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   STATEMENT OF THE PROBLEM

   OBJECTIVES

   HYPOTHESES

   RESEARCH METHODOLOGY

   RESULTS & DISCUSSION

   FINDINGS

   RECOMMENDATIONS/SUGGESTIONS

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CAPITAL STRUCTURE (DEBT-EQUITY) OF INDIAN PHARMACEUTICAL INDUSTRY – A STUDY

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ABSTRACT
In this paper, an attempt has been made to study the "Capital Structure (Debt-Equity) of Indian Pharmaceutical Industry". To this end, 12 pharmaceutical companies have been chosen and categorized into three distinct groups (A) Better Performing Companies (BPCs), (B) Moderately Performing Companies (MPCs) and (C) Low Performing Companies (LPCs). An analysis of long-term solvency, impact of financial leverage on the shareholders' earnings and justification for the use of debt by the Indian pharma industry through the application of ratio analysis, trend analysis and statistical test has been undertaken. From the study, it is found that BPCs and MPCs of IPI depended on equity financing, whereas, LPCs were on debt financing. The debt-equity mix of IPI tended to be pro-equity. The degree of financial leverage did not alter the earnings of the shareholders favourably in IPI. The interest coverage has been sufficient in BPCs and MPCs and therefore, justification for the use of debt is valid. But a reverse situation is observed in LPCs.

KEYWORDS
Debt-Equity Ratio, Financial Leverage, Indian Pharmaceutical Industry, Interest Coverage Ratio.

INTRODUCTION
One of the most critical areas of the finance function is to make decisions about the firm's capital structure. Capital is required to finance investments in plant and machinery, inventory, accounts receivable and so on. The term 'Financial Structure' refers to a firm's total liabilities. The current liabilities, funded debt and net worth including surplus and the various kinds of stock constitute the financial structure (Burtchett, F.F., and Hicks). The items on the liabilities side are of two kinds - those representing claims of creditors and those representing the claims of equity owners (Guthmann, H.G1976). The meaning of "Capital Structure" is sought to be limited to long-term sources of funds, viz., share capital, retained earnings and long-term borrowings. The term 'Capital Structure', therefore, has been generally defined to include only long term debt and total shareholders' investment (Walker, E.W, 1976).
It's necessary that companies should have optimal capital structure that can maximize the price of the company's stocks. Companies can choose a mix of financing options to finance its assets but it is very necessary that they choose the financing options that maximize its overall value. When companies don't have debt in their capital structure, then they are unlevered while on the other hand if the companies have debt in their capital structure then they are called leveraged firms. Unlevered company's total assets are always equal to total equity and it is the total value of the company. Proper planning of capital structure also helps companies to enlarge their area for getting funds as well as creates the mobility of sources of the funds.

OBJECTIVES
In order to study the capital structure of IPI, it is proposed to cover the following:
- Assessment of Long-term Solvency through debt-equity ratio.
- Impact of financial leverage on the earnings of shareholders.
- Justification for the use of debt through interest coverage ratio.

METHODOLOGY
Multi-stage Sampling Technique is adopted in selecting the sample for the study. Companies which undertake (i) Manufacturing; (ii) Research and Development; and (iii) Plant approvals by various International agencies alone are considered for making out the sample. Based on Return on Capital Employed (ROCE), companies have been categorized as: (i) Better Performing Companies (BPCs) under group – A where ROCE is 20 per cent and above; (ii) Moderately Performing Companies (MPCs) under group – B where ROCE is in between 10 and 19 per cent; and (iii) Low Performing Companies (LPCs) under group – C where ROCE is below 10 per cent. Twelve companies were chosen for the study consisting 4 each from A, B and C groups at random. The sample, therefore, constitutes 12 pharmaceutical companies formed into 3 distinct groups – A, B and C for the study. The data drawn from the annual reports of select companies for the period from April, 2002-03 to March, 2009-10 have been tabulated and analysed and interpreted through ratio analysis, trend analysis, co-efficient and student't' test.

