Capital Structure Analysis and Its Impact on Profitability of Hotel Sector

(With Reference to Soaltee and Everest Hotels)

A THESIS

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VIVA VOCE SHEET

We have conduct the viva voce examination of this thesis presented by

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(Comparative analysis between Soaltee and Everest Hotels)

And found the thesis to be original work of the student written in accordance with the prescribed format. We recommend the thesis to be accepted as the partial fulfillment of the requirement for the degree of Masters in Business Studies (M.B.S).

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RECOMMENDATION

This is to certify that the Thesis

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has been approved by this department in the prescribed format of Faculty of Management. This thesis is forwarded for examination.

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DECLARATION

I hereby declare that the work reported in this thesis entitled **"CAPTIAL STRUCTURE ANALYSIS AND ITS IMPACT ON PROFITABILITY OF HOTEL SECTOR (WITH REFERENCE TO SOALTEE AND EVEREST HOTELS)"** submitted to Nepal Commerce Campus, Faculty of Management, Tribhuvan University, is my original work done in the form of partial fulfillment of the requirements for the Master of Business Studies under the supervision of Professor **Dr. Bihari Binod Pokharel**, Nepal Commerce Campus.

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Thesis is really an appreciable curriculum of T.U. because it helps the students to express their theoretical concept gained during the study period into the practical field. So, being concerned to thesis, I have also got a chance to express my theoretical concept gained from class and library study into this practical field. The present study **"Capital Structure Analysis and Its Impact on Profitability of Hotel Sector (With Reference to Soaltee and Everest Hotels)"** has been prepared for the partial fulfillment of the requirement for Master Degree in Business Studies.

At first, I would like to pay thanks to my father and mother as well as my brother who headed me towards the light of education and path of truth. Due to their non-stopping effort for guidance, today I come in this position. So I would like to share the credit of my success with them. I'm really indebted by them.

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Umesh Chandra Ghimire
Researcher

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LIST OF ABBREVIAYION AND SYMBOLS

CBS	=	Central Bureau of Statistics
CDM	=	Central Department of Management
CO.	=	Company
CDE	=	Central Department of economics
D	=	Market Value of Debt
DE	=	Debt Equity
DFL	=	Degree of Financial Leverage
DOL	=	Degree of Operating Leverage
EAT	=	Earning After Tax
EBIT	=	Earning Before Interest and Tax
EBT	=	Earning Before Tax
EPS	=	Earning Per Share
e.g.	=	For Example
ed	=	Edition
EH	=	Everest Hotal
ES	=	Enterprises
et al.	=	and others
etc	=	etcetera
FOM	=	Faculty of Management
FY	=	Fiscal Year
GDP	=	Gross Domestic Product
GNP	=	Gross National Product
HMG/N	=	His Majesty government of Nepal
I	=	Interest Rate
i.e.	=	That is
IMF	=	International Monetary Fund
INT	=	Total Amount of Annual Interest
Kd	=	Cost of Debt

Ke	=	Cost of Equity
Ko	=	Overall Cost of Capital
LDCs	=	Least Development countries
Ltd	=	Limited
Mfg	=	Manufacturing
MPS	=	Market Price Per Share
NEPSE	=	Nepal Stock Exchange
NI	=	Net Income
NOI	=	Net Operating Income Approach
NOPAT	=	Net Operating Profit after Tax
No.	=	Number
NRB	=	Nepal Rastra Bank
PE	=	Probable Error
R	=	Correlation Coefficint
ROA	=	Return on Assets
ROE	=	Return on Equity
ROIC	=	Return on Investment Capital
Rs.	=	Rupees
S	=	Market Value of Stock
SBN	=	Security Board of Nepal
SSEBON	=	Securities Board Nepal
SH	=	Soaltee Hotal
.N.	=	Serial Number
SPSS	=	Software Programmed for Social Sciences
V	=	Total Value of Firm
Vol.	=	Volume
Vs	=	"Versus"; against
WACC	=	Weighted Average Cost of Capital

CHAPTER ONE

INTRODUCTION

1. Background of the Study

Economic development is the backbone of the development of a nation. The economic development of Nepal is backward in comparison to other developed and developing countries. Economic development is a challenging task in Nepal not just due to lack of resources but it is due to lack of proper utilization of the available resources in efficient manner. This problem needs to be researched which requires proper planning and strategy development and every development program needs capital. But capital could not be collected easily. Due to the scarcity of capital it becomes necessary to collect the fund scattered among different individuals and groups. Capital collection and its mobilization is essential condition for the uplifting of the nation.

The collected capital may be big or small in amount which builds up the financial power. It would be worthy and productive if such amount is collected from various people and utilized in proper way.

The study of capital structure an important place in the literature of finance. Capital structure has attracted intense debate and scholarly attention both from theorists and practitioner of financial management area over the past four decades. An important financial decision facing firms is the choice between debt and equity (Glen and Pinto, 1994:132). Capital structure, which is defined as total debt to total assets, influence the probability and riskiness of the firm (Bos and Fetherston, 1995:213).

Capital structure decisions are intertwined with other corporate decisions (Graham and Roger, 2002: 156). The financial decision of a firm involves the

choice of an appropriate mix of different source of financial, namely, ownership funds and outsider funds. The term capital denotes the long-term funds to the firms are financed by two components, i.e., debt capital and equity capital. Debt capital includes ling-term borrowing incurred by the firm. Equity capital consists long-term funds provided by the firm's owners. The mix of long-term debt and equity maintained by the firm is called structure. Capital structure shows, what percentage of the firm's capital is in equity and what percentage of firm's capital is in debt.

Capital structure is one of the most complex areas of financial decision making due to its inter-relationship with other financial decision variables. A financial manager must understand the firm's capital structure and its relationship to risk, return and value for attainment of its primary objective of wealth maximization.
Capital structure is very crucial part of the financial management as the various composition of debt and equity capital may impact differently on risk and rate of return to equity shareholders. The funds required to business enterprises are raised either through the ownership securities (i.e. equity shares and preference shares) and creditor shares (i.e. debentures or bonds). A business enterprise has to maintain proper mix of both the securities in manner that the cost and risk perception to the shareholders are minimized. The mix of different securities is portrayed by the firm's capital structure (Kothari, 1990:105).

Capital is a scare source and much more essential to maintain smooth operation of any firm. The available capital and financial sources should be utilized so efficiently that could generate maximum return.

Capital structure is considered as the mix of debt and equity and to operate in long run prospect. A firm must concentrate in its proportion. A firm can raise required fund by issuing various types of financial instruments. Investors and creditors being the key supply of capital, they hold greater degree of risk and hence have claims over firm's assets and cash flow. Similarly debt holders are also a source of financing fund and they have risk considering firm's cash flow

in uncertain ands principle. In the other hand, if a firm issues preference share, those shareholders have the priority in payment of dividend is fixed as the percentage of interest to debt, it is preferably paid off only after interest payment. Common shareholders are as the owner of the firm, they are paid from cash remaining after all payment is being made. Since the common share i.e equity fluctuates in the market more than the preference share and debt, there is more risk.

The above statement states in brief that either fund is raised by debt or equity financing, risk is associated in proportion of its uncertainty is being paid off. The required rate of return expected by investors according to their risks is cost of capital. Therefore a firm should try to obtain necessary fund at lowest cost of capital is fully dependent upon the proportion of debt and equity i.e. financial leverage, which is actually the capital structure used by the firm.

Capital structure concepts has important place in financial management theory. It is basically decision is concerned with shareholders wealth maximization. As capital refers to the proportion of debt and equity, a choice in proportion is actually financial decision in case to fulfill investment requirement. Therefore, it is a wise decision to select a financing mix, which maximizes shareholders wealth.

The Nepalese economy is quite dynamic with favorable economic indicators, viz, stable prices, strong balance of payments position and average annual economic growth of more than 4 percent during the decade of the 1990's. These descriptions however hide the fact that Nepal is a least developed country with widespread poverty and a gross national per capita income of US $240 in fiscal year 2006/07, with the country ranking 136 out of 177 countries in the United Nation Development program's human development index.

The growth of the GDP at constant 1998/9 prices fluctuated over the past six years from the peak of 6.0 percent recorded in FY 2002/2003, to the lowest

level of -0.4 percent in FY 2004/05. The high growth rate achieved in the FY2002/2003 resulted from an encouraging growth in the agriculture and non-agriculture sector of 4.9 percent and 6.8 percent respectively. The GDP growth rate declined to 4.8percent in 2003/04 and further dipped to -0.4 percent in the following FY 2004/05. The low growth rate recorded in the agriculture sector due to drought and double digit negative growth rate in manufacturing and trade, hotel and restaurant sub-sectors were attributed to the negative growth in that year.

The economy rebounded by 3.0 percent in the FY 2002/03 and was stagnant at 3.5 percent in FY 2003/04.The overall performance of the economy in FY 2004/05 decelerated to 2.3 percent growth due to unfavorable weather, negative growth recorded in trade, restaurant and hotel sectors due mainly to the slackness observed in trade and tourism and slowed public and private investment, which finally decline the expansion and growth of banking sector and others financial institution.

