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Analysis of Debt-Equity Ratio in Reliance Industries Ltd.

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Abstract

The present paper is an effort by the researchers to examine the financing pattern of a selected private company. The sample company selected for this research is Reliance Industries Ltd. and the study period is of five years (2015-2019).Long term solvency ratios indicate a firm's ability to meet the fixed interest and costs and repayment schedules associated with its long term borrowings. This research work is an attempt to analyze the relation between external and internal equity and its impact on the performance of the company under study. It provides insights into two widely used financial tools i.e., ratio analysis. The objective of this paper is to analyze the Impact of debt and equity capital over the performance of Reliance Industries Ltd and to help the reader understand how these tools should be used to analyze the solvency position of a firm. To demonstrate the process of Debt-Equity analysis of Reliance Industries Limited's various ratios calculated from balance sheet and income statements are analyzed in this paper. Regarding main result it has been found that the capital structure of the company is equally balanced by the outsiders and owners capital.

Keywords: *Debt-Equity, Proprietary, Solvency, Liquidity, Capital gearing*

INTRODUCTION

Fundamentally, finance for businesses falls into two separate categories, debt and equity. Debt, quite simply, is a cash advance of money that will have to be paid back, normally with an interest figure on top. Business equity, on the other hand, is financing that comes from investors and does not necessarily have to be repaid, although investors will normally expect a degree of return for their investment. Debt vs. equity financing is one of the most important decisions facing managers who need capital to fund their business operations. Debt and equity are the two main sources of capital available to businesses, and each offers both advantages and disadvantages. "Absolutely nothing is more important to a new business than raising capital.

REVIEW OF LITERATURE

Few studies focus on international samples to test capital structure models. Rajan and Zingales (1995) and Booth, Aivazian, Demirguc-Kunt, and Maksimovic (2001) are two noticeable exceptions. Rajan and Zingales (1995) find similar levels of leverage across the G7 countries, thus refuting the idea that firms in bankoriented countries are more leveraged than those in market-oriented ones. However, they recognize that this distinction is useful in analyzing the various sources of financing. They also find that the determinants of capital structure that have been reported for the U.S. (size, growth, profitability, and importance of tangible assets) are important in other countries as well. They show that a good understanding of the relevant institutional context (bankruptcy law, fiscal treatment, ownership concentration, and accounting standards) is required when identifying the fundamental determinants of capital structure. Booth et al. (2001) suggests that the same determinants of capital structure prevail in ten developing countries, but national environment is again important. These studies, however, do not shed any light on the adjustment process of capital structure and fail to discriminate between the main theoretical hypotheses.

Modigliani and Miller (1958) claim that under perfect capital market conditions, a firm's value depends on its operating profitability rather than its capital structure. In 1963, 4Modigliani and Miller (1963) fix the previous paper; argue that, when there are corporate taxes then interest payments are tax deductible, 100% debt financing is optimal. This means that the firm's value increases as debts increases.

Since then, extensions of the ModiglianiMiller theory have been provided by the following researches. Robichek and Myers (1965) argue that the negative effect of bankruptcy costs on debt to prevent firms from having the desire to obtain more debt. Jensen and Meckling (1976) identify agency cost in governing the corporation. The general result of these extensions is that the combination of leverage related costs (such as bankruptcy and agency costs) and a tax advantage of debt produces an optimal capital structure at less than a 100% debt financing, as the tax advantage is traded off against the likelihood of incurring the costs.

OBJECTIVES OF THE STUDY

* To analyze the Impact of debt and equity capital over the performance of Reliance Industries Ltd.
* To provide suggestive measures on the basis of findings for further betterment of the company under study.

RESEARCH METHODOLOGY

The present research work is analytical in nature and is entirely based on secondary data. The data has been collected from various secondary sources such as annual reports of the company, research papers, articles, dissertations, newspapers, magazines and internet as well. Various statistical tools like student's t test have also been utilized for testing of hypothesis.

SOLVENCY ANALYSIS OF RELIANCE INDUSTRIES LTD.

