CHAPTER – I

INTRODUCTION

1.1 General Background

The theory of the capital structure is an important reference theory in enterprise's financing policy. The capital structure referred to enterprise includes mixture of debt and equity financing. Whether or not an optimal capital structure exists is one of the most important and complex issues in cooperate finance.

The modern theory of the capital structure originated from the path breaking contribution of Modigliani and Miller in 1958, under the perfect capital market assumption that if there is no bankrupt cost and capital markets are frictionless, if without taxes enterprises should be 100% of the debt. But this seems to be unreasonable in, the firm's value is independent with the structure of the capital. This is known as MM Proposition. In 1963, under considering the corporate taxes, Modigliani and Miller modified the conclusion to recognize tax shield. Because debt can reduce the tax to pay, so the best capital structure of the real world.

Jensen and Meckling (1976) introduce the concept of agency costs and investigate the nature of the agency costs generated by the existence of debt and outside equity. When considering corporation tax, bankrupt costs and agency costs at the same time, trade-off theory can be introduced to derive the existence of the optimum capital structure. Leland (1994) extends the results of Merton (1974) and Black and Cox (1976) to include taxes, bankruptcy costs to derive the optimal capital structure. Deangelo and Masulis(1980) argue that the existence of non-

debt corporate tax shields such as depreciation deductions is sufficient to overturn the leverage irrelevancy theorem.

Hovakimian, Opler, and Titman (2001) tested the hypothesis that firms tend to a target ratio when they either raise new capital or retire or repurchase existing capital. They found firms should use relatively more debt to finance assets in place and relatively more equity to finance growth opportunities

Establishment and operation of industries need finance. The success and failure of Business depends manly upon the ability of management to make right financial decisions. Capital structure decision is one of the most complex area of financial decision making due to it's interrelationship with other financial decision variable. In order to achieve the firm's goal of owner's wealth maximization. The financial manager must be able to assess the firm's capital structure and understand its relationship of risk, return and value. For the optimal capital structure, the analysis of risk and return on various leverage positions is essential. The risk of bankruptcy depends to an important extent on the operating risk or business risk and return on equity depends on operating efficiency. Thus, the optimal debt/equity mix depends on the nature of the business and therefore on the nature of investment that the company makes. But the capital structure decision in addition these variables is influenced by several other variables viz. nature of the company capital market situation, interest of the management and investors to control, liquidity position and operating efficiency of the company, company act and regulation etc. if a judicious decision of capital structure is made taking consideration various factor it will be a thing to maximize the value of the company. Obviously, there are various source of capital which differs in nature and cost associated with them. The successes of any business also

largely depend upon the capital structure. It is simply the relationship between various long term forms of the financing such as debenture preference share capital and equity share capital. Financing the firm's asset is a very crucial problem in every business and as a general rule there should be a proper mix of debt and equity capital in financing the firm's assets. Though the capital structure cannot affect the total earning of the firms, it generally affects the earning available to equity share holders. In managing the value of shareholder wealth. A balanced capital structure is the prerequisite for successful business organization but it is lacking in almost all companies in Nepal. The capital structure of Nepalese company is of diverse nature, as no company seems to have followed a particular capital structure policy. Some of the companies' are using only equity capital and some are using both debt and equity irrespective of maximization of the firm.

1.2 Introduction of Dabur Nepal Pvt. Ltd.

Dabur Nepal Pvt. Ltd. is a first manufacturing base overseas for Dabur Nepal is the third largest and most modern manufacturing base for Dabur group. DNPL is an Indian Joint Venture Company Promoted by Dabur Indian Pvt. Ltd. It was established in the year 1989 and began its commercial operation the year 1993. The authorized capital of the company is Rs.140 millions. Dabur Indian has 80% share of the company where as 20% share is with domestic investors. The company produces fast moving consumer goods and herbal health care products. The company is currently employing 340 employees in which around 290 employees are Nepali. Dabur came into Nepal Planning a new business, with targeted local sales of Rs.50 million per annum. After experiencing a tremendous increase in business volume, the company is new expanding It's operation into newer field and forging alliances with a number of

organization both local as well as foreign and investing generally in producing packing material for its product besides expanding production of It's original line of herbal and non herbal products. The reason, Unlimited scope for the business of herbal product in Nepal. From the internal business of 50 million p.a. targeted from local sales the turnover of the company rose tremendously over the year because of huge exports to India. As results the companies how contribute 12% in Nepal's total export. Now Dabur Nepal is planning to start exporting direct to third countries. In order to give life to it's plan of direct exports to third countries, DNPL has begun expanding and increasing its production capacity on it's existing range of products. At present Dabur Nepal is using about 1200 MT per year of locally collected raw material that includes Sunthi, Jomar seeds, Pipla, Taxus accata, menthe etc. within three to four years DNPL plans to increase the locally collected raw materials consumption to around 2000 MT per year. However, DNPL does not process and the raw materials into finished products. In Taxus Baccata leaves, Dabur Nepal processes it up to third stage and exports an extracts to it's consumer for future processing .Similarly, Dabur Nepal doesn't wholly produce chyanwanprash the major ingredient in chawanprash is not available in sufficient quality in Nepal.

1.3 Statement of the Problem

The effect of capital structure on risk and return is controversy; conflicting option has been expressed on this issue. In fact this issue is one of the most continuous areas in the theory of finance and perhaps more theoretical and empirical works has been done on this subject then on any others (Panday, 1992:47). Traditional corporate finance models suggested that firms choose optional capital structure by trading of various taxes and incentive benefits of debt financing against financial

distress cost. In other words the risk and return is the function of capital structure (Solomon, 1969:42). Therefore studies devoted to capital structure have been so important in literature of finance. Given that a firm has a certain structure of assets which offers net operating earnings of given size and quality and given a certain structure rates in the capital markets, is there some specific degree of financial leverage at which the market value of firm security will be higher cost of capital will be lower than the other degree of leverage. Capital structure has been long recognized as an unresolved economic problem which requires rational solution if the prevailing economic model of corporate is to continue. The controversy centers on whether or not capital structure matters. Due the complex nature of this problems capital structure has been a subject of considerable study particularly since the emergency of classical work. (Modigliani and Miller 1958:247- 278). They hold the view that risk and return is not affected by capital structure. Against the MM's hypothesis traditionalists argue that capital structure decision affected risk and return. There are many empirical works regarding the MM views and traditional views some of the rejected the MM hypothesis while some of them supported the MM hypothesis. The study is especially concerned with examining the following position.

- What is impact on risk and return by making capital capitals structures decision?
- It fluctuating the profit margin due to the cause of change in its capital structure?
- What are the relationship among leverage size of capital employed, total assets and earning variability of DNPL?
- How far Dabur Nepal Private Limited been able to maintain appropriate capital structure?

1.4 Objectives of the Study

The basic objectives of the study is to assess the capital structure decision of Dabur Nepal Private Limited and its impact on risk and return on the basis of selected financial tools. The other specific objectives of the study are as follows:

1. To analyze the cost of capital of selected organization.

2. To study the profitability position of sample organization.

3. To analyze the debt servicing capacity of DNPL

4. To examine the relationship between EAT and Total debt, debt equity ratio and ROE and debt ratio and ROE.

1.5 Focus of the Study

In most of the Nepalese companies, there is not the existence of debt in their capital structure. Only equity capital is the source of financing. While in some cases the proportion of debt is very high, this creates the excess burden to the firm. Most of companies have debt capital relatively higher than equity capital. Consequently, most of them are operating at losses. Hence it is clear that Nepalese companies do not take capital structure decision seriously. So this study is concerned with the analysis of the capital structure of Dabur Nepal pvt.ltd . And its impact on risk and return. DNPL is selected for the study because it is one of the large-scale threads producing industry in Nepal It has created in a large number of job opportunities. DNPL has created employment opportunities but it has not played a vital role for the economic development of the country. There may be many causes behind it. The causes may be external or internal. The causes included by the external and internal environment are

Table 1.1

Factor may affecting the performance of DNPL

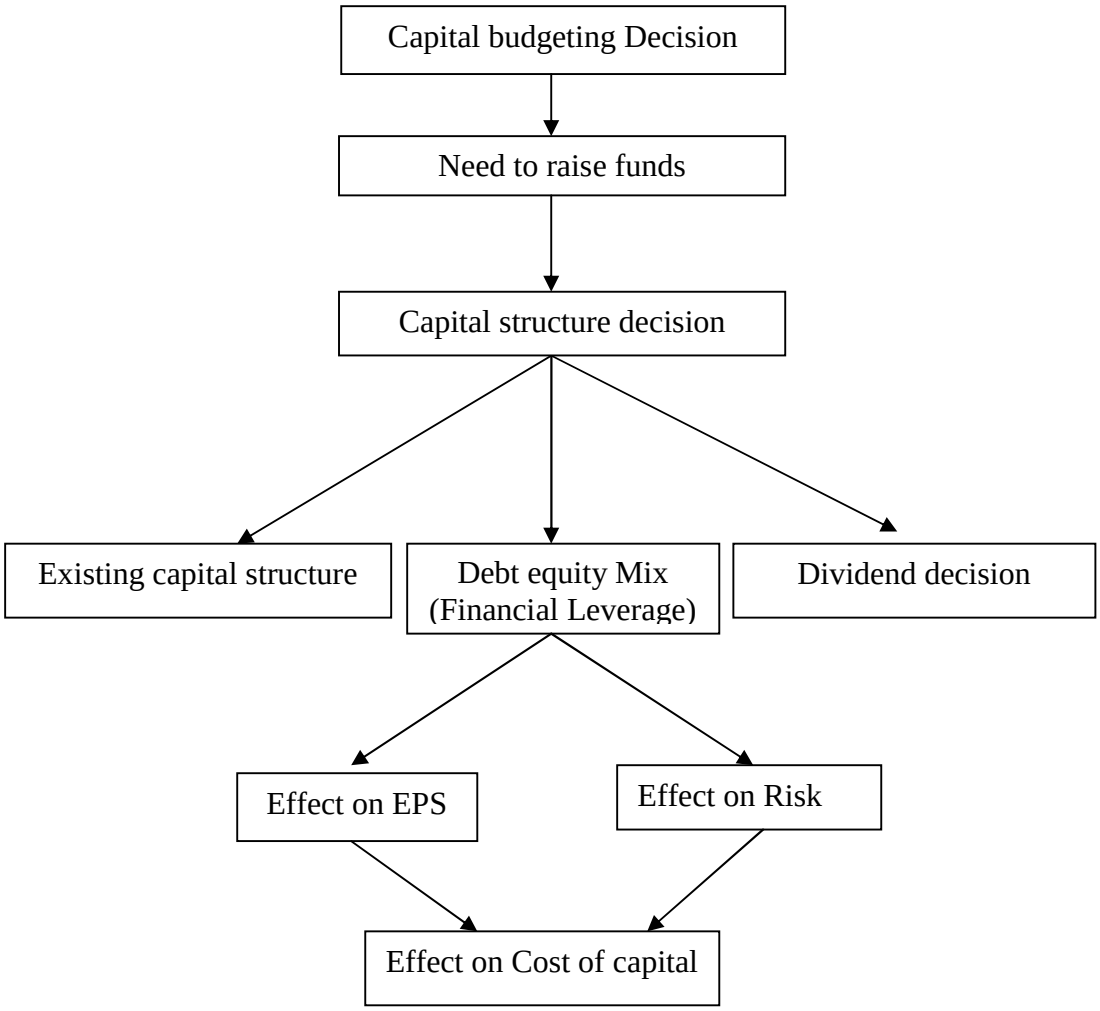
External Environment	Internal Environment
I, Not well established government II, Strike III ,Political parties IV, Not sufficient employee treaning agency V, Socio-culture	I, Policies, Strategies II, Organizational culture III, Organizational Structure IV, Capital Structure

The table 1.1 shows the causes due to which DNPL may not have played a vital role for the economic development of the country. Among them one of the main causes may be the inadequate structure of DNPL. The study has been performed to highlight the current capital structure practices of DNP

1.6 Significance of the Study

The capital structure decision is a significant managerial decision. It influences the shareholders risk and return. Consequently the market value of the share is affected by capital structure decision. The company has to plan it's capital structure initially at the time of it's promotion and subsequently whenever funds have to be raised to finance it's projects. It is also important for concerned company, investors and researcher. The process of capital structure decision making is known below:

The capital structure decision



Source: IM Pandey, Financial Management Vikash Publishing House (Pvt.) Ltd. New Delhi, 1987 Edition Page 675.

1.7 Limitations of the Study

Limitation exists everywhere and the study is also not an exception. The data problem in actual in Nepal, in order to make a study on Capital structure more fruitful, it is essential that data should be of frequent time intervals but, here such type of frequent data could not be obtained.

Therefore, due to time constraint and area of study covered by this research, it has certain limitations. These are as follows:

a. This study is only done for the prospective study of capital structure of DNPL.
b. This study has covered only secondary data.
c. This study have covered only a period of 5 years from fiscal year 2006 to 2010 and processed for drawing conclusion.
d. Most of the data are collected from financial statements. Therefore, the accuracy of the research work slowly depends on the data provided by the concerned company.
e. This study has been conducted to fulfill the requirements of the MBS program of T.U. for the prescribed time not for generalization purpose.

1.8 Scheme of the Study

This thesis is organized into five major chapters.

Chapter – I

This chapter is introductory and organized as background, focus of the study, statement of the problem, objective of the study, significance of the study, limitation of the study and organization of the study.

Chapter – II

The second chapter consists the available literature review. It includes the review of books, review of related journals and thesis. The review of

literature conducted in this chapter provide frame with help of which this study has been accomplished.

Chapter – III

This chapter is about the research methodology. It includes research design, nature and sources of data, population and sample and method of analysis. Method of analysis includes the tools applied to analyze and interprets the data.

Chapter – IV

This chapter is the major part of the study. In this chapter, the efforts has been made to analyze the capital structure decision and its impact on risk and return of DNPL. This chapter consists of presentation and analysis of data by using different financial and statistical tools. Major findings are also included by this chapter in the last.

Chapter – V

This chapter is the last chapter and includes the summary, conclusion and recommendation of the study.

Bibliography, appendix and other support documents have also been incorporated of the study.

CHAPTER – II

REVIEW OF LITERATURE

The purpose of reviewing the literature is to develop some expertise in one's area, to see what new contributions can be made, and to receive some ideas for developing a research design. This chapter broadly discussed about conceptual frame work of capital structure and related studies.

2.1 Conceptual Framework of Capital Structure

Capital structure is the combination of the long term sources of funding i.e. preferred stock common stock that are used to finance the firm. Similarly, capital structure is the mix of long term debt and equity maintained by the firm. Optimum capital structure can be defined as the mixed of debt and equity which will maximize the market value of a company. Theoretically the financial manager should plan an optimum capital structure for his company the optimum capital structure is obtained when the market value per share is maximum or the avenge cost of capital is minimum. The value of the firm will be maximized or the cost will be minimized when the marginal real cost of each source of founds is the same. The optimal capital structure is justified by analyzing the solvency of the company. The long term solvency is measured by various capital structure ratios. The capital structure ratios indicate whether the firm has resorted to an optimal financing mix or it is highly or lowly levered. This section is devoted to discuss briefly about the theoretical concept regarding the theories of capital structure and financial leverage.

2.2 *T*ypes of Capital

2.2.1 Common Stock

Common stock holders of a corporation are it's residual owners, their claim to income and assets comes after creditors and preferred stock holder's have been paid in full. As a result, a stock holder's return on investment is less certain than the return to leader or to a preferred stock holder. On the others hand, the share of a common stock can be authorized either with or without par value. The par value of a stock is merely a stated figure in the corporate chapter and is of little economic significance. A company should not issue stock at a price less than par value because stockholders who brought stock for less than par value would be liable to creditors for the difference between below par prices they paid and the par value (Horne: 1997:560). The equity share capital is the ownership capital does not carry any special or preferential rights in the payment of annual dividend or repayment of capital. The rate of dividend on such capital is not fixed. Dividend on equity capital is paid out of the residual profits left after paying interest on debenture and preference share divided. Similarly, equity shareholders are paid at the time of winding up of the company only after all the prior claims have been settled. Therefore, equity shareholders are the real risk bearer. But they share in the increasing profit of the company. They also enjoy voting rights in the management and control of the company.

2.2.2 Preferred Stock

Preference share capital carries certain special rights or priority rights. Firstly, dividend at a fixed rate payable on these shares before any

dividend is paid on equity shares. Secondly, at the time of winding up of the company, capital is repaid to preference shareholders prior to the return of equity capital.

