CAPITAL STRUCTURE MANAGEMENT OF SELECTED MANUFACTURING COMPANIES IN NEPAL

(A Case Study of Unilever Nepal Ltd. & Bottlers Nepal Terai Ltd.)

by:

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A Thesis Submitted to:
Office of the Dean
Faculty of Management
Tribhuvan University

In the partial fulfillment of the requirements for the degree of Master's in Business Studies (MBS)

Narayangarh, Chitwan

December, 2012

INTRODUCTION

Background of the Study

The capital structure refers to the proportion of debt and equity capital. This has an important place in the theory of financial management. The financing decision of a firm relates to the choice of proportion of debt and equity to finance the investment requirement of which a proper balance is necessary to ensure a trade off between risk and return to the shareholder. An optimal capital structure, which consists of reasonable proportion of debt and equity, can help to maximize the value and ultimately the shareholders wealth.

In Nepal, some companies do not plan capital structure and it develops of the financial decisions taken by the financial manager without any formal planning. Those companies may prosper in the short-run, but ultimately they will face great difficulties in raising funds to finance their activities. The unplanned capital structure of the companies will also fail to economize the use of their funds. Thus, it is being increasingly realized that a company should plan its appropriate capital structure to maximize the use of funds and be able to adapt more easily to changing conditions.

The research is concerned with the study of capital structure management of some selected manufacturing companies. To describe the capital structure of any firm the long-term source of funds is necessarily used. Well financial performance depends on optimal capital structure. The term capital refers to the long-term funds like debt equity. The capital mix, which leads to the maximum value and minimum cost of capital, is optimal capital structure, which can be obtained by changing the financing mix. Composition of capital structure is one of the most important components of solvency analysis. Capital structure refers to a company's sources of financing and its economic attributes. Capital structure is usually measured in terms of the relative magnitude of the various financing sources. A company's financing stability and risk of insolvency depend on its financing sources and the types and sizes of various assets its own. Common size and ratio analysis of capital structure are preliminary measures of the risk of the company's capital structure. The higher the proportion of debt, the larger the fixed charges of interest and debt repayment and the greater the likelihood of insolvency during period of earnings decline or hardship. Capital structure measures serve as screening devices (Bernstein and Wild, 1997:58). This study is directed towards analyzing the effect of capital structure on the value of the firm in the context of Nepalese manufacturing.

Unilever Nepal Limited

Unilever Nepal Limited (UNL) was formed as a subsidiary company of Hindustan Lever Limited, India. The factory is situated at Basamadi V.D.C. of Makawanpur district, which is about six kilometers far from Hetauda municipality, and its Corporate Office is situated at Heritage plaza II, Kamaladi, Kathmandu. Unilever Lever Ltd was established in 1994 as a joint venture company between Hindustan Lever Limited, India and Nepali Promoters under the Company Act 2021. The main objectives of the company is to manufacture soaps, detergent, cosmetics, toiletries, oleaginous, detergent, and other chemical products and marketed them in and outside the country under the brand name of the products of Hindustan Lever Limited. The register of this company is NIDC capital market limited which is situated as the Kamaladi, Kathmandu. The purpose of Unilever Lever is to meet the everyday needs of people everywhere to anticipate the aspiration of their consumers and customers are to respond creativity and competitively with branded products and services, which raise the quality of life.

Bottlers Nepal (Terai) Limited

Bottlers Nepal (Terai) Limited was established as a private; limited company under the company Act 1964 in 1973 A. D. It was converted into public limited company in 1984. It is one of the manufacturing and processing companies, which are manufacturing soft drinks, under the brand name Coca-Cola Company. The company also makes the sales of the soft drinks under the registered trade name of Coca Cola company that is managed by Singapore based F & N Coca Cola Pvt. Limited Company. Its registered office is located at Balaju, Kathmandu. The company has established a subsidiary Company, Bottlers Nepal (Terai) Limited in Chitwan District. The main objective of the company is to produce and to market soft drinks under the brand name of Coke, Fanta and Sprite etc in the country. Raw materials for the production are imported from France and Atlanta. Flavor of the coke is prepared by the company secretly and is sold without disclosure. These are brought from countries like Singapore, India and Germany. Company has production capacity of 430 bottles per minute.

