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IMPACT OF CAPITAL BUDGETING TECHNIQUES ON HERO HONDA COMPANY - AN EMPIRICAL STUDY

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ABSTRACT

Capital budgeting is concerned with allocation of the firm's scarce financial resources among the available favorable circumstances. The return of investment opportunities involves the comparison of the expected future returns from a project with immediate and subsequent return for it. The problems in capital budgeting decisions may be Future uncertainty, Time Element, Difficulty in Quantification of impact etc. Since we all know that automobiles companies requires large investment. Therefore, in this research, Researcher would like to study the impact of various capital budgeting techniques on the financial variables of the selected company. There is very less study done in India regarding the same. Therefore, there is a need to study the various issues involve in Capital Budgeting Practices in India.

KEYWORDS

NPV, IRR, Capital budgeting Techniques.

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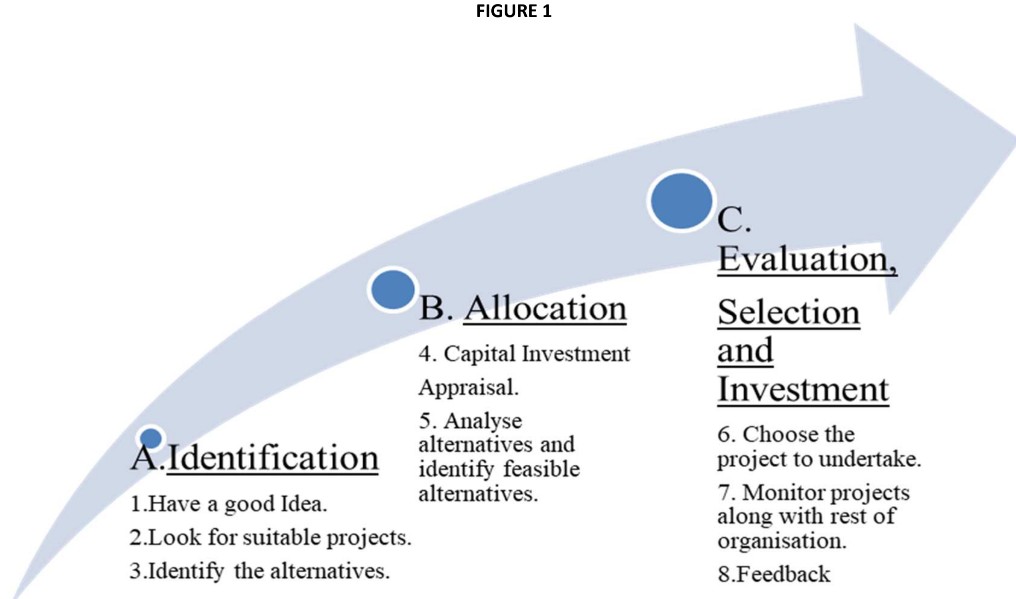
INTRODUCTION OF CAPITAL BUDGETING

As all we know that finance is the life blood of every business. In this competitive era the optimal usage of finance is crucial issue. Almost in every business huge amount of funds are required to purchase various assets and for the expansion of business. So before investing huge funds, every organization must know in advance the viability of the assets/projects. Capital Budgeting techniques are used to evaluate the profitability/viability of the concerned projects. **Capital budgeting** or **investment appraisal**, is the planning process, which is used to determine whether an organization's long term investments in new machinery, replacement of old machinery with new one, installation of other manufacturing equipment, lunching of new products and research development projects are worth-full for the organization or not. In other words we can say that Capital budgeting is the process in which a business determines and evaluates projected investments that are large in nature.

CAPITAL BUDGETING DECISIONS THROUGH EIGHT STEPS

FIGURE 1



There are number of **evaluation techniques** which may be recommended for evaluating the capital investment proposals. These methods can be classified into the following categories:

A. TRADITIONAL TECHNIQUES

Traditional techniques are grouped in to the following:
(1) Pay-back period method.
(2) Improvement of Traditional Approach to Pay-back Period Method.
(a) Post Pay-back profitability Method.
(b)Reciprocal Pay-back Period Method.
(3) Rate of Return Method or Accounting Rate of Return Method.