It is true that Nepalese economy is Agricultural - base economy, however trade and industry is also a vital factor for our economy. By the development of trade and industry economic growth can be achieved faster which is fueled by the development and expansion of banking and hotel sector. So, here it is tried to should some facts about the Nepalese's trade. After decline to 36.5 percent in FY 2004/05 from 41.7 percent in FY 2003/04 and reached to 39.0 percent in 2006/07 of Nepalese import and exports to GDP, this statistic has not change much between FY 2003/04 and FY 2006/07 As similar pattern can be noticed for the exports/ GDP ratio and the import /GDP ratio while the exports /GDP ratio declined to 11.1 percent in FY 2004/05 from 13.5 percent in FY 2003/04 and stood at 11.0 percent in FY 2006/07; the import/ GDP ratio decreased to 25.4 percent in FY 2004/05 from 28.1 percent in FY 2004/05 and went up gradually to 28.0 percent in 2006/07 from the above fact it is clear that still there is trade deficit in Nepalese economy and can be present until the proper investment in export oriented industry and agriculture product. And for the

proper and huge investment banking sector play vital role, which is interlinked with the development of tourism industry viz. hotel sector and restaurant which can earn money by providing service and deposit it in bank.

Nepal had a late start in development. Its pace of industrialization has been slow. The history of industrial growth in Nepal can be divided in three distinct eras, eras of crafts and cottage industry, era of haphazard industrial growth and era of planned industrial growth. However, growth of industries in Nepal has been a slow process. Various censuses of manufacturing establishment indicate that the number of manufacturing establishments has been declining in recent years. The mortally rate has been high for both manufacturing and service providing industries especially hotels. The targets and programmers set by various development plans for industrial development were ambitious. The achievements have been poor. Industrial infrastructure is in developing stage in Nepal. The enabling environment for industrial growth is missing. So in recent year it is feel that competitive environment is necessary for the growth and survival of industries.

In order to create an environment necessary to enable the private sector to play a principle role in the industrialization endeavor of the country, the public sector industries will mostly be privatized and no private sector industries will be nationalize. At the same time the government will make no interference in fixing the price of industrial product other than creating open and competitive atmosphere. If necessary, during the initial period of industrialization, government may establish in the form of join venture either with the national or foreign private sector and such industries will also be gradually transferred to private sector. As we know that for the industrialization the banking sector play the vital role so the government should inspire the banks to make investment in productive sector rather than in non-productive sector which is the major problem for the development and survival of industry in current situation

Within a period of two and half decades the Nepalese financial system has growth significantly both in terms of business volume and the size of assets and market. The period saw a number of financial institutions coming into existence with varied nature of operations and offering a wide range of financial service. Since the second half of the 1980, significant achievement have been made in the Nepalese financial system in Mid-July 2007, the Nepalese financial sector comprised 26 commercial banks 34 development banks, 70 finance companies 19 co-operatives and 47 non-government organization and some other non-banking financial institutions. The other non – deposit taking financial institutions includes 18 insurance companies, one employee provident fund, one citizen investment trust, one deposit Insurance and credit guarantee corporation, one Nepal stock exchange limited, one credit information Bureau; 116 postal saving offices and one rural self reliance fund. Commercial banks development banks fiancé companies and cooperatives and non- government organizations licensed to carry out limited banking business come under the regulatory and supervisory jurisdiction of NRB.

1.2. Focus of the Study

This study mainly focuses the Capital structure of the EH and SH. Capital Structure consists of the mixture of the long term debt along with equity capital. In order to find out the clear picture of the Capital Structure of EH and SH financial and statistics tools are used properly. Financial tools such as degree of operating leverage, degree of financial leverage, net income approach, net operating approach, current ratio, quick ratio, EBIT, EBT, EAT and statistics tools are used as per need in the study. This study takes care about the financial picture of the EH and SH. This study will also concern about the causes of bearing profit in previous some year and the about of now days profit increasing trends.

The study specially focused with analyzing the following questions:

- What factors should be considered for the appropriate Capital Structure?
- Whether the investment is financed in specific way or not?
- Effect of Capital Structure decisions on total value of the firm.
- Impact of Capital Structure of EH and SH on risk and return.
- Possibility of determining optimal Capital Structure.

Finally the main focus of the study is the debt and equity position of the companies and its impact on the net income of the companies. This study also focuses about the dependency of value of the firm on the Capital Structure.

1.3. Statement of the problems

Since the seminar of Modigliani and Miller (1985), many subsequent researches have been undertaken to find a coherent explanation for whether capital structure matters. In a idealized world without taxes, MM suggest that the average cost of capital to a firm is independent of its capital structure (Modigliani ad Miller, 1985: 123). Traditional corporate finance models suggest and firms choose optimal capital structure by trading off various taxes and incentive benefits of debt financing against financial distress costs.

Hamanda (1972) and Stiglitz (1974) supported MM independent hypothesis, however, their conclusion are at variance with what one sees in the real world, where capital structure matters and banks would be extremely unwilling to finance project entirely with dept capital.

Nepal is the one of the least developed country and it has poor economy. One of the strategies to develop its economic welfare is development of tourism industry like other industry.

Manufacturing sector and hotel sector is also one among the industry that helps in the promotion of the economy of the country. Nepal is giving strong stress on promotion of manufacturing sector and hotel sector like other productive areas. The term ‘underdeveloped economy’ usually refers to the economy of a country where national income, per capita income, productivity and financial investment are lower.

Thus, the development of manufacturing sector and hotel sector industry has a major role to play in the economic development of a lower developed country. Because of mixed economy system the private sector can contribute significantly in the development process of a country.

In order to regulate the any industry, finance is the basic requirement. Therefore the Capital Structure decision plays the most important role. In order to optimal use of finance, Capital Structure decision plays key role. While making Capital Structure decisions, there are two key factors, which are risk and returns.

Risk and Return = f (Capital Structure, Investment Decision, other market) ……. (1).

Mainly Manufacturing sector and hotel sector companies are suffering from the financial problem because of inefficiency and poor performance. So there is a requirement of good performance. Lower performance will affect the economic condition.

EH and SH are large leading company in service providing sector. Hotels are paying large amount of interest to the government bank and other financial institution. If the amount in hand and at bank are not invested properly that will be burden for the equity capital. In such way Capital Structure decision plays an important role to the companies.

Manufacturing sector and hotel sector companies are facing the financial problem when optimal Capital Structure is not maintained and can not able to utilize the collected funds, but other some cause also responsible for it.

This research about Capital Structure will focus and provide clear vision regarding financial problem, strategic implementation and tactful plan of the EH and SH.

1.4. Objectives of the study

The basis objective of the study is to test empirical relationship between the capital structure and cost of capital in Nepalese enterprises. The specific objectives of the study are as follow.

- To study and analyze the Capital Structure decision for EH and SH.
- To access the trend of change in Capital Structure of EH and SH.
- To examine Capital Structure, financial leverage and other relevant variables of the EH and SH.
- To evaluate the strength and weakness of the EH and SH.
- To know about the relationship between long-term debt and equity capital.
- To provide suggestions to the concerned hotels on the basis of major findings of the study.

