

PERSPECTIVA
A Case Research Journal
Volume II (2016)

Sherlock and the Capital Structure Maze

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Introduction

As he got down from the podium, Ashish gave a huge sigh of relief. He had just finished a presentation about his company to a group of investment bankers. He had outlined the expansion plans for his company and the need for funds to finance this expansion. He was very confident about his company's future prospects. Although the company was reasonably profitable but did not have very high amount of Profit before Tax. The company had had a stable growth rate in sales for the past couple of years although variability in operating income was a little on the high side. He had been very skeptical regarding this presentation. His father had been disappointed a number of times after making big plans for the company on previous occasions.

Background

Ashish Awasthy was the CEO and chairman of Kescon Electricals. The company was in the area of consumer durables. His grandfather, Ram Narain Awasthy, who had migrated to India from Pakistan, after the partition in 1947, had setup the business in 1953 as a dealer in electrical goods. The business grew handsomely over the years. When his father, Mahendra Awasthy, joined the business in late 1980's they diversified and set up a manufacturing plant for electrical motors. As the company grew over the years, so did the product portfolio of the company. Mahendra had thought of expanding the scale and scope of the business many times but had been constrained by the capital requirements for such an expansion. Ashish had been part of the company right from his school days. He used to visit the factory along with his father after school and in his holidays. After finishing his engineering, he joined the business in 2008. The business which had not been doing so well in the later part of 2000s had started looking up. In 2014, the economy was looking up and with the new government's thrust on "Make in India", the manufacturing sector looked quite upbeat. Ashish had substantial growth plans for his company but he realized the growth would not be possible without an injection of outside funds in the company. The presentation to the investment bankers was for this purpose. Ashish wanted funds for his expansion plans but was not sure whether issuing equity was the right way to go forward or to take on debt was the right way.

The Dilemma

As he approached the snack table for a cup of coffee, he heard loud voices behind him. As he turned, he saw the two big names in investment banking, Sherlock Homes and Moriarty arguing over the merits of taking more debt. He listened with interest to both sides of the argument.

Sherlock said, "Kescon Electricals should raise funds through equity. It makes more sense for the company. Financing through debt will increase bankruptcy risk for the company as unpaid debt would be considered as liability for the company. The company is in the consumer durable sector. This industry has a history of low taxable incomes, so raising money through equity makes more sense for them. Also, there is lot of variability in operating income over the years and the industry has very moderate levels of tangible assets. All this analysis, leads me to the conclusion that equity is the way to go for Kescon Electricals."

"What a load of rubbish!" exclaimed Moriarty, "Kescon Electricals would be better off raising money through debt. This would lead to higher valuation of the company in the long run. Also debt will bring in a tax advantage on the interest payments to the company. The company may have high variability in its operating income but the growth rate of sales is stable. The biggest advantage of debt would be that control will still be with the owner."

“The only point where I agree with you is that if Kescon issues debt, the control would remain with the owners. But rest of your arguments, do not hold any water. Look at Videocon industries, which has been doing very badly, mainly due to its high interest burden. Where is the advantage, then”, countered Sherlock. “Also, if you look at Lifecycle Financing theory, for a young company, it is always better to raise money through Equity”, he added

Listening to these arguments, Ashish became even more confused. Just then, he saw his friend Mycroft enter the room. He rushed forward to greet him. Mycroft was an advisor to Reserve Bank of India Governor and was also a close friend of Ashish.

Mycroft joined Ashish for coffee. Ashish decided to share his dilemma with his friend. Mycroft listened to Ashish patiently. He then turned to listen to the points being made by Sherlock and Moriarty. The argument between Sherlock and Moriarty had reached a deadlock, with each one trying to shout the other.

Decision Time

Mycroft intervened, “Gentlemen, lets cool down first. I am sure; all of us can present our viewpoints in a little more civilized manner. Why don’t you back your arguments with some solid hard data rather than just talking in the wind?”

He further added, “Lets see, if I give you some companies data, what do you think can be inferred from the data provided regarding capital structure of the company. Does the real live data satisfy the theoretical tenets of capital structure?”

“Let me give you both, select financial data of some companies (Exhibit I-V) and time till tomorrow. Tomorrow, sharp at 11 AM, both of you can make presentation to me and Ashish in Ashish’s office. Using this data, each of you have to back up the claim you have made here. Amongst you both, whoever is able to convince us with their set of arguments gets Kescon Electricals as client.”

Both Sherlock and Moriarty took the challenge and immediately started working on the data provided by Mycroft. Both of them were very sure that the data would help them in backing up their claims. Sherlock believed that data would reinforce the point that the company would be better of raising funds through equity. On the other hand, Moriarty was very sure that data would back his claim that debt was the way to go for Kescon Electricals.

Ashish eagerly awaited their analysis which he thought would bring clarity to him in this confusing maze of capital structure.