B. TIME ADJUSTED TECHNIQUE OR DISCOUNTED CASH FLOW TECHNIQUES

Time Adjusted Method further classified into:
(1) Net Present Value Method.
(2) Internal Rate of Return Method. (IRR)
(3) Profitability Index Method.
(4) Modified Internal Rate of Return (MIRR)
(5) Hurdle Rate
(6) Earnings Multiple Approach
(7) Adjusted Present Value (APV)
(8) Discounted Payback-Period

INTRODUCTION OF HERO HONDA COMPANY

Hero Motocorp Ltd., formerly **Hero Honda**, is an Indian motorcycle and scooter manufacturer based in New Delhi, India. The company is the largest two-wheeler manufacturer in world and also in India where it has a market share of about 46% in the two-wheeler category. The 2006 Forbes list of the 200 World's Most Respected Companies has Hero Honda Motors ranked at #108. On 31 March 2013, the market capitalisation of the company was 308 billion (US$4.8 billion). The company has sold over 47 million 2-wheelers since its inception in 1984 till March 2013.[2] It sold 6.07 million 2-wheelers in 2012, out of which 5.5 million were motorcycles. Hero Motocorp sells more two wheelers than the second, third and fourth placed two-wheeler companies put together. Its most popular bike Hero Honda Splendor sells more than one million units per year.

In 2013, Hero MotoCorp registered best ever calendar year performance of more than 6.1 million unit sales. By selling 625,000 units in the month of October, it became the first-ever manufacturer to cross landmark 6 lakh unit sales in a month. In the last quarter of the year or say in the festive season, the company sold more than 1.6 million units, while in non festive time in April–May 2013, it managed to sell out quite good numbers of units—1.1 million.

REVIEW OF LITERATURE

Jog and Srivastava (1991) surveyed the large Canadian corporations and provide direct empirical evidence on the capital budgeting process. They found many critical issues viz., cash flow forecasting methods, methods used to estimate the cost of capital and the cost of equity and the use of capital budgeting techniques risk analysis techniques. He concluded that most of the firms used multiple capital budgeting methods to evaluate capital investments however DCF methods were employed by more than 80% of our respondents to evaluate projects such as foreign operations and leasing, expansion-new operations and expansion-existing operations.

Block Stanley (2000) has surveyed the capital budgeting policies and procedures of 150 multinational companies in light of current financial theory. He had examined that some of the policies that MNCs used for the capital budgeting decisions are the logical extensions of domestic practices into the international area, while others appear to be misguided changes to normal capital budgeting procedures. According to his study, there are a number of misapplications such as applying corporate wide weighted average cost of capital to foreign affiliate cash flows rather than to cash flows actually remitted to the corporations. Also, risk is frequently measured on a local project basis (in a foreign country) rather than considering the multiple effect on the total corporations. Of the 150 survey respondents in this study, 69.7% believe that international investments increase the risk exposure of the firm and establish policies on that premise. Finally, he has shown that the survey respondents hedge against the uncertainty of the procedures by adding an importance to the weighted average cost of capital as computed by financial analysts given the inconsistent procedures that are often utilized in going from domestic to international capital budgeting.

Ryan Patricia A and Ryan Glenn P. (2002) had evaluated the capital budgeting decision methods used by the 800 manufacturing companies. According to him, most of the most of the companies preferred NPV as capital budgeting tool, which represents alignment between corporate theory and practice. Firms with larger capital investment budgets tend to favor NPV and IRR. PBP is used at least half of the time by 73.7% of the respondents. Fourth in popularity was the discounted payback model used at least half of the time by 58.9% of the companies. Finally at least half time usage was reported for the three models as follows. PI ranks fifth at 43.9%, followed by ARR at 32.3% and finally, IRR at 24.7%.

Gupta Sanjeev, Batra Roopali and Sharma Manisha (2007) had made an attempt to find out which capital budgeting techniques is used by manufacturing industries in Punjab, and the influence of factors such as size of capital budget, age and nature of the company, and education, gender and experience of the CEO in capital budgeting decisions. They conducted a primary survey of 40 companies in Punjab. Almost one-third of the companies had capital budget exceeding Rs. 150million. Majority of the sample companies still use non-discounted cash flow techniques like PBP and ARR. Only a few companies use DCF, and among them very less number use NPV technique to evaluate a new project. The most preferred discount rate is WACC. The most popular risk incorporating technique is 'Shorter PBP.

