

An Impact of Financial Leverage on Capital Structure of Selected Textile Companies in Gujarat

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Abstract: The existence of the company is totally dependent on the risk-taking capacity of its capital structure. The stronger the capital structure of the company, more the company will survive in the market. The risk-taking capacity is basically derived by its leverage analysis on its financial factors and performance. The capital structure of the firm shows the solvency and liquidity position of the company. And so, the financial management authority needs to decide and design the perfect and exact capital structure of the company so that the profit can be boosted and can be achieved at its maximum level. And so, the study aims to attempt the impact of financial leverage on capital structure on selected textile companies in Gujarat. The main aim of this paper is to figure out the relationship between financial leverage and working capital. The convenient sampling method was adopted and 3 companies were selected and the data for 5 years was collected. The conclusion shows a significant relation between working capital and financial leverage.

Keywords: Financial Leverage, Capital Structure, Working Capital, Textile Companies.

1. INTRODUCTION

In India, the origin of cotton textile industry is around 2000 years ago. The preliminary phase of the textile industry was cottage industry during 1800. Since then the India is exporting the cotton and silk products to the western nations. In its first phase of origin, the industry has to go with the various modern changes and modification in technological and physical sector. These changes were remarked in 18th century. The major reason for the changes in Indian Textile industry was British government. And so on, the industry has to pass through various other changes and advancement for it continues growth and development. According to Weber, "To produce the 1 tonne of finished cloth, 1 tonne of raw cotton is required". So, the production and raw material ratios always 1. So, there is no loss in the production of cloth from cotton. One can locate the cotton textile industry anywhere in whole of the India.

For any industry, the external sources of funds like equity and debenture are the main source for raising the capital for the company. This fund is financed to acquire an asset for the production purpose. The whole process of acquiring the funds and the application of funds is known as the capital structure. Technically, the capital structure of the company refers to the debt to equity and debt to capital ratio. The finest capital structure of the company is derived by its weighted average cost of capital. The company try to optimise the capital structure by issuing more equity and debentures.

The application of the financial leverage of the company and its impact on its capital structure helps in determining the risk bearing capacity of the company on its capital. But the capital structure may vary geographically due the various changes in the tax rates, government policy and other interest rates. So, in this study the relationship is being studied among the capital structure and the financial leverage of the selected textile companies. By using the different tools to study the efficiency of the available financial resources, they have same characteristics and so there will not be any difference in making the interpretation of the financial tools. This is because all the calculation uses the same information to carry out the specific conclusion. But in real world all this may vary because the mindset of the investor is different for the same company. So, the rate of the stock market also changes, the interest rates also may vary. This variance is highlighted in practice so it is truly said that the "Practice may vary from assumption".

Financial Leverage arises from the firm's fixed financing costs as interest on debt. It emanates from the existence of fixed interest expenses. When a firm has fixed interest expenses. One percentage change in earning before interest and tax leads to more than one percentage change in earning before tax. The financial leverage is very much helpful in locating the actual profit which will be helpful in designing the actual capital structure of the firm. It is basically associated with the financing activity of the company. The fluctuation on financial leverage can be measure with the changes in interest rates on advances and long-term loans and tax rates.

James Horne has defined leverage as, "the employment of an asset or fund for which the firm pays a fixed cost or fixed return".

2. REVIEW OF LITERATURE

(Khedkar, 2015)

Dr E. B. Khedkar(2015), in his paper titled, "A study of leverage analysis and profitability for Dr. Reddy's laboratories," has fantastically elaborated the functional relationships between leverage and profitability of Dr.Reddys laboratories. The paper has analysed the financial performance of Dr. Reddy's laboratories and also the relationship between financial leverage and profitability have been studied. In this paper it is concluded that the firm of Dr.Raddy's laboratories is not maintaining optimum financial leverage.

(Bhagyalakshmi, 2016)

Dr. K. Bhagyalakshmi (2016), in his paper titled, "Leverage Analysis in selected cement companies – A study," has shown the in-depth concept of operating leverage and financial leverage. The objective of this paper was to discuss the principles of leverage, to analyse the leverage of cement companies and to analyse the risk of the same cement companies. The researcher has used the statistical techniques like percentages, ratios and different types of correlation. In the conclusion the higher operating fixed cost have been determined which is increasing the financial risk.

(Ramankumar, 2014)

Dr. M. Ramankumar (2014), in his paper titled, "An Empirical study on relationship between leverage and profitability in Beta India Ltd.," has shown the impact of financial leverage on shareholders return in Indian Cement Industry. This paper finds that the profitability of a firm is positively corelated to its financial leverage. The actual impact of financial leverage on cost of capital and valuation of firm.

(Gill, 2011)

Gill (2011), in his research paper, "The Impact on Financial Leverage of Pakistani Firm's in Automobile sector" the regression model was used on 26 firms were selected for research work. The conclusion, they derived that the capital structure was negatively correlated with the profitability of the firm.

(R. Gharios, 2016)

R. Gharios, B. Hamda (2016), in their study "The Economic Impact of Liquidity and Leverage on the Financial Performance of MENA and GCC Companies", they observed the positive correlation between the liquidity and Return on Assets and they concluded the positive impact on profitability of the company.