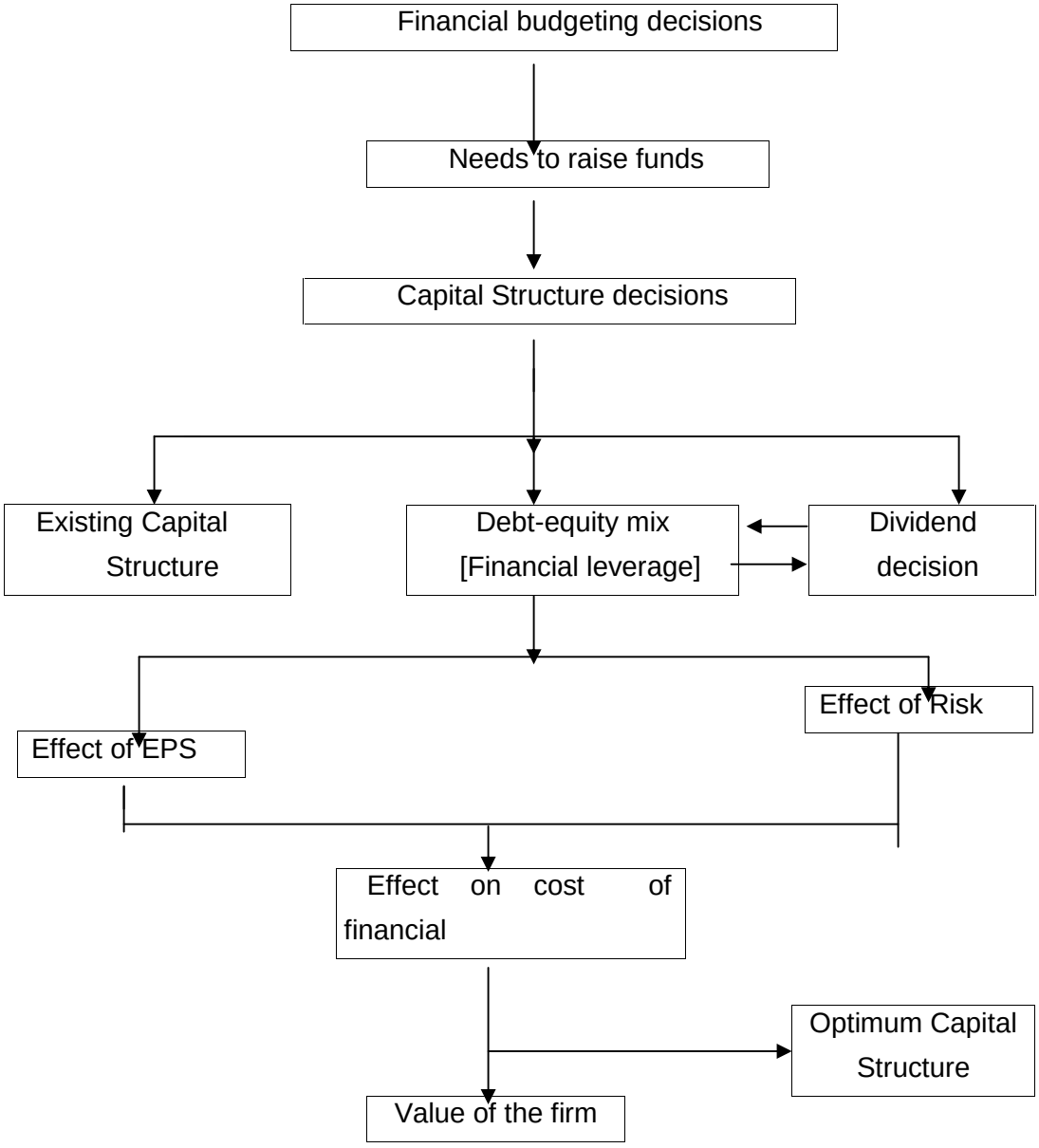
1.5. Importance of the Study

the capital structure affects on the profitability and long term financial position of the organization. The earning nature of the organization helps to adopt appropriate mix of debt and equity in the capital structure. On account of his significance, the capital structure and profitability of the organization is justified a specific matter for the study.

The study helps to analyze the relation between the capital structure and performance of the organization and leads to design appropriate capital structure. This helps also the researcher, creditors, investors and stockholders to analyze the financial position of the organization and they may know the impact if capital structure on the profitability of the organization.

This research focuses the Capital Structure of the EH and SH. How does the Capital Structure affect the company's profit? Study made on and EH and SH analyzes the financial situation and problems regarding debt and equity. This study properly analyzes the data, provides recommendation of financial affairs, provides forecast and provides conclusion to the EH and SH. This study is serious about the Capital Structure decision by the companies is beneficial or not to the shareholder or debtors. This study provides the sound financial planning idea, corrective action, useful feedback to the companies and other related parties.

Figure – 1.2: The Capital Structure Decisions



Source: I.M. Pandey, Financial Management.

1.6. Limitations of the Study:

This study has been made for the partial fulfillment of the requirement for the master's degree in business studies (M.B.S) but not a comprehensive study.

The study has been conducted with certain limitation. The time is the one factor of limitations. Besides it, the scope of the study is limited within the bank. Some more limitations are follows

- This study is based on the secondary data. Reliability of the finding depends up on these data.
- In absence of sufficient information, various financialization rates are assumed for average market condition during past five years
- The Capital Structure is affected by several factors, but this study is mainly concerned with debt- equity composition and its impact on risk and return.
- Financial constraint and time are also the major limitation of the study.
- Findings and suggestion may not applicable exactly to any other private or Airlines.
- Time of data from year 2003/04 to 2007/08.

1.7. Assumptions of the Study

Assumption of the study makes the result deviated and far from the reality. All facts in the study may not accurate, which creates unclear vision to the study. Few data are not audited. But the study is attempt to made clear vision. Some assumptions are made for the research. Which are mentioned below?

- Financial reserve has been not considered in determining debt equity ratio.
- Bank lone and long-term obligation is taken as a long-term debt.
- Except genuine income, other incomes are not considered in data analysis and interpretation.
- Five-year data is taken for the study.
- Assumption of the maximum analysis is based on the secondary data.
- Depreciation is out of consideration while determining the gross profit.

1.8. Organization of the Study

This study is of Capital Structure of the EH and SH. This study has five chapters. Titles of the chapter are as follows:

i) Introduction:

This chapter is organized as background, theoretical background, focus of the study, company's profile, statement of the problem, objective of the study, and importance of the study, limitation of the study Assumption of the study and organization of the study.

ii) Review of Literature:

This chapter is about review of various related books, journals, other publications and also unpublished master level dissertations.

iii) Research Methodology:

In this chapter, several tools and techniques employed for analysis and defined properly the presentation of data.

Iv) Presentation and Analysis of Data:

This chapter is about impact of Capital Structure on return and risk of EH and SH. This chapter consists of organizing, tabulating and assessing financial and statistical tools.

(v) Summary of Major Findings, Conclusions and Recommendations:

This is the last chapter about of major findings, prevailing issues and gaps of the corporation and suggestions to the companies that will help to improve companies in any way. Bibliography and annexes used in the study has been attached end of the thesis.

CHAPTER-TWO
REVIEW OF LITERATURE

2.1 Introduction

The purpose of literature review is thus to find out what research studies have been conducted in ones field of study, and what remains to be done. (Wolf and Panta,2005:102)

In introduction chapter described about introduction of capital structure, background of the study, focus of the study, statement of the problem, objective of study, limitation of study, significance of study, statement of hypothesis and organization of the study. This chapter deals with the review relating to the capital structure in more detail and descriptive manner. For this purpose various books journal articles from newspaper, magazines and other related studies have been reviewed. In the context of Nepal no specific research studies have been available regarding capital structure and its impact on profitability. A lot of effort has been made to cover various aspect of the study so that the adequate feedback could be obtained to broaden the base and input to the study.

2.2 Conceptual Framework

In this section, various books written by different writers are well reviewed. This makes clear about the conceptual foundation of this study. It provides the chance of examining views of different writers and scholars so that the new idea can be generated.

Under this section, concept of Capital Structure, assumptions and definitions, optimal capital structure as well as Capital Structure, business and financial risk, theories of capital structure, approaches of capital structure, factors affecting Capital Structure are well reviewed with the help of various books.

2.2.1 Theories of Capital Structure

In simple sense finance refers to money. Finance is an important factor of production. Finance is the lifeblood for the existence of company. A new business requires finance, and still more finance is needed if the firm is to expand. Finance is a scarce source and much more essential to maintain smooth operation of any firm. The required funds can come from different sources and many different forms. The available capital and financial resources should be utilized so effectively that it could generate maximum return. 'However all finance can be classified into two basic types- Long-term debt and equity capital.

Capital Structure is concerned with the analyzing the financial composition of the company. It is considered as the mix of long -term source of funds. The long-term source of fund are debt, preference shares, and equity shares that are use to finance the firm. A firm can raise required funds by issuing various types of financial instruments. So, firms can raise funds either by debt finance or by share financing. Raising fund as debt has several advantages and disadvantages. Debt holders, also known as creditors, receive interest as their return from the company where they invested capital. Interest is tax deductible which lower the effective cost of debt, debenture holders are limited to the fixed return, debenture holders do not have voting right, so stockholders can control the business with less money than would otherwise required. These are the advantages of raising capital through debt.

The higher the debt ratio, the grater the risk and thus higher the interest rate, if the company fall on hard times, and if its operating income is insufficient to cover the interest charges, the stockholders will have to make up the shortfall, and if they control, the company may be forced into bankruptcy. Good times just around the corner, but to much debt can keep the company from getting there and can wipe out stockholders in the process. These are the disadvantages of financing by debt capital. Shareholders are the actual owners of the firm. But preference shareholders have preference right to get return from the company

than the equity shareholders. So equity shareholders receive the remaining portion of net return after paying the preference dividend to preference shareholders, which is predetermined. So the company should make the appropriate financial mix while raising capital.

According to the above discussion, funds can be raised through long –term debt or equity financing. Risk is associated in proportion of its uncertainty in being paid off. The required rate of return expected by investors according to their risk is cost of capital. Therefore a firm should try to obtain necessary funds at lower cost. The overall cost of capital is fully dependent upon the proportion of long - term debt and equity capital i.e. financial leverage, which is actually the Capital Structure of the firm. So, overall the mix of components of Capital Structure affects cost of financial value of the firm and earning per share. "One of the most perplexing issue facing financial managers is the relationship between Capital Structure, which is the mix of long-term debt and equity financing, and the stock prices. (Iqwal, 1979 :693).

The concept of Capital Structure has important implication in the theory of financial management. It is basically known as Capital Structure, financial plan or leverage. But Capital Structure can be defined as the broader sense than capital structure. The owners of the company have the main objective of maximizing of shareholders wealth. So, it is a wide decision to select such a financial mix, which maximizes shareholders' wealth.

The financial Structure is a combination of long-term debt, short-term and equity and capital structure is only the part of financial Structure i.e. compromised to the total combination of preferred stock, common stock and long-term debt. If current liabilities are added from it we get financial Structure. So, financial Structure is a whole body of capital structure, which includes both long-term sources of funds such as equity share capital, preference share capital, long-

term debt and current liabilities. A firm's Capital Structure may be defined as the mixture of long-term debt and equity capital.