2.2.3 Debentures

Debentures are certificates issued by a company acknowledging debt a specified amount to the person named in it. Debenture includes debenture stocks, bonds, and any other securities of company representing a loan amount. Therefore a periodic payment of interest at the specified rate is to be paid on debenture. Apart from the interest the principle amount is also refunded to the holders, which is known as redemption of debenture. Thus, the capital with fixed interest charge is called debt and the payment of interest as well as principle on debt is an obligation of the firm that must be paid before any remaining profit after taxes is available for shareholders. (Copeland and Weston. 1990:567). The use of debt or leverage at once provides the potential of increasing the shareholders earning as well as creating the risk of loss of them. Therefore, debt is the two edged sword.

2.3 Capital Structure Theories

The use of debt as a source of capital or leverage affects the cost of capital and the value of the firm. The optimum capital structure would be obtained at that combination of debt and equity that maximize the total value of the firmer or minimize the weighted average cost of capital. However, all scholars do not accept the existence of the optimum capital structure. There is two extreme views i.e. Net income approach and net operating income approach and a middle position i.e. traditional approach. Another important theory in capital structure is propounded by Modigliani and miller, which called M-M approach.

Definition

In our analysis of capital structure theories following basic definition are used:

S = Market value of ordinary shares

B = Market value of debt/bond

V = Total Market value of the firm (S+B)

E = Accepted net operating income (NOI) i.e. Earnings before interest and taxes (EBTI).

F = Annual Interest charge i.e. Kb. B.

E = Earnings available to common stock holders (EACS)

ke = equity capital rate

ki = debt capitalization rate

ko = overall capitalization rate

The capitalization rates or cost associates with the different earning streams and the value of different securities can define as follows

Debt:

Debts capitalization rate (ki) = F/B ---------- (I)

Market value of debt (B) = F/K ---------- (II)

Equity:

Equity Capitalization rate (ke) = E/S ---------- (III)

Or

(ke) = EPS/PO ---------- (IV)

Market value of ordinary shares

I.e. Equity (S) = E/ke ---------- (V)

Weighted average cost of capital

Overall capitalization rate Ko = O/V ---------- (VI)

The overall capitalization rate is weighted average of the cost of equity and cost of debt. Thus, expressed as:

$$Ko = Ki\frac{B}{B+S} + Ke\frac{S}{B+S}$$

$$Ko = Ki\frac{B}{V} + Ke\frac{S}{V} \text{ ---------- (VII)}$$

2.3.1 Capital Structure Matters: The Net Income Approach

Net income approach suggests that there exist optimum capital structure. Its main hypothesis is that as leverage increase cost of capital decrease and total value of the firm increases. In other words, affirms can lower the overall cost of capital by increasing the proportion of debt in the capital structure.

This approach is propounded by David Durand in 1952. This theory assumes that the cost of debt and cost of equity remain constant as they change in the firm's capital structure. A change in the capital structure will lead to a corresponding change in the overall cost of capital as well as the total value of the firm. As the firms add cheaper debt to its capital

structure, the overall cost of capital declines which ultimately increases the value of the firm. The calculation is simplified by following table:

'O' = Net operating income

'F' = Total Interest (ki, B)

'E' = Earnings available to commons share holders (O-F)

'ke' = Equity capitalization rate

'S' = Total market value of equity (E/ke)

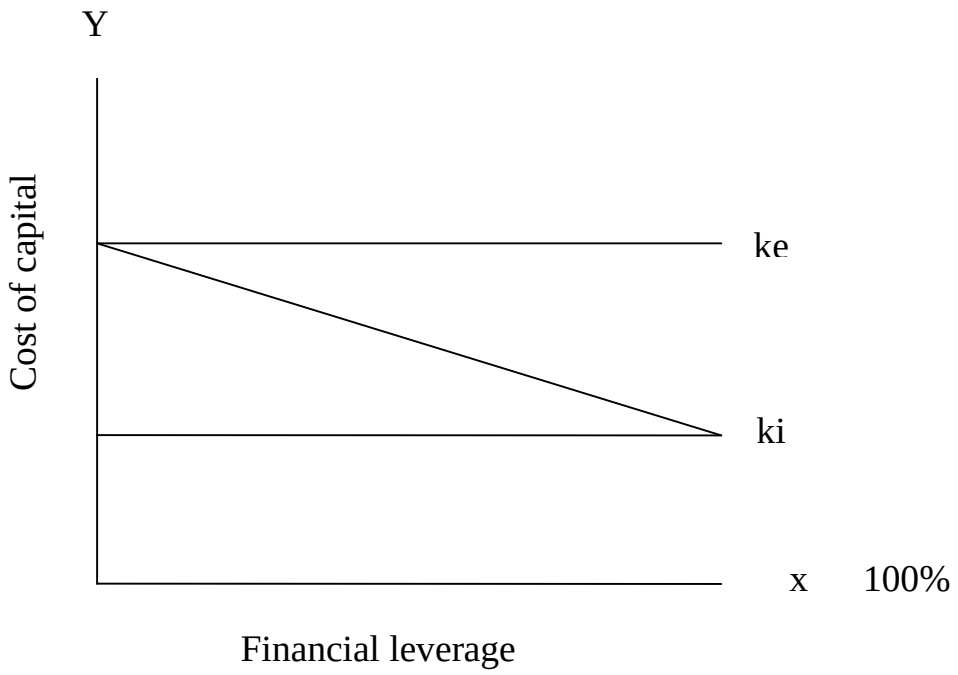
'B' = Total market value of debt

'V' = Total value of firm (S+B)

'Ko' = Overall capitalization (O/V)

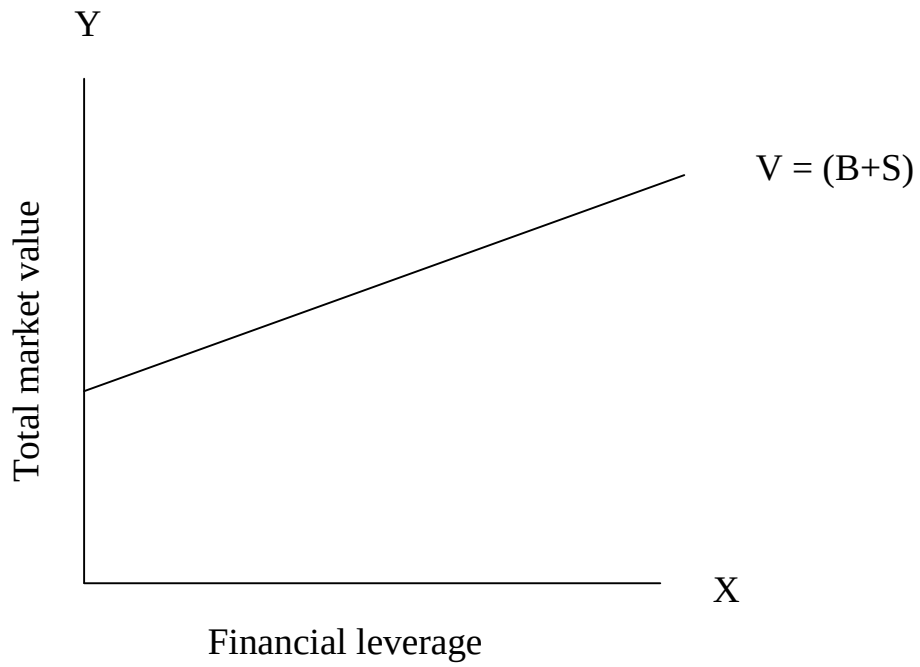
According to net income approach, both the cost of debt (ki) and the cost of equity capital (ke) are assumed to be independent of leverage: that is they are constant regardless of how much debt the firm uses. If debt is cheaper than equity, and if ki and ke are constant then the average cost of capital (ko) must decline as the firm uses more and more of the cheaper debt. Further this cost of the capital decline causes increase in the value of the firm. Graphically, the effect of leverage on the firm of capital and the effect of leverage on the total market value of the firm is shown below.

Figure 2.1: The effect of leverage on the cost capital



The net income approach ke and ki are assumed not to change with leverage. As the proportion of debt is increased in the capital structure, being loss costly, it causes weighted average cost of capital to decrease. The optimum capital structure would occur at the point where the value of the firm is increase and overall cost of capital is decree

Figure 2.2: The effect of leverage on the total market value of the firm



The net income approach's hypothesis is that as leverage increase, cost of capital decreases and total value of the firm increases. In other words, it can be said that the firm can increase its value or lower the overall cost of capital by increasing the proportion of debt in the capital structure.

2.3.2 Capital structure does not matter: Net operating income approach

Another approach to the valuation of the earning of a company is known as the net operating income approach. It suggests that there doesnot exit optimum capital structure. The main hypothesis of this approach is that the market value of the firm is not affected by the capital structure change. With this approach the overall capitalization rate O, as well as the cost of the debt funds ki, stays the same regardless of the financial

leverage employed. How ever the required return on equity, ke increases linearly with financial leverage measured as BIS (Horne, and John, 1997, P. 471)

'O' Not operating income

'Ko' Overall capitalization

'V' Total Value of the firm (O/ko)

'B' Market value of debt

'S' Market value of stock (V - B)

The earning available to common share holders is simply net operating income (O) minus interest payments.

I.e. E = O - Ki. B.

The implied require rate of return on equity is,

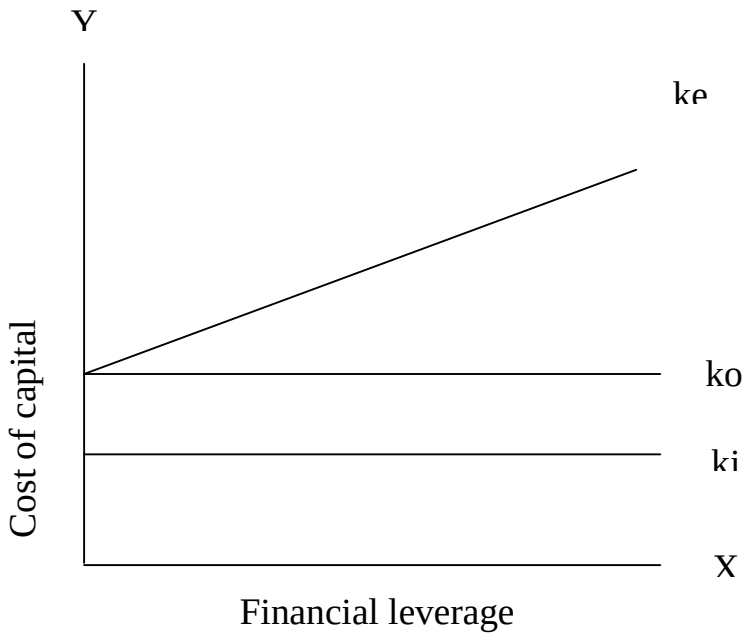
$$Ke = \frac{E}{S}$$

Alternatively, the implied required rate of return can be defined as follows:

ke = ko + (Ko-ki) B/S ---------- (VIII)

The equation indicates that, if ko and ki are constant, ke would be increased linearly with debt - equity ratio B/S. The effect of financial leverage on the value of the firm and cost of capital under NOI approach further illustrated graphically in following figures:

Figure 2.3: The effect of leverage on cost of capital (NOI approach)



Capital

Figure 2.3 shows that ko and ki are constant and ke increases with leverage continuously. As the average cost of capital, ko, is content this approach implies that there is not any unique capital structure. In other words this means that as the cost of capital is the same at all capital structures, every capital structure are optimum.

Figure 2.4: The effect of leverage on value of the firm

The figure 2.4 indicates that whatever will be the leverage, the value of the firm remains constant the change in ratio of the debt and equity does not effect at the total value of the firm.

2.3.3 Existence of optimum capital structure: The Traditional Approach

The preceding discussion show that the Net income approach and the Net operating income approach are two extremes in capital structure theory in regard the weighted average cost of capital and total value of the firm. The NI approach takes the position that use of debt in the capital structure will always affect the overall cost of capital and total valuation while the NOI Approach argues that capital structure is totally irrelevant. The traditional view is an intermediate approach which compromise between the Net income approach and the net operating income approach. The traditional approach to capital structure assumes that there is an optimum capital structure and the management can increase the total value of the firm through the judies use of financial leverage. This approach clearly implies that the cost of capital decreases within the reasonable limit of debt and the increase with leverage. Thus, an optimum capital structure exists and occurs when the cost of capital is minimum where the value of firm is maximum. Although investors raise the required rate of return on equity with increase in leverage, the increase in 'ke' does not entirely offset the benefit of using cheaper debt funds. The statement that debt funds are chapter then equity funds curries the clear implication that the cost of debt plus increased cost of equity, together on a weighted basis will be less than the cost of equity which existed on equity before debt financing (Alexander, 1963 P.11)

According to the traditional position, the manner in which they overall cost of capital reacts to changes in capital structures can be divided in to the three stages.

1. **First stage increasing value**

In the first stage, the equity capitalization rate (ke) rises only after a certain level of leverage and not before or rises slightly with debt. so that the use of debt does not necessarily increase the 'ke' and this slight increase in ke may not be so high as to neutralize the beuefit of using cheaper fund in other word, the advantage arising out of the use of debt is so large that even after allowing for higher ke, the benefit of use of the cheaper sources of found are still available. As result, the value of the firm V, increases while overall cost of capital falls with increasing leverage.

Under the assumption that ke, remain constant within the acceptable limit of debt, the value of the firm will be:

$$V = S + B$$

$$= \frac{O - Ki.B}{Ke} + \frac{Ki.B}{Ki}$$

$$= \frac{O - Ki.B}{Ki} + B$$

$$= \frac{O}{Ke} + \frac{(Ke - Ki)B}{Ke} \quad \text{---------- (IX)}$$

Thus, So long as Ke and Ki are constant, the value of the firm (V) increase at a constant rate

2. **Second Stage: Optimum Value**

Once the firm reached a certain degree of leverage, increase in leverage have a negligible effect on the value, or the cost capital of the firm. This is so because the increase in the cost of equity due to the added financial risk exactly offsets the advantage of low cost debt. Thus, within the rank or at the specific point. The value of the firm will be maximum or cost of capital will be minimum (Pandey, 1995 P. 684).

3. **Third Stage: Declining Value**

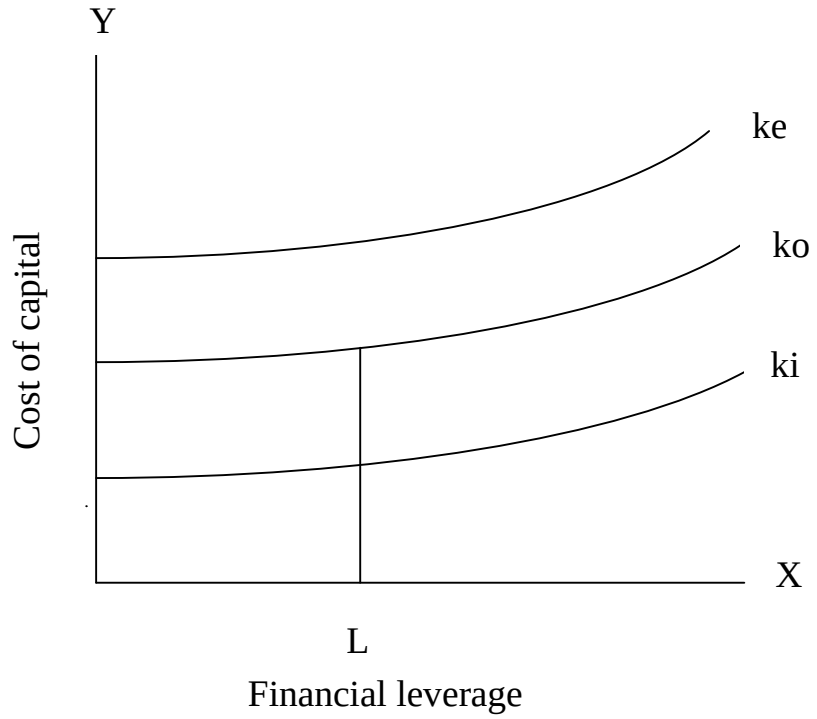
If the amount of debt is increased further beyond of the acceptable limit, then the firm would become very risky to the creditors who would like to be compensates by a higher return such that ki will rise. The use of debt beyond a certain point will. Therefore have effect of raising the weighted average cost of capital and conversely the total value of the firm.

Overall Effect

Thus, the overall effect of these three stage suggest that the cost of capital in the junction of leverage. Up to a point, the use of debt will favorably effect the value of firm, beyond the point, use of debt will adversely effect it. At the level of debt-equity ratio, the capital structure is an optimum capital structure. At the optimum capital structure, the marginal real cost of debt define to include both implicit and explicit will be equal to the real cost of equity. For the debt-equity ratio before that level the marginal real cost of debt would be less than that of equity capital, while beyond that level of leverage, the marginal real cost of debt would exceed that of equity. Thus, there would accord to traditional view, be an optimum capital structure (Khan and Jain 1990, P. 511).