Statement of the Problem

To operate the business activities generally every companies has its own policy in determining capital structure. Capital structure concept is not taken seriously by the Nepalese Companies. Therefore, optimal capital structure does not exist at all. Among the listed companies in the stock exchange very few are using the debt capital and contrary to this some of the companies are ruined by the excess burden of the cost of debt capital. Some of the business use only equity capital, some use only debt capital and some combine both equity and debt capital. Therefore determination of capital structure largely depends upon the company policy and cost of capital. Most of the companies make low cost of capital structure. In the initial period of any company they want to use only equity capital and do not want to include debt in their capital due to their high interest charge.

To solve such problem the management of the company should beware of importance of capital structure management. The purpose of this small study is to analyze, examine and make aware of the importance of the capital structures management of the firm. UNL and BNTL are using short-term debt, long-term debt along with the equity capital. But the combination is not satisfactory to generate the appropriate profit. The development of the manufacturing industry can be possible by making their capital structure balanced. Most of the Nepalese manufacturing companies have not the specific polices regarding the balanced capital structure. They generally make low cost capital structure. These companies also use the long-term debt.

Objective of the study

The main objective of this study is to analyze, evaluate and interpret their capital structure employed by the selected organizations. The specific objectives of the study are pointed out as under:

a) To analyze the DOL and DFL of BNTL & UNL.

b) To examine the capital structure and profitability ratios of BNTL & UNL.

c) To examine the value of the firm BNTL & UNL.

d) To analyze the cost of capital of BNTL & UNL.

e) To analyze the relation between total debt & shareholder equity, net profit & earning per share.

Research Questions

i) What are the major factors affecting the management of capital structure in selected manufacturing companies?

ii) Does unplanned capital structure of manufacturing companies have sound financial position?

iii) Does conflicting role of capital structure affect in the development of manufacturing companies?

iv) How does the proportion of debt or equity capital affect in selected manufacturing companies?

v) How does leverage affects the capital structure in selected manufacture Companies?

vi) What are the relationships among financial ratios of selected manufacturing companies?

Limitation of the Study

This research is from 2003/04 to 2009/10 and it is conducted under the following limitation:

- ❖ This research is focused on the analysis of the two manufacturing companies of Nepal only.
- ❖ Due to the lack of time and financial resources, only two companies are selected as sample of the study.
- ❖ This study is based mainly on the secondary data which are collected from books, reports of the relevant companies, NEPSE and security board. So the secondary data are not accurate as the primary data.
- ❖ The consistency of the result is strictly based on the information provided to us.

- ❖ The personal visits to the companies are more difficult and due to this, the study may be incomplete. The study has not used all the financial and statistical tools due to the various constraints.
- ❖ This may cause not to cover the total study and analysis.

Organization of the study

As discussed in previous section, this study intends to find the empirical relationship between the value of the company and capital structure together with other explanatory variables in the context of Nepalese listed manufacturing companies. To achieve the Objectives of the study as stated in above section, this study contains five chapters in the pattern as stated below:

Chapter I Introduction:

This chapter deals with the subject matter of the study consisting background of the study, overview of manufacturing companies, focus of the study, statement of problem, objective of the study and organization of the study.

Chapter II Review of literature:

This chapter deals about review of literature it includes a discussion on the review of books i.e. capital structure theories, financial leverage, determination of capital structure factors affecting capital structure review of major empirical studies and review of dissertations works relating to the capital structure study.

Chapter III Research methodology:

This chapter deals about research methodology, it consist of methodology, adopted to achieve the objective i.e. research design, nature and sources of data selection of enterprises, method of data selection, method of analysis and specification of the variables.

Chapter IV Presentation and Analysis of Data

This chapter deals with the analysis and interpretation of data by using statistically and financial models described in chapter.

Chapter V Summary, conclusion and recommendation:

This chapter indicate that the summary, conclusions and recommendations of the study.

After that, all necessary appendices are also included after bibliography.

