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A Study on Impact of Financial Leverage on Shareholders Return and Market Capitalisation *(with special reference to Indian Pharmaceutical Companies)*

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Abstract: The challenge before every financial manager in today's developing market is to keep its investors contended. Apart from investing decision the focus today is deciding right mix of financing structure and along with it maximizing the shareholders wealth. A firm should focus its productive activities and select such a financing source, which will achieve the objective of wealth maximization. The financial leverage is an essential requirement for achieving optimal capital structure. An optimal capital structure affects the value of firm through reduced cost of capital. In the present study, an attempt was made to determinate optimal financial leverage for the pharmaceutical sector and to find out its impact on the firms over all capital structure. Simple Linear Regression analysis was carried out to judge the impact of financial leverage on shareholders return and market capitalisation individually. The findings reveal that that financial leverage has no strong influence on the shareholder return of leveraged sample pharmaceutical firms.

Keywords: Financial leverage, Return on shareholders fund, Market capitalization

INTRODUCTION

The business objective of nearly all companies is to earn profits and maximises its firm value. Once the profits are generated, it then decides on what to do with those profits. The company may plan to hold back or retain the profits within the company, or they could pay it out to the owners of the firm in the form of dividends.

The financing decision determines the optimum mix of debt and equity, the relative numbers of shareholders and debt holders, and the decision for distribution of earnings between interest, dividends and capital gains. Financing and investment decisions are independent of each other and the latter determine the value of the firm. Therefore, as financing decisions have no effect on firm's value, they are irrelevant. However, in practice, firms, managers, and investors, devote much time and resources in analysing financing decisions about dividends and capital structure. The risk exposure of any firm can be divided into operating and financial risk. Operating risk arises due to manufacturing and production expense which are usually unavoidable. However, financial risk is borne by those firms who have debt fund in their capital structure as the company is required to mandatory pay fixed interest charge on its debt funds. Firms aim at optimal capital structure which leads to ideal level of financial leverage, wherein a company's return on equity capital increases because the use of leverage increases stock volatility, increasing its level of risk which in turn increases returns.

LITERATURE REVIEW

In the sense of finance & economics leverage is perfection to use borrowed money to buy an investment or to buy a company for business. One can gain a market advantage by leveraging his network of partners. In business, use of borrowed capital for an investment and expecting the profits made to be greater than the interest payable is leverage. Leverage is an important investment strategy in case firm plans for using borrowed money. Specifically it is the use of various financial instruments or borrowed capital to increase the potential return of an investment. A firm can finance its investments by debt, equity or a combination of both. The use of debt along with equity in the capital structure is described as financial leverage or gearing (Dare and Sola, 2010). A highly leveraged firm or property means that the firm is employing more debt than equity in its capital. Leverage results from investing borrowed funds with a view to expand the firm's asset base and generate returns on risk capital in the long term.

Agency cost theory explains the relationship between principals, for example shareholders and agents, such as a firm's executives. Agency cost is an economic concept concerning the cost to a principal, when the principal chooses or hires an agent to act on its behalf. Due to the separation between ownership and control, managers (agents) may not always act in the best interest of the firm's owner. This encourages shareholders to incur agency costs to monitor managers' behaviour. Dividend payments may help in reducing agency costs between managers and shareholders. As the two parties have different interests and the agent has more information, the principal cannot directly ensure that its agent is always acting in its best interests. Employing leverage in the company is one of the effective methods against manager's behavior.

Trade off Theory

Miller and Modigliani (1961) proposed that in a perfect market the dividend policy shows no impact on firm's value. In perfect competitive market, MM Theory is based on the assumptions that investors behave rationally as information is freely shared, there is no transaction and flotation costs taxes are absent. However, in the real world bankruptcy cost and market imperfections are present. Kraus &Litzenberger (1973) theory is resulted from the debate on the Modigliani and Miller propositions. As per this theory, a company uses debt instead of equity to a certain extent to maximize its enterprise value. Highly profitable firms have high debt ratios thus the chances of bankruptcy are less. Thus, trade-off theory suggests a positive relationship between profitability and leverage. An optimal Capital Structure can be achieved by establishing equilibrium between the tax saving benefits of debt and distress costs of bankruptcy due to debt. Bankruptcy costs arise when there is a high probability that a company will default in paying off its financial obligations. These costs are high in case when a company decides to raise more of its debt financing rather than use equity. According to the study of Haugen and Senbet (1978), the size of a firm influences how a firm overcomes its bankruptcy costs. Large capital firms are financial strong to repay its liabilities are less prone to experience financial distress as compared to smaller ones. Thus, leverage and dividend policy decisions are majorly influenced by size of the firm. According to Myers (1984), there exists a, "static trade-off framework, in which the firm is viewed as setting a target debt to value ratio and gradually moving towards it, in much the same way that a firm adjusts dividends to move towards a target payout ratio".