The manner in which the overall cost of capital reacts to change in capital structure can be presented graphically as follow.

Figure: 2.5: The cost of capital behavior (Traditional View).



The figure 2.5 is represents the cost behavior of traditional view of capital structure. According to this view cost of equity ke assumed to rise at an increasing rate with leverage and cost of debt kd is rise only after significant debt or leverage has occurred. In beginning average cost of capital declines with leverage. After a certain point the increase in ke will more than offsets of the use of cheaper debt fund and ko begins to rise. Therefore the optimal capital structure is that point where ko is at minimum point as in above figure. The traditional approach considers that the cost of capital is not an independent phenomenon of capital structure. There is an optimal capital structure of the firm.

2.3.4 Irrelevance of Capital Structure: The Modigliani-Miller Approach

The Modigliani-Miller (M-M) hypothesis is identified with the net operating income approach. M-M argue that, in absence of taxes, a firm's market value and the cost of capital remains invariant to the capital structure changes (Pandey, 1995, P. 686). In their 1985 article, they provide analytically sound and logically consistent behavioral justification in favor of their hypothesis and reject any other capital structure theory as incorrect. This approach based on the following assumptions:

i. Perfect competitive market environment information relating to investment is freely accessible. No transaction cost investors are free to sell and bye the securities and they can borrow without any restriction. All investors are rational and no investor can influence the capital market.

ii. Originally MM hypothesis assumed the no tax world. But this assumption was put aside in 1963.

(Modigliani and Miller, American Economic Review, June 1996:433443)

Basic Proposition

There are three basic proposition of the M-M approach, but M-M hypothesis can be best explained in term of their proposition I and II.

Proposition I (Without Taxes).

M-M argues that, for firms, in the same risk class the total market value is independent of the debt-equity mix and is given by capitalizing the excepted net operating income by the rate appropriate to that risk class (Modigliani and miller, 1969, P. 226). This is then proposition I. In equation this can be expressed as follow.

Value of firm = Market value of equity + Market value of debt.

$$= \frac{Expected\ net\ operating\ income}{Expected\ overal\ capitalization\ rate}$$

I.e. V= S+B = O/Ko ---------- (XI)

Proposition I can be expressed in term of the firms overall capitalization rate ko which is the ratio of the net operating income (EBIT) to the market value of the securities. That is

$$KO = \frac{O}{S+B} = \frac{O}{V} \text{ ---------- (Xii)}$$

Ko, can also be expressed,

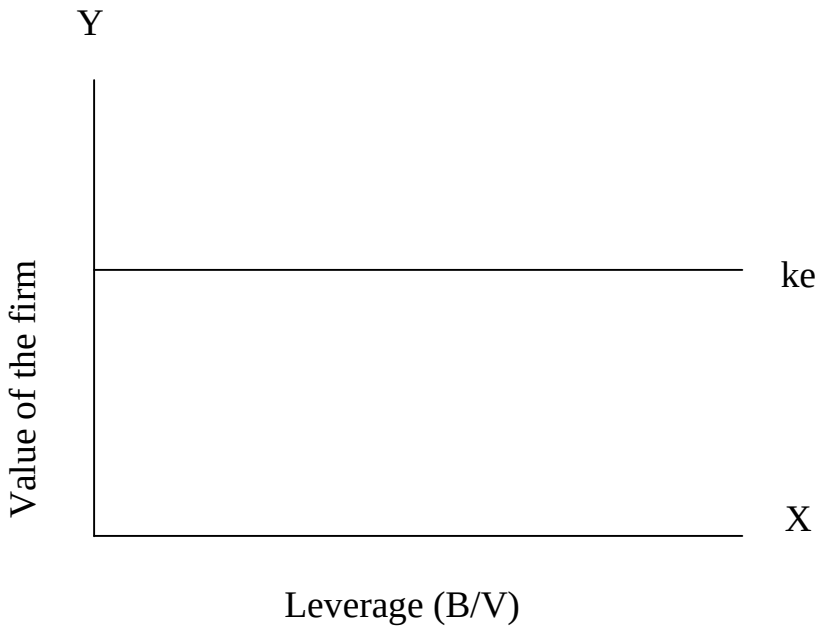
$$KO = Ke\frac{S}{S+B} + Ki\frac{S}{S+B}$$

$$= Ke\frac{S}{V} + Ki\frac{B}{V} - - - - - - (Xiii)$$

It means ko is the weighted average of the excepted rate of return of equity and debt capital of the firm. Since the cost of capital is defined as

the excepted net operating income divided by the total market value of the firm, and since M-M conclude that the total market value of the firm is unaffected the financing mix, it follows that the cost of capital is independent of the capital structure and is equal to the capitalization rate of a pure-equity stream of it's class (Pandey, 1995 P. 688). The cost of capital under M-M proposition I is shown in the following figure which clears the average cost of capital is constant and is not affected by leverage.

Figure: 2.6 Value of Firm (Under M-M proposition)



Arbitrage Process

The simple principle of proposition I is that two firms a like in every except capital structure must have the same total value, if not arbitrage will be possible, and its occurrence will cause the two firms to sell in the market at the same total value. MM future maintain that this situation cannot continue, for arbitrage will drive the total value of the two firms together. M-M argue that by investing in un-levered company, investor in levered company are able to obtain the same dollar return with no

increase in financial risk. Moreover theory is able to do so with smaller investment outlay (Modigliani and Miller 1990, 59-95).

Because investors would be better off with the investment requiring the lesser outlay, they would sell their share in levered company and buy shares in un-levered company. These arbitrage transactions would continue until leveret company share increased in price enough to make the total value of the two firms identical.

The action of number of investor undertaking similar arbitrage transaction will lead to drive up the price of un-levered company and increase its ke. This arbitrage process will continue until there is no further opportunity for reducing one's investment outlay and achieving the same dollar return. At this equilibrium, the total value of the firm must be same. As a result, their overall capitalization rate, ko also must be same. The principle involved is simply that investors are able to reconstitute their former positions by offsetting changes in corporate leverage with changes in personal leverage (Horne, P. 271). As a result investment opportunities available to them are not altered by change in the capital structure of the firm.

The proposition I state that the cost of equity raises proportionately with the increase in the financial leverage in order to compensate in the form of premium for bearing additional risk arising from the increased leverage (Pandey. 362-363) in other words it says that the cost of equity of levered firm (kei) equal to the cost of equity when un-levered (keu) plus a risk premium that depends upon the differences between keu and ki multiplied by the ratio of debt equity. It is as follows:

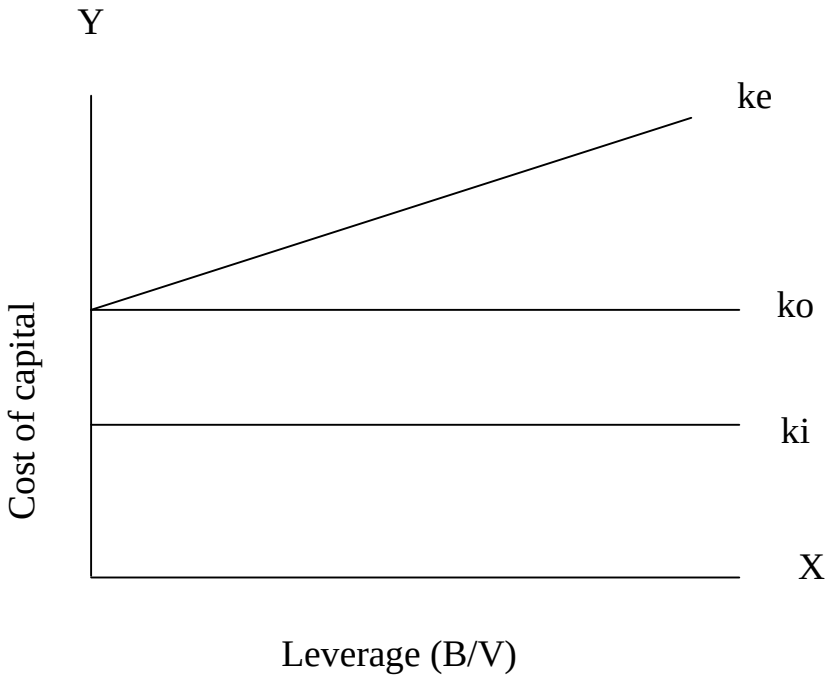
KeL = Keu + Risk premium

= keu + (keu-ki) B/S ---------- (xiv)

When company is un-levered ko=ke because company uses only equity funds hence equition (xiv) is also expressed as:

kel = ko + (ko-ki) B/S----------(xv)

Figure 2.7 cost of capital under the M-M Preposition I



The above figure indicates that higher the B/S ratio higher is the cost of equity ratio. It means the cost of equity; ke is a linear function of leverage, measured by market value of debt to equity, B/S. Thus, leverage will be result not only in more earning per share to shareholders but also increased cost of equity. The benefit of leverage is exactly taken off by the increased cost of equity, and consequently, the firms' market value will remain unaffected.

The crucial part of M-M hypothesis is that ko will not rise even if very excessive use of leverage is made. This conclusion could be be valid if the cost of borrowings, ki remains constant for any degree of leverage, but in practice ki increase with leverage beyond a certain acceptable or

reasonable level of debt. However M-M maintains that even if the cost of debt, ki is increasing, the weighted average cost of capital, will remain constant. They argue that when ki increase at a decreasing rate and may even turn down eventually. When ki increases with debt, ke will become less sensitive to further borrowing. The reason for this is that debt-holder in extreme situation on the firms's assets and bears some of the firms business risk. Since risk of shareholders is transferred to debt-holders ke declines.

2.3.5 Relevance of Capital Structure: The M-M Hypothesis under Corporate Taxes

With tax consideration, the theory process that the value of the firm increases will the inclusion of debt in the capital structure. The reason is that interest paid on debt deductible for tax purpose and it reduces the tax liabilities. This means that after tax net income increases by the amount of tax benefit resulting in an increase in the value of the firm by the same amount. In M-M article published in 1963, also they show that value of the firm will increase with debt due to the deducibility of interest charges for computation and the value of the levered firm will be higher then of the un levered firm (Modigliani and Miller, 1990, P. 433-443).

Proposition II (With Taxes)

As proposition I, the value of the firm is determined by capitalizing the net operating income (before tax) at a rate that appropriate to its risk class. When tax is considered the value is determined by capitalizing the net income after tax instead of net operating income (O).

i,e,

$$V = \frac{O(1-t)}{Ko} - \frac{NI}{Ko} \quad \text{---------} \quad (Xvi)$$

Thus the preposition I stream that the value of an un-leverage firm is the NI capitalized at the rate of appropriate to its risk claim, such as.

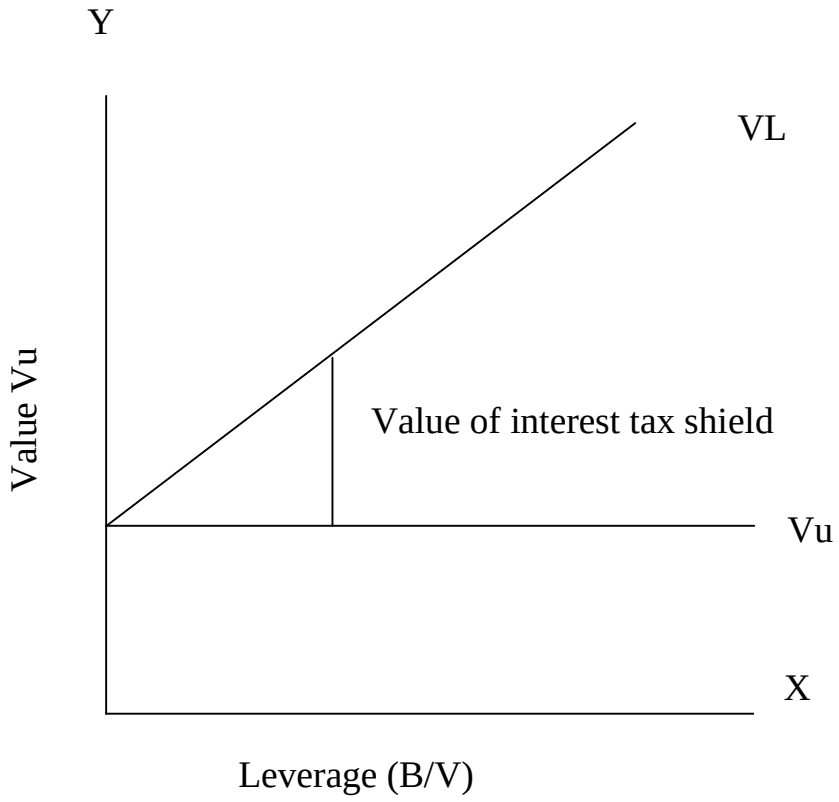
$$Vu = \frac{O(1-t)}{Kov} = \frac{O(1-t)}{Kev} = \frac{NI}{Ke} \text{ ---------- } (Xvii)$$

Because of the deductibility of interest on debt the value of levered firm (VL) increase by amount of tax saving. Hence, Vl equal to Vu plus tax saving. (Pradhan, P. 364).

VL=Vu+B.TC ---------- (xviii)

Thus, M-M proposition I with taxes indicates VL>Vu and suggested that a firms value rises continuously as moves from zero to hundred percent (0 to 100%) debt. This is clearly shown in following figure 2.8.

Figure 2.8: Value of levered firm.



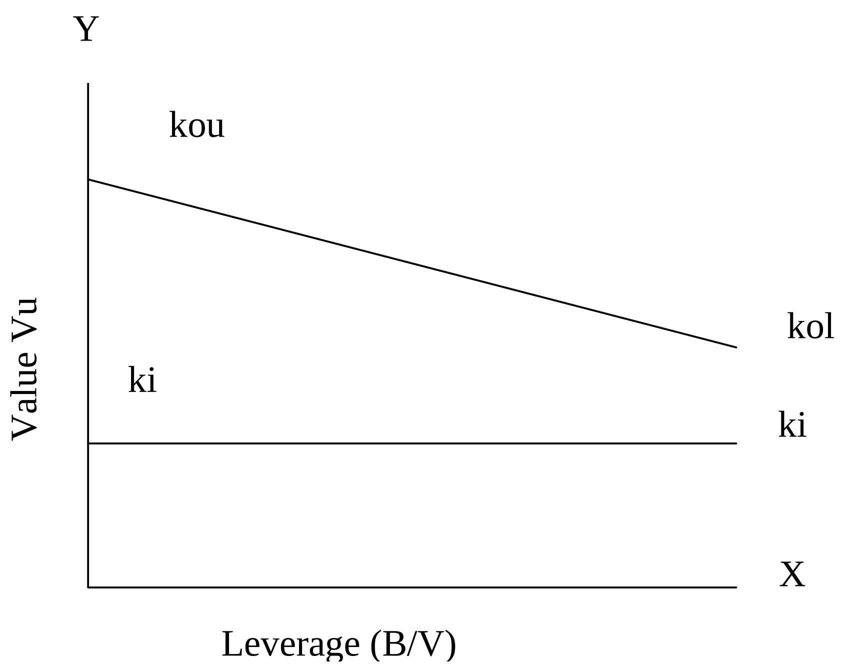
As M-M proposition II stress that the cost of equity of levered firm (KeL) rises with levered ratio to compensate for the additional levered risk while the cost of debt remains constant, because of the debt is assumed to be risk less. Accordingly, with tax consideration the cost of equity is calculated as follows:

Kel = keu + (keu-ki) (l-t) B/S--------------------------------- (xix)

The tax deductibility of interest on debt lower the cost of debt but still remains constant irrespective of debt equity ratio. Thus, this reduction in cost of debt as result of tax saving outweighs the increased cost of equity. Forcing the overall capitalization rate (Ko) decline with every unit additional debt financing. As result, weighted average cost of capital of the firm does not remain unchanged when there is a change in B/S ratio. This can be seen from the way of calculation of weighted average cost of capital (ko).

$$KoL = KeL\frac{S}{V} + Ki(1-t)\frac{B}{V} - - - - - - - - - - - - - - (\boldsymbol{XX})$$

Figure 2.9: Cost of capital of the levered from



The figure 2.9 indicates that as the cost of equity increase with the B/S ratio the overall capitalization rate decreases continuously unit it reaches to the level of cost of debt at 100% debt financing.

Thus, the M-M's 'tax corrected' view suggested that, because of the tax deducibility of interest charges a firm can increase it's value or lower it's cost of capital continuously with leverage. Thus the optimum capital structure is reached when the firm employs 100% debt. But the observed experience does not entirely support this view. In practice firms do not employ large amounts of debt not are lenders ready to lend beyond certain limit.

