COURSE. : III B. COM (CA)

SEMESTER. : 6

SUBJECT. : FINANCIAL MANAGEMENT (18BCA62C)

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UNIT – III

Leverages: Financial Leverage – Operating leverage – EBIT and EPS analysis – Theories of Capital Structure – Net income approach – Net operating income Approach – The Traditional approach - Modigliani and Miller (MM) Approach – De terminants of capital structure- Capitalisation – Over and Under capitalisation - M erits and Demerits.

UNIT - 3

LEVERAGE :

Leverage is an investment strategy of using borrowed money—specifically th e use of various financial instruments or borrowed capital—to increase the pote ntial return of an investment. Leverage can also refer to the amount of debt a fir m uses to finance assets.

FINANCIAL LEVERAGE

In finance, leverage is any technique involving using debt rather than fresh e quity in the purchase of an asset, with the expectation that the after-tax profit to equity holders from the transaction.

A company has a choice of the following two financial plans. you are required t o calculate the financial leverage. Interest at 10% on debt in all cases.		
particulars	X rs	Y rs
Equity capital	2,000	1,000
Debt	2,000	3,000

Operating profit	400	400

CALCULATION OF FINANCIAL LEVERAGE

Particulars	X rs	Y rs
Operating profit	400	400
Less : interest 10 %	200	300
PBT	**200**	**100**
FINANCIAL LEVERAGE :		
EBIT / PBT	400 / 200	400 / 100
FL	**2**	**4**

OPERATING LEVERAGE

Operating leverage is a measure of how revenue growth translates into gr owth in operating income. It is a measure of leverage, and of how risky, or volat ile, a company's operating income.

The installed capacity of a factory is 600 units. Actual capacity used is 400 unit s. Selling price per unit is ₹ 10 variable cost is ₹ 6 per unit. Calculate the operati ng leverage in each of the following three situations;
When fixed costs are Rs.400
When fixed costs are Rs.1,000
When fixed costs are Rs.1,200.

STATEMENT SHOWING OPERATING LEVERAGE

Particulars	Situation 1	Situation 2	Situation 3
Sales (400 x 10)	4,000	4,000	4,000
Less: variable cost (400 x 6)	2,400	2,400	2,400
contribution	**1,600**	**1,600**	**1,600**
Less: fixed cost	400	1000	1200
Operating profit	**1200**	**600**	**400**

Operating leverage = C / **op**	1600 = **1.33** / 1200	1600 = **2.66** / 600	1600 = **4** / 400

EBIT EPS ANALYSIS

EBIT-EPS analysis is a technique used to determine the optimal capital stru cture in which the value of earnings per share (EPS) has the highest amount for a given amount of earnings before interest and taxes (EBIT). In other wordsthe obje ctive of EBIT-EPS analysis is to determine the effect of using different sources of fi nancing on EPS.

A company has the following capital structure. 10,000 equity shares of ₹ 10 eac h ₹1,00,000. 2000 10% preference shares of ₹ 100 each ₹ 2,00,000. 2000 10% d ebentures of ₹ 100 each ₹ 2,00,000. Calculate the EPS for each the EBIT i) 1,00, 000 ii) 60,000 iii) 40,000 the company in 50% of tax, calculate financial leverage taking EBIT.

CALCULATION OF EPS			
Particulars	EBIT 1	EBIT 2	EBIT 3
EBIT	1,00,000	60,000	1,40,000
Less: Interest on debentures	20,000	20,000	20,000
PBT	**80,000**	**40,000**	**1,20,000**
Less: Income tax at 50%	40,000	20,000	60,000
PAT	**40,000**	**20,000**	**60,000**
Less: preference dividend	20,000	20,000	20,000
Earning available for equity shar eholders	**20,000**	-	**40,000**
EPS = EAES / No of equity shares	20,000 / 10,000		40,000 / 10,000

EPS	2	NIL	4

THEORIES OF CAPITAL STRUCTURE

Capital Structure means a combination of all long-term sources of finance. It includes Equity Share Capital, Reserves and Surplus, Preference Share capital, Loan, Debentures and other such long-term sources of finance. A company has to decide the proportion in which it should have its own finance and outsider's finance particularly debt finance. Based on the proportion of finance, WACC and Value of a firm are affected.There are four capital structure theories for this, viz. net income, net operating income, traditional and M&M approach.

NET INCOME APPROACH

This approach was suggested by Durand and he was in favor of financial leverage decision. According to him, a change in financial leverage would lead to a change in the cost of capital. In short, if the ratio of debt in the capital structure increases, the weighted average cost of capital decreases and hence the value of the firm increases.

NET OPERATING INCOME APPROACH

This approach is also provided by Durand. It is opposite of the Net Income Approach if there are no taxes. This approach says that the weighted average cost of capital remains constant. It believes in the fact that the market analyses a firm as a whole and discounts at a particular rate which has no relation to debt-equity ratio. If tax information is given, it recommends that with an increase in debt financing WACC reduces and value of the firm will start increasing.

TRADITIONAL APPROACH

This approach does not define hard and fast facts. It says that the cost of capital is a function of the capital structure. The special thing about this appr

oach is that it believes an optimal capital structure.Optimal capital structure impli es that at a particular ratio of debt and equity, the cost of capital is minimu m and value of the firm is maximum.

MODIGLIANI AND MILLER APPROACH (MM APPROACH)

It is a capital structure theory named after Franco Modigliani and Mer ton Miller. MM theory proposed two propositions.

Proposition I: It says that the capital structure is irrelevant to the value of a firm. T he value of two identical firms would remain the same and value would not affect by the choice of finance adopted to finance the assets. The value of a firm is depe ndent on the expected future earnings. It is when there are no taxes.

Proposition II: It says that the financial leverage boosts the value of a firm and red uces WACC. It is when tax information is available.

DETERMINANTS OF CAPITAL STRUCTURE

Trading on Equity

Desire to Retain Control

Size of Company

Nature of Business

Amount of capital Required

Cost of Financing

Growth Rate

Period of Finance

Flexibility

Profitability

Timing

Taxes

Attitude of Lenders

Purpose of Financing

CAPITALISATION

Capitalisation is combination of owner's capital and borrowed capital. Tha t means, it tells about total fund invested in a company. Share capitals, deben tures, loans etc.

OVER CAPITALISATION

In this, profits are not enough to pay interest on debentures and dividends t o shareholders over a period of time. That means, amount generated is used to ra ise capital than required capital, which results decline in rate of returns.

UNDER CAPITALISATION

Company will earn high profit than estimated, which gives additional funds to the company for expansion in form of profits. Goodwill of the company increa ses and return of capital increases