Capital Structure policy involves a trade –off between risk and return using more debt raises the risk ness of the firm's earning stream, but a higher debt ratio generally leads to higher expected rate of return. Higher risk associated with grater debt tends to lower the stock's price but the higher expected rate of return arises it. (Weston and Brigham, 1973:990).

The target Capital Structure varies from company to company. Capital Structure is the permanent and temporary financing of the firm, represented primarily by long-term debt, preferred stock and common stock.

The Capital Structure of the firm, defined as the mix of financial instruments use to finance the firm, is simplified to include long -term interest bearing debt, common stock and preferred stock. "Capital Structure is the combination of long -term sources of financing i.e. debt, preferred stock and common stock that are used to finance the firm." (Steven and Robert,1981: 938). The natures of Capital Structure differ from company to company, which is directly guided, regulated and controlled by the management of the company. However a reasonable satisfactory Capital Structure can be determined by considering relevant factors and analyzing the impact of alternative financing proposals on the earning per share. The most important goal of the company is the maximization of the value of the firm. To maximize the value of the firm the company should mix the long-term sources of financing at most and appropriately. Although short –term source of financing is necessary for day-to-day operation and running of the organization, which alternatively affect for value maximization objective of the firm. To, maximize the value of the company; the overall cost of capital of the company should be minimized as a result the earning per share will be maximized.

Given the objective of the firm to maximize the value of equity share, the firm should select a Capital Structure, which helps in achieving the objectives of financial management. If the Capital Structure decision affects the total value of the firm, a firm should select such a financial mix that will maximizes the shareholders wealth.

Therefore, Capital Structure can be defined as the combination of long-term source of funds i.e. preference hare capital, equity share capital and long-term debt capital. The Capital Structure mix affects the total value of the firm, its earning per share and overall or weighted average cost of capital. It should well plan. It should aims to maximize the value of the firm, earning per share by minimizing the overall cost of Finance without affecting the operation earning of the firm. So, firms always tend to maintain the appropriate Capital Structure, which is advantageous for the firm. A sound or appropriate Capital Structure should have the following features (Johnson,1973 :773).

- **Return:** The Capital Structure of the company should be most advantageous. Subject to other considerations, it should generate maximum returns to the shareholders without adding additional cost to them.

- **Risk:** The use of excessive debt threatens the solvency of the company. To the point debt does not add significance risk it should be used, otherwise its use should be avoided.

- **Flexibility:** The Capital Structure should be flexible. It should be possible for the company to adapt its Capital Structure with a minimum cost and delay if warranted by a changed situation. It should also be possible for the company to

provide funds whenever needed to finance its profitable activities.

- **Capacity:** The Capital Structure should be determined within the debt capacity of the company, and its capacity should not be exceeded. The debt capacity of the company depends on its ability to generate future cash flows. It should have enough cash to pay creditors' fixed charges and principal sum.

- **Control:** The Capital Structure should involve minimum risk of loss of control of the company. The owners of closely held companies are particularly concerned about dilution of control.

2.2.2 Capital Structure in Practice

Wide variations in asset structure and capital structure proportions are observed in practice. This generalization is supported by the book value of data presented below. First, the pattern of wholesale trade, retail trade and all manufacturing are compared. The ratio of shareholder's equity to total assets rises from 26 percent for retail trade to 33 percent for wholesale trade to 41 percent for all manufacturing. These variations reflect in part the different in nature of wholesaling, retailing and manufacturing activities. Note the general rise in debt ratios especially in manufacturing and retailing between 1984 and 1990. The shape rise in retail trade reflects some highly leveraged takeovers such as those by Robert Campeau of Allied and Federated stores.(Bureau of the census,quaterly Financial Report}

2.2.3 The Optimal Capital Structure

Capital Structure is the composition of long - term debt and equity securities that make up the firm's financing of its assets. Both long - term debt and equity securities are used in most large companies. The choice of amount of long term debt and equity is made after the comparison on certain characters of each kind of security of internal factors related to the firms operation and external factors that can affect the firm.

Thus Capital Structure decision affects the value of firm, earning per share and cost of capital. The objectives of the company are always related to maximizing the value of firm, earning per share and minimizing the overall cost of capital. To achieve this objective, company should make the appropriate composition of capita structure which also known as optimal Capital Structure.

An optimal Capital Structure would be obtained at the combination of long debt and equity that maximize the total value of the firm, (value of debt plus value of stock) or minimize the weighted average cost of capital. (Pandey,1991:376).

The optimal Capital Structure is the one that strikes the optimal balance between risks and returns and thereby maximizes the price of the stock.

Optimal Capital Structure can be defined as that mix of long term debt and equity, which will maximize the market value of the company. If such an optimal does exist, it maximizes the value of the company and hence the wealth of its owners: it minimizes the companies' cost of capital which in turn increases its ability to find new wealth creating investing opportunities. (Ezra,1969:676).

So, the optimal Capital Structure is that combination of capital structure which maximizes the value of the firm, earning per share, and minimizes the weighted average or overall cost of capital. Therefore, the firm should determine appropriate Capital Structure, to achieve its targeted objective of maximizing

the shareholders wealth. Although, it is theoretically to possible to determine the optimal Capital Structure, as a practical manner we can not estimate this structure with precision.

2.2.3 Assumptions and Definitions

In order to have the better understanding about Capital Structure theories, it is necessary to make some assumptions. The theories of Capital Structure make certain assumptions to exhibit the influence of mix debt in the capitalization on the valuation of the firm. To present the analysis as simply as possible we have the following assumptions (Van Horne,2001:876).

1. There are no corporate or personal taxes and bankruptcy cost (later, we remove these assumptions)
2. The ratio of debt to equity for the firm is changed by issuing debt to repurchase stock or issuing stock to payoff debt. In other words, a change in capital stock is affected immediately. In this regard, we assume no transaction costs.
3. The firm has a policy of paying 100 percent of its earning in dividends. Thus, we abstract from the dividend decision.
4. The expected values of the subjective probability distribution of expected future operating earning for each company are the same for all investors in the market.
5. The operating earning of the firm is not expected to grow. The expected value of probability distribution of expected operating earning for all future periods are same as present operating earnings.
6. One types of capital are employed: long-term capital (long term debt and shareholders equity)
7. The firm is expected to continue indefinitely.

In this analysis of Capital Structure theories, we shall use the following basic definitions.

S = Market value of stock
D = Market value of debt
V = Total market value of the firm (S+D)
K_e = Equity capitalization rate.
K_o = Overall capitalization rate.
K_d = Cost of debt capital (both short &long-term).
INT = Total amount of annual interest.
EBIT = Earning before interest and taxes.
EBT = Earning before taxes.

By using the above symbols, cost of capital and their respected values can be calculated by using the following formulas.

Cost of debt (K_d) = $\frac{INT}{D}$

Cost of equity (K_e) = $\frac{EBIT - INT}{V - D}$ = $\frac{EBT}{S}$

Value of debt (D) = $\frac{INT}{K_d}$

Overall cost of capital (K_o) = $\frac{EBIT}{V}$

The overall cost of capital is the weighted average cost of equity and cost of debt.
Thus,

$K_o = K_d (D/V) + K_e (S/V)$

The value of the firm is combined value of debt capital and share capital
So,

$$V = D + S$$

$$\text{Or} \quad \frac{EBIT}{K_o}$$

2.2.4 Business Risks and Financial Risks

Firms have to bear different types of risk while financing and operation. In a view point of Capital Structure analysis we can introduce two new dimensions of risk: Business risk or the risk ness of the firm's stock if the firm uses no debt, and financial risk, which is the additional risk placed on common stockholders as a results of firm's decision to use debt. In addition to the common stock, preferred stock also adds to financial risk of the company. Conceptually, the firm has a certain amount of risk inherent in its operation: this is its business risk. If it uses debt, then, in effect, it partitions its investors into two groups and concentrates most of its business risk on one class of investors – the common stockholders. However the common stockholders generally demand compensation for assuming more risk and thus acquire a higher rate of return.

2.2.4.1 Business Risk

Business risk is that portion of risk, which is; occur due to the operation of the firm, if it uses no debt capital. In other words, it is the risk ness of the firm's operation if it uses no debt. Business risk is inherent in the operation of the firm.

Business risk is defined as the uncertainty inherent in projection of future return on assets or return on equity (ROE) if the firm uses no debt. It is an important determinant of Capital Structure. Business risk can be defined as:

$$ROIC = \frac{NOPAT}{Capital}$$

Where,

ROIC = Return on invested capital

NOPAT = Net operating profit after tax i.e. Net income to equity shareholders + after tax interest payment.

If the firm uses no debt, then its interest payment will be zero, its capital will all equity and its ROIC will be equal to ROE (return on equity)

$$\text{ROIC} = \text{ROE} = \frac{\text{Net income to common shareholders}}{\text{Common equity}}$$

Therefore the business risk of unlevered firm can be measured by standard deviation of its ROE.

Thus, business risk of unlevered firm = $\exists_{ROE}$

Business risk varies not only from industry to industry but also among firms in the given industry. It can change over time because it is depends upon various factors. It is depends upon numbers of factors, the more important of which are listed below.

