pivotal role in generating economic growth, employment and exports. India needs to evaluate its strengths and weaknesses against the growing protectionism and evolve strategies to overcome the barriers. The textile industry should be declared a focus industry and national task force headed by the Prime Minister and Textile Minister to monitor the implementation and review of policy framework should be constituted to include the representatives of the industry and the government.

The basic features of the textile industries are;

They are the leading sectors in exports, textile production and overall income growth. Stable preference for cotton in home consumption, fed by new goods, fed in turn, by new competence of domestic producers acquired in the course of exporting. Informal sector as the leader in textile export and production. Improved capability in formal and seemingly, the informal sector via across the world market for inputs and machinery. Uneven adoption due to the presence in both formal and informal sectors of firms that were too rigid or constrained to adopt. As a result, segment of excess capacity and excess demand co-existed in all major sector of industry touched by reforms. Trends in global costs made India a potentially major producer in the man made textile sector.

Under progressive liberalization of world trade, the textile scenario will change drastically in next few years. But greater realization is needed on how acutely the performance of textile depends on sustained macro economic and enterprise reforms. India today is the third largest producer of cotton, second largest producer of cotton yarn and the largest exporter of cotton yarn in the world. The government has under its new textile policy set an ambitious export target of 50 billion dollars to be achieved in the year 2010. Technical textiles are used in defense, automobiles, house hold textiles, furnishings and floor covering for homes, hotels, offices and restaurants and in other sectors for the manufacture of automobile covers, kitchen products, light combat aircrafts, fiber nets, woven hoses, fire protection equipment and bullet-proof jackets for defense personnel.
The Union Government was expected to remove specific import duties on a large number of textile items from Pakistan and Bangladesh in order to give them greater access to the Indian Market. The proposal to reduce import duties on some 60-70% of 271 textile tariff lines was sent for Prime Ministers' approval. At present there are specific import duties ranging from Rs.25 to Rs.125 on certain items which might be reduced to 15%. The change was become effective from 1st January, 2006 with the coming into the force of the South Asian free trade agreement with SAARC.

3.2 LIBERALIZATION AS A PART OF OBLIGATIONS UNDER WTO

India has committed itself to WTO that we have to permit imports of all products including fabric and garments. However, in the world of textile, when large number of countries are competing it is not uncommon that dumping is resorted too. Industry and the Government must work together to ward off the unfair practices followed in the trade of textiles. We are emerging from highly protective environment. Our system and structures to deal with anti-dumping, have not only be strengthened by more people, but also the knowledge and information on what happens in the world market and procedures to study and analyze need to be comprehended to safe guard the nation interest. The Manchester of India, Coimbatore deals mainly in Textile Industries. That is why the Textile Industries are taken for the analysis of capital structure, to improve the nation's economy. The textile industries are broadly classified into Large scale sectors and small scale sectors. Large scale industries have Hi-Fi technologies and supply raw materials by its own sister concerns. They concentrate in mass production. Here risks and returns are high. Small scale industries are differentiated from large scale industries by the technique of production. They use modern power driven machines and employ labour as well. The raw materials are also obtained from outside, if not available locally. Their products are sold through traders beyond local markets. In many developing countries, the role of these industries are crucial as they provide employment to a large number of people.

3.3 MEANING AND DEFINITIONS OF CAPITAL STRUCTURE

Capital structure refers to the way a corporation finances itself through some combination of equity options, bonds and loans. Optimal capital structure refers to the particular combination that minimizes the cost of capital while maximizing the stock
price. The permanent long-term financing of a company, including long-term debt, common stock, preferred stock and retained earnings. It differs from financial structure which includes short-term debt and accounts payable. The capital structure of a firm is broadly made up of its amounts of equity and debt. Thus it supports the close relationship between leverage and value of a firm.

Ross defines capital structure as "the composition of a corporation's securities used to finance its investment activities; the relative proportions of short-term debt, long-term debt and owners' equity".

Capital structure can be defined as "the mix of the various debts and equity capital maintained by a firm also called financial structure".