ASSESSMENT OF LONG-TERM SOLVENCY
The long term solvency of a firm can be judged by using leverage or capital structure ratios. The relationship between borrowed funds and owners' funds is a popular measure of the long term financial solvency of a company. This relationship is shown by the debt-equity ratio. This is a vital ratio to determine the efficiency of the financial management of a business undertaking (Choudhary, A.B.R, 1970). This can be expressed as:

$$\textbf{Debt–Equity Ratio} = \frac{\textbf{Long Term Debt (LTD)}}{\textbf{Shareholders' Equity}}$$

STATISTICAL ANALYSIS OF DEBT-EQUITY RATIO (DER) OF ALL GROUPS VIS-À-VIS IPI
The Debt – Equity ratio is a financial ratio indicating the relative proportion of debt and shareholders' equity used to finance a company's assets. These two components are often taken from the firm's balance sheet or statement of financial position. A high debt-equity ratio generally means that a company has been aggressive in financing its growth with debt. This can result in volatile earnings as a result of the additional interest expense. A low debt/equity ratio usually means that a company has been friendly in financing its growth with debt and more aggressive in financing its growth with equity. A high debt-equity ratio is observed in case of LPCs with an average of 0.67 and in MPCs with an average of 0.44. The lowest debt-equity ratio of 0.04 times is found in BPCs group (See Table-1). It means that, the companies under LPC and MPC groups have relatively employed more debt to finance growth. The CV of debt - equity ratio of BPCs,

MPCs and LPCs are 50.00 per cent, 75.00 per cent and 17.91 per cent respectively, which shows that LPCs are more consistent than BPCs and MPCs in employing the debt in their capital structure. Lower variability in the debt-equity ratio in LPCs indicates stable management of debt-equity.

TABLE -1: DEBT-EQUITY RATIO OF ALL GROUPS VIS-À-VIS IPI (RATIO IN TIMES)

Year	Debt- Equity Ratio (DER)			
	BPCs	MPCs	LPCs	IPI
2002 – 03	0.04	0.42	0.77	0.35
2003 – 04	0.04	0.43	0.72	0.36
2004 – 05	0.04	1.03	0.8	0.64
2005 – 06	0.07	0.81	0.73	0.55
2006 – 07	0.06	0.43	0.75	0.36
2007 – 08	0.03	0.17	0.53	0.18
2008 – 09	0.01	0.12	0.64	0.15
2009 – 10	0.01	0.09	0.45	0.12
Mean	**0.04**	**0.44**	**0.67**	**0.34**
Standard Deviation	**0.02**	**0.33**	**0.12**	**0.19**
C.V (%)	**50.00**	**75.00**	**17.91**	**55.88**

TESTING OF HYPOTHESIS OF DEBT-EQUITY RATIO

Null Hypothesis : There is no significant difference between the debt-equity ratio of individual groups and that of the IPI.

Alt. Hypothesis : There is significant difference between the debt–equity ratio of individual groups and that of the IPI.

TEST STATISTICS

Name	Mean	Industry Mean	t - Value	Sig (2 tailed)
BPCs	**0.04**	**0.34**	**4.52***	**0.00**
MPCs	**0.44**	**0.34**	**0.73**	**0.48**
LPCs	**0.67**	**0.34**	**4.22***	**0.00**

*significant at 0.05 level (2 – tailed)

After testing the statistical hypothesis it is confirmed that when compared with IPI, the null hypothesis is accepted for MPCs and alternate hypothesis is accepted for BPCs and LPCs. Therefore, there is significant difference between D/E ratio of BPCs and LPCs.

DEBT–EQUITY RATIO [LONG TERM DEBT (LTD) + SHORT TERM DEBT (STD)]

Another method to express the debt-equity ratio is to relate the total debt i.e., long term and short term borrowed funds to the shareholders' equity. This can be expressed as**:**

$$\textbf{Debt–Equity Ratio} = \frac{\textbf{Total Debt}}{\textbf{Shareholders' Equity}}$$

STATISTICAL ANALYSIS OF DEBT (LTD+STD)-EQUITY RATIO OF ALL GROUPS VIS-À-VIS IPI

All the debt whether long-term or short-term is included to compute debt-equity ratio. The average debt-equity ratio of BPCs, MPCs and LPCs was recorded at 0.43, 1.13 and 1.70 times respectively. (See Table – 2). A high debt-equity ratio is observed in case of the LPCs and MPCs which implies that the companies under these two groups have been aggressive in financing their growth with debt.