- Demand variability
- Sales price variability
- Input cost variability
- Ability to adjust output prices for changes in input cost
- Ability o develop new product in the timely cost effective manner.
- Foreign risk exposed
- The extent to which cost are fixed: operating leverage.

Operating Leverage

Business risk depends in part on the extent to which a firm builds fixed costs into its operations. If fixed costs are high, even a small decline in sales can lead to a large decline on return on equity. So, other things remains constant, the higher the firm's fixed costs, the higher its business risk. If the high percentage

of total costs is fixed, then the firm is said to have a high degree of operating leverage. "In business terminology, a high degree of operating leverage, other factors held constant, implies that a relatively small change in sales results in the large change in ROE."(Ibid – 583).

Other things held constant, a higher the operating leverage, the higher its business risk. Or the higher the degrees of operating leverage, the higher the operating risk. Where, degree of operating leverage defines as the percentage change in operating income (EBIT) associated with a given percentage change in sales.

$$\text{Degree of operating leverage (DOL)} = \frac{\text{Percentage change in EBIT}}{\text{Percentage change in sales}}$$

So, operating leverage refers to the use of fixed costs in the operation of the firm. If the firm has fixed costs, it would have operating leverage and percentage change in the operating profit would be more for the given change in sales. A firm will have higher operating leverage, if the total costs have grater percentage of fixed costs. The concept of operating leverage was originally developed for use in capital budgeting. Still once a corporation's operating leverage has been established, this exacts a major influence on its Capital Structure decision.

2.2.4.2 Financial Risk

Instead of business risk companies have to bear financial risk, if they use debt capital while financing. If the company is unlevered, that company bears the business risk only but that should bear the financial risk as a result of decision to finance with debt. So, financial risk is the additional risk placed on common stockholders as a result of decision to finance with debt.

Financial leverage refers to the use of fixed income securities – debt and preferred stock – and financial risk is the additional risk placed on the common

stockholders as a result of using financial leverage. Conceptually, the firm has a certain amount of risk inherent in its operation; this is business risk, which is defined as an uncertainty inherent in projection of future ROE. By using debt and preferred stock (financial leverage) the firm concentrates its business risk on common stockholders.

Therefore financial risk can be defined as the portion of stockholders' risk over and above the basic business risk, resulting from the use of financial leverage (Weston & Brigham, 2004:698).

Financial Leverage

Financial risk is depends upon the financial leverage of the firm. If the financial leverage exists financial risk will occur. Operating leverage affects the business risk whereas financial leverage affects the financial risk.

The use of 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 can be defined as the extent to which fixed income securities (debt and preferred stock) are used in the firm's Capital Structure.

Financial leverage can be measured by using various tools. The most commonly used measures of financial leverage are

1. Debt ratio (DR): The ratio of debt to total capital

$$\text{i.e. } DR = \frac{D}{V} = \frac{D}{D+S}$$

2. Debt to equity ratio(DER): The ratio of debt to equity

$$\text{i.e. } DER = \frac{D}{S}$$

3. Interest coverage ratio(TIE)

$$\text{i.e.TIE} = \frac{\text{EBIT}}{\text{Interest}}$$

Financial leverage affects the earning per share. When the economic conditions are good and firm's EBIT is increasing, its EPS increase faster with more debt in the financial structure. The degree of financial leverage is defined as the percentage change in earning per share that is associated with given percentage change in earning before interest and taxes (EBIT). DFL may be calculated by using any one of the following formulas:

$$\text{DFL} = \frac{\text{Percentage change in EPS}}{\text{Percentage change in EBIT}}$$

Or

$$\frac{\text{Percentage change in EBT}}{\text{Percentage change in EBIT}}$$

DFL shows that to what extent the firm is able to bear its fixed charges. DFL of unlevered firm will be 1 and it will be grater than 1 in case of levered firm.

2.2.5 Approaches to Established Appropriate Capital Structure

Capital Structure decision affects the value of the firm, it's earning per share and overall capitalization rate of the firm. So companies should plan properly to established target Capital Structure. The target Capital Structure should affect the firm positively. Or it should optimal or appropriate. While establishing the appropriate Capital Structure firm first should identify the sources of funds and then understand about the advantages and disadvantage of each source of funds. And the company should make

a proper mix of those sources of funds while financing. Therefore, company should test the effects of various alternative sources of financing and should select an appropriate combination or alternative financial plan, with the help of appropriate approach or technique.

Capital Structure will be planned initially when a company is incorporated. The initial Capital Structure should be designed very carefully. The management of the company should set the target Capital Structure and subsequent financing decisions should be made with a view to achieve a target Capital Structure. The financial manager has also to deal with an existing Capital Structure.

The company needs capital to finance its activities continuously, every time when capital is needed, the financial manager should tests the advantages and disadvantages of various sources of finance and select the most advantageous source of capital. Thus, the Capital Structure decision is a continuous process and it has to take whenever the company needs additional funds. Financial manager can use various approaches while establishing appropriate Capital Structure. But the selection of appropriate approach is necessary. The following most common approaches to decide about the Capital Structure are explained here.

- EBIT – EPS Analysis
- Cash Flow Analysis

2.2.5.1 EBIT-EPS Analysis

This is a most common approach to establish appropriate Capital Structure. This approach analyzes the impact of various financial plans on earning per share. This approach analyzes that what is an effect of debt or preferred stock financing on earning per share. The common goal of companies is to maximize the shareholders' wealth i.e. earning per share. So, the company should select that financial plan which maximizes the earning per share of the company.

One widely used means of examining the effect of leverage is to analyze the relationship before earning before interest and taxes (EBIT) and earning per

share (EPS). Essentially, the method involves the comparison of alternative methods of financing under various assumptions as to EBIT.

The EBIT –EPS analysis is an important tool in the hand of financial manager to get an insight into the firm Capital Structure management. He can consider the possible fluctuations in EBIT and examines their impact on EPS under different financial plans (Pandey, 1991:376).

To decide about the appropriate source of funds to finance, the financial manager first develop various alternative financial plans and judge the impact on the earning per share, by calculating earning per share for some hypothetical level of EBIT. Note that interest in debt is deductible before taxes while preferred stock dividends are deductible after taxes. Then with the help of earning per share at different alternatives, it is essential to find out indifference point in EBIT. The indifference point of EBIT can be determined either graphically or mathematically.

Insight comes in comparing indifference point between two financial alternatives, like total debt versus common equity, with the existing and expected level of EBIT. The higher the level of EBIT in relation to indifference point the stronger the case that can be made for debt financing, all other things being the same. The lower EBIT is in relation to the indifference point the stronger the case for common stock financing. This is particularly true when the indifference point is below the existing level EBIT.

So, the EBIT- EPS analysis can be used to evaluate the various Capital Structures in light of the degree of financial risk they entail and the return they provide the firm's owners.

The EBIT-EPS analysis is one of the widely used methods employed to determine appropriate level of debt. Through the analysis, the financial manager seeks to compare alternative methods of financing under various

assumptions as to EBIT and to obtain indifference level of leverage. Indifference point refers to the EBIT level at which EPS remains unchanged irrespective of debt –equity mix.

2.2.5.2 Cash Flow Analysis

Cash flow analysis is another approach to establish an appropriate Capital Structure. In indicates the capacity of the firm to pay fixed charges on the basis of its ability of cash generation. When considering the appropriate Capital Structure, we should also analyze the cash flow ability of the firm to serve fixed charges. The grater the amount of senior securities the firm issues ant the shorter their maturity, the grater the fixed charges of the firm. Where, fixed charges include payment of interest, preference dividend, principal payment and lease payment. They depend on both the amount of loan securities and term of payment.

The amount of fixed charges will be high if the company employs large amount of debt or preference capital with long-term maturity. Whenever the company thinks of raising additional debt, it should analyze expected future cash flows to meet the fixed charges. The inability to meet these charges, with the expectation of preference stock dividends, may result in financial insolvency. The grater and more stable the expected future cash flows of the firm, the grate the debt capacity of the company. It is quite risky to employ fixed charge source of finance by those companies whose cash inflows are unstable and unpredictable. It is possible for high growth and high profitable companies to suffer from cash shortage if its liquidity management is poor.

The cash flow analysis indicates when the firm will find it difficult to serve its debt. Therefore it is useful in providing good insights to determine the debt capacity, which helps to maximize the market value of the firm (Upadhyay, 1999:211).

Cash flow analysis is helpful to determine the debt capacity of the firm debt capacity is the amount which a firm can serve easily ever under adverse condition; it is the amount that the firm should employ. Some ratios can be used to analyze the total debt capacity of the firm. Among the ways we can gain knowledge about the total debt capacity of the firm is through the use of coverage ratios. Among the coverage ratios, most widely used coverage ratio is time interest earned or interest coverage ratio, which can be calculated by using following formula:

$$\text{Time interest earned} = \frac{\text{EBIT}}{\text{Interest on debt}}.$$

This ratio measures the ability to pay interest. It also measures the extent to which operating income can decline before the firm is unable to meet its annual interest costs. Failure to meet this obligation can bring legal action by the firm's creditors, possibly resulting in bankruptcy. Note that earning before interest and taxes, rather than net income, is used in numerator. Because interest is paid with pre tax amount, the full amount of EBIT is available to pay interest.

