INTERNATIONAL JOURNAL OF RESEARCH IN COMMERCE & MANAGEMENT

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ANALYSIS OF PROFITABILITY AND RISK: A CASE STUDY OF MRF LTD.

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ABSTRACT

Profitability and risk are very important to determine the financial condition and performance of a firm. Again profitability and risk have same direction; in order to have greater profitability, we need to take greater risk. But in practice a firm must accomplish a minimum risk to achieve maximum profitability. This paper makes an attempt to provide an insight into the profitability performance of MRF in comparison to risk. The study is based on secondary data collected from published annual reports cover a twelve years' period from 2003 to 2014. The available data have been analyzed by using important profitability ratios and risk factor. Profitability ratios are ranked and selected into a uniform boundary to compare their performance with risk.

KEYWORDS

profitability, risk Factor, trade-off.

1. INTRODUCTION

Profit is a very good indicator of business performance; every business must earn sufficient profits to sustain the operations of the business and to fund expansion and growth. It is difficult for a business to breathe well without profit. It may be regarded as a mirror of the performance of business activities. In short, profit is the legitimate object of an enterprise form the shareholder. Accountant ascertain profits, is not only a reliable measure of efficient performance by means of production resources. But also, means of measuring the progress of the business and of indicating when and whole corrective action, if necessary shall be taken. The management of a business firm has to take some vital managerial decision like further development, raising of an additional finance and dilemma dividend payments etc. and for this purpose the management very much rely-upon the profitability of the business firm.

On the contrary risk is the "effect of uncertainty on objectives". It can be seen as relating to the profitability of uncertain future actions. Risk analysis is the technique of defining the analyzing the threats posted to businesses by adverse dealings. Financial deals which creating a proper outline to maximize profits at a given level of risk. In pursuing this balance, the firm must develop controls over the flows of funds while allowing sufficient flexibility to respond to changes in the operating environment. Thus, the firm must manage a tolerable risk so as to achieve maximum profitability.

2. COMPANY SNAPSHOT

Since 1984, MRF Tyres has consistently been chosen by almost every major car manufacturer in India. MRF is the one of the biggest company in the Indian tyre industry. The company manufactures the largest range of tyres in India and with the largest market share in almost every segment of the tyre industry. The company's six manufacturing facilities are located at southern part of the country. At present MRF export tyres to over 65 countries. It is the first tyre company in India to achieve a turnover of Rs. 5,000 Crore. In fact, its gross revenues crossed the Rs. 10,000 Crore mark in financial year 2010-11. It also has one of the highest Net Profit growth rates over the last 5 years. During 2015 the company plant to invest Rs. 4,500 Crore in Tamil Nadu over next seven years as part of expansion plan and will soon sign a pact with the state government in this regard.

3. OBJECTIVES OF THE STUDY

The study is being done with the following objectives:

(1) To examine the profitability position of the company over the study period.
(2) To measure the risk factor of the company during the period of study.
(3) To know the association between profitability and risk.

4. EXPERIMENTAL DETAILS

The study is concerned with the twelve years' data on MRF Ltd. for a period of (2003-2014). The data is of secondary in nature and is obtained from various published reports. The available data has been analyzed through various profitability ratios and drawing out the profitability position of the said company. Statistical tool Rank correlation has been applied by ranking the observations. Further, statistical t-test has been applied to test the hypothesis and draw conclusions.

5. RESULTS AND DISCUSSION

PROFITABILITY ANALYSIS

The profitability of the enterprise is popularly measured with the help of financial ratios conveying quantitative relationship between two variables considered for the purpose. The gross profit ratio indicates the limit beyond which sales are not tolerated to fall. A high ratio of gross profit to sales is a symbol of good management for the firm. Similarly operating ratio determines the operational efficiency of the management. Higher operating ratio indicates that the firm has got enough margins to meet its non operating expenses well as to create reserve and pay dividends. Alternatively, net profit ratio indicates the efficiency of management to operate the firm successfully in relation to earned revenues and all types of costs associated with it at a reasonable level of risk and uncertainty. The high net profit ratio ensures good return to the owners. Simultaneously return on capital employed explains the overall utilisation of fund by a business. It reveals the efficiency of the business in utilisation of funds entrusted to it by, share holders, debenture-holders and long-term liabilities. While Return on Networth indicates how profitably the shareholders' fund or net worth has been utilized by the enterprise. It is an important yardstick to judge the performance of a firm for the equity shareholders.

The theoretical model of Profitability analysis is given as follows:

Independent Variables	Dependent Variable
Gross profit Ratio	Profitability Performance of the company
Operating Profit Ratio	
Net Profit Ratio	
Return on Capital Employed	
Return on Net Worth	

Table no. 1 depicted the consolidated profitability position of MRF Ltd from 2003 to 2014

TABLE 1: CONSOLIDATED PROFITABILITY POSITION OF MRF LTD.