Klammer, Thomas P. (2008) took a sample of 348 firms in France from the 2001 listing of manufacturing firms that appeared in significant industry groups and invest at least $1 million of capital expenditures in each of the five years 2001-2006. He concluded that Present value method was most popular among the various manufacturing companies.

Pettway (2009) surveyed a random sample of 310 business firms. Questionnaire were sent to companies through mail engaged in retailing, manufacturing transportation, land development, entertainment and public utilities to study the capital budgeting process and the methods used to adjust for risk. He concluded that firms considered the Internal Rate of Return technique to be the most important technique for decision-making.

Lawrence G. and Forrester (2010) analyzed the responses of 125 manufacturing firms that reported as having the greatest stock price growth over the 2004-2009 periods. The survey containing questions related to techniques used in capital budgeting process, the division of responsibility for capital budgeting decisions, the most important and most various difficulties faced in implementation of capital budgeting techniques, the cutoff rate and the various methods used to evaluate the risk factor.

Brighman (2011) conducted the research study of the capital budgeting projects of 15 large manufacturing firms, he found that although techniques that smaller firms prefer PBP method to evaluate the investment proposal but large manufacturing firms most relied on discounted cash flow techniques. Moreover these manufacturing firms assumed some variable constant when discounted cash flow techniques were used. For example, some firms' simplifying assumptions include the use of the same economic life and same cash inflows for all projects even though the actual lives and actual cash flows might be different. Further, firms often did not make any adjustment regarding analysis for risk. This survey indicated the result that most of firms preferred discounted techniques.

Adeniyi (2012) asserted that in spite of the theoretical limitations of the payback period method, it is the one that is most widely used in practice. He offered the following reasons for its usage: it is easily understood by all levels of management; it provides an insight on how quickly the initial can be recouped; most managers see risk as time-related i.e. the longer the period, the greater the chance of failure; where a firm faces liquidity constraints and requires a fast repayment of investments, the pay-back period is more useful; it is appropriate in situations where risky investments are made in uncertain markets that are subject to fast design and product changes or where future cash flows are particularly difficult to predict.

Meigs, et al (2014) a business may benefit from good capital budgeting decisions and suffer from poor ones for many years. Many non-financial factors are also considered in making capital budgeting decisions. For example, many companies give high priority to creating new jobs and avoiding layoffs. However, it is also essential that investments in plant assets earn a satisfactory return on the funds available to finance the project and the company will not be able to generate sufficient funds for future investment projects. The capital budgeting techniques are classified into two -non discounted cash flow and discounted cash flow techniques.

Masa, Imegi and Akenbor (2015), investment decisions relate to the corporate decision to invest its resources in the most efficient manner in business activity with the hope that the activity will, in turn, generate a stream of future returns over time. It asks the question; into what uses do we put the available funds of the business such that we become better in the future? It is the responsibility of the financial experts in collaboration with the accountants to analyse and decide on the type of asset to commit a firm's funds in anticipation of future returns.

STATEMENT OF THE PROBLEM

Capital budgeting is concerned with allocation of the firm's scarce financial resources among the available favorable circumstances. The return of investment opportunities involves the comparison of the expected future returns from a project with immediate and subsequent return for it. The problems in capital budgeting decisions may be **Future uncertainty, Time Element, Difficulty in Quantification of impact etc.**

Since we all know that automobiles companies requires large investment. So In this research, Researcher I would like to study the impact of various capital budgeting techniques on the financial variables of the selected company. There is very less study done in India regarding the same. So, there is a need to study the various issues involve in Capital Budgeting Practices in India.

OBJECTIVES

1. To study the procedure of Capital Budgeting in selecting companies.
2. To study the impact of sound capital budgeting techniques on the financial performance (i.e. total revenue, net profits, market capitalization price etc.) on the selected companies

HYPOTHESES OF THE STUDY

Ho1. Correlation between fixed investments and the selected financial factors (i.e. total revenue, net profits, etc.) is not significant.

RESEARCH METHODOLOGY

In this study the researcher has made use of varying sources of information keeping in mind the cost and time constraints. The major decision with regard to research plan while executing the research study is based on various sources of information. Secondary data will be collected for addressing the research problem and fulfilling the objectives of the study. The data is processed using the Microsoft Windows Excel. Along with that the mix of appropriate analytical tools and techniques including statistical tables, simple frequency tables, percentages, arithmetic mean, standard deviation and correlation are used to analyze the data and address the research problem. The data is collected for 5 years i.e. from 2013-2017.