Time interest earned ratio tells us nothing about the ability of the firm to meet principal payments on its debt. The inability to meet principal payment constitutes some legal default as failure to meet an interest payment. Therefore, debt service coverage ratio is useful to test the ability to serve debt. This ratio is:

$$\text{Debt service coverage} = \frac{\text{EBIT}}{\text{Interest} + \frac{\text{Principal payment}}{1 - \text{Tax rate}}}.$$

If the company uses assets on lease, at that time total debt service coverage ratio can be calculated by adding lease payment on both denominator and

numerator. The closer the ratio is to one, the worse thing are, all other thing the same. Even with the coverage of less than one, a company may still meet its obligations if it can renew some of its debt when it comes due.

A firm can avoid the risk of financial distress if it can maintain its ability to meet contractual obligation of interest and principal payments. Debt capacity therefore, should be tough in terms of cash flows rather than debt ratios. A high debt ratio is not necessarily bad. If firm can serve high debt without any risk, it will increase shareholders' wealth. On the other hand, a low debt ratio can prove to be burdensome for a firm, which has liquidity problem. A firm faces financial distress when it has cash flow problem.

The point to be emphasizes is that a firm should carry out cash flow analysis to get a clear picture of its ability to serve debt obligation even under the adverse condition, and thus, decide about the proper amount of debt in the Capital Structure. This can be done by examining the impact of alternative debt policies on the firm cash flow ability. The firm then chooses the debt policy, which it can service.

2.2.6 Factors Affecting the Capital Structure

Capital Structure is the composition of long -term sources of funds i.e. long-term debt,

Preference share capital and equity share capital. Capital Structure decision affects the value of firm, earning per share and cost of capital. So, the Capital Structure decision is very important aspect of financial management. All the activities of financial manager of the company should be motivated to maintain the optimal Capital Structure. Optimal finance is that mix of debt and equity that maximize the value of the firm and earning per share and minimizes the overall cost of capital of the firm. At any point in time, the firm's management has a specific target Capital Structure in mind, presumably the optimal one, although this target may change over time. Here target Capital Structure can be defined

as the mix of total debt, preference stock and common equity that the firm would like to have in its Capital Structure.

Although it is theoretically possible to determine the optimal Capital Structure, as a practical matter we cannot estimate this structure with precision. While maintaining the target Capital Structure the financial executive should considered various factors, which affects that target Capital Structure. Firms consider many factors, which can have the important, though difficult to measure, bearing on the optimal Capital Structure. Some of those important factors, which affect the target Capital Structure, are as follows:

1. **Sales Stability**

A firm whose sales are relatively stable can safely take on more debt and incur higher fixed charges than a company with unstable sales. Utilities companies, because of their stable demand, have historically been able to use more financial leverage then industrial firms.

2. **Assets Structure**

Firms whose assets are suitable, as security for loans tend to use debt rather heavily. General-purpose assents, which can be used by many businesses, make good collateral, whereas special purpose assets do not. Thus real estate companies are usually highly levered, whereas companies involved in technological research employ less debt.

3. **Operating Leverage**

Other things the same, a firm with less operating leverage is better able to employ financial leverage because, as we saw, the interaction of operating and financial leverage determines the overall effect of declines in sales on operating income and net cash flows.

4. Growth Rate

Other things the same, faster growing firm must rely more heavily on external capital. Further the floating costs involved in selling stock exceed those incurred when selling debt. Thus rapidly growing firms tend to use somewhat more debt than slower growing companies.

5. Profitability

One often observes that forms with very high rates of return on investment use relatively little debt. Although there is no theoretical justification for this fact, on practical explanation is that very profitable firms such as IBM, 3M, and Kodak simply do not need to do much debt financing. Their high rate of return enables them to do most of their financing with retained earning.

6. Taxes

Interest is deductible expense, and deductions are most valued by firms with high tax rates. Hence, the higher a firm's corporate tax rate, the great the advantage of using debt.

7. Control

The effect of issuing debt versus stock might have a management's control position by influence of Capital Structure. I f management currently has voting control (over 50 percent of stock) but is not in a position to buy more stock, it may choose debt for new financing. On the other hand, the management group may decide to use equity rather than debt if the firm's financial situation is too weak that the use of debt might subject the firm to serious risk of default, because if the firm goes into default, the managers will almost surely loss their jobs. However to little debt used, management runs the risk of a takeover. Thus, control considerations do not necessarily suggests the use of debt or equity, because the type of capital that best protects management will vary from situation to situation. However, if management is at all insecure, it will surely take account of the effect of Capital Structure on control.

8. Management Attitude

If the absence of proof that one Capital Structure will lead to higher stock prices than another, management can exercise its own judgment about the proper Capital Structure. Some management tends to be more conservative than others use less debt than the average firms in the industry, whereas for other managements the revenue is true.

9. Lender and Rating Agencies Attitude

Regardless of manager's own analysis of the proper leverage factors for their firms, there is no question but that lenders' and rating agencies attitudes are frequently influence Capital Structure decision. In the majority of cases, the corporation discusses its Capital Structure with lenders and rating agencies and gives much weight to their advice.

10. Market Conditions

Conditions in the stock and bond market undergo both long and short run changes that can have an important bearing on the firm's optimal Capital Structure. For example, during the credit crunch in the winter of 1982, there was simply no market at any reasonable interest rate for new long-term bonds rated. Therefore, low rated companies in needed of capital were forced to go to the stock market or the short term debt market, regardless of their target Capital Structures. When conditions eased, however, these companies were able to bring their Capital Structure back to their target level.

11. The Firm's Internal Condition

A firm's own internal condition can also have a bearing on its Capital Structure. For example: suppose a firm has just successfully completed and R&D program and it projects higher earnings in the immediate future. However, the new earnings are not yet anticipated by investors and hence are not reflected in the price of the stock. This company would not want to issue stock, it could prefer to finance with debt until the higher earnings maximize and are reflected in the

stock price, at which time it might want to sell an issue of common stock, retire the debt and return to its Capital Structure.

12. Financial Flexibility

It has been noted that firm can earn a lot of money from good capital budgeting and operating decisions than they can form good financing decisions indeed. The researchers really are not sure how (or even if) financing decisions affects stock prices, but they do not know that having to turn down a large order because funds are not available for buying the raw material of equipment needed to fill it will lower profits. For this reason, many treasurers have as their primary goal to always be in a position to raise the capital needed to support operations. We also know that when times are good firm can raise capital with either stock or bonds, but when times are bad, supplies of capital are much more willing to make funds available if they are given a secured position, and this means bonds.

These are the main factors affecting the target Capital Structure. Other factors like- nature of the company, flotation costs, capacity of raising funds, agency cost, cash flow ability, external risk assessment, contractual obligation, timing, solvency etc. should also be considered while making Capital Structure decisions.

2.3 Review of Related Studies

Previous studies are reviewed in this section. It consists of thesis and dissertations done by previous master's level student as well as other research works related to the Capital Structure of the firm. In this section, the following research studies have been reviewed.

A research work done by **Mr Ramesh Shrestha** in the analysis of Capital Structure of selected public enterprises has concluded that the selected public

enterprises under study have a very confusing Capital Structure since the corporations are not guided by the objectives based on financial plan and policies. In many instances ad- hocism become the basis of Capital Structure and in that also, most of them, want to eliminate debt if possible to relieve financial obligations. He has also suggested that, the debt –equity ratio should neither be highly levered to create too much financial obligations that lie beyond capacity to meet nor should it be much low levered to infuse operational strategy to bypass responsibilities without performance and the calculation of the equity capitalization rate according to given data provide very fantastic results in many cases, although they carry valid and meaningful result in some instances.

In the study conducted by **Mr. Bibek Guragain** on the comparative evaluation of Capital Structure between Butwal spinning mills ltd. and Jota spinning mills ltd., analyzed the Capital Structure of these companies by using financial and statistical tools. He has concluded his study as:

- Both the sampled companies have high debt equity ratio and are highly levered and as increased financial risk to the considerable extent.
- Both the companies have positive correlation coefficient between long-term debt and shareholders equity. Or there is significant relationship between long-term debt and shareholders equity. But there is no significant relationship between interest payment and EBIT.
- Total debt has not been fully utilized in the management of assets.
- Debt removing capacity is weak in both the companies. And return on capital employed is not significant.
- Both the companies have negative overall capitalization and equity capitalization rate but the market value per share of those companies are higher than the par value.

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To overcome these problems he has suggested to:

- Maintain optimal Capital Structure.
- Minimize the operating cost.
- Utilize optimal capacity.
- Install diesel plant for electricity.
- Enhance competitive capacity.
- Revise the capitalization rate.
- Expand operation.

In the study conducted by **Mr. Raja Ram Aryal** about the evaluation of Capital Structure of Bottlers Nepal Ltd has suggested that, the management must bring about the satisfactory compromise among these confusing factors of cost, risk, control and timing. And it was found that the company has high debt to equity ratio, so the company is regarded, as highly geared company is to lower down the amount of debt and to obtain additional funds through the issue of equity capital from debt capital if the company has high earning per share. The company would have to issue its share, when the company had high rate of return and the company has to follow the grater norms of optimal Capital Structure2: 1.