Year	Operating Profit		Gross Profit		Net Profit		ROCE		RONW		Total	Ultimate Rank
	Rate	R*	Rate	R*	Rate	R*	Rate	R*	Rate	R*		
Sep '03	10.05	7	8.53	4	5.36	4	13.57	8	16.67	8	31	**8**
Sep '04	7.70	10	7.08	8	1.11	12	10.33	10	3.98	12	52	**10**
Sep '05	5.86	12	5.66	10.5	1.35	11	5.03	12	5.35	11	56.5	**12**
Sep '06	6.88	11	5.66	10.5	2.13	10	8.50	11	9.69	10	52.5	**11**
Sep '07	10.24	6	9.21	3	3.89	8	18.97	6	17.42	7	30	**7**
Sep '08	8.65	8	5.30	12	2.80	9	13.11	9	12.66	9	47	**9**
Sep '09	12.42	3	8.03	6	4.50	7	27.88	2	18.82	6	24	**4**
Sep '10	11.20	4	7.71	7	4.74	6	22.01	5	20.93	3	25	**5**
Sep '11	8.37	9	5.82	9	6.37	3	15.21	7	26.95	1	29	**6**
Sep '12	10.64	5	8.09	5	4.82	5	22.09	4	20.02	4	23	**3**
Sep '13	14.56	2	11.48	1	6.61	2	28.04	1	22.00	2	8	**1**
Sep '14	14.60	1	11.40	2	6.80	1	24.79	3	19.87	5	12	**2**

Source: Compiled from the www.economicstime.com (R* = Rank)

The ratios are ranked in the order of their influence on Profitability. The higher the ratio; the greater is the Profitability. Further, the ultimate rank has been considered from the total of the ranks of ratios. The ultimate ranking has been completed on the principle that the lower the aggregate of the individual ranks, the more profitable is the liquidity position and vice versa.

RISK ANALYSIS

This risk is generally measured with the help of financial ratios. It is to be noted that there are no prescribed accounting ratios for risk evaluation. Some specific index value methods are also followed to determine the risk. Risk factor helps to know about the financing of the current assets through long term funds after fixed assets are financed in full. In this study we use the following formula for measuring non-insurable risk of MRF:

$$R_k = \{(E_j + L_j) - A_j\} \div C_j$$

Where,
R_k = Risk Factor,
E_j = Equity + Retained Earnings,
L_j= Long term Loans,
A_j = Fixed Assets and
C_j = Current Assets.
Implications of Risk Factor (R_k):
(i) R_k = 0: indicates the firm is using the aggressive policy and normally the profitability would be high.
(ii) R_k = 1: indicates the firm is using the conservative policy and normally the profitability would be low.

Table no. 2 depicted the data relating to the risk factor, its ranking order, and the type of policy adopted by the company during the study periods. The following mentioned table indicates that the R_k values were found neither closed to 0 nor closed to 1; hence this parameter clearly reveals a moderate level of risk policy. It indicates standard profitability situation.

TABLE 2: CALCULATION OF RISK FACTOR IN RANKING ORDER

Year	(in Rs. Cr.)				Risk Factor (R_k)	Rank
	Equity + Retained Earnings (E_j)	Long-Term Loans (L_j)	Fixed Assets (A_j)	Current Assets (C_j)		
Sep '03	704.20	191.73	398.47	839.69	0.59	**12**
Sep '04	723.41	166.32	419.22	917.00	0.51	**6**
Sep '05	754.05	299.57	536.81	1,061.63	0.48	**5**
Sep '06	824.29	309.65	649.67	1,158.02	0.41	**1**
Sep '07	986.15	395.55	656.75	1,318.14	0.54	**10**
Sep '08	1,120.79	634.29	866.55	1,696.39	0.52	**7.5**
Sep '09	1,361.42	189.75	933.56	1,290.10	0.47	**4**
Sep '10	1,690.68	541.95	1,328.91	1,974.44	0.45	**3**
Sep '11	2,297.77	1,209.30	1,971.38	2,890.09	0.53	**9**
Sep '12	2,857.80	1,433.34	2,913.80	3,160.78	0.43	**2**
Sep '13	3,645.14	1,259.92	2,969.54	3,682.24	0.52	**7.5**
Sep '14	4,517.64	1,390.87	3,428.69	4,215.84	0.58	**11**

Source: Compiled from the www.economicstime.com

TRADE OFF BETWEEN PROFITABILITY AND RISK

Table no.3 exhibits that the correlation coefficient between two series of ranks is called 'Rank Correlation Coefficient'(r) and it is -0.15. Spearman's Rank Correlation uses rank rather than actual observation and makes no assumption about population from which actual observations are drawn. Hence the profitability and risk are negatively associated but the degree of relationship is low. Again the null hypotheses drawn state that profitability and risk of the firm are negatively correlated which is tested by using student's t test for confirming the association between the risk and profitability. Calculated 't' value of 'r' at 0.05 level of significance and (n - 2) degree of freedom is -0.480 where as the table value of t is 1.812. As the calculated value is less than the critical value, the null hypothesis is accepted. Thus, it can be said that the profitability and risk are negatively correlated.

TABLE 3: RISK AND PROFITABILITY: THE RELATIONSHIP (using rank correlation)

Year	Ranking of Profitability	Ranking of Risk Factor
Sep '03	**8**	**12**
Sep '04	**10**	**6**
Sep '05	**12**	**5**
Sep '06	**11**	**1**
Sep '07	**7**	**10**
Sep '08	**9**	**7.5**
Sep '09	**4**	**4**
Sep '10	**5**	**3**
Sep '11	**6**	**9**
Sep '12	**3**	**2**
Sep '13	**1**	**7.5**
Sep '14	**2**	**11**
'r'	**- 0.15** (Low negatively correlated)	
't' value of 'r'	**- 0.480**	

Source: Calculations are done using MS Excel.

6. CONCLUSION

The overall profitability position showed a mixed performance over the study period. The ranking of profitability ratios denotes that during the year 2013 the company enjoyed the highest profitability and the poorest profitability was recorded in 2005. The index value of risk factor is not satisfactory over the study period. However, the highest risk was recorded during the year 2003. It is practical that there is a low degree of negative association between profitability and risk. Further, the profitability and risk of the firm are also negatively correlated.

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