Research Gap

As the above research works are concerned with capital structure. They are mostly done by taking single or multiple firms and their analysis is in absolute nature. The studies also observed same defects in capital structure. The tools used for analysis have been limited to ratio analysis. So this study tries to explore the capital structure patterns in manufacturing companies. Moreover this research is comparative study of two manufacturing companies which will provide information to the concern party for comparative analysis. Furthermore this study will be helpful to the interested groups. At least this study will be different from the above in-terms of sample manufacturing companies, data presentation as well as statistical used for interpretation and analysis of data with using latest data from FY 2003/04 to 2009/10.

Major Findings of the Study

The study includes the capital structure of Nepalese manufacturing companies. It has already mentioned the detailed about the related subject matter. Thus, in the conclusion the major findings of the study are as follows:

1) The average of DOL for UNL & BNTL are 14.76, & -1.84 UNL

has high DOL, which indicates the riskiness of the company. So, the UNL should try to manage its DOL whereas BNTL should try to increase its sales volume to improve the operating position of the company.

2) The average DFL for UNL is higher in comparison to BNTL.

3) The average debt equity ratio is 211.14 for the UNL and 67.21 or the BNTL. This situation indicates that the debt amount is comparatively high for asset financing as per the figure of the ratio.

4) On the basis of interest coverage ratio, the average interest coverage ratio of UNL and BNTL are 116.39 and 300.18 respectively. Due to the use of lower amount of debt; the coverage ratio for BNTL is very high. The UNL has very good coverage ratio. This clarifies that some of the companies do not have a good amount of profit; as well they are ruined by the burden of the huge amount of interest.

5) The profit margin of the companies does not show a satisfactory picture during the study. The profit margin for UNL is higher then BNTL which indicates the good earning capacity of the company by selling its products.

6) Earning per share for UNL seems to be higher than that of BNTL. So the investors can be attracted by the proposal of UNL.

7) The investors of the UNL are getting more returns from their investments. BNTL have satisfactory result to the return on the equity shareholders.

8) The average ROA is higher for the UNL indicating the good production power of assets. Another manufacturing company has low return on assets which indicates that other companies have also

not good financial condition in nature.

9) From the calculation of overall capitalization rate, we can see that UNL shows its highest average overall capitalization value than BNTL. The data ofequity capitalization is also higher in an average for UNL then the selected manufacturing company listed in NEPSE. The use of less costly debt fund increases the risk to the shareholders.

10) The correlation between SHE & Total Debt of UNL is -0.81 and it is -0.15 in BNTL, which shows negative relationship in both the company. Coefficient of determination (r^2) of UNL indicated that 66% variation in SHE is explained by the independent variable Total Debt, where as in the case of BNTL 2% of the variation in the SHE is explained by Total Debt.

11) The correlation between EPS & Net Profit of UNL is 0.99 and it is 0.75 in BNTL, which shows highly positive relationship in both the company. Coefficient of determination (r^2) of UNL indicated that 98% variation in EPS is explained by the independent variable Net Profit, where as in the case of BNTL 56% of the variation in the EPS is explained by Net Profit.

Summary

This study is based upon the capital structure management of two selected manufacturing companies of Nepal. It covers the period of seven years from 2003/04 to 2009/10. It included the data of two manufacturing companies listed with Nepal Stock Exchange. (NEPSE)

The brief introduction of this study has been already presented in the first chapter. In the second chapter the available literature about the capital structure management has been reviewed. Research methodology has explained in the third chapter. And the available data have been presented and analyzed in the fourth chapter. This is the last chapter of this study. This chapter summarizes the whole study. The main objective of the study is to draw the major findings and conclusions and forwards the recommendation for the better capital structure management of Nepalese manufacturing companies.

The capital structure has many relevant dimensions. The financing mix is one of them. Other dimensions involve the investment decisions of the firm and the optimal use of leverage, within the constraints imposed by the internal and external environmental conditions. The conceptual framework, different view of different writers, books and journals and articles has been dealt in the Review of literature section. As per the objective of this study, it tries to analyze the relationship between debt and shareholders' equity of manufacturing companies to provide suggestion on the basis of findings. To fulfill this purpose, the study follows the analytical and descriptive research design.

Research methodology is studied in the third chapter. It has included the research design. It presents nature and sources of data, data collection and processing techniques and financial tools used.