Mr. **B. R. Acharya** conducted the study on " Capital Structure position in Arihanta Multi Fiber Ltd. " In this study he concluded that the long term financial position of the company is not favorable. The company has long term debt financing to acquire fixed assets. The interest on capital employed ratio seems to be low as it fails to pay off interest. The return on owner's equity is negative, which indicated that debt capacity to generate income is not favorable. Debt to equity ratio is high, which shows the outsiders claims on return are greater than that of equity holders. These all shows that the financial risk of the company is in increasing trend.

CHAPTER THREE
RESEARCH METHODOLOGY

3.1 Introduction

“Research methodology refers to the various sequential step to be adopted by a researcher in studying problem with certain object in view. It would be appropriate to maintain that research project are not susceptible to any one complete and inflexible sequence of steps and the type of problems to be studied will determine the particular steps to be taken and their order too “(Kothari,1999: 154).

Research methodology is a technique of analyzing the obtained data to solve the research problem. It consists of descriptive approach and statistical tools. Descriptive approach is used to analyze the research problem. Setting hypothesis and other theoretical problem. Statistical tools are used to analyze the numerical data. Researcher has used the following methodology to complete the research.

3.2 Research Design

“A research design is the arrangement of conditions for collecting and analysis of data in a manner that aims to combine relevance to the research purpose with economy in procedure” (Claire selltiz and others research methods in social sciences, 1962: 50). The research design is the conceptual structure within which research is conducted, it constitutes the blue print for the collection, measurement and analysis of data. To conduct the research of this study, descriptive and analytical research design has been adopted. In other words it is a conceptual structure within which a research is conducted. It helps in the analysis of data related to study. The research design basically follows the comparative evaluation of dividend practices in the sample insurance companies and their effect on stock prices. Research design helps researcher

to enable him to keep track of action and to know whether he was moving in the right direction to achieve his goal.

3.3. Population and Samples

Nowadays a number of several public limited companies have been emerging rapidly. Some have already been established and other are in the process of establishment. It is not possible to study all of them. So, all the companies are population of the study. Among them Soaltee Hotel and Everest Hotel have been selected as samples for the present study on the basis of provide good service.

3.4 Data Period Covered

This study is based on only five year data of each hotel i.e. from 2003/04 to 2007/08.

3.5 Data Collection Procedure:

In order to achieve the objectives of the study, primary as well as secondary data collection procedure has been adapted. Once the purpose of statistical investigation has been defined, the next step is to collect the data which are relevant for analysis in a meaningful manner. Thus, the collection of data is considered as an integral part of the research activity. The sources of information are generally classified as primary and secondary.

Primary Data:

Data collected by the researcher or through agent for the first time form related field and possessing original characters are knows as primary data.

Secondary Data: Data collected by someone else, used already and are made available to others in the form of published statistics are known as

secondary data. Once primary data have been used, it loses its originality and becomes secondary.

3.6 Methods of Analysis

Most of the analysis are based on secondary data however some primary data however some primary data are also used for analysis. In this study data are collected form different sources i.e. Nepal Stock Exchange Website such as www.nepalstock.com and www.google.com plus the respective firms' central office. From these organizations annual reports are collected and some related information all taken from Economic Survey and people concerning and relevant to the study. For the purpose of analysis of data 5 years will be taken as sample from 2003/04 to 2007/08. These will be analyzed in two ways.

1. Using Financial Tools
2. Using Statistical Tools

3.6.1 General financial tools:

Ratio analysis: the ratio analysis explains the relationship between two variables so that the accepted activity in the organization is held or not can be examined. For this purpose, the following ratios are considered in this study.

i. Leverage Ratios:

Mainly the term leverage concerned with the debt fund used in the Capital Structure. Leverage ratios are associated with the long terms financing sources and assets.

The ratio of leverage measure the financial proportion owners compared with the financial proportion of external parties. Leverage ratios also measures risk of debt financing through computation the fix charge coverage. Ratios regarding leverage used in the study are defined below properly.

Debt equity ratio (DE ratio)

Debt equity ratio (DE is the most widely used leverage ratio to evaluate the long term solvency of a firm. This ratio expresses the relationship between the debt

capital and equity capital and reflects the relative claim of them on the assets of firm. It is simply calculated by dividing total debt by total equity.

$$D/Eratio\ \mathrm{X}\frac{\text{Total Debt}}{\text{Total Equity}}$$

Debt to Total Capitalization Ratio

The ratio express the relationship between debt capital and total capital viz equity capital and debt capital in equation

$$\text{Debt total capitalization ratio}\ \mathrm{X}\frac{\text{Total Debt}}{\text{Total Capital}}$$

Debt To Total Assets Ratio

The debt – assets ration (DA) simply known as debt ratio shows the proportion of total debts used in financing total assets of a firm. It is calculated as:

$$\text{Debt to Assets ratio}\ \mathrm{X}\frac{\text{Total Debt}}{\text{Total Assets}}$$

Interest Coverage Ratio (TIE Ratio)

The ratio that indicates the extent to which the firm is able to satisfy interest payment out of earning before interest and taxes is Interest coverage ratio. It is calculated by dividing EBIT by interest charges.

$$\text{TIEratio}\ \mathrm{X}\frac{\text{EBIT}}{\text{Interestexpenses}}$$

Degree of Financial Leverage

The degree of financial leverage is the percentage change in earning available to common stockholders (EPS) associated with a particular percentage change in EBIT.

$$\text{DFL}\ \mathrm{X}\frac{\text{EBIT}}{\text{EBIT-I-}\frac{\text{DPS}}{\text{1-T}}}$$

or

$$\text{DFL } X \frac{\%\,\text{Change in EPS}}{\%\,\text{Change in EBIT}}$$

ii. Profitability Ratios:

This ratio provides the firms relationship between firms operating efficiency with the profit. This ratio provides solution of how effectively the operations are managed. Mainly we concern the following ratios.

Profit Margin on Sales

Net profit margin is the ratio between net income and sales of a firm. It shows the firm's ability to generate net income per rupee of sales and is calculated as:

$$\text{Net profit margin } X \frac{\text{Net income}}{\text{Sales}}$$

Return on Assets

The return on assets (ROA) which is often called the firm's return of total assets measure the overall effectiveness of management in generating profit which its available assets. It is calculated as follows.

$$\text{ROA } X \frac{\text{Net Income}}{\text{Total Assets}}$$

Return on Net worth / Equity (ROE)

The ROE measure the return on the owner's investment in the firm higher ratio of return on equity is better for owner, It is calculated as follows

$$\text{ROE } X \frac{\text{Net Income}}{\text{Total Equity}}$$

Return on Capital Employed (ROC)

The return on capital employed measure the return on the both the owner's and creditor's investment in the firm. It is calculated as follows

$$\text{ROC } X = \frac{\text{Net Income}}{\text{Total Capital Employed}}$$

3.6.2 Statistical Tools

Some statistical tools are used in the analysis and interpretation of data.

The main statistical tools used in this study are mentioned below properly.

i. Correlation Coefficient:

Correlation is a statistical tool which studies the relationship between two variables and correlation analysis involves various methods and techniques used for studying and measuring the extent of the relationship between the two variables. Correlation is the analysis of the co-variation between two or more variables. The Correlation Coefficient can be calculated mathematically as follows:

$$r = \frac{N\sum XY - (\sum X)(\sum Y)}{\sqrt{N\sum X^2 - (\sum X)^2} \times \sqrt{N\sum Y^2 - (\sum Y)^2}}$$

Where,

r= correlation coefficient between two variables X and Y.

X= First variable

Y= Second Variable

N= No of observations

ii. Probable Error:

P.E. denotes probable error of the correlation coefficient, which is the measure of testing the reliability of the calculated value of r. If r be the calculated value of r from a sample of n pair of observations, then P.E. is defined by

$$\text{P.E.} = 0.6745\ 1-r^{2}/\sqrt{N}$$

Where,

r = Correlation Coefficient

N = Number of Pairs of observations

It is used in interpretation whether calculated value of r is significant or not.

If r < P.E., it is insignificant and if r > 6 P.E., it is significant. The P.E. of correlation coefficient may be used to determine the limits within which the population correlation coefficient lies. Limits for the population correlation coefficient are r± P.E.

iii. Graphical Approach:

It is one quantitative method used to determine patterns in data collection overtime. It is used to detect patterns of change in statistical information over the time. This is the simplest and the easiest method of studying trend of fluctuations. In this method, points are plotted taking time along X-axis and the value of the variable under study along Y-axis. In this study graphical approach is presented and analyzed by line chart and bar diagram wherever it is necessary.

iv. Chi square: non-parametric test:

It is depends only on the set of observed and expected frequency and degree of freedom. Since chi square test doesn't make any assumption about population parameters, it is also called distribution free test. This test is good for nominal or ordinal scale of measurement. Nominal scale of measurement deals with the data which can only be classified into categories such as Strongly Agreed, Agreed, Disagree, Strongly disagreed and so on where as the ordinal level of measurement assigns different ranks. Similar to the binomial distribution, chi square test is also used for analysis qualitative variables such as opinions of person.

n, religious affiliation, smoking habits and so on. CHI square test is a test, which describe the magnitude of difference between observed and expected (theoretical) frequencies under a certain assumption. In other words, it is described the magnitude of the discrepancy between theory and observation it is defined as

$$\text{Chi square} = \frac{(O - E)^2}{E}$$

Where, O =observed frequencies

E =Expected frequencies

Expected frequencies= RT × CT

Where,

N= Number of observation.

