# CHAPTER – I

## INTRODUCTION

### Background of the study

Every business firm needs capital to operate business. The term 'capital' denotes the long term fund of the firms. The term capital structure is used to represent the proportionate relationship between debt and equity. Capital structure decision is significant managerial decision. It influences the shareholders return and risk. The market value of the share may be affected by the capital structure decision.

The term capital structure is used to represent the proportionate relationship between debt and equity. Equity includes paid up capital, share premium and reserve and surplus (retained earnings).

The capital structure decision is a significant managerial decision . It influences the share holder return and risk. Consequently, the market value of the share may also be affected by the capital structure decision. This decision will involve an analysis of existing capital structure and factors which will govern the decision at present. The new financing decision of the company may affect it's debt – equity mix. The debt equity mix has implications for the shareholders earnings and risk, which in turn , will affect the cost of capital and the market value of the firm.

Capital structure refers to the mix of long term sources of funds, such as debenture, long-term debt, preference share capital and equity share capital including reserves and surplus (i.e., retained earnings).

The sources of financing are usually grouped into debts and equity which normally characterize the firm's capital structure. Debt capital include all long-term borrowing incurred by the firm, while equity capital consists of long term fund provided by the firms owners, stock holders. On the other hand the borrowed capital or debt fund has a fixed charge irrespective to the earnings of the firm and the firm has to pay the fixed charge as interest periodically to the borrowed fund provider.

The success and failure of the industry mainly depends up on the ability of top management to make appropriate capital structure decision. Some companies do not plan their capital structure, and it develops as a result of the financial decision taken by the financial manager without any formal planning. These companies may prosper in the short-run, but ultimately they may face considerable difficulties in raising funds to finance their activities. With unplanned capital structure, these company may also fail to economize the use of their funds. Consequently, it is being increasingly realized that a company should plan its capital structure to maximize the use of the funds and to be able to adapt more easily to the changing condition.

Capital structure is closely related concept linked to cost of capital and therefore, is important for capital budgeting decision. Changes in leverage result in change in level of returns and associated risk. Generally, increase in leverage result in increase return and risk. Whereas decrease in leverage result in decrease in return and risk as well as value of firm. Because of its effect on value, the financial manager must understand how to measure and evaluate leverage when attempting to create the best capital structure.

The concept of capital structure occupies an important place in the theory of financial management. Capital structure is the mix of debt, preferred stock and common equity with which the firm plans to raise capital.  Firms should analyze a number of factors, and then establish a capital structure. Capital structure may change over time as condition change but at any given moment management should have a specific capital structure in mind. If the actual debt ratio is below the target level, debt should generally issue to raise capital, whereas if the debt ratio is above the target, equity should generally be issued. The firm should select capital structure, which will help in achieving the objective of financial management that is to maximize the value of equity shares. The Capital structure should be examined from the viewpoint of its impact on the value of the firm. It can be legitimately expected that if the capital structure decision affects the total value of the firm, a firm should select such a financing-mix as will maximize the shareholder's wealth. Such a capital structure is referred as the optimal capital.

Capital structure policy involves a trade-off between risk and return. Using more debt raises the risk borne by stockholders. However, using more debt generally leads to a higher expected rate of return on equity. Higher risk tends to lower a stock price, but higher expected rates of returns raise it. Therefore, the optimal capital structure must strike a balance between risk and return as to maximize the firm's stock price

## 1.2 Introduction of Jyoti Spinning Mills Ltd.

**Joyti Spining Mills Ltd.** (JSML) is one of the large-scale thread industries in Nepal. JSML is incorporated in Nepal at 13 magh. 2045 and its registered office is in Chorni VDC, Bara District as private Limited. Later it changes as public limited at 27$^{th}$ Shrawan 2046. It's prime objectives are to fulfill the domestic need of thread, cut down importers of thread and  to help increase employment opportunities of people. The commercial production has been started from 28$^{th}$ March 1992. Indian company Laxmi machine workers Limited koymvtor, Swiss LUWA and Italy SAVIO, supplies the machinery and equipment. Annual capacities of these plants are 3300 Metric To. The authorized capital of the company is Rs.1000 million and called up capital is Rs.270 million and paid up capital is Rs.193.8444 million. The company has provided 825 people as a permanent and temporary job and 110 people on contact is in best of ten companies in comparison with Indian and Nepalese best companies.

The raw materials of the mills are cotton, fibers, polyester, viscose's fiber and acrylics fibers. Cotton is generally produced in Nepal and some are imported from India and Bangladesh. The remaining fibers are imported from India, Indonesia, Thailand and Italy. Raw materials being agriculture product can not be found in the same ratio through out the year and on the hand, there is no proper cultivation of such in Nepal. The mill produces different types of threads. Which consumed inside the nation, the main consumers being textile mills?