3. OBJECTIVES

- To understand the capital structure of selected Textile Companies.
- Evaluate and analysis the Financial Leverage and Capital Structure.
- To identify the relationship between Financial Leverage and Capital Structure of selected Textile Companies.

4. HYPOTHESIS

H₀ :- There is no significant relationship between Financial Leverage and Capital Structure of selected Textile Companies.

5. RESEARCH METHODOLOGY

The study consists of three selected textile companies from Gujarat region which are also linked with the export business. The data is collected of five years i.e., from 2014-2015 to 2018-2019. All the selected companies are listed in BSE.

The list of the companies is as under.

- Anjani Synthetics Limited
- SantramSpinners Limited
- Soma Textile & Industries Limited

The data is collected from the annual reports of the companies for selected previous five financial years for the purpose of the study.

The statistics used for the study is descriptive statistics and for the analysis of different variable, ANOVA (Analysis of Variance), Correlation and Regression model are used to find the relationship between dependent and independent variable. The correlation will signify the relationship between financial leverage and working capital.

6. DATA ANALYSIS AND INTERPRETATION

The financial leverage is a risk managing tool for the fixed expenses incurred by the firm for the capital investment like fixed asset and to gain the optimal return from that investment. The financial leverage is determined by the ratio proportion of earnings before interest and tax to its earning after interest and tax.

The financial leverage of three companies for 5 years of data is as follows.

Table1: *Financial Leverage*

YEAR	AS Ltd	SS Ltd	STI Ltd
2018-19	1.1527	1.2419	0.9634
2017-18	1.0243	1.2326	0.5595
2016-17	1.0187	1.2142	0.8798
2015-16	1.0152	1.2359	0.8732
2014-15	1.0137	1.2283	0.8321

Source: *Computed from the data extracted from the annual reports.*

The above table of financial leverage shows that the highest levered firm is SS Ltd and the lowest levered firm is STI Ltd. The maximum leverage of SS Ltd is 1.242 in the year 2018-2019 and the lowest leverage of STI Ltd is 0.560.

Table2. *ANOVA test for Financial Leverage*

ANOVA						
Source of Variation	SS	df	MS	F	P-value	F crit
Between Groups	0.419	2	0.209	22.885310	8.0324E-05	3.88
Within Groups	0.109	12	0.009			
Total	0.529	14				

Source: *The One-Way ANOVA has been performed in EXCEL*

From the above table, the ANOVA test has been computed at the significant level of 0.05.

The main component of capital structure is working capital. The working capital is used to meet the day-to-day variable expenses and trading operations. The optimal working capital is calculated by the deduction of current liabilities from current asset.

Table3. Working Capital

YEAR	AS Ltd	SS Ltd	STI Ltd
2018-19	8.356	27.189	-0.7098
2017-18	9.2267	24.6162	-2.8333
2016-17	10.9415	23.2444	-3.5268
2015-16	10.092	47.9381	227.3496
2014-15	7.42928	26.3198	-2.1138

Source: Computed from the data extracted from the annual reports.

The above data of working capital shows the working capital turnover ratio of the selected textile companies. The highest working capital turnover ratio is of STI Ltd which is 227.35 and the lowest working capital turnover ratio is of also STI Ltd. which is -3.5268. It is assumed that the company is managing its capital once a specific interval of financial years and then carrying it forward to following financial years.

Table4. ANOVA test of Working Capital

ANOVA						
Source of Variation	SS	df	MS	F	P-value	F crit
Between Groups	3001.99	2	1500.99	0.42262	0.6647	3.88529
Within Groups	42619.43	12	3551.61			
Total	45621.42	14				

Source: The One-Way ANOVA has been performed in EXCEL

From the above table, the ANOVA test has been computed at the significant level of 0.05 where the null hypothesis for the Independent variable is accepted. In the ANOVA testing, the P-value of independent variable is significant at 0.66 confidence level.

Table5. t test and correlation result for Financial leverage and Working Capital

Company	r value	Correlation	t value	Hypothesis
AS Ltd	-0.324	Negative	-0.593	Accepted
SS Ltd	0.4034	Positive	0.763	Rejected
STI Ltd	0.1913	Positive	0.58	Rejected

Source: The r value and t test has been computed in EXCEL

The above table indicates the correlation of financial leverage and working capital. The study shows the negative correlation for AS Ltd and positive correlation for SS Ltd and STI Ltd. The Hypothesis for AS Ltd is accepted which shows that there is no significant relation between financial leverage and working capital. The Hypothesis for SS Ltd is rejected which shows that there is significant relation between financial leverage and working capital. The Hypothesis for STI Ltd is rejected which shows that there is significant relation between financial leverage and working capital.

7. CONCLUSION

The strategy for acquiring the optimal capital structure varies from company to company. All the three selected textile companies are using different strategy to determine the working capital. STI Ltd is not maintaining the appropriate accounting policy to maintain the working capital as its capital is getting negative in certain number of years and uncertainly increasing in different year.

The financial leverage of the selected textile companies is positive as they are maintaining the proper strategy of earnings before interest and tax and the payment of tax. The risk bearing capacity of AS Ltd is very high so this firm is said highly levered firm.

The testing of ANOVA signifies the variation of financial leverage and working capital for the selected textile companies. The null hypothesis is rejected which shows that there is significant relation between financial leverage and working capital.

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