Capital structure is "the proportion of a debt and preference and equity shares on a firms' balance sheet".

"Capital structure depends on the financing decisions of a firm". Optimum capital structure is, "the capital structure at which the weighted average cost of capital is minimum and thereby maximum value of the firm".

3.4 THEORIES OF CAPITAL STRUCTURE

A firm should select such a financing mix which maximizes its value/ the shareholders wealth or minimizes its overall cost of capital, such a capital structure is referred to as the optimum capital structure. Different kinds of theories have been propounded by different authors to explain the relationship between capital structure, cost of capital and value of the firm. Main contributors to the theories are Durand, Ezra, Solomon and Modigliani and Miller. The important theories are

3.4.1 NET INCOME (NI) APPROACH

NI Approach suggested by Durand, the capital structure decision is irrelevant to the valuation of the firm. A change in the financial leverage will lead to a corresponding change in the overall cost of capital as well as the total value of the firm. Therefore the degree of financial leverage as measured by the ratio of debt to equity increased, the weighted average cost of capital will decline, while the value of the firm as well as the
market price of ordinary shares will increase. Conversely, a decrease in the leverage will cause an increase in the overall cost of capital and a decline both in the value of the firm as well as the market price of equity shares.

**ASSUMPTIONS**

- There are no taxes.
- The cost of debt is less than the equity capitalization.
- The use of debt does not change the risk perception of investors.

### 3.4.2 NET OPERATING INCOME (NOI) APPROACH

NOI theory is diametrically opposite to the NI approach. The main sequence of this approach is that the capital structure decision of a firm is irrelevant. Any change in leverage will not lead to any change in the total value of the firm and the market price of shares as well as the overall cost of capital is independent of the degree of leverage.

**ASSUMPTIONS**

- Over all cost of capital/capitalization rate (Ko) is constant. The market evaluates the firm as a whole. The split of the capitalization between debt and equity, is therefore, not significant.
- The equity – Capitalism rate/cost of equity capital(Ke) increases with a degree of leverage.
- The cost of debt, includes both explicit cost (is the rate of interest paid on debt) and implicit cost (is the increase in cost of equity due to increase in debt) and the real cost of equity according to NOI approach are the same and equal Ko. Total value of the firm is unaffected by its capital structure. Any capital structure is optimum according to the NOI approach.

### 3.4.3 MODIGLIANI – MILLER (MM) APPROACH

The MM thesis, relating to the relationship between the capital structure, cost of capital and valuation is a kin to the NOI Approach. NOI approach is conceptual and lacks behavioural significance. The MM proposition supports the NOI approach.
relating to the independence of the cost of capital of the degree of leverage at any level of debt equity ratio. The significance of their hypothesis lies in the fact that it provides behavioural justification for constant over all cost of capital and therefore total value of the firm. In other words, MM approach maintains that the weighted average(over all)cost of capital does not change.

ASSUMPTIONS

• There are no corporate taxes but removed later.
• The dividend payout ratio is 100%
• There is a perfect market.
• Arbitrage implies that investors are free to buy and sell securities.
• Assuming that all investors have the same expectations of firm’s EBIT with which to evaluate the value of a firm.
• Business risk is equal among all firms within similar operating Environment divided into equivalent risk class or homogeneous risk class.

TRADITIONAL APPROACH

The traditional approach is also known as intermediate approach is a compromise between two extremes of NI approach and NOI approach. The value of the firm is increased. Initially or the cost of capital can be decreased by more debt as the debt is a cheaper source of funds than equity thus optimal capital structure can be reached by a proper debt-equity mix; Beyond a particular point, the cost of equity increases because increased debt increases the financial risk of the equity share holders. Thus, overall cost of capital, according to this theory decreases upto a certain point, remains more or less unchanged for moderate increase in debt thereafter, and increases or rises beyond a certain point.

ASSUMPTIONS

If debt is used optimum and over all cost of capital decreases. If more debt is used to finance in a place of equity, the value of the firm decreases and over all cost of capital increases.
3.5. CAPITAL STRUCTURE IN THE REAL WORLD

If capital structure is irrelevant in a perfect market, then imperfections which exist in the real world must be the cause of its relevance. The theories below try to address some of these imperfections, by relaxing assumptions made in the M & M model.