### 1.3 Focus of the study

In most of the Nepalese companies, there is not the existence of debt in there 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 Jyoti spinning mills Ltd. and its impact on risk and return. JSML 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. Most of the carpet industries in Nepal depend up on JSML for thread. JSML 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**

**Factors May affecting the Performance of JSML**

| **External environment** | **Internal environment** |
|---|---|
| i) Not well established government<br>ii) Strike<br>iii) Political Parties<br>iv) Not sufficient employee training agency<br>v) Socio-Cultural | i) Policies, Strategies<br>ii) Organizational culture<br>iii) Organizational structure<br>iv) Capital structure |

The table 1.1 shows the causes due to which JSML 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 JSML. The study has been performed to highlight the current capital structure practices of JSML.

**1.4 Statement of the problem**

The capital structure concept has been the subject of controversy since the publication of Modigliani and Miller's classic paper in 1958 (Modigliani and Miller, 1958). There are many empirical works regarding the capital structure supporting and refusing the MM view and traditional view. The study by Barges (1963), Weston (1963), Wippern (1981) and Pandey rejected the MM hypothesis while Mamanda (1972) and Stiglitz (1974) study supported the MM hypothesis. Weston (1963) used MM's cost of capital for his sample of 59 utilities in 1959. He found that the regression co-efficient of leverage to be positive and significant. However multiple regression was run, the result is consistent with the traditional view. Barges (1963) used simple regression techniques to analyze the relationship between leverage and the average cost of capital, stock yield and debt equity ratio utilized cross section data of the three industries. Pandey (1981) computed multiple regression equation to test the validity of MM proposition and his result concluded that cost of capital is the function of capital structure.

There are some studies conducted in the capital structure management of different companies in Nepal . Adhikari (1991), Ghimire (1999) and Khatri (1989) tested the MM hypothesis on listed companies. They used multiple regression model to test MM propositions and found that the result support the traditional proportion.

Capital structure concept is not taken seriously in the Nepalese organizations. Which results not the existence of optimal capital structure. Among the listed companies, some of them use debt capital while some use equity capital only. Athough the companies which do not have optimal capital structure are ma

king profit that is another matter. They are making profit due to higher demand of their product or may be due to friendly environment but in reality they are paying higher cost for their capital.

Generally every business organization have their own policy to raise funds make capital structure because there is no any best way to make capital structure. It largely depends up on the company policy and its cost of capital.

There is one of the main mystery of success of the successful organization is the balanced (optimal) capital structure. All the decision maker about the capital structure know that mystery then the question may arise that (a) is the exiting capital structure decision significant ? (b) Whether the cost of capital structure declines with leverage ? (c) How the leverage affects the cost of equity (d) Whether or not the capital structure decision affect the market value of shares ? (e) Is there impact of Capital structure of JSML on return and risk? To solve such problems, the management of the company should be aware of the importance of capital structure management. The purpose of this study is to analysis examine and make aware of the importance of capital structure management for Jyoti Spinning Mills Ltd.

### 1.5. Objective of the study

The basic objective of this study is to asses the capital structure decision of JSML and it's impact on risk and return on the basis of selected tools.

The other specific objective of this study are as follows:

- To examine the capital structure of JSML.
- To asses the return of JSML.
- To analyze the impact of capital structure on risk and return of JSML.

### 1.6. Significance of the study

The capital structure decision is a significant managerial decision. It influences the shareholder’s return and risk. Consequently, the market value of the share is affected by capital structure decision. The company has to plan its capital structure initially at the time of its promotion and subsequently, whenever funds have to be raised to finance its project. It is also important for concerned company, investor and researcher. It enables them to know the effects of exiting capital structure on the value of share, risk and return. if the exiting capital structure effect is positive on the value of share and risk and return then the exiting capital structure is optimal and if not, the study will help the management to change the exiting capital structure in near future. The study is also significant for the investor. The study will shed light in details on the exiting capital structure of JSML which will help the investors whether to invest in JSML or not ? Consequently the researcher will also be benefited by getting many inputs. They can take advantage of conceptual foundation of capital structure decision as well as reliability of different aspect of its impact on risk and return.

### 1.7 Population and Sample of the stydy.

To get the information about capital structure decision and its impact on risk and return, more representative and comprehensive sample is selected for the wide coverage of population. There are 18 manufacturing companies listed in NEPSE out of them JSML is selected on the basis of purposive sampling method.

### 1.8 Limitation of the study

This study is only concerned with "the capital structure decision and its impact on risk and return." It is partial study, for the study some limitations are to be considered as follows.

1. This study covers only five-year period from fiscal year 059/060 to fiscal year 063/064.

2. This study only focuses the capital structure, return and risk of Jyoti Spinning Mills Ltd

3. Results and finding depends on validity and reliability of collected data.

4. Coefficient of Z-score is used as given by Altman.

## 1.9 Organization 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 JSML. 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.

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