The CV of debt-equity ratio of the BPCs, MPCs and LPCs are 18.60 per cent, 61.06 per cent and 24.71 per cent, which shows that the BPCs are more consistent than MPCs and LPCs in employing debt in their capital structures. Lower variability in the debt-equity ratio indicates proper or efficient management of debt equity.

TABLE – 2: DEBT (LTD+STD)-EQUITY RATIO OF ALL GROUPS VIS-À-VIS IPI (Ratio in Times)

Year	*Debt-Equity Ratio*			
	BPCs	*MPCs*	*LPCs*	*IPI*
2002 – 03	*0.46*	*1.00*	*1.43*	*0.89*
2003 – 04	*0.48*	*2.44*	*1.17*	*0.87*
2004 – 05	*0.49*	*1.64*	*1.35*	*1.18*
2005 – 06	*0.54*	*1.46*	*1.87*	*1.23*
2006 – 07	*0.42*	*0.98*	*2.45*	*1.02*
2007 – 08	*0.38*	*0.59*	*1.86*	*0.70*
2008 – 09	*0.34*	*0.56*	*2.00*	*0.67*
2009 – 10	*0.31*	*0.39*	*1.46*	*0.52*
Mean	***0.43***	***1.13***	***1.70***	***0.89***
Standard Deviation	***0.08***	***0.69***	***0.42***	***0.25***
C.V (%)	***18.60***	***61.06***	***24.71***	***28.09***

TESTING OF HYPOTHESIS OF DEBT (LTD+STD) -EQUITY RATIO

Null Hypothesis: There is no significant difference between the debt-equity ratio of individual groups and that of the IPI.

Alt. Hypothesis: There is significant difference between the debt–equity ratio of individual groups and that of the IPI.

TEST STATISTICS

Name	Mean	Industry Mean	t - Value	Sig (2 tailed)
BPCs	**0.43**	**0.89**	**4.92***	**0.0002**
MPCs	**1.13**	**0.89**	**0.95**	**0.3536**
LPCs	**1.70**	**0.89**	**4.69***	**0.0003**

*significant at 0.05 level (2 – tailed)

After testing the statistical hypothesis, it is confirmed that when compared with IPI, the null hypothesis is accepted for MPCs and alternate hypothesis is accepted for BPCs and LPCs. Therefore, there is significant difference between D/E ratio (LTD+STD) of the BPCs and the LPCs.

EFFECT OF FINANCIAL LEVERAGE ON THE SHAREHOLDERS' EARNINGS

The primary motive of a company in using financial leverage is to magnify the shareholders earnings under favourable economic conditions. The role of financial leverage in magnifying the earnings of shareholders is based on the assumption that the fixed charges funds (debt carrying fixed rates of interest) can be obtained at a cost lower than the company's rate of return on its assets. Thus, when the difference between the earnings generated by assets financed by the fixed charges funds and costs of these funds is distributed to the shareholders, they get additional earnings without increasing their own investments. Consequently, the earnings per share or the rate of return on the common shareholders' equity increases. However, earnings per share or the rate of return on equity will fall if the company obtains the fixed charges funds at a cost higher than the rate of return on the company's assets. The earnings per share (EPS) and the rate of return on equity are important figures for analyzing the impact of financial leverage (I.M. Pandey, 1979).