Debt-equity ratio: Debt-to-Equity ratio indicates the relationship between the external equities or outsiders' funds and the internal equities or shareholders funds

$$\text{Debt equity ratio} = \frac{\text{outsiders fund}}{\text{shareholders fund}}$$

Table – 1 : Statement of Outsiders fund to shareholders fund

(Rs. in Crore)

Year	Outsiders Fund	Shareholders Fund	Ratio (Times)
2015	119467.51	141002.98	**0.85**
2016	153417.00	15403.00	**1.00**
2017	157746.00	169445.00	**0.93**
2018	180302.00	182055.00	**0.9**
2019	**230156.00**	**198687.00**	**1.16**

Interpretation:

Table 1 indicates the level of soundness of long-term financial policies of the company. It shows the relation between the portion of assets provided by the stockholders and the portion of assets provided by creditors. During the study period it has been analyzed that the company has used the capital equally as it shows 0.85 times of debt of equity has been used in the year 2015 mounting Rs. 119467.51. A ratio of 1.00, 0.93, 0.99 & 1.16 has been observed in 2016, 2017, 2018 & 2019 respectively which means has that more proportion of debt has been used in 2019 as compared to yester years. A ratio of 1 or 1: 1 means that creditors and stockholders equally contribute to the assets of the business.

Proprietary ratio:

Proprietary ratio refers to a ratio which helps the creditors of the company in seeing that their capital or loans which the creditors have given to the company are safe. Proprietary ratio can be calculated as follows: – Proprietors funds/Total Assets.

$$\text{Property Ratio} = \frac{\text{stakeholders fund}}{\text{total assets}} \times 100$$

Table – 2 : Statement of shareholders fund to total assets

(Rs. in Crore)

Year	Shareholders Fund (Rs.)	Total Assets (Rs.)	Ratio (%)
2015	141002.98	260468.16	**54**
2016	154093.00	307519.00	**50**
2017	169445.00	327191.00	**52**
2018	182055.00	362357.00	**50**
2019	**198687.00**	**428843.00**	**46**

Interpretation

Table 2 shows the contribution of stockholders' in total capital of the company. It represents the share of shareholders fund in total assets of the company. A consistent share of stockholders fund has been contributed in total capital (Total assets) during the study period i.e.54%, 50%, 52% and 50% in 2015, 2016, 2017 and 2018 respectively. In 2019 the figure has dropped down to 46% which is not a good sign for the company.

Solvency ratio:

The solvency ratio measures the size of a company's after-tax income; excluding non-cash depreciation expenses, as compared to the firm's total debt obligations. It provides a measurement of how likely a company will be to continue meeting its debt obligations.

Solvency ratio =

$$\frac{\text{total liabilities to outsiders}}{\text{total assets}} \times 100$$

Table – 3 : Statement of shareholders fund to total assets
(Rs. in Crore)

Year	Total liabilities to outsiders (Rs.)	Total Assets (Rs.)	Ratio (%)
2015	119467.51	260468.16	**45.87**
2016	153417.00	307519.00	**49.89**
2017	157746.00	327191.00	**48.21**
2018	180302.00	362357.00	**49.76**
2019	**230156.00**	**428843.00**	**53.67**

Interpretation:

Table 3 depicts the relationship between total liabilities to outsiders and total assets .It shows the contribution of outsiders in total capital of the company. As per analysis the contribution by the outsiders has been consistently about 50% from 2015 to 2018 but in 2019 it has increased up to 53.67 %.which means that the amount of outsiders capital has increased to a large extend during last two years than that of formers years.

Capital Gearing Ratio:

Capital gearing ratio measures the percentage of capital employed that is financed by debt and long term financing. The higher the gearing, the higher the dependence on borrowing and long term financing. Whereas, the lower the gearing ratio, the higher the dependence on equity financing.

Capital Gearing Ratio =

$$\frac{\text{equity share capital} + \text{reserve and surplus}}{\text{preference capital} + \text{long term debt}}$$

Table – 4 : Statement of shareholders fund to long term debt
(Rs. in Crore)

Year	Total liabilities to outsiders (Rs.)	Total Assets (Rs.)	Ratio (Times)
2015	141002.98	64605.52	**2.18**
2016	154102.00	79988.00	**1.93**
2017	169445.00	82635.00	**2.05**
2018	182055.00	89322.00	**2.04**
2019	**198687.00**	**133811.00**	**1.48**

Interpretation

Table 5 represents the measure of capital structure analysis and financial strength of the company and is of great importance for actual and potential investors. While analyzing the table it has been found that the company under study has low geared capital structure. In 2015, 2017 and 2018 the ratio has been above 2 , which means that equity capital used by the company is twice than that of outsiders but in 2016 and 2019 that ratio has dropped down to 1.93 and 1.48 respectively. This shows that the company has increased the proportion of outsider's capital.

Debt-service or interest coverage:

This ratio relates the fixed interest charges to the income earned by the business. It indicates whether the business has earned sufficient profits to pay periodically the interest charges.