Pecking Order

Myers and Majluf (1984) and Myers (1984) presented another capital structure theory named Pecking Order Hypothesis. The pecking order ranks internal equity at the top of the order, followed by debt and then hybrid securities, with external finance in the form of equity capital at the bottom of the pecking order. This order is followed as it reduces the chances of taking up profitable opportunities. Initially Donaldson developed the theory, which in 1984, Myers and Majluf modified further. According to this theory, managers follow a hierarchy of financing. They use internally generated funds as principal source of long-term financing. If internal financing is not enough, it resorts to debt financing and finally to equity and prefer to raise equity as a last option. Higher dividend payout means greater need of funds, which suggests positive relationship between dividend payout and leverage.

Dividends are declared only after meeting all its investment opportunities. Profitability and liquidity of a firm have a significant role in deciding for leverage and dividend policy.

If a company employs a high level of operating and financial leverage, even a small variation in the sales level will drastically effect the Earnings per share of the holders. (Mandelkar,et at, 1984). A company having varying sales level will have fluctuating EPS, but the variation in EPS will be more when the operating and financial leverages are also high. A high degree of FL allows the shareholders to obtain a high return on equity but on the other hand they are exposed to high level of risks if the return on investment is low.

Al-Najjar (2009) conducted research in Jordan and used dividend per share, leverage, earning per share, institutional ownership, return on equity, and business risk as variables. He concluded "the factors which affect the likelihood of dividend payment are similar to those which affect the dividend policy". The results showed strong negative relation between institutional ownership and dividend policy; which were in accordance with signaling theory. Finally, the results showed that the Linter model is valid for Jordanian data, and that Jordanian firms have target payout ratios and that they adjust to their target relatively faster than firms in more developed countries.

Short et al. (2002) examine the potential association between ownership structures and dividend policy using three alternative dividends models for the UK companies. They were the first to present the results for UK, and concluded that ownership structures are different from those of the US. The results consistently showed positive association between dividend payout policy and institutional ownership. The results found that a negative association exists between dividend payout policy and managerial ownership. Gugler & Yurtoglu (2003) investigates the relationship between dividend and ownership and control structure of the firm for 214 Austrian and German non-financial firms over the period of 1991-1999. The results indicate that state-controlled firms engage in dividend smoothing, whereas family-controlled firms do not. The findings show that over the years the dividend payouts have declined and high growth oriented firms have larger payout targets irrespective in whose hands the control of the firm is vested. Kumar (2003) examines the possible association between ownership structure, corporate governance and firm's dividend payout policy of all manufacturing firms over the period 1994-2000. He examines the payout behavior of dividends and the association of ownership structure for Indian corporate firms. Kumar finds positive association between ownership structure and dividend payout policy and that dividend payout are not influenced by the ownership structure of the firms. The results reveal that Debt and equity are negatively related whereas past investment opportunities have positive relationship with dividends.

OBJECTIVES OF THE STUDY

1. To study the impact of financial leverage on shareholders return of selected pharmaceutical companies.
2. To study the impact of financial leverage on market capitalization of selected pharmaceutical companies.

METHODOLOGY

The study is empirical in nature to find out the influence of financial leverage on shareholders return and market capitalisation of selected sample pharmaceutical companies. For this purpose, data was collected in its current state and both quantitative and qualitative data was used. Data was collected from different websites (like, nseindia.com, moneycontrol.com, and yahoofinance.com), Print media, newspapers, accounts which are produced by the company to the stock exchange and official website of the respective company. Sample of top 5 market capitalization companies, which are listed in index of national stock exchange during the period of 1st April 2012 to 31st March 2021. The data used in this category was collected from official website of national stock exchange, consider that data sources used as highly reliable due to its function for the financial markets.

Variables: (a) Dependent Variable: The dependent variables are shareholder return and market capitalization.

(b) Independent Variable: Financial leverage is used as an independent variable.

Simple linear regression has been used for data analysis.

Hypothesis Testing

The NIFTY pharmaceutical index comprises of 20 listed firms. The industry is dominated by top 20 companies which comprises nearly 70% of the total production of the country. Out of which we have drawn a sample of five major companies. Impact of

financial leverage on shareholders return and market capitalization of all companies of different sector was tested through regression analysis. For which shareholder return were measured through EPS, DPS, ROE.

Hypothesis for the research was set as follows:

H01: There is no significant influence of financial leverage on the return of shareholders of Cipla.

H02: There is no significant influence of financial leverage on market capitalization of Cipla.