RT= Row total

CT= Column Total

3.7 Test of hypothesis

In testing of hypothesis, assumptions is made about the sample selection from population and testing whether the assumption or hypothesis is correct or incorrect with respect to two contending and get the sound conclusion in the light of the sample observations. In testing the hypothesis the initial way is to set the hypothesis and present it into in standard way. For this, null hypothesis (H_0) and alternative hypothesis (H_1) have been formulated. Under this study, the hypothesis is formulated and tested while applying The Regression Analysis and Chi Square Test.

A) Creation of hypothesis under regression analysis (for secondary data)

For first model:

Null Hypothesis (H_0) : The Profitability is dependent on capital employed, long term debt and sale.

Alternative Hypothesis (H_1) : The Profitability is not dependent on capital employed, long term debt and sale.

CHAPTER-FIVE
SUMMARY, CONCLUSION AND RECOMMENDATIONS

This chapter is a complete conclusion and suggestive package which contains summary, conclusion of the findings and actionable plans i.e. suggestion for further improvement. This would be meaningful to the hotels in capital structure. Summary gives the brief introduction to all the chapters of the study and shows the actual facts of the present situation under the topic of the study. Conclusion of the findings is based on the consequences of the analysis of relevant data by using financial as well as statistical tools. The recommendation is presented in term of suggestion, which are prepared on the basis of findings and conclusion.

5.1 Summary

Overall national development of any country depends upon the economic development of that and economic development largely depends upon the financial infrastructure of that country. Therefore, the primary goal of any nation including Nepal is rapid economic development to promote that welfare of the people and the nation as well. Nepal being one of the least development countries has been trying to embark upon the path of economic development by economic growth rate and developing all sectors of economy. Basically the entire research work focuses on the study on capital structure and profitability management of Soltee Hotel and Everest Hotel.

Nepal had a late start in development. Its pace of industrialization has been slow. Various censuses of manufacturing establishments indicate that the number of manufacturing establishments has been declining in recent years. The mortality rate has been high for industries. The target and programs set by various development plans for industrial development were ambitious. Establishment of manufacturing companies is the main way of industrial development in the country whereas hotel sector directly and indirectly involved

in industrial development. Located in Kathmandu Valley the Soaltee hotel and Everest Hotel are two hotels are two hotels operating in this Valley.

This study "A Capital Structure Analysis & its Impact on Profitability of hotel sectors" is primarily prepared for the partial fulfillment of the requirement of the master of business studies (MBS). This study is mainly based on secondary and primary data provided by concern companies, security board of Nepal (SEBON) and respondents. Among the listed companies two hotels are selected as a sample of study. The main objective of the study is to assets the capital structure and to know the impact of leverage on the risk and return to the shareholders. However due to the time and resource constraints all types of analysis are not conducted information are gathered during the period of 2003/04 to 2007/08.

The collected information is presented analyzed and conclusion is drawn from the study.

Chapter one is concerned with the introduction of the whole study. It explained about the concentration of the study objectives and organization of the study which provides guideline for entire study.

Chapter two is for the review as well as the review of related previous studies is conducted.

Chapter three species the guidelines, tools and research design to achieve the objectives of the study.

In Chapter four for the analysis of data, some statistical and financial tools are used. Ratio Analysis, Leverage Analysis and analysis of capital structure are the main financial tools used. In this study Correlation Coefficient between figures as well probable error are considered as the main statistical tools in this study.

In chapter five, main findings are concluded as the conclusion of the study. Based on the analysis and conclusion of the study some recommendations are made in this chapter.

5.2 Conclusion

Based on the major findings the following conclusion are observed

- The leverage position of the company can be analyzed with the help of different leverage analysis. Two Soaltee hotel and Everest Hotel have negative operating leverage. The capacity of financial activities of Everest is higher than that of Soaltee due to low amount of debt capital.

- The two companies are using equity as well as debt capital in their capital structure. However the total debt amount is increasing for EH while it is decreasing for Soaltee hotel. From the leverage analysis EH have higher percentage of debt equity ratio. Soaltee hotel use more than 50% equity capital of their assets whereas other sample company use less than 50% equity capital.

- The interest ratio for Soaltee is -1.72 and Everest are 3.21 which show poor interest paying capacity of the company.

- By analyzing debt-equity ratio it is found that there is no huge difference between the average ratios of two hotels. the ratio for Soaltee is 108% but the ratio of EH is 157%.

- In comparison between two hotels. ROE for EH is more than that of Soaltee as well as profit margin of EH is also greater than Soaltee.

- According to NI Approach the market value of firm is not affected by a change in capital structure. In this approach, net operating income is capitalized at an overall capitalization rate to obtain the total market

value of firm. In this approach overall capitalization Ko as well as cost of debt Kd stay the same regardless of the degree of leverage. So, the company can use high amount of debt capital with the same rate of interest. Comparatively, Ko of EH is somehow greater than that of hotel Soaltee.

- The conclusion of correlation Coefficient between D/E ratio and Ko shows the negative correlation but it is not significant for Soaltee. But the correlation is positive for EH and is also significant.

- The respondents of the practioners and academicians are not support of particulars theory of capita; structure as it is evident that they ranked retained earnings as the first alternative sources of financial for the new project income response ranking analysis of benefit and cost of debt. Some of the structured questionnaires if the response in the former is consistent with later.

- From the study of "A Study on Capital Structure Analysis & its Impact on Profitability of Hotels Sector", it is tried to establish the relationship between leverage and profitability. Some ratios which are related with capital structure are completed overall capitalization rate and equity capitalization rate. Correlations between some relevant variables are also included for primary data.

5.3 Recommendations

Based on the major findings the following recommendations are observed

- The information that is related to the study of capital structure is systematic manner. To know the impact of long-term debt into profitability the amount of interest on long-term debt should be know. The interest coverage ratio here it is computed on the basis of total interest. So actual impact may not be judge. So, it is recommended to the

concern company that the details and systematic study. And analysis such information should be maintained properly.

- The value of the firm can be maximized either by maximizing the market value of the market value of debt and stock or by minimizing the overall cost of capital. The capital structure without long-term debt may not lead to minimized cost of capital. The levered firm Soaltee hotel and Everest hotel are recommended to increase their debt service capacity in order to take benefit of leverage and higher profitability.

- It is found that DFL of Everest hotel is high and some has low. It is the impact of fixed cost, which ultimately affects the profitability of the company. So to earn higher level of profit, all the companies should maintain the optimal level of interest cost in business. The companies which are suffering form losses are suggested to decrease interest cost.

- The capital structure decisions are not found to be considered properly by the companies. It affects the value of firm and overall cost of capital so every investment and financing decision of the company should be taken by considering the capital structure of firm.

- It is recommended that cost and benefit should be analyzed before raising fund from different source of capital. Although debt creates tax benefit and increase ROE.

- It is recommended that more independent variable should be added to capture the industry nature of Nepalese firm to better explain the variability in the profitability.

- It is recommended that try to maintain information system between management and investor. The

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ANNEX

Questionnaire used for primary data collection "Capital Structure Analysis and Its Impact on Profitability of Hotel Sector". A survey of participants view the respondents are assumed that the responses will maintain anonymity. If respondents are interested, the findings would be shared. The co-operation of the respondents be highly appreciated

Name:

Occupation:

Age:

Firm type: private/public

Please answer the following question as they relate to dividend policy of any commercial bank.

Q.NO.1. Do you agree that more use of debt ratio helps to increase the value of firm?

a. strongly agree (…….)

b moderately agree (…….)

c disagree (…….)

d strongly disagree (…….)

e don't know (…….)

Q.NO.2. Do you think the current political situation affect the profitability ratio of service sector?

a. strongly agree (…….)

b. moderately agree (…….)

c. disagree (…….)

d. strongly disagree (…….)

e. don't know (…….)

Q.NO.3. Do you think the debt use by service sector is more?

a. strongly agree (…….)

b. moderately agree (…….)

c. disagree (…….)

d. strongly disagree (…….)

e. don't know (…….)

Q.NO.4.Do you think the capital structure of service sector is optimal?

a. strongly agree (…….)

b. moderately agree (…….)

c. disagree (…….)

d. strongly disagree (…….)

e. don't know (…….)

Q.NO.5. Do you think the degree of risk associated with in the organization will also increase as leverage increase?

a. strongly agree (…….)

b. moderately agree (…….)

c. disagree (…….)

d. strongly disagree (…….)

e. don't know (…….)

Q.NO.6. Do you agree the government policy effect the combination of debt and equity?

a. **strongly agree** **(……)**
b. **moderately agree** **(……)**
c. **disagree** **(……)**
d. **strongly disagree** **(……)**
e. **don't know** **(……)**

Q.NO.7. Do you think the capital structure followed by service sector is same?

a. **strongly agree** **(……)**
b. **moderately agree** **(……)**
c. **disagree** **(……)**
d. **strongly disagree** **(……)**
e. **don't know**