Influence of Financial Leverage on Shareholders Return and Market Capitalization: A Study of Automotive Cluster Companies of Pithampur, (M.P.), India

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Abstract - Financial leverage measures firm’s exposure to the financial risk. A high level of financial leverage allows shareholders to obtain a high return on equity, but they are also exposed to a higher risk of significant loss, if the return on assets is lower. The financial leverage employed by a firm is intended to earn more on the fixed charges funds than their relative costs. Market capitalization represents the aggregate value of a company or stock. It can be obtained by multiplying the number of shares outstanding by their current price per share. The Pithampur Auto Cluster is guided by industry ownership, public-private partnership, impartiality, and it is industry driven, creating sustainable value and financial independence to the auto companies. The cluster approach creates favorable conditions and encourages linked organization to work and learn together by sharing common problems and creation of geographical brand. The present research paper explores the effect of financial leverage on shareholders’ return and market capitalization of automotive cluster companies of Pithampur (M.P.), India. The seven major automotive public companies were undertaken for representation of the cluster. Simple linear regression analysis was carried out to judge the impact of financial leverage on shareholders’ return and market capitalization individually to find out the state of influence of the leverage. Further, discussion was held to find out the probable causes of the findings opening the new avenues of research. It was suggested that bankers and debt providers should help the industry out by charging lower cost of debt

Keywords: Financial Leverage, Shareholder’s Return, Market Capitalization.

I. INTRODUCTION

A. Financial leverage

Financial leverage reflects the debt amount used in the capital structure of the firm. Financial leverage is an impact on returns of a change in the extent to which the firm’s assets are financed with borrowed money. Other things remaining same, lower the amount borrowed, lower the interest, lower will be the profit, where as greater the amount borrowed, lower the interest, greater will be the profit. Debt carries a fixed service obligation of payments of interest. There is an opportunity to greatly magnify the results at various levels of business operations by using financial leverage (mbaii_fin.pdf, 2012). Financial leverage measures firm’s exposure to the financial risk. So, degree of financial leverage indicates the percentage change in EPS resulting from a unit percentage change in EBIT. Financial leverage can accelerate EPS under favourable economic conditions but depresses EPS when the economic goings is not good at economy and for the firm. The unfavourable effect of financial leverage on EPS is more severe with more debt in the capital structure when EBIT is negative. Similarly, financial leverage can increase shareholders’ return and as well can increase the firm’s risk also. The financial leverage employed by a firm is intended to earn more on the fixed charges funds than their relative costs (Pandey, 2007).

Financial leverage is the final component of return on equity. Financial leverage is a measure of how much firm uses equity and debt to finance its assets. As debt increases, financial leverage increases. Management tends to prefer equity financing over debt since it carries less risk. The Financial leverage ratio is calculated by dividing assets by shareholder equity (Matt, 2000). When the surplus increases and deficit decreases, the return on the owners’ equity, referred to as a double-edged sword, financial leverage provides the potentials of increasing the shareholders’ wealth as well as creating the risks of loss to them. The financial leverage is a prerequisite for achieving optimal capital structure. An optimal capital structure can influence the value of firm and wealth of shareholder’s through reduced cost of capital. Hence, determination of optimal debt level and its impact on the firm’s over all capital structure is regarded as an integral part of a firm’s financial decision (Franklin and Muthusamy, 2011). Financial leverage, or an increase in financial efficiency, called the variation of return on equity, depends on the return on assets and the cost of credit i.e., interest rate. Financial lever also expresses the impact of financial expenses due to loans on the return on equity of an enterprise (Brezeanu, 1999).