Thus, M-M suggests that firm would adopt a target debt ratio so as not to violate the limit of the debt level imposed by lenders.

2.4 Factors Affecting a Target Capital Structure

Capital structure is the composition of long-term source of found 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. Optimal capital is mix of debt and equity that maximize the value of the firm and earning per share and minimizes of overall cost of capital of the firm. While maintaining the target capital structure firms should consider many factors. These are important and may be difficult to measure. Some of these important factors, which affect the target capital structure, are as follows (Pandey, 1993:725)

2.4.1 Size of the Company

The size of the company is an important determinant of the sources of founds. For the large and well-known companies has relative flexibility in designing it's capital structure. It can obtain loans at easy term and sell common shares. Preference share and debenture to public. Because of the large size of issue, it's cost of distributing a security is less than that for a small company. The sources of capital for a small company are constrained by many factors. There are not many opportunities available to collect necessary found through capital market and even if they raised found, the cost on such capital will be very high in comparison to large corporation. Similarly, the collection of fund through bet for small company cost very high because lender will feel that it is very risky. Thus, size of the firm has an influence on the amount and the costs of funds.

2.4.2 Stability of Sales

A firm whose sales are relatively stable can safely taken on more debt and incu higher fixed changes the company with unstable sales. The firm with stable sales will have stable EPS and thus, can employ a high degree a leverage as they will not face difficulty in meeting the fixed commitments. This likely fluctuations in sales increase the business risk. A small change in EPS. As a result, the shareholders perceive a high degree of financial risk if the company employs debt.

2.4.3 Growth Rate

A rapidly growing firm tends to use somewhat more debt than slower growing companies. The growth firms may usually employ a high degree of leverage. Companies with declining sales would not employ debt or

preference share capital in their capital structure, as they would find difficulty in meeting their fixed obligation.

2.4.4 Operating Leverage

A firm with less operating leverage is better able to employ financial leverage because the interaction of operating and financial leverage determines the overall effect of declines in sales on operating income and net cash flows.

2.4.5 Taxes

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

2.4.6 Profitability

A firm with very high rates of return on investment uses relatively little debt.Although there is no theoretical justification for this fact on practical explanation is that very profitable firms such as IBM and kodak simply do not need debt financing. Their high rate of return enables them to do most of their financing with retained earning.

2.4.7 Market Conditions

Conditions in the stock and bond market undergo both loan and short run changes that can have an important bearing on the firms optimal capital structure. Therefore, low rated companies, which needed capital forced to go to the stock market or the short term debt market regardless of their target capital structures.

2.4.8 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 proper capital structure. Some management tends to be more conservative than others use less debt than the average firms in the industry

2.4.9 Control

The effect of debt versus stock on a management control position can influence capital structure. If management has voting control over the company and is not in a position to buy more stock debt may be a choice debt for new financing. On the other hand, management group that is not concerned about voting control many decide to use equity rather then debt. An excessive amount of debt can also cause bankruptcy which win mean a complete loss of control.

2.4.10 Assets of structure

Firms whose assets are suitable as security for loans tend to use debt rather having general purpose assets, which can be used by many business make a good collateral, where as special purpose assets do not thus real state companies are usually highly leverage where as companies involved in technological research employ less debt. These are the main factors affecting that target capital structure other factors like nature of the company, internal condition, financial flexibility flotation costs, capacity of raising funds, agency cost, cash flow ability, external risk assessment, etc. should also be considered while making capital structure decision.

2.5 Leverage

The term 'leverage' results from the use of fixed cost assets or fund to magnify returns to the firm's owners changes in leverage result in changes in level of return and associates risk. Generally, increase in leverage results in increase in return and risk, whereas decrease in leverage results in decrease return and risk. The amount of leverage in firm's capital structure is the mix of long-term debt and equity maintained by the firm. The three basic types of leverage can be defined with leverage to the firm's income statement. These are operating leverage, financial leverage and total leverage which are clearly labeled in following General income statement format:

Table 2.4

General Income Statement Format and Types of Leverage

Operating Leverage	Sales Revenue Less: Cost of goods sold	…….. ……..
	Gross profit Less: Operating expenses	…….. ……..
Financial Leverage	EBIT Less: Interest	…….. ……..
	Net profit before tax Less: Taxes	…….. ……..
	Net profit after tax Less: Preferred stock dividends	…….. ……..
	Earnings available to common Stockholders Earnings per share (EPS)	……..

From above table, it is clear that operating leverage is concerned with the relationship between the firm's sales revenue and it's operating interest and taxes or EBIT. While financial leverage is concerned with the relationship between the firm’s earnings before interest and tax (EBIT) and it's earnings per share of common stock. Our study is combined with only financial leverage.

2.5.1 Financial Leverage

Financial leverage result from the presence of fixed financial cost in the firms income stream. It can be defined as the potential use of fixed financial cost to magnify the effect of changes in earning before interest and taxes on the firm's earning per share. The two fixed financial cost normally found on the firm's income statement are:

- Interest of debt and

- Preferred stock dividend

These changes must be paid regardless of the amount of EBIT available to pay them. The effect of financial leverage is such that an increase in the firms EBIT result in a greater than proportional increase in the firm's earning per share while a decrease in the firm's EBIT result in a more than proportional decrease in EPS.

Measuring the degree of financial leverage (DFL)

The degree of financial leverage is the numerical measure of the firm's financial leverage. It can be computed in fashion similar to that used to measure the degree of operating leverage. It can be derived by using following formula.

$$D.F.L = \frac{EBIT}{EBT}$$

Whenever DFL is grater than 1, there is financial leverage.

2.6 Review of Related Studies

The objective of review of related studies is to gain knowledge about what the previous researchers have identified and recommended solving the excising problem in the related field of study. This part has been sub divided in three parts namely review of journals review of articles and review of related thesis.

2.6.1 Review of Journals

Different scholars different part of the world have carried out numerous theoretical as well as an empirical works. But leading theoretical and empirical works. But leading theoretical and empirical works have been engaged out from USA since the publication of M-M independent hypothesis.

The Modigliani and Miller Study

In the study done by Modigliani and Miller they used the previous work of 'Allen and Smith' in support of their independence hypothesis. In first part of the work M-M tested their proportion I, the cost of capital is irrelevant to the firm's capital structure by correlating after tax cost of capital with leverage. They found that the correlation co-efficient is statically insignificant and positive in sign. In the second part of their study they tested their proposition II the expected yield on common share is a linear function of debt to the equity ratio.

Modigliani and Miller the second study in correlation of the original hypothesis (1963) concluded that the leverage has a tax saving and value of the firms can be maximized when the leverage measured by DL=VL=1. Thus in other words cost of capital can be minimized when equity financial is zero.

They tested this tax saving of leverage in 1963 A.D. with 63 samples of the large electric utilities of USA for the years 1954, 1956 and 1957 A.D. In this test they concluded that the leverage is significant factors because of the tax advantage involved in it.

Roy L. Somberly professor California state university, has conducted a research and published an article "Re-thinking capital structure" in the field of capital structure management. According to him the prevailing theory of capital structure, which emphasize on optimum capital structure is incomplete. Because he urge researchers in financial management have not found the optimum capital structure. Use of leverage is one way to improve the performance is some circumstance but it fails to conceder the complexities of competitive environment or long term survival need of the organization. He examined the economic performance of over 700 firms across 31 industries. He ranked in ordering of industries based on the degree of environmental dynamism. He found that the firms in high level of dynamism were more successful if they have low level of debt. In other words debt is negatively related to profit in these industries. The result of this study seen a serous challenge to the traditional capital structure literature.

Horn (1999) has also presented controversial decision about capital structure. According to this decision, financial signalizing occurs when capital structure changes convey information to security holders. It

assume symmetric information between management and stockholders. Management behavior results in debt issue being regarded as good new by investors and stock issues as bad news.

2.6.2 Review of Articles

Shrestha (1999) one his article "*Focus on capital structure*" (selected and listed public companies) found that in Nepalese public enterprise the definition of capital structure is not a problem but what matters is the problem of putting the definition of capital structure into practice. As for instance public enterprises as well as listed public limited companies have higher debt-equity Mix. As a result their liabilities have increased together with higher fix charges due to failure to utilize borrowed capital properly. Thus, the market circle investors often express dissatisfaction for not getting excepted return as per commitment made by the listed companies in the prospectus to the investing public. This is even very serious in government owned companies.

The author clearly suggested that the capital structure of both selected public enterprises and listed companies have high proportion of debt mix with equity. Most of them have to face high interest burden on one side and increasing accumulated losses on the other hand. She further suggested to the government that it is important to monitor the use of debt and it's impact on the overall earning of enterprises.

Pandey (1998), the Professor of Indian Institute of Management, Ahmedabad has also studies about capital structure. According to him, under favourable economic conditions the earning per share increase with leverage. But leverage also increases also the financial risk of the shareholders. As a result, it cannot be stated definitely whether or not the value of the firm will increase with leverage. Further he has said if the

value of firm can be affected by capital structure which maximizes the market value of the firm. Pandey further added there exists conflicting theories pm the relationship between capital structure and the value of the firm. On the context of capital structure, Pandey has argued that the capital structure decision of the firm can be characterized as a choice of that combination of debt and equity. Which maximize the market value of the firm? He has supported to traditional approach the cost of equity declines with leverage at acceptable range of debt and then starts of increase with increasing debt in capital.

Titman (1984) demonstrates the idea of indirect bankruptcy costs. He argues that stakeholders not represented at the bankruptcy bargaining table, such as customers, can suffer material costs resulting from the bankruptcy. Leland (1994) demonstrates a standard trade-off model. At the optimal capital structure, marginal bankruptcy costs associated with firm's debt are equated with marginal tax benefits. The static tradeoff theory was the original retort to the theory of capital structure relevance. Modigliani and Miller (1963) argue that, when there are corporate taxes then interest payments are tax deductible, 100% debt financing is optimal. In this framework, firms target an optimal capital structure based on tax advantages and financial distress disadvantages. Firms are thought to strive toward their target and can signal their future prospects by changing their structure. Adding more debt increases firm value through the market's perception of higher tax shields or lower bankruptcy costs. But optimal capital structure at a 100% debt financing are clearly incompatible with observed capital structures, so their findings initiated a considerable research effort to identify costs of debt financing that would offset the corporate tax advantage.

Since then, extensions of the Modigliani-Miller theory have been provided by the following researches. Robichek and Myers (1965) argue that the negative effect of bankruptcy costs on debt to prevent firms from having the desire to obtain more debt. Jensen and Meckling (1976) identify agency cost in governing the corporation. The general result of these extensions is that the combination of leverage related costs (such as bankruptcy and agency costs) and a tax advantage of debt produces an optimal capital structure at less than a 100% debt financing, as the tax advantage is traded off against the likelihood of incurring the costs.

Shrestha (1985), on "*Analysis of capital structure of selected public enterprises*" concluded that the capital structure of those enterprises were quite confusing. This is because those enterprises were not guided by the objective based financial plans and policies. Most of them, to relive financial obligations debts are eliminated. It was further added that the calculation of equity capitalization rate and overall capitalization rate has been given very fantastic results in many cases. The use of NI and NOI approach in those were rather academic practice than providing valid. The debt equity ratio was improperly determined and the contribution of the debt procurement of assets was very insignificant and suggested that debt equity ratio neither should be highly levered to create too much financial obligation that lies beyond capacity to meet nor should it be much low to infuse operational lethargy to pass responsibilities without performances. The aid donor strategies should be properly taken in to considerations as the inflow of foreign government and international financial decision institution credit has dominant influence in the capital structure.

Franco Modigliani and Miller, on their study of debt equity composition stated that, the impact of the additional debt in a tax less and economically perfect world the total market value of the company's debt plus equity should not be charged as debt is sustained for equity. Although expected earning per share will increases as debt is sustained by equity (or additional financing is done with debt rather equity) this effect is exactly offset by the markdown in the company's price/earning ratio. The markdown occurs because the additional debt exposes the common stockholder to an extra financial risk.

2.6.3 Review of Related Thesis

Under this section various maters level dissertation related to this study have been reviewed. These are as follows:

Devkota, is (2002) on his study "*An analysis of capital structure of Necon Air Ltd*" the main objectives of this study are:

- To analyze various ratios, correlation coefficient and capital structure approaches related to the leverage.
- To find out the debt service capacity, growth rate and capital structure approach.

For this study she found that debt service capacity of the company is highly positive, position of debt is higher so most of the assets were financed by the debt capital. The relationship between debt ratio and NOI is significant and these is no significant relationship between EBIT and interest, company is operating in the risky condition, EPS is in fluctuating trend, revenue generation is normal.

Dhital ,(2004) had conducted a study on "*A Capital structure decisionand it's impact and risk and return analysis of Hulas Still Industry Private Limited*". The main objectives of this study are:

- To examine the relationship between capital structure and profitability of the company.
- To suggest the appropriate capital structure for the Hulas Still Industries Private Limited.

For this study, he found that debt equity ratio of the company very poor. The long term debt to total assets ratio indicate that loans are not fully secured with assets. The HSIPL should try to reduce short term debt and use more long-term funds.

A study conduced by Upreti, in (2005) entitled "A study on capital structure decision and its impact on risk and return of Bottlers Nepal Limited". The main objectives of this study are:

- To analyze the related variable of capital structure, determing risk and return.
- To evaluate the capital structure of BNL with respects to its net worth.
- To experiment the relationship between the capital structure and value of BNL.

For this study, he found that long term debt to debt ratio was higher than the general acceptable level. The debt servicing capacity of company was not satisfactory due to negative I/C ratio. The return on capital employed and debt servicing capacity also was not satisfactory due to negative earning. The overall capitalization rate was also negative firm. Main

suggestions are: Capital structure should well planned operating efficiency and earning power should improve, market share should expand and expenditure, should control.

Ranjit, (2007) had conducted a study on "*Capital structure of manufacturing company of Nepal*." The main objectives of this study are:

- To decide the proportion of equity capital debt capital to make the capital structure balance and maximizes the shareholders wealth.
- To examine the dynamics of the capital structure of Nepalese manufacturing companies.
- To examine about the correlation between long-term debt and net worth capital.

For this study, he found that these company are highly unleveled, debt equity ratio of these companies are consistent in nature. Thus, suggested the minimizes the industrial risk and try to maintain leverage position.

2.7 Research Gap

All the above studies are concerned with research title "Capital structure." Some researchers have selected various companies for this research and some have concentrated in only one institution. But this study selects only one manufacturing company (Dabur Nepal Pvt. Ltd.) to cover the analytical part and fulfill the objective of this study. This thesis work has covered the period of the study till 2010 whereas the previous thesis work covered only 2008.It has used all possible financial and statistical tools to cover the objectives of this study. It has analyzed regression analysis which is statistical method for investing relationship between the variables by the establishment of an approximate functional between

them. In this study, by the use of regression analysis, the strength of relationship between two variables (long-term debt and earning after tax) and earning after tax and shareholders equity have determined. This study will be fruitful to those interested person scholar, civil society, stakeholder, students, teachers, businessmen and government for academically as well as policy perspectives.

CHAPTER-III

RESEARCH METHODOLOGY

'Research methodology' is composed of two words: 'Research and methodology'. Research is a systematic and organized effort to investigate a specific problem that needs a solution (Sekavan, 1992). This process of investigation involves a series of well thought out activities gathering, recording, analyzing and interpreting the data with the purpose of finding answers to the problem. Thus the entire process by which we attempt to solve the problem is called research (Wolf and Pant, "Social science research and thesis writing" Second edition, 1999, first print, 2000, A.P. p. 203). While methodology is the research method used to test the hypothesis.

Thus research methodology is the way to solve systematically about the research problem. It refers to the various sequential steps to adopt by a researcher is studying a problem with certain objectives.

In view (Kothari, "Research Methodology' Method and Techniques New Delhi: Wiley Eastern Pvt., 1989). For this purpose, the research is exploratory as well as analytical. In order to accomplish the objectives of the study, the research methodologies have been designed on the basis of secondary data by using useful financial and statistical tools. The research methodologies have been designed on the basis of secondary data by using useful financial and statistical tools. The research methodologies adopted in this study are discussed in the following manner. This chapter is composed of six sections:

- Population and sample

- Period covered.
- Nature and source of data.
- Method of analysis and interpretations.
- Specification of the study.
- Limitation of the study.

3.1 Research Design

The analysis of this study is based on certain research design. Selection of appropriate research design is necessary to meet the study of objectives. It emphasizes on descriptive and analytical study of the collected data as of profit and loss account and balance sheet over a period of time and it gives digestion on the improvement of the capital structure. Comparatively this study has been designed as a descriptive analytical design. The study gives some measurable suggestion to strengthen the capital structure management.