3.5.1. TRADE-OFF THEORY

Trade-off theory allows bankruptcy costs to exist. It states that there is an advantage to financing with debt, the tax benefit of debt and there is a cost of financing with debt, the bankruptcy costs of debt. The marginal benefit of further increases in debt declines as debt increases, while the marginal cost increases, so that a firm that is optimizing its overall value will focus on this trade-off when choosing how much debt and equity to use for financing. Empirically, this theory may explain differences in D/E ratios between industries, however it does not explain differences the same industry.

3.5.2. PECKING ORDER THEORY

Pecking order theory tries to capture the cost of asymmetric information. It states that companies prioritize their sources of financing (from internal financing to equity) according to the law of least effort, or of least resistance, preferring to raise equity as a financing means “of last resort”. Hence internal funds are used first, and when that is depleted debt is issued, and when it is not sensible to issue any more debt, equity is issued. This theory maintains that businesses adhere to a hierarchy of financing sources and prefer internal financing when available and debt is preferred over equity if external financing is required. Thus, the form of debt a firm chooses can act as a signal of its need for external finance.

3.5.3. AGENCY THEORY

One of the defining characteristics of business in the 1990s was the adoption of prescriptions from agency theory to address the managerial excess of the 1970’s and 1980’s. The classic agency theory concept was developed by Berle and Means (1932). They observed that ownership and control had become separated in larger corporations as a result of the dilution in equity positions. This situation provided an opportunity for
professional managers, as those in control, to act in their own best interest. Today, the central issue for agency theory is how to resolve the conflict between owners and managers over the control of corporate resources through the use of contracts which seek to allocate decision rights and incentives. Managers have a number of incentives to pursue growth-oriented strategic options. The larger the organization, the greater the economic and political power of the top management teams, and the greater the ability of the organization to marshal resources necessary to deal effectively with its competitive and social environment. Also, larger organizations are seen as being able to maintain their freedom from the discipline of the capital markets. As a generalization, it can be said that growth does lead to increasing the wealth of shareholders. However, the concern is that too many of the activities associated with increasing the size of organizations are motivated not by a desire for maximizing shareholder wealth, but by opportunities for the self-aggrandizement of management.

The contractual device suggested by agency theory to accomplish the transfer of wealth from the organization to the investors is debt creation. Debt provides a means of bonding manager’s promises to pay out future cash flows. It also provides the means for controlling opportunistic behavior by reducing the cash flow available for discretionary spending. Top managers’ attention is then clearly focused on those activities necessary to ensure that debt payments are made. Companies failing to make interest and principal payments can be declared insolvent and can be dissolved. This use of debt as a disciplinary tool makes survival in the short-term the central issue for all concerned.

Agency theory also has implications for the relationship between stockholders and debt-holders. Stockholders are interested in the return over and above that amount which is required to repay debt. Stockholders are seen as sometimes being interested in pursuing riskier business activities than debt-holders would prefer. When this occurs debt-holders may charge higher prices for debt capital and institute greater control measures to prevent top managers from investing capital in riskier undertakings.

However, agency theory does not take into consideration competitive environment, nor does it consider the necessity for managers to make choices beyond a stockholder wealth-maximizing prospective. This would seem to be a serious omission.
for two reasons. First, debt and equity represent different constituencies with their own competing, and often mutually exclusive, goals. Second, as the level of debt increases, the corporate governance structure can change from one of internal control to one of external control. For firms that adopt debt as a control mechanism, lenders become the key constituents in the corporate governance structure. This can have a significant impact on both managerial discretion, and on the ability of an organization to deal effectively with its competitive environment.

3.5.4 COMPETITIVE DYNAMICS

A distinguishing characteristic of the strategic management discipline is the emphasis it places on the firm’s competitive environment. An organization must find a match or fit between the demands of its competitive environment and its internal management systems in order to succeed and to survive. The management system and organizational structure most appropriate for any firm will be a product of the specific set of environment contingencies being faced.

