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IMPACT OF CAPITAL STRUCTURE ON PROFITABILITY OF ITC LTD

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Abstract— *This study has been undertaken to examine the effect of Capital Structure on profitability of ITC Ltd., one of the leading FMCG companies in India. Secondary data from some important data banks were collected and used to perceive whether capital structure influence the profitability of the company. The study realized that the Debt Equity Ratio has influence on the profitability measures viz.,ROTA, ROCE and ROE of ITC Ltd. It was known from the study that the capital structure has a negative influence on profitability of the selected company.*

Keywords— *Capital structure, profitability, fast is moving consumer goods.*

INTRODUCTION

Over the years, ITC Ltd., one of the leading FMCG companies in India has evolved from a single product company to a multi-business corporation. Its diverse businesses include fast moving consumer goods such as cigarettes, cigars, branded packaged foods, lifestyle apparel, personal care products, education & stationery products, safety matches and agarbattis, as well as hotels, paperboards & specialty papers, packaging, agri business and information technology. Each of these businesses is vastly different from the others in its type, the state of its evolution and the basic nature of its activity, all of which influence the choice of the form of governance. The challenge of governance for ITC therefore lies in fashioning a model that addresses the uniqueness of each of its businesses and yet strengthens the unity of purpose of the Company as a whole.

Since the commencement of the liberalization process, India's economic scenario has begun to alter radically. Globalization will not only significantly heighten business risks, but will also compel Indian companies to adopt international norms of transparency and good governance. Equally, in the resultant competitive context, freedom of executive management and its ability to respond to the dynamics of a fast changing business environment will be the new success factors. ITC's governance policy recognizes the challenge of this new business reality in India. In view of the above, it is felt that it is necessary, to undergo a study with regard to the financial performance of the company.

Financial performance refers to the act of performing financial activity. In broader sense, financial performance refers to the degree to which financial objectives are being or has been accomplished. It is the process of measuring the of firm's policies and operations in monetary terms. It is used to measure firm's overall financial health over a given period of time and can also be used to compare similar firms across the same industry or to compare industries or sectors in aggregation. Financial analysts often assess firm's production and productivity performance, profitability performance, liquidity performance, working capital performance, capital structure, fixed assets performance, fund flow performance and social performance. However in the present study financial health of ITC Ltd. is measured in the perspective of capital structure and its impact on profitability.

CONCEPT OF CAPITAL STRUCTURE

The term “Capital structure” represents the proportion of capital used by the company during its operation. Companies can either use equity or debt capital or the mixture of both in order to finance assets. Work on capital structure initially presented by the Modigliani& Miller (MM) (1958). Later on different researches were conducted to identify the effect of capital structure on financial performance of companies and shown contradictory results. But a comprehensive and detailed study has not been conducted so far especially in FMCG sector. Present study is based on the secondary data extracted from the annual reports published from Money control. com in order to determine the effect of capital structure on the Profitability of the leading FMCG Company ITC Ltd.

REVIEW OF LITERATURE

The review of literature is highly useful to design the present study as it indicates the research gap in the study of financial performance of the FMCG firms. Measuring the financial performance of the corporate sector has always been an area of controversy from the point of view of the government, shareholders, investors, creditors, employees. Some of the important studies conducted on the financial performance are reviewed here.

Alan J. Auerbach (1983) has revealed that the financial policy of any country is widely distorted by differential treatment of debt and equity. He attempted to examine using firm-level panel data of 200 corporations, the relationship between real and financial decisions by corporations, in part to determine the extent to which biases offset or reinforce each other. He has critically evaluated all the capital structure theories in detail including the 'all debt' theory by Modigliani- Miller and the Bankruptcy/Agency Cost theory. He has explained the determinants affecting the type of debt-funds raised by the firms and also their tenure i.e. long-term borrowing and short-term borrowing.

Myers (1984) has made a study on the debt-equity structure and he has called it the pecking order theory of capital structure. The pecking order theory has two important empirical implications: most profitable firms tend to borrow the least and less profitable firms have higher debt-equity ratio.

Pandey (1985) has conducted a study on "The Financial Leverage in India". He has found out that there is no definite structural relationship between the degree of financial leverage, profitability and growth. The study reveals that Indian companies follow a high-leverage capital structure

Sinha (1993) has made an attempt to investigate the debt-equity ratio of the private sector companies in India. His study shows that there is a negative correlation between the debt-equity ratio and profitability in the case of public limited companies but in the case of private limited companies, the margin on sales has a negative correlation with debt-equity ratio.

Tobias Adrian and Hyun Song Shin (2008) have attempted to document the relationship between balance sheet size and leverage. They have tried to show that leverage is strongly pro-cyclical and that expansions and contractions of balance sheets have an impact on risk appetite of the corporates. The authors have redefined liquidity as the rate of growth of aggregate balance sheets. They opine that the financial market commentators often use the metaphors such as "liquidity sloshing around in the market" or markets awash with liquidity do not capture the precise meaning of the term liquidity.

V.V. Acharya and S.Viswanatahn (2010) aver that financial firms raise short term debt in order to finance asset purchases. When asset fundamentals worsen, debt induces firms to risk-shift which also limits their funding liquidity to roll over debt. Firms can de-liver by selling assets to better-capitalized firms. They opine that that the market liquidity of assets depends on the severity of the assets shock and the system-wide distribution of leverage.

Dr. Umar Butt (2011) attempted to study the relationship between the policies adopted by the corporates and the degree of leverage in their capital structures. The author avers that those firms which have proper corporate governance practices in place also tend to have higher leverage ratios. He further states that those firms which are enjoying positive relationship between profit and financial leverage have good government practices firmly established. The author investigates as to what are the considerations for selecting various sources for finance and how corporate governance influences the selection of the source.