3.2 Population and Sample

Various studies have already done by master degree researcher and other researcher, on the topic of capital structure decision. But only some study considered on capital structure decision and its impact on risk and return although these study basically not considered about private manufacturing company. The main drawbacks of private manufacturing companies do not want show their debt capital in composition of capital structure. In other words, most of the companies and enterprises are unleveled or use of debt capital is negligible in amount. By reviewing these difficulties, the researcher focused on Dabur Nepal Pvt. Ltd. Which

is Nepal’s leading private manufacturing companies in the sector of Ayurveda and natural resources.

3.3 Period Covered

For the study, only five years data form fiscal year 2006 to 2010 of Dabur Nepal private limited have been collected. The of five years range is not sufficient for analysis but this study unable to obtain more than five years data.

3.4 Sources and Types of Data

This study based on secondary data. Thus secondary data reextensively used in this study. The raw secondary data are modified. To some extent for the study purpose. Mostly, data are collected from balance sheet, income statement and profit and loss account of Dabur Nepal Private Limited. Some others necessary data used in this study have also been supplemented from auditors general reports' and various related journals in management and other publication. To some extent, necessary primary data are also collected by interviewing related Dabur Nepal managers and others personnel.

3.5 Data Collection Technique

The sources of data used in this study are basically secondary in nature. It constitutes mostly the annual reports which compress balance sheet and profit and loss account statement. Information has also been supplemented from various publications of Nepal Stock Exchange Ltd. Department of Industry, Central Bureau of Statistics and Federation of Nepalese Chamber of Commerce and Industry. Besides these, however, primary data are also derived to some extent through observation, cross

sections, frequent visits and discussions with general and financial managers of the concerned companies.

3.6 Data Analysis Tools

The main purpose of analyzing the data is to change it from an unprocessed from to an under stable presentation. The method of analysis employed in this study, consists of two types of analytical tool and technique.

a. Financial tools

b. Statistical tools

3.6.1 Financial Tools

The financial tools employed in this study basically represent ratio analysis leverage analysis, EBIT-EPS analysis and others.

3.6.1.1 Ratio Analysis

Ratio analysis is the powerful tools of financial analysis. Financial ratios represent the relationship between two accounting figures, expressed mathematically. Ratio analysis is defined as the systematic use of ratio to interpret the financial statements so that the strengths and weaknesses of a firm as well as its historical performance and current financial condition can be determined (Khan and Jain, op. cit p 80). Like others tools of financial management, ratio analysis involves two types of comparison, first, it is employed to compare present ratio with post and expected figure ratio for same corporation. Second, the comparison is done to see the different exist between ratio of one corporation with those of similar corporation or with industries averages of same period. The required financial ratios for this study are enabled in details as follows:

Leverage Ratio

Leverage ratio measures the contribution of financing by owners compared with financing provided by the outsiders. They also provide some measure of the risk of debt financing by the calculation of the coverage of fixed charges. In this study, following leverage ratios have been calculated.

(a) Long term debt to equity ratio

Long term debt to equity ratio reflects the relative claims of creditors and shareholders against the assets of the firm. It is calculated as:

$$D/ERatio = \frac{Long\ Term\ Debt}{Shareholder's\ Equity} \text{ ---------- (I)}$$

A high debt equity ratio indicates that the claim of creditors is greater than that of the owners and vice-versa.

(b) Debt to total capital ratio

The relationship between creditor's funds and owner's capital can also be expressed in terms of 'debt to total capital ratio'. One approach is to relate the long term debt to the permanent capital of the firm, it is calculated as:

$$\text{Debt to total capital ratio} = \frac{Long\ Term\ Debt}{Perminant\ Capital} \text{ ---------- (II)}$$

'Permanent capital' consists of shareholder's equity as well as long term debt.

(c) Total debt to total assets ratio

The total debt of the firm comprises long term debt plus current liabilities while total assets consist of permanent capital plus current liabilities. Thus it can be calculated as:

$$\text{TD/TA ratio} = \frac{Total\ debt}{Total\ assets} \text{---------- (III)}$$

This ratio however, gives somewhat similar indication as the debt equity ratio.

(d) Interest coverage Ratio

It is also known as 'time interest earned ratio'. This ratio measures the debt servicing capacity of a firm in so far as fixed interest on long term loan is concerned. It is calculated as:

$$\text{Interest coverage ratio} = \frac{EBIT}{Total\ assets} \text{---------- (IV)}$$

Larger the coverage ratio, the greater the ability of the firm to handle fixed charge liabilities and the more assured the payment of interest to the creditors. However, too high a ratio may imply unused debt capacity.

Liquidity Ratio

Liquidity ratio measures the ability of the firm to meet its current obligations. In this study, current ratio is calculated as liquidity ratio. The current ratio of a firm indicates the extent of liquidity or lack of it to the firm. It is computed by dividing current assets by current liabilities.

$$\text{Current ratio} = \frac{Current\ assets}{Current\ Liability} \text{---------- (V)}$$

Profitability Ratio

Profitability ratios give answers how effectively the firm is being managed. In this study, following profitability ratios are calculated:

(a) Profit margin on sales

The profit margin on sales is computed by dividing net income after taxes by sales.

$$\text{Profit margin on sales} = \frac{Net\ income}{Sales} \text{ ---------- (VI)}$$

(b) Return on total assets

It is also known as 'return on investment' or ROI on before tax basis.

$$\text{Return on total assets} = \frac{EBIT}{Total\ Assets} \text{ ---------- (VII)}$$

While on after tax basis, because of the lax shelter benefit of interest, we add the after tax interest expenses to net income for the numerator of the ratio.

Return on total assets ratio Total Assets =

$$\frac{Net\ income + intrest(1-t)}{Total\ assets} \text{ ---------- (VIII)}$$

(c) Return on net worth (Ordinary shareholder's Equity)

The ratio of net profit after taxes to net worth measures the rate of return on the stockholder's investment. It is computed by dividing EAT with net worth. Here net worth represents only equity capital.

EBIT-EPS analysis

'EBIT-EPS analysis' is one of the widely used financial tool that is used to examine the effect of financial leverage by analyzing the relationship between 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 (J.C. Van Horne Op. cit. p. 654). In this study, following format is used for EBIT-EPS analyses.

Profit before interest, tax, depreciation and provisions	…….
Less: Interest	…….
Profit before tax, depreciation and provisions	……..
Less: Depreciation	……..
Profit before tax, and provisions	……..
Less: Provision for housing	……..
Less: Provision for bonus	……..
Net operating margin (Profit before tax)	……..
Less: Tax @ …%	……..
Earnings Available to Common Shareholders (EACS)	……..
No. of common share holder's (n)	……
EPS = EACS/N	……

Other Calculated Financial Tools

- Degree of financial leverage
- Overall capitalization rate, equity capitalization rate and total value calculation under different approaches.

3.6.2 Statistical Tools

Many statistical tools are often employed in the analysis and interpretation of data as an aid to management and managerial decisions. Following statistical tools are used more systematically in this chapter.

- Regression analysis

Other tools are also used as and when they are felt necessary.

Definition of the Terms

To avoid ambiguity, confusing and misunderstanding the key terms used in this study have been defined as follows:

1. **Long term debt**

The long term debt refers to the debt used by the company for a long period of time. Long term means the time of one year and above.

2. **Total debt**

Total debt implied those capitals, which are total of all short terms and long term loan.

3. Total asset

It is the total of current and fixed asset

4. Capital employed:

Capital employed may be defined as not-current liabilities plus owner's equity.

5. Shareholders equity

Shareholders equity includes common shareholders equity plus preference.

CHAPTER - IV

PRESENTATION AND ANALYSIS OF DATA

This chapter, the effort has been made to analyze impact of capital structure on risk and return of Dabur Nepal Pvt. Ltd. For this the major variables as well as the variables affecting capital structure are considered for analysis. The analysis of data consists of organizing, tabulating and assessing financial and statistical result. In this chapter first proceeds with financial analysis by tabulation and then, at last with stastical analysis. The financial analysis is done through presentation of data and calculating various financial ratios, which reflects the relationship variables affecting capital structure used for analysis are short-term debt long term debt total debt equity capital, Earning Before Interest and Tax (EBIT), interest Earning Per Share (EPS), sales total assets and other related variables are also used if they necessary.

4.1 Analysis of Capital Structure of Dabur Nepal Pvt. Ltd. (DNPL)

Capital structure analysis refers to the composition of source of funds. Source of funds composed of short and long term debt, preference share capital and equity share capital. Many theories developed in the field of financial management to explain about the capital structure of the firm. In chapter - II some of the important theories of capital structure have been reviewed. Dabur Nepal is not listed in Nepal stock exchange. It has not issue its share to the public here researcher mainly concerned to revaluated capital structure composition and its impact on risk and return of Dabur Nepal Pvt. Ltd. Study of capital structure is concerned with

analyzing the capital composition of the company. Capital is the permanent source of financing of the firms, representing primarily by long term debt, preferred stock and common stock. But short term loan also to be show to revealed clear picture of the capital structure of the firm. The capital composition of the Dabur Nepal Pvt. Ltd. Is presented in table 4.1.

Table 4.1

Capital Structure Composition of Dabur Nepal Pvt. Ltd.

Rs. In Lacs

Year	Equity		Short Term loan		Long Term Loan		Total
	Rs.	%	Rs.	%	Rs.	%	
2006	6194	59.53	2157	20.73	2054	19.74	10405
2007	6698	51.76	6194	47.87	48	0.37	12940
2008	7146	60.13	4690	39.47	48	0.40	11884
2009	7330	65.35	3830	34.15	57	0.50	11217
2010	8329	63.38	2863	21.79	1948	14.83	13140
Average	7139	60.03	3947	32.82	831	7.17	11917

Source: Annual report of Dabur Nepal Pvt. Ltd.

From the table 4.1 it is revealed that the capital structure is composed by short term loan long term loan and shareholder equity. In year 2006 total capital is Rs. 10405 lacs. Where 20.73% is short term loan, 19.74% is long term loan and 59.53% is equity in that amount. In the last year of study 2010 total capital is Rs. 13140 lacs. This amount is composed by

short term loan long term loan and equity 21.79%, 14.83% and 63.38% respectively. In average total capital is 11917 lacs.

This figure is graphically presented in figure 4.1

Figure 4.1

Composition of Capital Structure

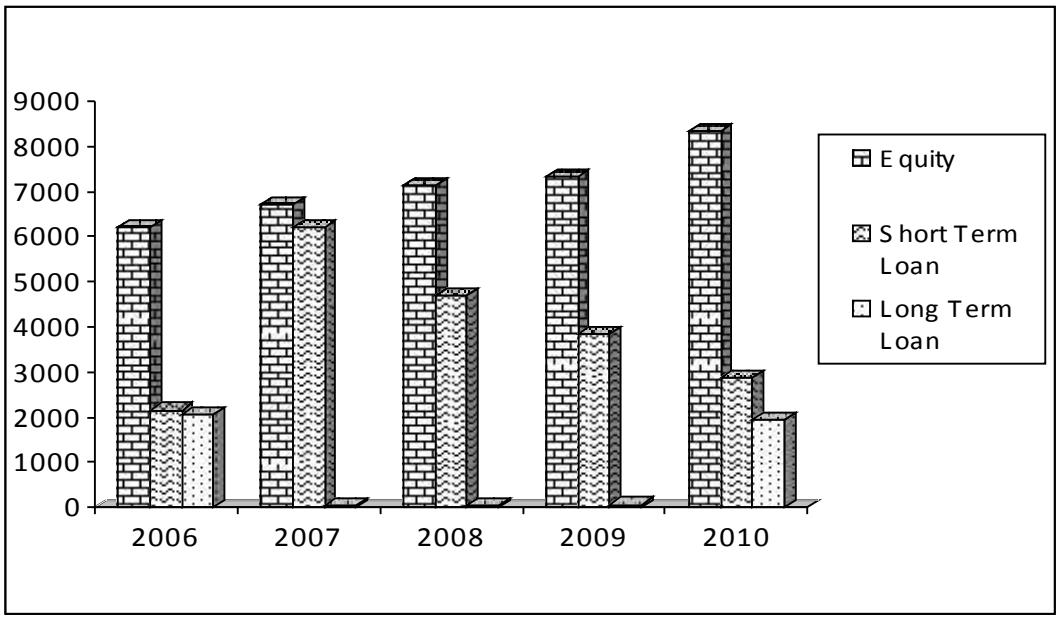


Figure 4.1 shows that share holder equity is slightly increasing year by year short term debt is in fluctuating turn around the average long term debt is decreasing and last year 2010 is increasing.

4.1.1 Analysis of Debt Composition

Short term and long term debt is the sources of funds. Company should pay interest for the use of debt capital. Debenture holders do not get the voting right or cannot control of firm directly. They are creditors of the firm not the owners. But there are some advantages of debt financing.

Under M-M Model the value of the firm increases which debt. Under this assumption value of the firm is the maximum at 100 percent debt financing. Companies can get the advantage of tax shield benefit from debt financing. The comparative position of short and long-term debt of Dabur Nepal Pvt. Ltd. is presented in the table 4.2.

Table 4.2

Composition of Debt

Rs. In Lacs

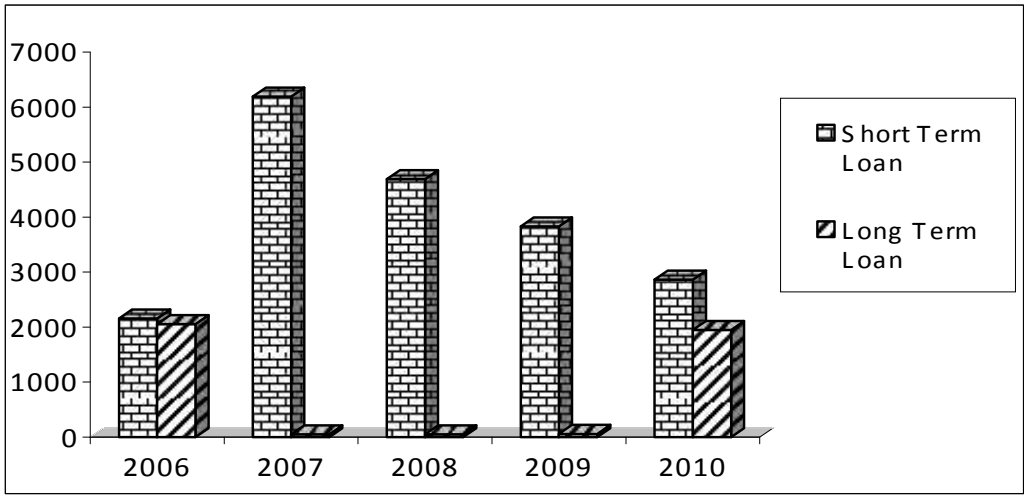
Year	Short term loan	Percentage	Long term loan	Percentage	Total
2006	2157	51.22	2054	48.78	4211
2007	6194	99.23	48	0.77	6242
2008	4690	98.99	48	1.01	4739
2009	3830	98.53	57	1.47	3887
2010	2863	59.51	1948	40.49	4811
Average	3947	81.50	831	18.5	4778

Source: Annual report of Dabur Nepal Pvt. Ltd.

The average long term debt of Dabur Nepal Pvt. Ltd. is about 831 lakcs which is less than the long term debt of fiscal year 2006 and 2010 and is greater than the long term debt of reaming sampled years. In last year 2010 of the study 59.51% short term and only 40.49% is long term loan in average 81.50% is consist of short term and 18.50% is long term loan in total loan composition. Generally more short term loan is considered risky in the context of solvency of the company.

Figure 4.2

Composition of Debt



4.2 Ratio Analysis

The important financial tool for analysis of capital structure ratio analysis. It is defined as the systematic use of ratio to interpret the financial statements so that the strengths and weaknesses of a firm as well as its historical performance and current financial condition can be determined. Financial ratios can be classified in to liquidity ratio, profitability ratio leverage or capital structure ratio, turnover ratio or activity ratio etc. But our study based on following ratios that are directly or indirectly related to the capital structure of the firm. The detailed analysis of these ratios has been done in the following pages.

4.2.1 Analysis of Debt and Shareholders' Equity

The ratio of borrowed funds and owner's capital is a popular measure of the long-term financial solvency of firm. In usual, the debt/equity ratio is the ratio of long-term debt to total equity. Here debt equity ratio is

computed by simply dividing total debt of the firm by shareholders equity. Where total debt includes short-term debt plus long-term debt and shareholders equity includes equity share capital and past-accumulated profits only because our samples company doesn't use preference share capital. The D/E ratio is an important tool for the financial analysis to appraise the financial structure of a firm. This ratio reflects the relative contribution of owners and creditors

Share of financing. It also reflects that the creditors claim is higher against the assets of firm or not. The low D/E ratio has just opposite implications. Thus in table 4.3 these ratios are presented in quantitative term to show the movement of the trend from fiscal year 2006 to 2010 of Dabur Nepal Pvt. Ltd.