Debt-service or interest coverage =

$$\frac{\text{net profit (before int erest \& tax)}}{\text{fixed int erest}} \times 100$$

Table – 5 : Statement of net profit to fixed interest
(Rs. in Crore)

Year	Net profit (before interest and tax) (Rs.)	Fixed Interest (Rs.)	Ratio (Times)
2015	19243.75	2063.31	**9.33**
2016	23923.00	2411.00	**9.92**
2017	22107.00	2893.00	**7.64**
2018	**21813.00**	**3463.00**	**6.30**

Interpretation:

Table 5 reflects the relationship between net profits to fixed interest expenses, Times interest earned ratio is very important from the creditors view point. According to analysis the ratio in 2015 and 2016 has been 9.33 and 9.92 times respectively in 2017, 2018 and 2019 the ratio has dropped down to 7.64 , 6.30 and 6.15 times respectively. It means that the interest expenses of the company are 7.4 times at an average for study period covered by its net operating profit (profit before interest and tax).

FINDINGS

* Regarding debt–equity ratio it has been found that the capital structure of the company is equally balanced by the outsiders and owners capital. In 2015 the share of outsiders fund is 119467.51 and 1141002.98 is owners fund i.e., 0.85:1. In 2016, 2017 and 2018 the ratios are 1.00:1, 0.93:1 and 0.99:1 respectively. In 2019 the company has increased the amount of external equity more than that of internal equity and the ratio for that year is 1.16:1.
* With reference to shareholders fund ratio (Proprietary ratio) the figures has remained quite consistent during the study period. The contribution of owners in the total assets of the company from 2015- 2118 has been up to 50%.In this year the amount of total assets has increased to large amount than that of investment from the shareholders.
* While analyzing the solvency ratios, the trend has been increasing during the study period which means that with the increase in total liabilities to outsiders the amount of total assets has also increased .In 2019 this ratio has increased up to 53.67%.
* Regarding capital gearing ratio the company is found low geared during the study period which shows that the amount of capital invested by shareholders is more than that capital borrowed from outsiders. In 2019 a satisfactory increases in the long term debt has been observed.
* While analyzing interest coverage ratio figures in 2015 and 2016 has been 9.33 and 9.92 times respectively in 2017, 2018 and 2019 the ratio has dropped down to 7.64 , 6.30 and 6.15 times respectively. It means that the interest expenses of the company are 7.4 times at an average for study period covered by its net operating profit (profit before interest and tax).

SUGGESTIONS

* Generally speaking, a low ratio (Debt being low in comparison to shareholders fund) is considered favourable form long term creditors point of view because a high proportion of owner's funds provide a larger margin of safety for them. While considering this fact the company should maintain the balance as it has maintained during the study period this will help in motivating more and more creditors to finance the company and at the same time motivate its shareholders by increasing the amount of low cost fund to magnify their earnings by adopting a sound financial policy.
* Equity ratios of the company are found unsatisfactory during the study periods because higher the share of shareholders in the total capital of the company better is the long term solvency position of the company. In order to overcome this problem company needs to increase the amount of shareholders found but at the same time the amount of capital invested in assets should be maintained as well.
* Solvency ratio is the variant of Equity ratio the larger the equity ratio smaller is the solvency ratio. Solvency ratio is inversely proportionate to equity ratio any increase in equity ratio will result in the decrease in the solvency ratio and vice versa ,because lower the ratio of total liabilities to total assets , more satisfactory or stable is the long term solvency position of a firm.
* Regarding capital gearing ratio, the company is dealing with low capital gear during the study period. Gearing must be kept in such a way so that the company is able to maintain a steady rate of dividend.
* While analyzing the interest coverage ratio the figures has been found satisfactory during 2010 and 2011 but afterwards this ratio has dropped down to 6.15 (times) in 2014 which is not a good sign from creditors point of view. The recommendation in this regard for the company is to use the low interest debt that will be helpful in increasing this ratio.

CONCLUSION

A properly conducted solvency analysis can provide positive assurance that after giving consideration to the effect of the subject transactions, the company under study meets the primary criteria for solvency. After analysis it can be concluded the solvency analysis is one of the useful as well effective tool for identifying the long run functioning of the company. This paper is an outcome of the efforts made by the researcher in order to find out the financial policy of the company under study as well as its implementation. The study suggests that the company should increase the proportion of outsider's equity in order avail the benefits of low cost debt.

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