Strategic management also recognizes that the firm has multiple constituencies and objectives, and it accepts that it may not be possible to maximize the returns to all constituencies, or to achieve all objectives. More importantly, strategy is concerned with the long term survival of the organization within its competitive environment. This requires a more complex model of the firm than that envisioned by either finance or economics. These disciplines assume away cognitive limits in their assumption of complete information and efficient markets. Strategic management, on the other hand, accepts the argument that managers are limited in their ability to gather and process information. Therefore, we can say that the choice of capital structure is less a matter of predefined alternatives and more a search for alternatives in a complex and uncertain environment.

Across industries there are significant differences in the environmental characteristics impacting firms. Most relevant among these characteristics is environmental dynamism, define as the rate of environmental change, and the instability of that change. Environmental dynamism is a product of several forces operating at one time. These include an increase in the size and number of organizations within an
industry, and an increase in the rate of technological change and its diffusion throughout that industry.

For all parties (including top managers, stockholders, debt-holders and others), as environmental dynamism increases it will result in actors, increased inability to assess accurately both the present and future state of the environment. This limits their ability to determine the potential impact of decision-making on current and future business activities, and to determine viable alternatives which organizations should pursue. This means that an effect of increasing levels of environmental dynamism is to reduce access to knowledge needed to make critical decisions. This, in turn, reduces the stability and predictability of relations among firms and their constituents within an industry. It is then a logical inference that varying degrees of environmental dynamism can have a differential impact on similar activities occurring across industries. That is, as the degree of environmental dynamism varies across industries, it is reasonable to expect that there should be significant differences in the adaptive capabilities required for survival, and that these differences should have performance implications.

From a firm’s perspective, a higher cost of debt capital can decrease its attractiveness to various stockholders, and greater external control by debt-holders may interface with the firm’s ability to navigate effectively within its competitive environment. This would indicate that firms needing to engage in riskier business activities because the firm must respond to changing competitive pressures, the use of debt financing would be an impediment subjecting managers to both the discipline and constraints of the capital markets.

3.5.5. DEBT VS FINANCING

Financing a business through borrowing is cheaper than using equity. This is because:

- Lenders require a lower rate of return than ordinary shareholders. Debt financial securities present a lower risk than shares for the finance provides because they have prior claims on annual income and liquidation. In addition security is often provided and covenants imposed.
A profitable business effectively pays less for debt capital than equity for another reason: the debt interest can be offset against pre-tax profits before the calculation of the corporation tax bill, thus reducing the tax paid.

Issuing and transaction costs associated with raising and servicing debt are generally less than for ordinary shares.

There are some valuable benefits from financing a firm with debt.

Thus Determinants of the Firm Optimal Capital Structure is Based On

- The Tax Deductibility of Interest

  The tax deductibility feature of interest expense tends to increase the use of debt in the firm’s capital structure.

- Financial Risk

  The increased financial risk that comes with increased use of debt tends to moderate the use of debt in the firm’s capital structure. So, the firm’s optimal capital structure should represent a balance between debt and equity. Such cost advantage that comes from using cheaper debt is just matched by the increase in financial risk that comes with more debt. Practically speaking,

  1. It is difficult (or impossible) for the financial manager to exactly determine the firm’s optimal capital structure.

  2. The financial manager needs to consider demand sustainability and volatility as well as cost stability when making the debt/equity choice.

  3. There probably exists a range of acceptable (optimal) debt/asset ratios.

There are many methods for the firm to raise its required funds. But the most basic and important instruments are stocks or bonds. The firm’s mix of different securities is known as its capital structure. A natural question arises: What is the optimal debt-equity ratio? For example, if you need Rs.100 million for a project, should all this money be raised by issuing stocks, or 50% of stocks and 50% of bonds (debt-equity ratio equals 1), or some other ratio? Modigliani and Miller (MM) showed that the financing decision doesn’t matter in perfect capital markets. Their famous Proposition I states that
the total value of a firm is the same with whatever debt-equity ratio (assuming no taxes). If this is true, the basic exercise in capital budgeting (in Bond valuation) can be directly applied to project evaluation for firms with different debt-equity ratio. However, in practice, capital structure does matter. This theory is valid under certain conditions. If the theory is far from true, so are the conditions. An understanding of the MM's theory helps to understand those conditions. Which, in turn, to understand, why a particular capital structure is better than another. In addition, the theory tells us that what kinds of market imperfection we need to look for and pay attention to. The imperfections that are most likely to make a difference are taxes, the costs of bankruptcy and the costs of writing and enforcing complicated debt contracts.