Table 4.3

Total Debt to Equity of Dabur Nepal Pvt. Ltd

Rs. In Lacs

Year	Total Debt	Share Holder Equity	Ratio	Change %
2006	4211	6194	0.68	-
2007	6242	6698	0.93	0.65
2008	4739	7146	0.66	-0.27
2009	3887	7460	0.52	-0.14
2010	4811	8329	0.57	0.056
Average	4778	7165	0.67	

Source: Annual report of Dabur Nepal Pvt. Ltd.

The calculated in table 4.3 clarifies that the Dabur Nepal Pvt. Ltd. has decreasing trend of D/E ratio. Fiscal year 2007 debt to equity ratio is

0.93:1 which is highest among five years. After words D/E ratio is 0.68:1, 0.66:1, 0.52:1, and 0.57:1 in fiscal year 2006, 2008, 2009 and 2010 respectively. The above calculated ratios shows that the ratio is 2008, 2009 and 2010 are less than average ratio and debt to equity ratio of fiscal year 2006 and 2007 are greater than of average ratio. The greater ratio implies that the higher claim of creditors then the owner of the company. The average D/E ratio of Dabur Nepal Pvt. Ltd. Is 0.67:1, which implies that, the claim of creditors stronger than that of owner of the company? Therefore it was suffering by the higher amount of interest on debt the study period. But this ratio has decreasing in last two year. The D/E ratio of year 2007 is 0.93:1 only, which can be assumed as near of minimum level. Generally 1:1 debt to shareholders equity can be considered as an appropriate level of debt equity ratio. Beside these, no doubt those both high and low debt/equity ratios are not desirable what is needed is the ratio which strive a proper balance between expected return against increased risk.

4.2.2 Analysis of Debt to Capital Employed Ratio

The relationship between debt and capital employed has also important role to maintain an optimum capital structure. This relationship tells about the proportion of debt share holders found in the capital structure. Especially this relationship point out the contribution of debt in the capital employed by the company. Where debt denotes all these debts and capital employed represents all debt and shareholders fund of the company. Again share holders fund is composed of share capital, reserve and surplus or accumulated profit of the firm. We can analyze this relationship by simply dividing total debt by the capital employed of the company. This ratio is also known as debt to permanent capital ratio. Where permanent capital means total assets minus current liabilities,

same as capital employed. The debt to capital employed ratio presented in the table 4.4.

Table 4.4

Debt to Capital Employed Ratio

Rs. In Lacs

Year	Total Debt	Capital Employed	Ratio	Change %
2006	4211	10405	0.41	-
2007	6242	12940	0.48	0.07
2008	4739	11884	0.40	-0.08
2009	3887	11217	0.35	-0.05
2010	4811	13140	0.37	0.02
Average	4778	11917	0.40	

Source: Annual report of Dabur Nepal Pvt. Ltd.

According to the table 4.4 ratio of debt to capital employed in year 2006 is 0.41. It means about 41% contribution of debt exists in the capital employed or the remaining portion i.e.59% is contributed by shareholders fund. Similarly, this ratio increased 48% in year 2007. Debt to capital employed ratio is increasing. Then It has decreased to 40%, 35% and 37% in year 2008,2009 and 2010 respectively. The average ratio of debt to capital employed of Dabur Nepal Pvt. Ltd. is 40%.The greater proportion of debt shows the greater claim of debt holders in to the form. The higher ratio indicates the higher burden of company to pay interest expenses. It may be a cause of decreasing responsibilities from the side of owners. The interventions of creditors may increase. From the above analysis, it is found that Dabur Nepal Pvt. Ltd. has moderate debt to

capital employed ratio. This implies that borrowed fund i.e. debt has satisfactory proportion. In the permanent capital of Dabur Nepal Pvt. Ltd.

4.2.3 Analysis of Long-term Debt to Total Debt Ratio

The relationship between long term debt and total debt has decisive impact on the financial structure of the company. This relationship implies that what percentage of total debt covered by long-term debt of the firm. Generally firms use short-term debt as well as long-term debt. Current liabilities and provision are also occurred during the operation of the firm. The relationship between the long term debt and total debt can be analyzed by simply dividing long-term debt by the total debt of the firm. Where total debt includes all types of borrowed fund and current liabilities and provisions. In this relationship the role of current liabilities is very important. If the firm uses short term loans in the large amount and occur current liabilities and provision in the large amount, the percentage of long-term debt on total debt will be low and vice versa. Higher the ratio of long term debt to total debt indicates the higher claim of long-term debt holders up on the total debt and lower the ratio indicates the higher portion of short-term loan and current liabilities in the total debt of the firm. The higher or lower the amount of short-term loan and current liabilities is depends up on the liquidity of the firm. The comparison will be clear from the table 4.5.

Table 4.5

Long-term Debt to Total Debt Ratio

Rs. In Lacs

Year	Long-term Debt	Total Debt	Ratio	Change %
2006	2054	4211	0.490	-
2007	48	6242	0.008	-0.480
2008	48	4739	0.010	0.002
2009	57	3887	0.015	0.005
2010	1948	4811	0.405	0.390
Average	831	4778	0.174	

Source: Annual report of Dabur Nepal Pvt. Ltd.

The calculation shows that the ratio of long-term debt to total debt is 0. 49 in fiscal year 2006. This means the contribution of long-term debt in total debt is 49% and the remaining portion is contributed by the current liabilities. This ratio of Dabur Nepal Pvt. Ltd. decreased trend of fiscal year 2007, 2008 and 2009.In the last year 2010 the ratio has increased. The company has 17.4% of average long term debt to total debt. The total debt to long term debt ratio of the company is decreasing fiscal year 2007 to 2009. Composition of long-term and short-term debt in the beginning and last year analysis is satisfactory but trend of increasing current liabilities should not good message for shareholders. Increasing trend of current liabilities makes current obligation high. It may bring difficult condition for day to day operation of the company.

4.2.4 Long-term Debt to Total Capital Ratio

This ratio is computed by simply dividing the long-term debt of the firm by its permanent capital permanent capital here represents the equity capital plus long-term debt. The long-term debt to permanent capital ratios of Dabur Nepal Pvt. Ltd. is calculated and presented in table 4.6.

Table 4.6

Long-term Debt to Total Capital of Dabur Nepal Pvt. Ltd.

Rs. In Lacs

Year	Long-term debt	Permanent Capital	Ratio	Change
2006	2054	8248	0.250	-
2007	48	6746	0.007	-0.242
2008	48	7194	0.006	-0.001
2009	57	7387	0.008	0.001
2010	1948	10277	0.189	0.182
Average	831	7970	0.1042	

Source: Annual report of Dabur Nepal Pvt. Ltd

Above table shows debt-equity ratio in fiscal year 2006 the long-term debt to total capital ratio is 25% and 0.7%, 0.6%, 0.8% and 18.9% in fiscal year 2007, 2008, 2009 and 2010 respectively. In fiscal year 2006 long-term debt to total capital ratio is higher and the ratio is decreasing in fiscal year 2007 and 2008 the ratio i.e. 0.72% and 0.67%.And also last two year increasing trend. An arbitrary rule is that long-term debt should not be more than 67% of the permanent capital. However it depends at the characteristics of an industry. But here, the average ratio of long-term debt to total capital is low according this rule.

4.2.5 Liquidity Ratio

It is essential for a firm to be able to meet its obligations as they become due. Liquidity ratio measure the firm's ability to meet current obligations. Both high liquidity and lack of liquidity are not good for business. The current ratios are calculated Dabur Nepal Pvt. Ltd. taking five years balance sheet and presented in table 4.7.

Table 4.7

Current Ratio of Dabur Nepal Pvt. Ltd.

Rs. In Lacs

Year	Current Assets	Current Liabilities	Current Ratio	Change
2006	8972	4605	1.95	-
2007	7413	4345	1.71	-0.24
2008	9874	7914	1.25	-0.46
2009	9880	6816	1.45	0.20
2010	8459	3915	2.16	0.71
Average	8919	5519	1.70	

Source: Annual report of Dabur Nepal Pvt. Ltd

The above table clarifies that Dabur Nepal Pvt. Ltd. has fluctuating trend of current ratio. During the study period it is ranging from minimum 1.25:1 in fiscal year2008 to maximum 2.16:1 in fiscal year 2010. The trend of this current ratio is decreasing from 2006 to 2008. The average current ratio is 1.70:1 as a conventional rule, a current ratio of 2:1 is considered to satisfactory. Thus from above analysis current ratio of Dabur Nepal Pvt. Ltd. is good. That means the company is in the balance

condition of liquidity and it can pay its short term bill in time from this point of view.

4.2.6 Interest Coverage Ratio

This ratio is also known as ‘time interest earned ratio’. This ratio measure the debt serving capacity of a firm is so far as fixed interest on long-term loan is concerned. Interest coverage ratio is designed to relate the interest charge of a firm to its ability to service them. It is simply the ratio of earning before interest and taxes for a particular reporting period to the amount of interest charges of a period. This ratio measures the extent to which earning can be decline without resultant financial embarrassment to the firm because of inability to meet annual interest costs. It should not that this ratio use the concept of net profit before tax because interest is tax deductible. So the tax is calculated after paying interest on loan. This ratio as the name suggests. Show how many times the interest changes are covered by EBIT out of which they will be paid. In other words it indicated the extent to which a fall in EBIT is tolerable in the sense that the ability of the firm to serve its debt would not adversely affected.

In order to analyze the debt serving capacity of a firm. It is necessary to analyze the EBIT and interest, which can be analyzed through interest coverage ratio. From the point of view of creditors, the larger the coverage ratio, the greater the ability to offer assured payment of interest to the creditors. The interest coverage ratio is useful to measure long-term debt serving capacity of the firm. In this way it is better to use fixed interest changes of firms which is payable way it is better to use fixed interest change of firm, which is payable due to the use of long term debt. But the limited data provided by the concerned companies invite a problem. As a result it is unable to classify the amount of interest relating

to short-term and long-term loans. So the analysis interest coverage ratio is based on the total amount should pay by the firm whether that is relating to long term as well as short term loan.

This interest coverage ratio of Dabur Nepal Pvt. Ltd. is calculated and presented in table 4.8 to measure the Dabur Nepal Pvt. Ltd's debt servicing capacity.

Table 4.8

Interest Coverage Ratio of Dabur Nepal Pvt. Ltd.

Rs. In Lacs

Year	EBIT	Interest	Interest Coverage Ratio	Change
2006	811	302	2.68	-
2007	986	307	3.21	0.52
2008	935	368	2.54	-0.67
2009	333	315	1.06	-1.48
2010	1445	245	5.90	4.84
Average	902	307	2.93	

Source: Annual report of Dabur Nepal Pvt. Ltd

The computed interest coverage ratio of Dabur Nepal Pvt. Ltd.In above table shows that the debt servicing capacity of the company is in consistent level. It is 2.68:1 in fiscal year 2006 and 5.90:1 in last year 2010. The average ratio is 2.93:1 which means even if Dabur Nepal Pvt. Ltd.'s EBT declines to the present level the net profit available for servicing the interest on loan would still be equivalent to the claims of the creditors.

4.2.7 Profit Margin on Sales

Net profit margin on sales is computed simply by dividing net profit after tax amount of sales. Net profit is obtained by subtracting operating expenses and income tax from the gross profit. This ratio of profit margin on sales indicates the firm's capacity of with stand in adverse economic conditions. A firm with as high profit margin ratio would be in an advantageous position to service in the face of falling selling prices, rising costs of production or declining demand for the product and vice-versa. Thus, to analyze the position of profit margin on sales of Dabur Nepal Pvt. Ltd. the table 4.9 is presented.

Table 4.9

Profit Margin on Sales of Dabur Nepal Pvt. Ltd.

Rs. In Lacs

Year	EAT	Sales	Profit on Sales %	Change %
2006	485	19400	2.50%	-
2007	533	21988	2.42%	-0.08%
2008	441	24475	1.80%	-0.62%
2009	15	27200	0.06%	-1.75%
2010	944	27652	3.41%	3.36%
Average	484	24143	2.04%	

Source: Annual report of Dabur Nepal Pvt. Ltd

From the observation that profit margin ratio of Dabur Nepal Pvt. Ltd. is the highest in fiscal year 2010 among five years operation period as earning after tax is 3.41% of sales revenue. This ratio is 0.0.06% in fiscal year 2009 which is the lowest of all five years ratios. To comparing profit

margin on sales is not the satisfactory level because of the standard is 15%. The average profit on sales is only 2.04% Due to the various reasons this margin is decreasing in low rate. The company should be concern to it and need to more effort to earn more profit to grow the company on long lasting.

However the sales figure is increasing but profit margin is in opposite side. It means it's operating and other cost is increasing which reduces the profit margin.

4.2.8 Return on Total Assets

Return on total assets is computed simply by dividing earning after tax by total assets on after tax basis. But earning after tax (EAT) represents only residual income for shareholders. Therefore it is conceptually unsound to use EAT to calculate return on total assets. Thus, here after tax interest expenses is added to EAT for the numerator of the ratio, this ratio measures the profitability of the total funds/investments of Dabur Nepal Pvt. Ltd. Thus, the ratio of return on total assets is calculated by taking five years balance sheet and profit and loss account of Dabur Nepal Pvt. Ltd. as given in table 4.10.

Table 4.10

Return on Total Assets of Dabur Nepal Pvt. Ltd.

Rs. In Lacs

Year	EAT+I	Total Assets	Return on total assets %	Change %
2006	787	10405	7.56%	-
2007	840	12940	6.49%	-1.07%
2008	809	11884	6.81%	0.32%
2009	330	11347	2.91%	-3.90%
2010	1189	13287	8.95%	6.04%
Average	791	11973	6.61%	

Source: Annual report of Dabur Nepal Pvt. Ltd

From table 4.10 it obvious that percentage return on total assets of Dabur Nepal Pvt. Ltd. is ranging from minimum of 2.91% is fiscal year 2009 to maximum of 8.95% in fiscal year 2010. The trend of ROA is flutings and on average 6.61%. The company is gaining moderate ROA ratio that means it is utilizing satisfactory use of its assets in operating the business. However the overall efficiency is still good.

4.2.9 Return on Net worth (Common Share Holder)

The return on net worth ratio is the measure of productivity of share holder's funds. It carries the relationship of return to shareholders equity. *The shareholders equity includes common share capital, preference share capital and reserves and surplus*. But Dabur Nepal Pvt. Ltd. has not issued preference share capital. Thus, for Dabur Nepal Pvt. Ltd. Both ratios of return on net worth and return on common shareholder's equity are the same. The ratio is regarded as very important measure because it reflects exclusively the return on the owners. As the common shareholders are the residual owners in the real sense of the word, they assume the maximum risk, and have the highest stake in company. So, to judge whether the firm has earned a satisfactory return for it common shareholders (equity share holders) or not, table 4.11 is constructed.

Table 4.11
Return on Net worth (Common Share holders Equity) of Dabur Nepal Pvt. Ltd.

Rs. In Lacs

Year	EAT	Net worth	Return on Net worth %	Change %
2006	485	6194	7.83%	-
2007	533	6698	7.96%	0.13%
2008	441	7146	6.17%	-1.79%
2009	15	7460	0.20%	-5.97%
2010	944	8329	11.33%	11.13%
Average	484	7165	6.75%	

Source: Annual report of Dabur Nepal Pvt. Ltd

From the study of above table it is clear that the trend of return on net worth is decreasing year to year from 2008 and 2009. The return on net worth is 11.33% in 2010 fiscal year while only 0.20% in year 2009. The average return on net worth 6.75% is good but is decreasing trend would discourage to shareholders to get the higher return which they are getting from last few years. The ratio indicates how well the firm has used the resources of the common shareholders original owners of the company. It gives the satisfaction or dissatisfaction to the shareholders about company performance and their management. So to provide maximum satisfaction to it owners the company should earn normal return on net worth.

4.2.10 Analysis of Total Debt to Total Assets Ratio

The relationship between creditors fund and owners capital can also be the expressed in terms of another leverage ratio. This is debt to total capital ratio. This type of capital structure ratio is a variant of debt equity ratio. This can be calculated in different way. One approach of calculating the debt to capital ratio is to relate the total debt to total assets of the firm. The ratio of total debt to total assets generally called the debt ratio, measure the percentage of total fund provided by coeditors. Total debt includes current liabilities and all loans. This debt to total assets ratio can be calculated by simples dividing total debt by the total assets of the firm. Total assets include all types of assets. In constrict to the creditors performance for the low debt ratio, the owner may seek high gearing. If the debt ratio is too high, there is a danger for encouraging irresponsibility on the part of the owners. The stake of owner can become so small that speculative activity, if it is successful, will yield a substantial percentage return to the owner, if the venture is unsuccessful, however the only, a moderate loss is incurred by the owners because their investment is small. The debt ratio or total debt to total assets ratio on

DNPL calculated on below. And the calculated ratio can be present in table 4.12 and interpret in the following way.