B. Share Holders Return

The return on equity is a result of the efficiency of all commercial, operational and financial activity of the enterprise (Niculescu, 1997). Shareholders’ return (SR) is a concept used to compare the performance of different companies’ stocks and shares over time. The absolute size of the total share holders’ return will vary with stock markets, but the relative position reflects the market perception of
overall performance relative to a reference group. It can be expressed as follows:

With \( \text{Price}_{\text{begin}} \) = share price at beginning of period, \( \text{Price}_{\text{end}} \) = share price at end of period, and \( \text{SR} \) = Shareholders’ return, \( \text{SR} \) is computed as follows:

\[
\text{SR} = (\text{Price}_{\text{end}} - \text{Price}_{\text{begin}}) \times \text{No. of Shares}
\]

Whereas total shareholders’ return (TSR) combines share price appreciation and dividends paid to show the total return to the shareholder (http://www.investordictionary.com).

C. Market Capitalization

The sum derived from the current stock price per share times the total number of shares outstanding. Although the market capitalization of a company is an indication of the value of the company, it is only a temporary metric based on the current stock market. The true value of the company i.e., its profits, product positioning, balance sheet, etc. may not be reflected in the market capitalization. Conversely, a company can be doing well, but still have a low market capitalization, if its products and reputation have not caught the fancy of the masses (www.answers.com). Market capitalization represents the aggregate value of a company or stock. It is obtained by multiplying the number of shares outstanding by their current price per share (www.investorwords.com). Market capitalization is the total value of the tradable shares of a publicly traded company; it is equal to the share price times the number of shares outstanding. As outstanding stock is bought and sold in public markets, capitalization could be used as a proxy for the public opinion of a company's net worth and is a determining factor in some forms of stock valuation. Preferred shares are not included in the calculation (http://en.wikipedia.org).

D. Automotive Cluster Companies of Pithampur

With a view to enhancing the international competitiveness of Indian domestic industry, the Madhya Pradesh Government and the Confederation of Indian Industry, Madhya Pradesh Chapter, have signed a memorandum of understanding to develop an automobile industry cluster at Pithampur, Dhar District Industrial Area in Madhya Pradesh, India. Pithampur is also known as Detroit of India. The Pithampur cluster is one of the nineteen identified clusters in India. The Pithampur Industrial area has auto majors like, Force Motor Ltd., Eicher Motors Ltd., Hindustan Motor Ltd., Man Industry Ltd., Crompton and Greaves Ltd., Larsen and Toubro Ltd., and Porwal Auto Components Ltd., while it has at least seventy five to hundred auto spare parts manufacturing companies in private limited and other form. The cluster is guided by industry ownership, public-private partnership, impartiality, and it is industry driven, creating sustainable value and financial independence. The cluster creates competitive business, appropriate, research and training facilities, supportive labor market, infra structure and policy environment. The cluster approach creates favorable conditions and encourages linked organization to work and learn together by sharing common problems. It looks for individual and group solutions. Working in cluster is designed to create more successful business in more successful industries (www.business-standard.com).