H03: There is no significant influence of financial leverage on the return of shareholders of Zydus.

H04: There is no significant influence of financial leverage on market capitalization of Zydus.

H05: There is no significant influence of financial leverage on the return of shareholders of Lupin.

H06: There is no significant influence of financial leverage on market capitalization of Lupin.

H07: There is no significant influence of financial leverage on the return of shareholders of Sunpharma.

H08: There is no significant influence of financial leverage on market capitalization of Sunpharma.

H09: There is no significant influence of financial leverage on the return of shareholders of Dr. Reddy.

H010: There is no significant influence of financial leverage on market capitalization of Dr. Reddy.

Data Analysis

The companies taken for the study are Cipla, Zydus, Lupin, Sun Pharma and Dr Reddys. The data was analysed company wise. On significant level of 5%, nine hypothesis were accepted, whereas H010 was rejected. The R values are (.245) for shareholders return and (.030) for market capitalization on sig level .146 and .634 respectively. Therefore, there is no significant influence of financial leverage on shareholders return and market capitalization of Cipla Pharmaceuticals.

The R values are (.013) for shareholders return and (.255) for market capitalization on sig level .749 and .137 respectively. Therefore, there is no significant influence of financial leverage on shareholders return and market capitalization of Zydus Pharmaceuticals.

The R values are (.153) for shareholders return and (.222) for market capitalization on sig level .263 and .170 respectively. Therefore, there is no significant influence of financial leverage on shareholders return and market capitalization of Lupin Pharmaceuticals.

The R values are (.072) for shareholders return and (.030) for market capitalization on sig level .454 and .410 respectively. Therefore, there is no significant influence of financial leverage on shareholders return and market capitalization of Sun Pharmaceuticals.

The R values are (.315) for shareholders return and (.659) for market capitalization on sig level .091 and .004 respectively. Therefore, there is no significant influence of financial leverage on shareholder's return.

The results show that high leveraged companies increase shareholders return only when the return on equity capital is higher than the cost of debt. The capital structure of the selected sample companies consist of very less percentage of debt and the cost of debt may be higher or equal to the cost of equity capital.

Table 1: Simple Linear Regression Output

Hypotheses	Company	Variables	R Square	F value	Beta	Sig. value
H01	Cipla	Shareholder's return	.245	2.596	-96.920	.146
H02		Market Capitalization	.030	.244	71402.261	.634
H03	Zydus	Shareholder's return	.013	.109	-23.702	.749
H04		Market Capitalization	.255	2.732	-72507.891	.137
H05	Lupin	Shareholder's return	.153	1.446	-36952.464	.263
H06		Market Capitalization	.222	2.280	-37.106	.170
H07	Sun	Shareholder's return	.072	.620	-5348.820	.454
H08		Market Capitalization	.086	.756	.942	.410
H09	Dr. Reddy	Shareholder's return	.315	3.678	-368122.205	.091
H010		Market Capitalization	.659	15.454	-1579.294	.004

Company	Regression Equations	Result
Cipla	Shareholder's Return = 120.323 +(-96.920)FL	Insignificant
	Market Capitalization = -30223.859 +(71402.261)FL	Insignificant
Zydus	Shareholder's Return = 50.065 +(-23.702)FL	Insignificant
	Market Capitalization = 113849.495 +(-72507.891)FL	Insignificant
Lupin	Shareholder's Return = 87072.373 +(-36952.464)FL	Insignificant
	Market Capitalization = 80.801 +(-37.106)FL	Insignificant
Sun	Shareholder's Return = 131311.481 + (-5348.820)FL	Insignificant
	Market Capitalization = 3.575 +(.942)FL	Insignificant
Dr. Reddy	Shareholder's Return = 431156.511 + (-368122.205)FL	Insignificant
	Market Capitalization = 1731.710 +(-1579.294)FL	Significant

CONCLUSIONS AND SUGGESTIONS

Financial leverage show significant influence on shareholders return and market capitalization when the cost of debt fund is lower than the cost of equity. In Pharmaceutical sector the sample companies taken for the study comprises nearly 40% of the total pharma sector with a market capitalization of nearly 2.2 lacs crores. Increasing expenditure in R & D and acquisition are driving

this sector's growth and needs more capital. It is suggested to the research scholars to include wide spread areas for further studies so that the results may be generalized for the entire business sectors of the country. In addition, the researchers are suggested to collect data for more years for further studies. The study reveals that some companies provide lack of financial information, which was a limitation for the present study. Therefore, to overcome the problem the companies are suggested provide adequate information required to enhance the leverage and return of shareholders fund. Last but not the least, all business sectors are advised to reduce their business risks regarding the factors that influence the revenue growth of the companies.

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