DEGREE OF FINANCIAL LEVERAGE (DFL) IN ALL GROUPS VIS-À-VIS IPI

The DFL at a particular EBIT (Earnings Before Interest and Taxes) level is measured by the percentage change in (EPS) relative to the per cent change in EBIT. The following equation can be used to determine the degree of financial leverage.

$$DFL = \frac{EBIT}{EBT}$$

FAVOURABLE AND UNFAVOURABLE FINANCIAL LEVERAGE

The effect of financial leverage may be favourable or unfavourable. Positive or favourable leverage occurs when the earnings per share increases due to the use of debt in the capital structure and vice versa. The Impact of financial leverage on earnings per share, as well as return on equity of BPCs, MPCs, LPCs and IPI are shown in Table - 3. Trends in the DFL of BPCs were maintained uniformly at the same level. Whereas, trends of ROE as well as EPS have shown fluctuations indicating that the DFL has not influenced ROE and EPS in BPCs.

The MPCs have been characterized by a declining trend in DFL. But the trends of ROE and EPS depicted fluctuations, thereby indicating that the DFL did not influence either the ROE or EPS. An analysis of the trends in LPC group points that with an increase in DFL there was decline in both ROE and EPS. It is, thus, evident that DFL had an unfavourable effect on ROE and EPS in LPCs. The LPC trends also are repeated in case of IPI. Hence, it is concluded that DFL had not shown any favourable impact on ROE and EPS in IPI.

TABLE – 3: TRENDS IN THE DEGREE OF FINANCIAL LEVERAGE, RETURN ON EQUITY AND EARNIGS PER SHARE

	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08	2008-09	2009-10
	BPCs							
DFL (%)	101.57	100.93	100.78	101.01	101.10	100.92	100.56	100.22
Trends	(100)	(99)	(99)	(99)	(100)	(99)	(99)	(99)
ROE (%)	25.02	30.65	27.29	29.39	39.94	29.16	27.54	23.91
Trends	(100)	(123)	(109)	(117)	(120)	(117)	(110)	(96)
EPS (Rs.)	25.75	39.74	37.26	50.88	65.19	42.45	47.49	40.10
Trends	(100)	(154)	(145)	(198)	(253)	(165)	(184)	(156)
	MPCs							
DFL (%)	117.08	109.58	109.92	105.46	105.11	105.32	111.99	106.43
Trends	(100)	(94)	(94)	(90)	(90)	(90)	(96)	(91)
ROE (%)	25.43	25.75	24.23	27.03	24.35	26.38	22.12	16.45
Trends	(100)	(101)	(95)	(106)	(96)	(104)	(87)	(65)
EPS (Rs.)	19.40	17.03	15.38	21.10	16.55	22.88	22.55	18.61
Trends	(100)	(88)	(79)	(109)	(85)	(118)	(116)	(96)
	LPCs							
DFL (%)	136.63	123.42	173.62	173.21	118.53	111.41	167.59	111.54
Trends	(100)	(90)	(127)	(127)	(87)	(82)	(123)	(82)
ROE (%)	17.44	16.00	6.21	7.11	19.20	19.64	5.23	22.97
Trends	(100)	(92)	(36)	(41)	(110)	(113)	(30)	(132)
EPS (Rs.)	10.97	14.01	6.74	(2.03)	6.87	7.91	(6.08)	18.91
Trends	(100)	(128)	(61)	(-19)	(63)	(72)	(-55)	(172)
	IPI							
DFL (%)	113.50	107.73	108.82	107.48	104.62	104.34	109.15	104.98
Trends	(100)	(95)	(96)	(95)	(92)	(92)	(96)	(92)
ROE (%)	23.71	25.27	21.58	24.02	25.69	26.25	21.60	19.40
Trends	(100)	(107)	(91)	(101)	(108)	(111)	(91)	(82)
EPS (Rs.)	56.12	7078	59.38	69.95	88.61	73.24	63.96	77.62
Trends	(100)	(126)	(106)	(125)	(158)	(131)	(114)	(138)

JUSTIFICATION FOR THE USE OF DEBT

The use of debt in any business undertaking is justified, provided, the coverage for fixed interest charges is adequate. It indicates the number of times the fixed interest charges (debenture interest, interest on loans) is covered by the net profit (net profit before interest and tax). It is calculated by dividing the net profit before interest and taxes by the amount of fixed interest charges. The higher the coverage, the better will be the position of debenture holders or loan creditors regarding their fixed payment of interest, the greater will be the profitability, and the better will be the management efficiency (S.KR. Paul, 2002). The universal standard for ICR is around 7 to 8 times.