DATA PROCESSING AND ANALYSIS

The following Table shows impact of sound capital budgeting techniques on the financial performance

TABLE 1

Particular	Formula	March 2017	March 2016	March 2015	March 2014	March 2013
1. Assets Efficiency-y Ratio	Sale/ Total Assest	3.051	3.88	4.48	4.85	4.83
2. Net Profit Percentage-e	Net Profit/ Sale * 100	10.95	10.15	8.14	7.77	8.25
3. Earning power %	1*2	33.41	39.38	36.47	37.68	39.87
4. Fixed Assets Efficiency-y Ratio	Sale/Gross Fixed Assets	4.5	5.21	6.24	7.22	5.8
5. Plant and machinery turnover ration	Sale/ Plant and machinery	60.92	77.56	89.45	96.45	102.35
6. Plant and machinery to Gross Fixed Assets	Plant and machinery/ Gross Fixed Assets*100	7.38	6.713	6.98	7.46	5.66

Source: Annual report of Hero Honda Company

TABLE 2: CORRELATION BETWEEN THE VARIABLES (Amount In Crores)

Years	Sale	Net Profit	Plant& Machinery
March 2017	30846.12	3377.12	506.33
March 2016	30857.48	3132.37	397.85
March 2015	29302.94	2385.64	327.58
March 2014	27155.82	2109.08	280.43
March 2013	25659.94	2118.16	250.70

Source: Annual report of Hero Honda Company

TABLE 3: CORRELATIONS

		sale	Plantandmachiner
Sale	Pearson Correlation	1	.884*
	Sig. (2-tailed)		.047
	Sum of Squares and Cross-products	2.123E7	833699.170
	Covariance	5307488.785	208424.793
	N	5	5
Plantandmachiner	Pearson Correlation	.884*	1
	Sig. (2-tailed)	.047	
	Sum of Squares and Cross-products	833699.170	41898.592
	Covariance	208424.793	10474.648
	N	5	5

*. Correlation is significant at the 0.05 level (2-tailed).

TABLE 4: DESCRIPTIVE STATISTICS

	Mean	Std. Deviation	N
Sale	28764.4540	2303.79877	5
Plantandmachiner	352.5780	102.34573	5

TABLE 5: DESCRIPTIVE STATISTICS

	Mean	Std. Deviation	N
Plantandmachiner	352.5780	102.34573	5
netProfit	2624.4740	592.33877	5

TABLE 6: CORRELATIONS

		Plantandmachiner	Net Profit
Plantandmachiner	Pearson Correlation	1	.963**
	Sig. (2-tailed)		.009
	Sum of Squares and Cross-products	41898.592	233451.572
	Covariance	10474.648	58362.893
	N	5	5
netProfit	Pearson Correlation	.963**	1
	Sig. (2-tailed)	.009	
	Sum of Squares and Cross-products	233451.572	1403460.870
	Covariance	58362.893	350865.217
	N	5	5
**. Correlation is significant at the 0.01 level (2-tailed).			

Source: Use of SPSS

FINDINGS AND CONCLUSION

An in-depth analysis has been carried out to observe the trend and insight into factors that influence capital budgeting decisions. The results of the survey and its analysis have been provided in the above section. The selected company do have specific amount of average size of annual capital budget and all project size requires formal quantitative analysis. However, such analysis and use of capital budgeting method differ on the basis of nature and size of a particular project under consideration. One of the objectives of this research is to analyze how 'Risk' and 'Uncertainty' in the future estimates in investment projects is being taken care of. Sensitivity analysis is considered as the most important technique while scenario analysis is considered as the second important technique for assessing risk. The other more sophisticated techniques like Decision tree, Monte Carlo simulation, Certainty equivalent, Probability analysis, Beta analysis has got very low ratings that means these techniques are rarely used in the selected company. Further, An effort has been made to develop a relationship between the independent variables; Plant and machinery and sales to explain the variation in the dependent variable as operating income of the company. The analysis has been carried out with the help of regression analysis. The period covered in the study is last five financial years (2014-2017). The summarized results of analysis for each company are provided in the analytical section. The above hypothesis is also not true according to the findings of the above study.

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