If capital structure is irrelevant in a perfect market, then imperfections which exist in the real world must be the cause of its relevance. The theories below try to address some of these imperfections, by relaxing assumptions made in the M & M model.

**MM Proposition I and Proposition II: No Tax Scenario**

MM Proposition I concerns about the irrelevancy of the value to capital structure. It is to be noted that follows financial instruments are assumed to take only two forms: stocks and bonds. In this set up, the value of a firm is defined as:

\[ V = B + S \]

where \( B \) is the market value of the firm's debt and \( S \) is the market value of the firm's equity.

**MM Proposition I and Proposition II: With Corporate Taxes**

In the real world, corporations are taxed at rates as high 34%. However, there is a quirk in the tax code that only those earnings after interest payments are taxable. This is one of the most important reasons for firms to use debt financing.

**Implications of the MM theory**

The market value of a levered firm equals the market value of an unleveled firm plus the present value of interest tax shields. In order to get the simple expression above, we have assumed that the debt is perpetual. More generally, the tax shield term would be the present value of the interest tax shields.
The implication of the model with corporate taxes is that the value of the firm is maximized when it is financed entirely by debt. This is not a very attractive implication for the Model. Clearly, no firm is financed 100% by debt. There are a number of real world constraints that need to be considered. First, there are institutional and legal restrictions (some institutional will not purchase stock of a firm that has a debt-equity ratio that exceeds some cutoff). Second, there are costs imposed for going bankrupt that might persuade the firm’s management not to increase the debt-equity ratio too high. Third, the interest tax shield may exhaust taxable income (this suggests an upper bound on the amount of debt). Finally, there may be conflicts of interest between stockholders and bondholders.

The empirical evidence suggests that the 100% debt policy is clearly not what is observed. The wide range of debt-equity ratio in the market could indicate that the original proposition about the irrelevance of the capital structure may have more merit than mentioned earlier.

3.5.6 BANKRUPTCY COST

There are many costs involved in bankruptcy. The direct costs are legal fees and court costs. The indirect costs arise from discontinued operations, the hesitancy of customers to purchase the product and the unwillingness of suppliers to extend any credit. These costs make it unlikely that a firm will push its debt equity ratio very high. If the bankruptcy costs are taken into account, then there may be an optimal capital structure where the marginal tax advantage equals the marginal bankruptcy costs. Note that the marginal bankruptcy costs may be different across firms. This may explain why all firms do not have the same level of debt-equity.

3.5.7 EXHAUSTING BENEFITS

Obviously, if the firm is unlikely to earn taxable profits, the effective tax shield is small. As a result, it should not borrow.

3.5.8 CONFLICTS OF INTEREST

Once the debt is outstanding, shareholders have the incentive to take actions that benefit themselves at the expense of the bondholders. So if there is debt outstanding, the
objectives of maximizing the value of the firm and the value of the equity are not identical. Some examples of bondholder—shareholder conflicts are: claim dilution, dividend payout and asset substitution. Let's examine in more detail some of these conflicts.

Considering claim dilution, With debt outstanding, stockholders have incentives to issue claims of equal or senior priority. The proceeds from the “new” debt issue will be greater the higher the priority of the new debt. The claim dilution increases the risk of the “old” debt and its market value falls. The combined value of the new and old debt is fixed. By making new debt equal or higher priority, the value of the old debt falls and the proceeds from the new debt issue rises. Claim dilution benefits the stockholders at the expense of the “old” bondholders. The price of the books equals the present value of the expected cash flows. The bondholders include the effects of conflicts of interest in estimating cash flows and pricing the debt. Bondholders only pay for what they expect to get.