STATISTICAL ANALYSIS OF INTEREST COVERAGE RATIO (ICR) OF ALL GROUPS VIS-À-VIS IPI

This ratio is used to determine how easily a company can pay interest on outstanding debt. The ICR is calculated by dividing a company's earnings before interest and taxes of one period by the company's interest expenses of the same period. The lower the ratio, the more the company is burdened by debt expense. When a company's ICR is lower, its ability to meet interest expenses becomes questionable and it indicates that the company is not generating sufficient revenues to satisfy interest expenses. The ICR is a measure of the number of times a company could make the interest payments on its debt with its earnings before interest and taxes. The lower the ICR, higher is the company's debt burden, and the greater the possibility of bankruptcy or default.

Table 4 shows that the ICR of BPCs which recorded at 156 times is more than IPI average of 16.08 times. This is an indication of the less debt burden and hence more safety to creditors. The average ICR of MPCs and LPCs reported at 14.37 and 5.25 respectively are less than the industry average, which indicates lesser margin of safety for the lenders of credit. The co-efficient of variation of ICR of the BPCs, MPCs, and the LPCs is 82.83 per cent, 37.09 per cent and 59.24 per cent respectively, which shows less consistency during the study period because the CV of the IPI as a whole is 35.45 per cent. Greater variability in the ICR indicates imbalanced use of debt funds.

TABLE – 4: INTEREST COVERAGE RATIO OF ALL GROUPS VIS-À-VIS IPI (Ratio in Times)

Year	Interest Coverage Ratio (ICR)			
	BPCs	MPCs	LPCs	IPI
2002 – 03	64.69	6.85	3.73	8.41
2003 – 04	108.08	11.44	5.27	13.94
2004 – 05	128.73	11.08	2.36	12.33
2005 – 06	99.81	19.3	2.37	14.37
2006 – 07	91.92	20.59	6.4	22.64
2007 – 08	110.12	19.81	9.76	23.97
2008 – 09	180.15	9.34	2.48	11.92
2009 – 10	465.32	16.56	9.66	21.07
Mean	**156.10**	**14.37**	**5.25**	**16.08**
Standard Deviation	**129.29**	**5.33**	**3.11**	**5.70**
C.V (%)	**82.83**	**37.09**	**59.24**	**35.45**

TESTING OF HYPOTHESIS OF INTEREST COVERAGE RATIO

Null Hypothesis : There is no significant difference between the ICR of individual groups and that of the IPI.

Alt. Hypothesis : There is significant difference between the ICR of individual groups and that of the IPI.

TEST STATISTICS

Name	Mean	Industry Mean	t - Value	Sig (2 tailed)
BPCs	**156.10**	**16.08**	**3.06***	**0.008**
MPCs	**14.37**	**16.08**	**0.61**	**0.547**
LPCs	**5.25**	**16.08**	**4.71***	**0.0003**

*significant at the 0.05 level (2 – tailed)

After testing the statistical hypothesis, it is confirmed that when compared with IPI, the null hypothesis is accepted for MPCs and alternate hypothesis is accepted for BPCs and LPCs. Therefore, there is a significant difference between the ICR of BPCs and LPCs.

CONCLUSION

The BPCs and MPCs of IPI have depended on equity financing, whereas, LPCs on debt financing. The debt-equity mix of IPI has tended to be pro-equity. DFL didn't influence ROE and EPS in BPCs and MPCs. But, the DFL in LPCs had unfavourable impact on ROE as well as EPS. On the whole, DFL did not alter the earnings of the shareholders favourably in IPI. The Interest coverage is less in LPCs than the other two groups indicating higher amount of debt used and commitment of more interest. The margin of safety available to creditors is not adequate enough in this group. The BPCs and MPCs of IPI may employ more debt funds in their capital structure to reap the advantages of leverage.

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