Table 4.12

Total Debt to Total Assets Ratio

Rs. In Lacs

Year	Total Debts	Total Assets	Ratio	Change %
2006	4211	10405	0.41	-
2007	6242	12940	0.48	0.07
2008	4739	11884	0.40	-0.08
2009	3887	11347	0.34	-0.06
2010	4811	13287	0.36	0.02
Average	4778	11973	0.40	

Source: Annual report of Dabur Nepal Pvt. Ltd

The above calculated ratios of DNPL shows that the trend is fluctuating of total debt to total assets on the fiscal year 2006 it is 0.41 which implies that the claim of the creditors in the assets of the company is 59% and the reaming 41% only is the claim of shareholders. And in the fiscal year 2007, 2008, 2009 and 2010 the 48%, 40%, 34% and 36% of total assets is financed by outsider fund respectively. The company has the 40% average debt ratio where in two fiscal year 2009 and 2010 the total debt to total assets ratio is below the average ratio. And in the remain sampled fiscal year the ratio is equal and greater than the average ratio of the company. This ratio indicates that the creditors claim on total assets of the company is lower than the owners claim.

4.2.11 Analysis of EBT to EBIT Ratio

The relationship between EBT and EBIT shows the decisive impact of interest burden in the earning before tax. Earning before interest and tax (EBIT) is the operating profit of the company form which the company has to pay for creditors as interest and government as tax. Interest amount is the expenses of the company and also the income of creditors. If the creditors income i.e. interest is high the owners income will be low and vice versa. So, the company should reduce one's return in order to increase the return of others.

According to the above description, we can find out the burden of interest expenses of the company by using the ratio of EBT to EBIT. We can calculate the ratio of EBT to EBIT simply dividing EBT by EBIT of the company. This ratio measures the interest burden of the company. If the ratio of EBT to EBIT is high the burden of interest expenses will be low and vice versa. The higher ratio increase of positive EBT and EBIT is preferable. It shows that the burden of interest is low. Similarly, the lower the ratio indicates the higher burden of interest to the company, which cannot assumed as good signals. The loan funds are the fixed expenses to the creditors. The lower ratio Of EBT to EBIT indicates the higher expenses to the fixed income securities of creditors. Therefore company should try to reduce to expenses on interest to maximize the return of owners.

Table 4.13

EBT to EBIT Ratio

Rs. In Lacs

Year	EBT	EBIT	Ratio	Change %
2006	590	811	0.73	-
2007	679	986	0.69	-0.4%
2008	567	935	0.61	-0.8%
2009	18	333	0.05	-56%
2010	1200	1445	0.83	78%
Average	611	902	0.58	

Source: Annual report of Dabur Nepal Pvt. Ltd

The EBT to EBIT ratio of DNPL in fiscal year 2006 is 73% which implies that 73% of EBIT of DNPL transferred as EBT: the remaining portion i.e. 27% of EBIT constituted as interest amount. Likewise, the ratio of EBT to EBIT of DNPL increased to 83% in fiscal year 2010. This is going towards a preferable signal for the company. Again the EBT to EBIT ratio is 69%, 61% and 5% in fiscal year 2007, 2008 and 2009 respectively. The average EBT to EBIT ratio of DNPL is 58%.The average ratio of EBT to EBIT of DNPL greater than the ratios of fiscal year 2009 and less then the ratio of remaining sample years.

4.2.12 Analysis of EAT to Total Debt Ratio

The EAT to total debt ratio indicates the relationship between the net profit of the company and creditors funds of the company. Companies borrow funds from the creditors to finance on assets. On behalf of using that fund, company has to pay certain amount as interest to the creditors

of the company. If the creditors fund is greater than the owner's capital, the company has to bear the larger burden of interest expenses. If the company does not use borrowed fund, it has not any burden to pay interest. But the financing without any debt fund also can be assumed as good. Because the proper mix of owners capital and creditors fund results an appropriate capital structure of the firm. So firms use debt capital and bear the interest expenses.

In this way the EAT to total debt ratio can be helpful to measure the debt removing capacity from the profit of the company.

A higher ratio of EAT to total debt indicates the strong debt removing capacity of the firm and vice versa. If company wants to remove or reduce the borrowed fund from its existing capital structure, it has to be paid the loan for to the creditors from its net profit. Therefore if the firm has higher net profit the ratio will also be high and indicates the higher capacity of removing or reducing the debt capital. So this ratio is an important tool of analyzing relationship between EAT to total debt. The calculation of ratio of EAT to total debt of DNPL has been presented in the P table 4.14.

Table 4.14
Presentation of EAT to Total Debt Ratio

Rs. In Lacs

Year	EAT	Total debt	Ratio	Change %
2006	485	4211	0.115	-
2007	533	6242	0.085	-0.0297
2008	441	4739	0.093	0.0077
2009	15	3887	0.004	-0.089
2010	944	4811	0.196	0.192
Average	483	4778	0.101	

Source: Annual report of Dabur Nepal Pvt. Ltd

The EAT to total debt ratio of DNPL is 11.5% in fiscal year 2006. This shows that the DNPL can reduce it's total debt by 11.5% from its earnings after tax in this year. The ratio decreased to 8.5% in fiscal year 2007. Again the ratio is 9.3% in 2008, 4% in 2009 and 19.6% is 2010. The average EAT to total debt ratio constitutes 10.1% the implies that the company can remove its total debt by 10.1% from its net profit on an average. This ratio does not show the strong debt removing capacity of DNPL. The average ratio of EAT to total debt is less than the ratio of fiscal year 2006 and 2010 and greater than the ratio of reaming sampled year. The higher debt employing condition of DNPL may because of lower EAT to total debt ratio.

4.3 Analysis of Leverage

Leverage refers to the use of special force of power to have more than normal results from a particular action. It also refers to as effectiveness power, or ability. But in the area of finance the term leverage has special measuring. It is used to describe the firm's ability to use fixed cost funds to magnify the return to its owners or shareholders. So, leverage refers to the employment of an assets or fund for which the firm pays the fixed costs or fixed return or it can be defined as the firms ability to used-fixed costs assets or funds to magnify the return to it's owners.

Leverage refers to the often-favovable condition of having a stable element of cost support a wide range of profit values. It implies that results a large change in income. It may be maintained that the leverage may occur in varying degrees. The higher the degree of leverage, the higher is the risk. i.e. the possibility of higher rate of return to the shareholders (Munankarmi First Edition:122).

There are three types of leverage, operating leverage, financial leverage and combined leverage. The measurement of leverage are based on the functions relationship between the certain income statement items. Where operating leverage is the function of fixed cost, contribution margin and sales volume financial leverage is the relationship between EBIT and EBT and combined leverage is the combined effect of operating leverage and financial leverage. The operating leverage indicates the impact of changes sales on operating income and financial leverage exist when the capital structure of the firm comprises debt capital. So, financial leverage is the relevant issue of this study. The financial leverage is related to the capital structure of the firm.

Therefore only about the financial leverage is explained in this section.

4.3.1 Analysis of Financial Leverage

The use of fixed changes source of funds, such as debt and preference capital along with the owner's equity in the capital structure, is described as financial leverage. Financial leverage exists when the capital structure of the firm comprises debt or funds from other sources carrying fixed charges. Debt capital carries some fixed charges i.e. interest. Financial leverage explains the relationship between earning before interest and taxes and net profit of the company. As such, with the existence of fixed charge leverage, a charge in operating profit (EBIT) leads to the large change in earning before taxes (EBT). If the firm does not use fixed charges bearing securities, a change in EBIT will be accompanied by a similar charge in EPS. The degree of financial leverage measure a proportionate change in EPS as a result of given charge in EBIT. Thus, degree of financial leverage is the relationship between operating profit and interest charges.

Debt ratio, debt to equity ratio and interest coverage ratio are the main measure of the financial leverage. These ratios are already explained in the previous ratio analysis section of this study. In this section, the degree of financial leverage is explained below.

Degree of financial leverage can be calculated by using either EBIT and EBT or EBIT and EPS. In this analysis the first one is taken in to account. Because of tax policies are changeable in Nepal. So, for the comparative analysis and uniformity, degree of financial leverage has been calculated by EBIT divided by EBT. The comparative degree of financial leverage of DNPL can be presented in the following table 4.15.

Table 4.15

Presentation of Degree of Financial Leverage

Rs. In Lacs

Year	EBIT	EBT	D.F.L	Change
2006	811	590	1.37	-
2007	986	679	1.45	0.07
2008	935	567	1.65	0.20
2009	333	18	18.50	16.85
2010	1445	1200	1.20	-17.29
Average	902	611	4.83	

Source: Annual report of Dabur Nepal Pvt. Ltd

The trend of DFL of DNPL reveals that it has fluctuating trend. The degree of financial leverage of DNPL in fiscal year 2006 is 1.37which implies that one percent change in EBIT leads to one hundred thirty seven percent change in EBT. The DFL of DNPL increase to 1.45 increased by 8 in fiscal year 2007 and but it decreases to 1.2 times in fiscal year 2010

but it has increased 18.5 times in fiscal year 2009 . Whereas the average financial risk for the DNPL is 4.83.

4.4 Correlation Analysis

The correlation co-efficient is denoted by 'r' and indicates the direction of relationship between variables. In other words, correlation is the relationship between (or among) two or more variables (only one variable dependent and one or more variables independent). Correlation analysis is defined as the statistical technique which measure the degree of relationship (or association) between among the variables.

Correlation analysis does not tell anything about cause and effect relationship. There are three types of correlation: simple partial and multiple. But our concern is only the simple correlation. A method of measuring correlation is called Pearson's coefficient of correlation. In this analysis, the correlation coefficients between earning after tax (EAT) and total debt, debt ratio and ROE, D/E ratio and ROE, and D/E ratio and ROA are analyzed.

4.4.1 Correlation between Total Debt and Earning After Tax (EAT)

Total debt is a source of financing other than equity capital of the company. And earning after tax (EAT) i.e. net profit is the income available for share holders of the company. It is an actual earning earned by a company for actual shareholders after payment of the interest and tax. If the earning of the company is high the earning per share will also be high. The relationship between total debt and earnings after tax (FAT) has been analyzed by the Karl Pearson's correlation coefficient formula. Researcher try to measure where increase or decrease in total debt effect

in earning after tax or not. The calculated correlation coefficient has been shown in the following table 4.16.

Table 4.16

Correlation between total debt and Earning After Tax (EAT)

Rs. In Lacs

Year	EAT	Total debt
2006	485	4211
2007	533	6242
2008	441	4739
2009	15	3887
2010	944	4811
	483	4778

Correlation coefficient = 0.42

See Calculation in Appendix I.

The correlation between earning after tax and total debt of DNPL is 0.42. This figure shows that there is positive correlation between these variables. This value or r is not very close to than 1. So we can conclude that the total debt and EAT of DNPL has moderate positive correlation between these variable 0.42 implies only 42% on earning after tax dependent on total debt.

4.4.2 Correlation between Debt Equity Ratio and ROE

Debt to equity ratio measure the proportion of borrowed funds in comparison to shareholders equity. Where return on equity indicates the

profit percentage available for shareholders. Here, correlation of D/E ratio and ROE is calculated and presented in table 4.17.

Table 4.17

Correlation between Debt Equity Ratio and ROE

Rs. In Lacs

Year	D/E ratio	ROE
2006	0.68	0.078
2007	0.93	0.079
2008	0.66	0.062
2009	0.52	0.002
2010	0.57	0.113

Correlation Coefficient = 0.343

See Calculation in Appendix II.

As table 4.18 correlation coefficient between D/E ratio ROE revelated 0.343. Where 1 is aught most positive correlation. Calculated figure 0.343 is positive correlation. That means D/E ratio and ROE are positively correlated. Any change in D/E ratio can affect the ROE of the company.

4.4.3 Correlation between Debt Ratio and ROE

Deb ratio is the relationship between creditors fund and owners capital. It measures the percentage of total funds provided by creditors. Asset includes all types of assets. Here, debt ratio is obtained by dividing total debt by total asset. Return on equity (ROE) is the percentage of net profit or earning after tax in comparison of shareholders equity. The correlation between debt ratio and EOE is presented in table 4.18 as under.

Table 4.18

Correlation between Debt ratio and ROE

Rs. In Lacs

Year	Debt Ratio	ROE
2006	0.405	0.078
2007	0.482	0.079
2008	0.399	0.062
2009	0.343	0.002
2010	0.362	0.113

Correlation Coefficient = 0.833

See Calculation in Appendix III.

From the table 4.19 the correlation coefficient of debt ratio and ROE is relevant 0.833 where 1 is the perfect positive correlation. The calculated figure is near about prefect positive correlation. That means the debt about prefect positive correlation. That means the debt ratio and return on equity has positive correlation i.e. increase or decrease in debt ratio can affect the return on equity.

4.5 primary Data analysis

Primary data Analysis upon my study over Dabur Nepal Pvt. Ltd for Capital Structure and its impact on risk and return a set of questionnaire were distributed to 30 staff of the company. Out of them 21 respondents answered to the questionnaire. The result obtained from the analysis of their responses show that 60% of employees of the company are highly committed to their duties and responsibility.

Similarly, on question about monitoring of activities by the management, 55% of the respondents replied that management takes initiatives on

monitoring employee's activities at average level. On the study about job and related practices it is found that neither there is formal job design nor the practice of job rotation. Even the job description are also not prepared and implemented.

On question about investment analysis, it is found that 70% responded that shareholders are satisfied with the present level of return on their investment. Even in the present recession. Company has good image. Therefore, the MPS in share market is significantly higher than the other company.

Employee of the company are highly motivated and committed. Since the company practices the employee's promotion and conducts various program on career development .

Upon study about teamwork in the company practice of teamwork is very good due to this practice , profit is increasing , goodwill is extending and alliance is being strong and competitive .Good leader is that who continuously work for achieving goals. On study about leadership style in the company , researcher found the practice of democratic style of leadership .consultation with junior in leading the organization is really a peculiar feature of this company in Nepal.

Company's generally makes participation of lower level staffs in making decision regarding operation of business, For corporate planning and policy making. This practice is also a good symbol of effective management. Company's uses the quality circle in doing job and inconsequence .The productivity of employees is very high. Therefore, the positive impact of quality circle is seen on the profit.

Managing time is crucial management function for organization like this. Upon observation about time management .The researcher found that the

best example of time management is seen in this company. In case of conflict company generally resolves the conflicts by negotiation between the parties and person .However management sometimes enforces it's power to re solve the conflict making by the management where ever it is necessary.

At the end of the study we conclude that the overall efficiency of the company's is very high. Management is efficient and effective. There is no communication gap along with good understanding.

4.6 Major Findings of the study

Based on the data provided by the concerned company, the following major findings can be drawn capital structure composition:

Capital structure is composed by equity, short term loan and long-term loan. Average total Capital of the analysis period is Rs. 11919.2 lacs out of this total capital 60.03% is equity 32.82% is short-term loan and 7.17% is long term loan.

Debt Composition

Average total debt is Rs. 4778 lacs in the analysis period. Where short term debt is 3947 lacs (81.5%) and long-term debt is 831 lacs 18.5% short term loan is in increasing and long-term loan is in decreasing trend.

Important ratios

Total debt to total asset ratio 0.399 or 39.9% in average of analysis period. Total debt to equity ratio is 0.67. Deb to capital employed ratio is 0.40 and long-term debt to total debt ratio is 0.1739 in average of analysis period.

Some other ratio analysis has been examined. According to these analysis liquidity ratio is 1.62:1 in average. Average interest coverage ratio is 2.93:1 profit margin on sales is 2%. Return on total assets is recorded 6.61% return on shareholder equity is 6.75% and EBT to EBIT ratio 68% average of 5 years period.

Financial Leverage

Financial leverage is 4.83 in average in the analysis period. The trend is fluctuating.

Correlation analysis

Correlation between EAT and total debt 0.424 likewise. Correlation between debt ratio and ROE 0.833. Again correlation between debt equity ratio and ROE is 0.339.

CHAPTER - V

SUMMARY, CONCLUSION AND RECOMMENDATIONS

The intent of this study is to analyze the capital structure and its impact on risk and return of DNPL. 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 an analyzed in the forth chapter.