The profit margin of the companies does not show a satisfactory picture during the study period. The profit margin for UNL is higher then the BNTL. Earning per share for UNL is the highest. The ROE for UNL is highest than for another. The average ROA is highest for the UNL among the selected companies for study. The overall capitalization rate of UNL is higher among the companies. Cost of equity capitalization is also higher on an average for UNL among the selected manufacturing companies listed with NEPSE.

Conclusion

The average DOL, for UNL is 14.76 and for BNTL is -1.84. Among the same type of manufacturing industries, there is a vast difference in the DOL. UNL has a very high degree of operating leverage which is also harmful for the good health of the company. When the company has high degree of operating leverage, a small change is sales makes comparatively a high change in EBIT. The average DFL for UNL is 1.11 and for BNTL is -0.46. None of the companies show consistency in the DFL. BNTL has very low DFL, which is not a good sign; therefore companies should concentrate on restructuring their structure of capital. There is no LTD in the capital structure of UNL and BNTL during the research period, which means that the TD is composed of short-term loans, which is in a variable trend.

The average ratio of shareholders equity to total asset for UNL is 211.14 which show that on an average the input of equity for the assets is 211.14%. The average ratio of shareholders equity and total assets for BNTL for the complete study period is 67.21%. The overall analysis and calculation indicate that the assets financed mainly from the equity capital. Among the selected companies, only UNL has a good proportion of owners and outsiders fund for financing the assets. The interest coverage ratio for UNL during the study period is fluctuating with the average of 211.14 times. BNTL is not using the long-term debt in its capital structure at all and the amount of interest is also comparatively on lower side among the selected companies for the study.

The average interest coverage ratio is approximately 300.18 times. The above result shows that the capital structure of the company is not fixed. The lower amount of interest means the use of lower amount of debt capital in the capital structure of the firm and use of high amount of equity capital. In such circumstance, the company should understand that the high percentage of equity capital means the high tax payment to the government. It should try to increase its sales volume and minimize costs to enhance profitability to sustain in the competitive world. The average profit margin ratio is 9.67% for UNL. The sales volume of UNL is increasing except for the F.Y. 2003/04 and 2004/05, the management needs to pay attention in this respect. The situation of the UNL is far better among the selected companies for research on this count. However, the company despite increasing sales volume, the profit is not in an increasing order. The profit margin ratio for BNTL is 5.71% on an average.

The net profit is also increasing but the profit margin ratio is fluctuating. The increase in profit is not as much as of increase in sales, which is the reason of fluctuating ratio. The fluctuating situation of the company tells us about the inefficiency in running the business. The overall calculation shows that the net profit is fluctuating and the profit margin ratio is also decreasing whereas the sales on increasing. This indicates the company should make such policy to earn high amount of profit from the sales revenue by increasing operating efficiency. Earning per share for UNL seems to be higher than that of BNTL. So the investors can be attracted by the proposal of UNL. ROE for UNL is higher than of another. The investors of the UNL are getting more returns from their investments. The average ROA is highest for the UNL indicating the good production power of assets. From the calculation of overall capitalization rate, we can see that the UNL has the highest average value of K_o among all the companies.

Recommendations

- Sound capital structure management ensures that the company success and it is also indicated that the overall financing condition. The concept of capital structure has not received much attention in the Nepalese manufacturing companies while designing the capital structure. Based on the major findings of the study of the selected manufacturing companies listed in NEPSE, the following recommendations are presented in order to facilitate investors, businessmen, planners, policymakers, researchers and other concerned parties.

- It is suggested that and UNL should increase the equity proportion in financing its assets to be in a safe mode against liquidation. Thus manufacturing companies should maintain liquidity standard to compensate the short-term risk.
- The UNL and BNTL should try to access long-term source of debt, which will belles costly for them rather than relying heavily in short-term loans. Both the companies should try to streamline their sales.
- As per the increase in sales the profit for UNL is not correspondingly increasing. From the sales revenue, the UNL should make policy to earn high amount of profit by increasing operating efficiency.
- Due to the higher operating cost of production some of the Nepalese manufacturing companies are incurring loss. The management should give emphasis towards the minimization of administrative and operating expenses.
- The unskilled manpower, over-staffing, unsystematic purchase of raw materials, unnecessary expenses, misuse of facilities, heavy expenses on overhead etc are the major causes for high operating cost. These causes should be eradicated by the management of the company.