II. LITERATURE REVIEW

There has been a movement away from the traditional tax-bankruptcy cost argument toward a consideration of agency costs as the major determinant of financial leverage. It was showed that with risky debt outstanding, a firm's investment policy is not fixed (Jensen and Meckling, 1976). It was recognized that the underinvestment problem by noting that shareholders of firms with risky 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. When the expected return is less than the promised payment, shareholders fail to exercise the investment option or invest less than the optimal amount, which reduces firm value. It is this decline in firm value which limits the amount of debt a given firm can issue (Myers, 1977). The impact of operating leverage is evident, when a given percentage changes in net sales results in a greater percentage change in operating income (EBIT). DOL and DFL combine to magnify a given percentage change in sales to a potentially much greater percentage in EBIT. Operating and financial leverages together cause wide fluctuation in EPS for a given change in sales. If a company employs a high level of operating and financial leverage, even a small change in the level of sales, will have dramatic effect on EPS (Mandelkar, et al, 1984). The effectiveness of either bond covenants or implicit capital market monitoring is reduced specially in weak form of market efficiency. Since the market cannot effectively monitor investment decisions, it instead limits the amount of debt. Because high-growth firms cannot be effectively monitored, they will have lower financial leverage (Benjamin, 1985). Financial risk analysis can be done both on the breakeven point and by analysing changes in the return on equity due to the financial policy, which can be followed by a financial leverage effect (Eros-Stark and Pantea, 2001). A company with cyclical sales will have a fluctuating EPS, but the swings in EPS will be more pronounced if the company also uses a high amount of operating and financial leverage. There is the need to combine degree of operating and financial leverages to see the effect of total leverage on EPS associated with a given change in turnover as a result of improved purchasing power enabled by capital structure (Ishola, 2008). First, even if the return on equity is high, a substantial financial leverage causes a great instability in the net profit, i.e., on the volatility of dividends distributed per share. Therefore, the shareholder will claim a premium to cover the risk. A high level of financial leverage allows shareholders to obtain a high return on equity, but they are also exposed to a higher risk of significant loss if the return on assets is low. Also, using loans may lead to restricting the independence of the company’s management, and creditors are interested in the indebtedness of the company. Financial leverage is combined with the operating leverage. The combined effect is equal to the product of the operating and financial leverage (Nicoleta, 2010). The variables sales, interest, cash flow, asset structure, interest coverage, firm’s size, retained earnings, earnings before interest and tax and intrinsic value of shares influence financial leverage (Franklin and Muthusamy, 2011).

III. OBJECTIVE OF THE STUDY

To study the influence of financial leverage on shareholders’ return and market capitalization of automotive cluster companies of Pithampur, Madhya Pradesh, India.

IV. RESEARCH QUESTIONS

Does financial leverage of automotive cluster companies of Pithampur influence shareholders’ return?
Does financial leverage of automotive cluster companies of Pithampur influence market capitalization?

A. Hypothesis
H01: There is no significant influence of financial leverage on shareholders’ return.
H02: There is no significant influence of financial leverage on market capitalization.

B. Research Methodology
Type of Study: The study is of empirical nature aimed to find out influence of financial leverage of automotive cluster companies on shareholders’ return and market capitalization by using statistical tools.

Population: The population of the study includes the automotive cluster companies of Pithampur, (M.P.), India.

Period of Study: The study covered five years time period from 2006 – 07 to 2010-11.

Data Type and Source: Data is secondary. The data were collected from various sources, like, www.moneycontrol.com and www.bseindia.com. The data were converted into heterogeneous form to homogeneous form.

Variables:
a) Dependent Variable: The dependent variables are shareholders’ return and market capitalization.
b) Independent Variables: The independent variable is financial leverage.

Tools for Data Analysis: Linear simple regression has been used as a tool to analyse the data by SPSS IBM-19 version.

V. RESULT AND DISCUSSION
On significant level of 5%, the null hypothesis H01 and H02 are accepted. The beta values are (.181) for shareholders’ return and (.221) for market capitalization on significance level (.771) and (.721) respectively. So answer to the research questions is that there is no significant influence of financial leverage on shareholders’ return and market capitalization.