This is a last chapter of the study, in this concluding chapter, an attempt has been made first to make present summary of the study, then conclusion of the analysis and some recommendation which are useful to take corrective action from the side of DNPL.

5.1 Summary

This study capital structure decision of Dabur Nepal private limited and its impact on risk and return has been prepared to fulfill the requirements of Master's of Business Studies (MBS) mainly this study is based on the data provided by the concerned company. While starting this study, one main issue has taken, is there any impact on return by decision of capital structure. To justify this statement some objectives of the study has been made. To fulfill the mentioned objectives various tools have been used and analysis has been made. To conclude this study, the whole study has been divided into five chapters of different aspects. The summary of the study can be presented in the following paragraphs.

First chapter provides the brief introduction of this study. Dabur Nepal Pvt. Ltd. Is a leading company in this sector? That is so why this company is chosen to study.

Statement of problems, objective of the study, significance and limitation of the study is highlighted in this chapter. The effort has been made to analyze impact of capital structure on risk and return of Dabur Nepal Pvt. Ltd. For this the major variables as well as the variables affecting capital structure are considered for analysis.

The literature related to the capital structure decision and it's impact on risk and return have been reviewed in second chapter. In this chapter, the theoretical review an empirical review. I.e. review of related studies has been presented separately. From the theoretical review section, we may take advantages of conceptual foundation of capital structure decision as well as reliability of different aspects of its impact on risk and return. Similarly, by reviewing some previous studies, many inputs can be taken also take advantage from this section. Form this chapter we can conclude that, all the theories of capital structure are not properly applicable in the DNPL contest and almost all previous studies conducted by previous master's level students has almost some conclusion. Third chapter explains about the methodology of this study. Mostly the secondary data are used in this study. This study covers the five years data of DNPL. Descriptive and analytical research deign has been used in this study. Financial as well as statistical tools are used. This includes capital structure analysis, ratio analysis, leverage analysis, correlation analysis and trend analysis.

Date are presented and analyzed the fourth chapter, data analysis tools mentioned in the third chapter is used to analyze the data in this chapter.

Various ratios that are related to the capital structure of the firm, correlation analysis between two variables leverage analysis etc. have been used to evaluate the capital structure. Even thought different capital approaches cannot be used because of the unavailability of market value data. For this chapter we can conclude the DNPL fifth chapter is the concluding chapter. This chapter explains about the overall conclusion of this study. Summary, conclusion and recommendation are presented separately.

5.2 Conclusion

Following conclusion have been drawn as the basis of analysis.

Composition of Capital Structure

Capital structure composed by short-term loan, long-term loan and share holders equity. In year 2006 total capital is 10405 lacs where 20.73% is short-term loan 19.74% is long term loan and 59.53% is equity in that amount. In the last year of study 2010 total capital is 13140 lacs this amount is composed by short term loan, long term loan and equity 21.79%, 14.83% and 63.38% respectively. In average total capital 11917 lacs. The long term debt is in drastically decreasing trends. Short term debt is in fluctuating but around the average. Share holders equity is slightly increasing year by year. Long term loan is consider good for profitability and financially safe than short-term loan but DNPL has left only a nominal long term loan in source of capital composition of debt.

Long-term debt is major proportion up to 2006. It is decreased drastically in later year. Short-term loan is around average in the study period. The average long-term debt of DNPL is 831 lacs. In year 2009 98.53% short-term and only 1.47% is long-term loan. In average 81.50% is consist of short-term and 18.5% is long-term loan in total loan composition.

Generally, more short-term loan is considered risky in the context of solvency of the company. Composition of long-term and short-term debt in the beginning year of analysis is satisfactory. Increasing trend of current liabilities makes current obligation high.

Total Debt to Total Assets Ratio

The total debt of total assets ratios of DNPL shows the fluctuating trend on the fiscal year 2006 40.5% which implies that the claim of the creditors in the assets of the company is 40.5% and the remaining 59.5% only is the claim of share holder's. And in the fiscal year 2007, 2008, 2009 and 2010 the 48.2%, 39.9%, 34.3% and 36.2% of total assets is financed by outsiders fund respectively. The company has the 39.9% average debt ratio. The ratio indicates that the creditors claim on total assets of the company is lower than the owners claim.

Trend of Debt to Equity

Dabar Nepal Pvt. Ltd. has decreasing trend of D/E/ ratio in fiscal year 2059/60 debt to equity ratio is 1.86:1 which is highest among five years. After wards D/E ratio is 1.69:1, 0.80:1, 0.81:1 and 0.78:1 is fiscal year 2060/61, 2061/62, 2062/63 and 2063/64 respectively. The average D/E ratio of DNPL is 1.19:1 which implies that the claim of creditors is stronger than that of owners. But the D/E ratio of fiscal year 2062/63 is 0.81: only which can be assumed on satisfactory level. Generally 1:1 debt to shareholders equity can be considered as an appropriate level of debt-equity ratio.

Debt to Capital Employed Ratio

Ratio of debt to capital employed in fiscal year 2006 is 0.41 it means about 41% contribution of debt exists in the capital employed or the

remaining portion i.e. about 59% is contributed by shareholders fund. Similarly this ratio increased to 48% and decreased to 35% in fiscal year 2007 and 2009 respectively. Debt of capital employed ratio is in fluctuating trend. It has 40% and 37% in fiscal year 2008 and 2010 respectively. The average ratio of debt to capital employed of DNPL is 40%. The greater proportion of debt shows the greater claim of debt holders into the firm. The higher ratio indicates the higher burden of company to pay interest expenses. The interventions of creditors may increase. From the above analysis, it is found that DNPL has moderate debt to capital employed ratio. This implies that burrowed fund is in satisfactory proportion in the permanent capital of DNPL.

Interest Coverage Ratio

The interest coverage ratio of Dabar Nepal Pvt. Ltd. is 2.68:1 in fiscal year 2006 and 5.90:1 in 2010. The average ratio is 2.93:1. It shows that the debt servicing capacity of the company is in profit margin on sales consistent level.

From the observation of profit margin ratio of Dabar Nepal Pvt. Ltd. it is highest in fiscal year 2010 among five years operation period as earning after tax is 3.41% of sales revenue. This ratio is 0.06% in fiscal year 2009 which is the lowest of all five years ratios. This profit margin on sales is not the satisfactory level because of the standard is 15. The average profit on sales is only 2% how ever the sales figure is increasing every year but profit margin is in opposite side. It means its operating and other cost is increasing which reduces the profit margin.

Return on total Assets

Return on total assets of Dabar Nepal Pvt. Ltd. is in range from minimum of 2.91% in fiscal year 2009 to maximum of 8.95% in fiscal year 2010. The trend of ROA is decreasing and on average 6.61% the company is gaining moderate ROA ratio that means it is utilizing satisfactory use of its assets in operating the business.

Return on Net Worth

Return on net worth is fluctuating trend year to year from 2006 to 2010. The return on net worth is 7.83% in 2006 fiscal year while only 0.2% in year 2009 and 11.33% in 2010 . The average return on net worth 6.75% is good but it's fluctuating trend would discourage the shareholders.

Liquidity ratio

Both high liquidity and lack of liquidity are not good for business. Dabar Nepal Pvt. Ltd. has used more long term debt in previous year is comparison to short term debt. During the study period current ratio is ranging from minimum 1.25:1 in fiscal year 2008 to maximum 2.16:1 is fiscal year 2010. The trend of this current ratio is fluctuating trend. The average current ratio is 1.62:1 as conventional rule, a current ratio of 2:1 is considered to be satisfactory. The company is in the balance condition of liquidity.

EAT to Total Debt Ratio

The EAT to total debt ratio of DNPL 11.5% in fiscal year 2006 again, 8.5% in 2007, 9.3% in 2008, 0.4% in 2009 19.6% in 2010. The average EAT to total debt ratio constitutes 10.1%. This implies that the company

can remove its total debt by 10.1% from its net profit on an average. This ratio does not shows the strong debt removing capacity of DNPL.

Financial Leverage

The trend of DFL of DNPL reveals that it has fluctuating trend. The degree of financial leverage of DNPL in fiscal year 2006, 1.37 again 1.45 in 2007, 1.65 in 2008, 18.5 in 2009 and 1.2 in 2010. Whereas the average financial risk for the DNPL is 4.83 which imply that one percent change in DFL leads to four hundred eighty-three percent change in EBT.

Correlations

In this study, the correlation co-efficient between earning after tax (EAT) and total debt, debt ratio and ROE, D/E ratio and ROE are analyzed. Correlation between total debt and net profit (EAT):- The correlation between EAT and total debt of DNPL is revealed 0.424.Where it is the positive correlation. Therefore calculated figure 0.424 can considered only moderately correlated. Correlation between those variable implies only 42.2% on earning after tax dependent on total debt.

Correlation between debt ratio and ROE:- the correlation coefficient of debt ratio and RoE is 0.833. The calculated figure is position correlation.

Correlation between debt equity ratio and ROE: Correlation coefficient between D/E ratio and ROE is revealed 0.339. This figure is positive correlation. That means D/E ratio and ROE are positively correlated.

5.3 Recommendations

Based up on the above mentioned issued and constraints some recommendation have been made. These guidelines would help in taking

prompt decision in relation to the capital structure management for justifying the constraints these recommendations are presented below.

Maintain Debt Service Capacity

Debt service capacity of DNPL is found weak in this way DNPL is suggested to maintain sound debt service capacity. This is possible by reducing the interest expenses. So, recommended to DNPL for maintain sound debt service capacity.

Maintain Debt Removing Capacity

The debt removing capacity of DNPL is low. This capacity is low due to the lower earning of the firm in relation to the total debt of the company. To maintain the sound debt removing capacity of this firm; it is necessary to either reduce the amount of debt (mainly short-term debt) or increase the value to earning after taxes. So DNPL recommended maintaining the sound debt removing capacity of the company to maintain believes of the creditors as well as its owners.

Reduce Expenditure

From the analysis of profit margin on sales the profit margin has declined drastically in the final year of the study period. Thus the company should control the administration expenses. DNPL is bearing high amount of interest expenses. As a result, the return of the firm is not satisfactory. So, the company is recommended to minimize interest expenses by using cheaper debt to increases EBT.

Improve in Operating Efficiency and Earning Power

It is seemed from the analysis of return on total assets that though the company is performing well however it is not satisfactory. The return on

total assets is declining year by year. Thus it is suggested to improve the operating efficiency, which would ultimately result in better earning power of the company.

Well Planned Capital Structure

It is found that DNPL is unable to plan it's capital structure properly because debt equity ratio of DNPL is not satisfactory. Due to this reason, EPS may not be maximize so, we recommended to DNPL to plan and maintained capital structure by analyzing the possible alternative financial plans.

After the overall study of the capital structure of the firm, financial condition of the company is satisfactory. The earning position of the company is still good. It is better to conduct the further research and to modernize the company with the latest plant with modern technology, which could reduce the labour cost. Save time and provides the product with better quality and more in quantity in less time.

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APPENDICES

APPENDIX - I

Calculation of Correlation EAT and Total Debt

EAT X_1	Total Debt X_2	X_1^2	X_2^2	$X_1.X_2$
485	4211	235225	17732521	2042335
533	6242	284089	38962564	3326986
441	4739	194481	22458121	2089899
15	3887	225	15108769	58305
944	4811	891136	23145721	4541584
$\sum X_1 = 2418$	$\sum X_2 = 23890$	$\sum X_1^2 = 1605156$	$\sum X_2^2 =$ 117407696	$\sum X_1 X_2 =$ 12059109

Let, us denote EAT to X_1 and Total Debt to X_2

Now,

$$= \frac{n\sum x_1 x_2 - (\sum x_1).(\sum X_2)}{\sqrt{n\sum x_1^2 - (\sum x_1)^2}.\sqrt{n\sum x_2^2 - (\sum x_2)^2}}$$

$$= \frac{5 \times 12059109 - 2418 \times 23890}{\sqrt{5 \times 1605156 - (2418)^2} \times \sqrt{5 \times 117407696 - (23890)^2}}$$

$$= \frac{2529525}{1476.16 \times 4038.12}$$

$$= 0.424$$

APPENDICES

APPENDIX - II

Calculation of Correlation Debt equity ratio and ROE

D/E Ratio X_1	ROE X_2	X_1^2	X_2^2	$X_1.X_2$
0.68	0.078	0.4622	0.0061	0.0532
0.93	0.079	0.8685	0.0063	0.0742
0.66	0.062	0.4398	0.0038	0.0409
0.52	0.002	0.2715	0.0000	0.0011
0.57	0.113	0.3336	0.0128	0.0655
$\sum X_1 = 3.374$	$\sum X_2 = 0.3349$	$\sum X_1^2 = 2.376$	$\sum X_2^2 = 0.0291$	$\sum X_1 X_2 = 0.2348$

Let, us denote D/E Ratio to X_1 and ROE to X_2

Now,

$$= \frac{n\sum x_1 x_2 - (\sum x_1).(\sum X_2)}{\sqrt{n\sum x_1^2 - (\sum x_1)^2}.\sqrt{n\sum x_2^2 - (\sum x_2)^2}}$$

$$= \frac{5 \times 0.2348 - 3.374 \times 0.3349}{\sqrt{5 \times 2.376 - (3.374)^2} \times \sqrt{5 \times 0.0291 - (0.3349)^2}}$$

$$= \frac{0.044}{0.7113 \times 0.1825}$$

$$= 0.339$$

APPENDICES
APPENDIX - III
Calculation of Correlation Debt Ratio and ROE

Debt Ratio X_1	ROE X_2	X_1^2	X_2^2	$X_1.X_2$
0.405	0.078	0.164	0.006	0.031
0.482	0.079	0.233	0.640	0.386
0.399	0.062	0.159	0.384	0.247
0.343	0.002	0.117	0.000	0.001
0.362	0.113	0.131	0.013	0.041
$\sum X_1 = 1.991$	$\sum X_2 =$1.613	$\sum X_1^2 =$0.804	$\sum X_2^2 =$1.043	$\sum X_1 X_2 =$0.706

Let, we denote Debt Ratio to X_1 and ROE to X_2
Now,

$$= \frac{n\sum x_1 x_2 - (\sum x_1).(\sum X_2)}{\sqrt{n\sum x_1^2 - (\sum x_1)^2}.\sqrt{n\sum x_2^2 - (\sum x_2)^2}}$$

$$= \frac{5 \times 0.706 - 1.991 \times 1.613}{\sqrt{5 \times 0.804 - (1.991)^2} \times \sqrt{5 \times 1.043 - (1.613)^2}}$$

$$= \frac{0.319}{0.237 \times 0.1616}$$

$$= 0.833$$

Questionnaire

Appendix –I

A collection of quality information and data of the company.

DEAR SIR/MADAM

I humbly request you to help me by sharing the information about company as for as possible that they are used for the preparations of this entitled 'Capital Structure and its impact on risk and return". Necessary of qualitative data to accomplish the task of them preparation would be fulfilled by questionnaire to some extent. I am a student of University campus, T.U. kirtipur and hope for your kind co-operation in this regriden.

Your information will be kept much confidential and I request to all respondent to be unbiased on their opinion.

Regards
Pushpa Raj Gaire

Name:
Department:
Designation:

1) Are the employees committed and devoted towards their duties? If yes how committed they are?
-Highly committed
-Committed
-Un committed

2) Does the management take initiatives for the monitoring the activities of employees?
-High iniatives
-Moderate iniatives
-Weak iniatives

3) Do your share holders /owners satisfy with the present dividend payment policy?
-Satisfied
-Dissatisfied

4) Does your company adopt the stock dividend? If yes what are the benefits?
-Consumer satisfaction

-Increase in profit
-Increase stock

5) What response do you get from your customer dividend?
-Very good response
-Good response
-No response

6) Are there increase in your profit from the employee's promotion of carrier development opportunities?
-Yes
-No

7) Which types of motivation is used in your company?
-Extrinsic
-Intrinsic

8) What benefits have been achieved from team work?
-High profit
-Goodwill
-Alliance
-All of the above

9) Which leadership style has been practiced in your company?
-Autocratic
-Democratic
-Free rein

10) What is the dividend per share (DPS) of your company in recent year?
-Increasing
-Decreasing
-Constant

11) How Does Company's manages the conflicts?
-By negotiation
-By enforcement
-By low suit

12) Whether there is timely decision making or not
-Yes
-No

13) Do you have culture to make participation of lower level staff in decision making? If yes, what is the level of participation?
-High
-Average
-Low

14) Whether there is timely decision making or not?
-Yes
-No

15) Is there the practice of time management? If yes how effective is the time management?
-High effective
-Poor effective
-Normal

16) Does your company use the quality circle in performing jobs? If yes what is its impact on productivity and efficiency?
- Positive
- Negative
- Indifference