Since the conflicts of interest between stockholders and bondholders reduce the price of the debt, the stockholders bear all the costs of the conflict. Even though the shareholders bear the cost of the conflict, there is still an incentive to extend value or expropriate from the bondholders- after the debt is outstanding.

Since the stockholders bear the costs that arise from the conflicts of interest, they have an incentive to minimize the agency costs. Bond covenants are detailed enforceable contracts that reduce agency costs by restricting the stockholders’ actions after the debt is issued. The covenants may restrict the production and investment policy (i.e. mergers, sale of certain assets and lines of business). The covenants may restrict the financial policy of the firm (i.e. dividend payouts, priority and total debt). Furthermore, there is usually a provision for auditing. The bond covenants will reduce but will not eliminate these agency costs. Note that there also costs involved in monitoring the firm’s actions.

**Capital Structure as Options**

It is mentioned that both the debt and the equity of the firm could be considered options. The bondholders are promised payments of next period. If default occurs, then the bondholders own the firm. The stockholders receive all residual cash flows after the payments to bondholders. Consider the distribution of the value of the firm.
Now consider the payoff schedule. Suppose the debt has time to maturity, $T$. The standard deviation of the firm's value is $STD$.

<table>
<thead>
<tr>
<th>Payments to</th>
<th>$V \leq A$</th>
<th>$V &gt; A$</th>
<th>Position</th>
</tr>
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<tbody>
<tr>
<td>Stockholders</td>
<td>0</td>
<td>$V - A$</td>
<td>$c(A,T,STD)$</td>
</tr>
<tr>
<td>Bond holders</td>
<td>$V$</td>
<td>$A$</td>
<td>$V - c(A,T,STD)$</td>
</tr>
<tr>
<td>Total</td>
<td>$V$</td>
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Note that $c(A,T,STD)$ is a call option. The call option is a function of the exercise price, $A$, the time to maturity, $T$, and the standard deviation of the return on the underlying asset, $STD$. The payments to the stockholders and bondholders add up to the total cash flows of the firm.

Consider the position diagrams. The position diagram for the call option is Straight forward.

Payoff to Equity
Note that $V$ represents the value of the firm at the expiration or final payment of the principal on the debt. This diagram indicates that the stockholders have a call option on the value of the firm. The payoff is determined by $\text{Max}(0, V-A)$.

The position diagram for bondholders is slightly more complicated. Payoff to Debt

\[ \text{A} \quad \text{V} \]

The bondholders hold the value of the firm and write a call option (the shareholders buy it in the form of common equity). Combining the payoffs of the long position in the value of the firm with a short position in the call delivers the above diagram. The pay off stream is $\text{Min}(V, A)$.

3.6 IMPORTANT TERMS OF CAPITAL STRUCTURE

DEBT

A debt is when the company owe somebody money. Debts get bigger every week if the company is charged with interest. Interest is an extra charge on the original debt.

EQUITY

Equity means a firm's total assets minus its total liabilities. It is the share Capital plus retained earnings minus treasury shares. Share holders equity represents the amount by which a company is financed through common and preferred shares. The first and original source is the money that was originally invested in the company along with any additional investments made thereafter. The second comes from retained earnings which
the company is able to accumulate over time through its operations. The retained earnings portion is the largest component.

**TREASURY STOCK (TREASURY SHARES)**

The portion of shares that a company keeps in their own treasury. It may come from a repurchase or buy back from share holders, or it may have never been issued to the public in the first place. These shares do not pay dividends, voting rights and should not be included in shares outstanding calculations.

**DIVIDEND**

A distribution of a portion of companies earnings, decided by the board directors to a class of its share holders.