OBJECTIVES

- To identify the relationship between capital structure and profitability
- To find out the impact of capital structure on profitability
- To suggest the select company to increase its profitability through adapting a better strategic frame work of capital structure.

Hypotheses

Following hypothesis is frame d for the present study:

*H0:-*There is no significant relationship between capital structure and the profitability of firms.

*H1:-*There is significant relationship between capital structure and the profitability of firms.

Methodology

The aim of the study is to assess the impact of capital structure on profitability of ITC Ltd., being one of the leading FMCG companies in India The Debt to Equity ratio is used as a dependent variable while profitability ratios ROTA, ROCE, ROE and NP is used as independent variables. The data for the study has been collected from Money Control.com. for a period of ten years from 2005-06 to 2015-16

To assess whether the study is statistically significant and to find out whether there exists significant relationship between dependent variables and independent variables, regression and correlation analysis have been used

Table 1: Relationship between Capital Structure and ROTA (Correlation)

		ROTA	*Capital Structure*
RO TA	Pearson Correlation	1	-216
	Sig (Two tailed)		.000
	N	18	18
Capital Structure	Pearson Correlation	-216	1
	Sig (Two tailed)	.000	
	N	18	18

*****. Correlation is significant at the 0.01 level (2-tailed).***

Table 1 depicts the results of Correlation between the Capital structure and ROTA. It is found that the coefficient is negative and it is highly significant at 1per cent level which means a negative relationship exists between ROTA and Capital structure.

Table 2: Model Summary

Model	*R*	*R^2*	*Adjusted R^2*	*Standard Error*
1	-216	112	104	08.12482

A Model Summary for the correlation analysis has been presented in Table 2 which shows the value of R, R^2 and the adjusted R^2. The value of R^2 shows that 11.2 % impact on profitability is caused by Capital Structure and other 89.8% is caused by other variables.

Table 3: Coefficients

Model	*UnstandardizedCo-efficients*		*Statistical Coefficients*	*t*	*Sig.*
	B	*StdError*	*Beta*		
(Constant)	28.012	4.695		5.327	.000
Capital structure	-6.583	2.872	-216	- 1.86	000

In table 3 t value also show the significant negative impact of capital structure on the Return on Total Assets. It is clear that an increase in Debt capital results decrease in Return on Equity and vice versa.

Table 4: Relationship between Capital Structure and ROCE (Correlation)

		ROCE	*Capital Structure*
RO CE	Pearson Correlation	1	-186
	Sig (Two tailed		.000
	N	18	18
Capital Structure	Pearson Correlation	-186	1
	Sig (Two tailed)	.000	
	N	18	18

*****. Correlation is significant at the 0.01 level (2-tailed).***

Table 1 depicts the results of Correlation between the Capital structure and ROCE. It is found that the coefficient is negative and it is highly significant at 1per cent level which means a negative relationship exists between ROCE and Capital structure.

Table 5: Model Summary

Model	*R*	*R^2*	*Adjusted R^2*	*Standard Error*
1	-186	104	83	06.486

A Model Summary for the correlation analysis has been presented in Table 5 which shows the value of R, R^2 and the adjusted R^2. The value of R^2 shows that 8.3 % impact on profitability is caused by Capital Structure and other 91.7% is caused by other variables.

Table 6: Coefficients

Model	*UnstandardizedCo-efficients*		*Statistical Coefficients*	*t*	*Sig.*
	B	*StdError*	*Beta*		
(Constant)	21.012	3.892		3.567	000
Capital structure	-5.583	1.986	-186	-1.63	000

In table 6, t value is found to be significant negative impact of capital structure on the Return on Capital Employed. It is understood that an increase in Debt capital results decrease Return on Capital Employed and vice versa.

Table 7: Relationship between Capital Structure and ROE (Correlation)

		ROE	*Capital Structure*
ROE	Pearson Correlation	1	-176
	Sig (Two tailed)		.000
	N	18	18
Capital Structure	Pearson Correlation	-176	1
	Sig (Two tailed)	.000	
	N	18	18

*****. Correlation is significant at the 0.01 level (2-tailed).***

Table 7 depicts the results of Correlation between the Capital structure and ROE. It is found that the coefficient is negative and it is highly significant at 1per cent level which means a negative relationship exists between ROE and Capital structure.

Table 8: Model Summary

Model	*R*	*R^2*	*Adjusted R^2*	*Standard Error*
1	-176	082	096	05.56824

A Model Summary for the correlation analysis has been presented in Table 8 which shows the value of R, R^2 and the adjusted R^2. The value of R^2 shows that 8.2 % impact on profitability is caused by Capital Structure and other 91.8% is caused by other variables.

Table 9: Coefficients

Model	*UnstandardizedCo-efficients*		*Statistical Coefficients*	*t*	*Sig.*
	B	*StdError*	*Beta*		
(Constant)	24.0587-	5.965		5.327	.000
Capital structure	-4.6325	3.352	-176	- 1.86	000

In table 9, t value also shows the significant negative impact of capital structure on the Return on Equity. It is inferred that an increase in Debt capital results decrease Return on Equity and vice versa.

CONCLUSION

This study involves determining the relationship between capital structure (Debt/equity) and profitability of ITC Ltd., one of the leading FMCG companies in India. Capital structure of the company is found to be a significant negative relationship with all profit measuring ratios viz ROTA, ROCE and ROE. So the null hypothesis in all cases is rejected. It is concluded from the study that debt capital is negatively associated with the profitability. It means an increase in debt capital results a decrease in the profitability ***(ROTA, ROCE and ROE)*** of ITC and vice versa.

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