The main objective of the research paper is to quantify the influence of financial leverage on shareholders’ return and market capitalisation. As it is well known fact that financial leverage is one of the means by which shareholder’s return and market capitalization can be improved, the effect of financial leverage can be utilised for stimulation of shareholders’ return and market capitalisation thereof. However, it is more beneficial at the stage of inception and growth phase of the companies. Probably, the companies are old enough not to exhibit the significance of financial leverage on shareholders’ return and market capitalization. The basic purpose of using the financial leverage is to increase the shareholders’ return under growing economic condition. The significance of financial leverage is inferred to increase the shareholders’ return based on the assumption that the fixed charge can be easily recovered at lower cost than the firm’s rate of return on net assets. Therefore, the difference between the earnings generated by assets financed by the fixed charge fund and the cost of these funds is distributed to the shareholders, as a result, the return on equity increases. However, the results of the study show that financial leverage has no influence on the shareholders’ return of levered firms of automotive industry. The probable reason might be that these companies have not found cheaper debt capital in huge quantum than equity capital over the period of five years from 2006-07 to 2010-11. Contrary to the common presumption of debt fund being cheaper than equity, there might be the reason that the over all cost of debt was greater than that of equity fund. The cause may be that the industry relish equity source of finance as a low cost option by keeping a low payout ratio. So as a result, the study assumes that the theory which makes financial leverage beneficial was not fulfilled and the leverage benefits could not come true in the levered firms of auto companies of Pithampur, India. Probably debt fund presumes high risk premium to be charged to the companies as nature of the business depends up on the growth of the economy and companies require greater capital. The technology upgrading essentials, emission standards, increasing competition, fashion of changing models puts the automobile companies at higher business and financial risk, making debt to charge higher. The study indicates confirmation of MM theory. From the result and discussion it is conclusive that high levered firm increases shareholders return only in case when rate of return on equity fund is higher than the cost of debt fund. In this study it seems that the companies of automobile sector of Pithampur, India are highly capitalist. It also seems that capital structure of the companies consists of very less percentile of debt and the cost of debt fund and floatation cost there of might be higher or equal with the cost of equity fund, opening new vistas of research considering macro economic variables prevailing.

VI. CONCLUSION
The over all findings indicate that there is not significant influence of financial leverage on shareholder’s return and market capitalization. The study also concludes that there might be other non quantitative factors which may lead to nullify the impact of financial leverage on shareholders return like recession, saturation of auto industry, competition and government policy. It is important to note that financial leverage is a speculative technique and there are special risks and costs involved with financial leverage. Indeed there can be no assurance that a Financial Leverage strategy will be successful during any period in which it is employed.

VI. SUGGESTIONS
It is suggested that the company should use higher capital gearing ratio so as to get significant impact of financial leverage on optimal capital structure decision should be looked up on in the context of degree of operating leverage so as to leave greater space for significant benefit of financial leverage. Bankers and debt providers should help the industry out by charging lower cost of debt. As the industry requirement warrants it to charge lesser debt service as a special industry having export potential. Cluster automotive companies are advised to have collective bargaining for procurement of debt finance with banks, state financial corporations and financial institutions.
VII. IMPLICATION

Financial leverage may influence or may not influence shareholders’ return and market capitalization. Cost of debt should be kept lower than cost of equity to get significant benefits of financial leverage. Adequate equity capital be employed so as to increase borrowing capacity of the firm to get significant influence of financial leverage.

APPENDIX:

Table 01:

<table>
<thead>
<tr>
<th>Hypothesis</th>
<th>Variables</th>
<th>R square</th>
<th>F Value</th>
<th>Beta</th>
<th>S-V</th>
</tr>
</thead>
<tbody>
<tr>
<td>H1</td>
<td>Total Shareholders’ Return</td>
<td>.181</td>
<td>.101</td>
<td>.181</td>
<td>.771</td>
</tr>
<tr>
<td>H2</td>
<td>Market Capitalisation</td>
<td>.221</td>
<td>.154</td>
<td>.221</td>
<td>.721</td>
</tr>
</tbody>
</table>

Table 02:

<table>
<thead>
<tr>
<th>Regression Equation</th>
<th>Result</th>
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<tr>
<td>Shareholders Ret. = 10.165 + .708 FL</td>
<td>Insignificant</td>
</tr>
<tr>
<td>Market Cap. = 10.502 - .274 FL</td>
<td>Insignificant</td>
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REFERENCES


CA Sachchidanand Pachori possesses an academic experience of 7 years in the Collegiate Education and in practice as a Chartered Accountant since 2005 in India. He has also entered in the realm of research and waiting to be awarded Ph.D. Book Title “Corporate Law and Secretarial Practice” has recently got published and many other books and Research Papers are in pipeline.

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