### 3.7 DETERMINANTS OF CAPITAL STRUCTURE

Though the empirical evidence is not conclusive, theoretically speaking the combination of debt and equity does not affect cost of value of the firm. The capital structure is said to be optimum when the marginal real cost of each available source of financing is identical with an optimum debt and equity mix, the cost of capital is minimum and market price per share is maximum. When the principal attraction of debt is the tax benefit, if cost is financial distress and reduced commercial profitability. The term financial distress includes a broad spectrum of problems ranging from minor liquidity shortage to bankruptcy. This will increase financial leverage. The expected cost of financial distress is outweigh the tax benefits. A firm is, thus concerned with a trade-off between risk and return emanating from the use of debt. A proper balance between the two, is therefore, called for. Therefore determination of an optimum capital structure is a formidable task. Identifying the precise percentage of debt that will maximize price per share is almost impossible. To determine the approximate proportion of debt to use in the financial plan in conformity with the objective of maximizing share prices.
The key factors governing the capital structure decisions are

Profitability aspect, Liquidity aspect, Control, Leverage ratios in industry, Nature of Industry, Consultation with investment banks/lenders, Commercial strategy, Timing, Company characteristics, Tax Planning etc.

PROFITABILITY ASPECT

EARNINGS BEFORE INTEREST AND TAX(EBIT) – EPS ANALYSIS

It is an approach for selecting capital structure that maximize EPS over the expected range of earnings before interest and taxes. It is first step for designing capital structure EBIT-EPS shows the impact of various financing alternatives on EPS at various levels of EBIT. EPS is a measure of a firm’s performance – given the P/E ratio. The larger the EPS, the larger would be the value of firm’s shares. EBIT – EPS analysis information can be extremely useful to the finance manager in arriving at an appropriate financing decisions.

COVERAGE RATIO

Coverage ratio measures the size of interest payments relative to the EBIT and the adequacy of EBIT to meet payment obligations.

LIQUIDITY ASPECT

In liquidity aspect cash flow analysis evaluates the risk of financial distress and debt capacity relates to how much debt can be comfortably serviced.

CONTROL

While planning the types of funds, the management wants to maintain control in its own hand, the issue of senior securities will be recommended as the issue of additional equity shares would involve the risk of losing control.

LEVERAGE RATIOS FOR OTHER FIRMS IN THE INDUSTRY

When framing capital structure, a comparison with the debt equity ratios of companies belonging to the same industry having a similar business risk. Debt equity
ratios appropriate for other firms in a similar line of business should be appropriate for the company.

NATURE OF INDUSTRY

Another important element of determining the degree of financial leverage is a firm can carry safely without any bankruptcy risk. Life cycle of industry has a crucial bearing in assigning relative weightage to various sources of raising finance.

CONSULTATION WITH INVESTMENT BANKERS / LENDERS

It is important to ask the opinion of Investment analysts, institutional investors, investment bankers and lenders. They are the ultimate providers of the funds to the firm. Therefore type of securities which they prefer to buy are significant information for the financial manager and taking decisions while issuing securities. Manoeuverability implies the ability to adjust source of funds. In response to change in the need for funds; thereby expecting flexibility. Flexibility as to financing is important when the future external financing is necessary.

TIMING OF ISSUE

The government follows a cheap money policy to boost the economy during a recession and a dear money policy during inflationary periods. Timing in obtaining funds is exercised within limits imposed by the timing of needs for funds, the extent of flexibility and existing capital agreements.

CHARACTERISTICS OF COMPANY

Size of the Industry and credit standing are also play a vital role in determining the share of senior securities and equity in its capital structure. Firms enjoying a high credit standing among investors/lenders in the capital market are in a better position to get funds from the sources of their choice.

TAX PLANNING

Under Income Tax Act 1961, when interest on borrowed funds is allowed as deduction under section 36(1)(iii), dividend on shares are not deductible from the
operating profit of a company. Corporate taxation is an important determinant of the choice between different sources of financing. The choice of an appropriate debt policy involves a trade off between tax benefits and the cost of financial distress. The greater the operating risk, the less is the debt the firm can use. The use of debt in lieu of equity represents to obtain subsidy.

3.8 CONCLUSION

After considering the common factors such as trading on equity, size of business, control, legal requirements, purpose of financing, time, market sentiment, government policy, provision for future etc. are to be critically evaluated and conclusion to be drafted.