Exhibit 1

Selected Financial Data of Constituents of BSE Consumer Durables Index*for the year ended 2011 (Rs. Crores)

Company Name	Bajaj Electricals Ltd	Blue Star Ltd	PC Jeweller Ltd	Rajesh Exports Ltd	Symphony Ltd	Titan Company Ltd	TTK Prestige Ltd	Videocon Industries Ltd	VIP Industries Ltd	Whirlpool of India Ltd
Sector**	Domestic Appliances - White Goods	Air-conditioners	Diamond Cutting / Jewellery - Medium / Small	Diamond Cutting / Jewellery - Large	Domestic Appliances - White Goods	Diamond Cutting / Jewellery - Large	Domestic Appliances - Cookers / Others	Electronics - TV / Audio / VCR / VCP	Moulded Luggage	Domestic Appliances - White Goods
Year	Mar 11	Mar 11	Mar 11	Mar 11	Jun 11 ***	Mar 11	Mar 11	Dec 10 ***	Mar 11	Mar 11
Total Shareholders Funds	611.11	573.5	325.67	1,596.78	123.01	1,025.38	191.48	9,433.88	201.21	422.37
Secured Loans	44.76	204.59	136.42	2,495.79	0	9.45	0.02	5,937.60	84.47	0
Unsecured Loans	72.2	213.79	3.14	38.41	0.17	58.25	2.28	5,836.16	22.2	0
Total Debt	116.96	418.38	139.56	2,534.20	0.17	67.7	2.3	11,773.76	106.67	0
Total Assets	744.06	994.93	465.52	4,136.59	125.45	1,137.13	206.02	21,207.64	310.46	485.79
Net Sales	2,741.35	2,858.92	1,977.06	20,533.75	232.76	6,520.89	763.57	14,409.69	742	3,081.67
Operating Profit	266.01	283.01	215.68	437.45	68.23	668	129.05	2,713.94	97.48	289.4
Interest	36.65	24.36	49.6	166.69	0.37	34.52	4.43	950.55	6.14	5.65
Depreciation	10.8	31.71	2.97	1.96	1.69	34.48	4.26	712.96	14.82	44.51
Reported Net Profit	143.79	155	144.86	247.99	44.93	430.41	83.75	744.69	62.02	166.03
Earning Per Share	14.09	16.1	32.44	8.3	62.57	92.91	71.89	19.45	20.3	12.18

Source : Capitaline Database

*S&P BSE CONSUMER DURABLES, Ticker: BSETCD

The S&P BSE Consumer Durables index comprises constituents of the S&P BSE 500 that are classified as members of the consumer durables sector as defined by the BSE industry classification system. (<http://www.asiaindex.co.in/indices/equity/sp-bse-consumer-durables>)

**As per the industry module in capitaline database

*** Financial year is different from other companies. Data available for the latest financial year end.

Exhibit II

Selected Financial Data of Constituents of BSE Consumer Durables Index*for the year ended 2012 (Rs. Crores)

Company Name	Bajaj Electricals Ltd	Blue Star Ltd	PC Jeweller Ltd	Rajesh Exports Ltd	Symphony Ltd	Titan Company Ltd	TTK Prestige Ltd	Videocon Industries Ltd	V I P Industries Ltd	Whirlpool of India Ltd
Sector**	Domestic Appliances - White Goods	Air- conditi oners	Diamond Cutting / Jewellery - Medium / Small	Diamond Cutting / Jewellery - Large	Domestic Appliances - White Goods	Diamond Cutting / Jewellery - Large	Domestic Appliances - Cookers / Others	Electronics - TV / Audio / VCR / VCP	Moulded Luggage	Domestic Appliances - White Goods
Year	Mar 12	Mar 12	Mar 12	Mar 12	Jun 12 ***	Mar 12	Mar 12	Dec 11 ***	Mar 12	Mar 12
Total Shareholders Funds	699.86	473.9	555.79	1,991.49	150.99	1,449.90	285.29	9,952.98	242.58	490.19
Secured Loans	97.29	115.23	576.07	3,218.07	7.43	5.89	34.86	9,835.64	28.01	0
Unsecured Loans	111.76	258.34	2.2	38.6	0	0	44.56	8,820.38	56.14	0
Total Debt	209.05	373.57	578.27	3,256.67	7.43	5.89	79.42	18,656.02	84.15	0
Total Assets	930.7	850.41	1,134.67	5,257.28	158.74	1,513.34	379.24	28,736.46	329.17	546.18
Net Sales	3,098.96	2,700.83	3,041.93	25,653.85	250.13	8,838.38	1,103.44	12,650.22	860.22	3,036.61
Operating Profit	251.51	13.25	348.79	803.3	72.14	927.07	180.42	2,426.08	122.24	235.39
Interest	63.04	70.25	77.21	369.35	0.67	43.72	10.91	1,045.14	8.99	4.38
Depreciation	12.52	31.45	6.59	2.07	1.69	44.9	6.25	607.56	17.29	49.7
Reported Net Profit	117.88	-89.15	231.29	412.43	50.34	600.16	113.38	539.91	67.69	123.73
Earning Per Share	11.38	0	17.26	13.97	13.5	6.48	97.63	17.6	4.53	9.62

Source : Capitaline Database

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**As per the industry module in capitaline database

*** Financial year is different from other companies. Data available for the latest financial year end.

Exhibit III

Selected Financial Data of Constituents of BSE Consumer Durables Index*for the year ended 2013 (Rs. Crores)

Company Name	Bajaj Electricals Ltd	Blue Star Ltd	PC Jeweller Ltd	Rajesh Exports Ltd	Symphony Ltd	Titan Company Ltd	TTK Prestige Ltd	Videocon Industries Ltd	V I P Industries Ltd	Whirlpool of India Ltd
Sector**	Domestic Appliances - White Goods	Air-conditioners	Diamond Cutting / Jewellery - Medium / Small	Diamond Cutting / Jewellery - Large	Domestic Appliances - White Goods	Diamond Cutting / Jewellery - Large	Domestic Appliances - Cookers / Others	Electronics - TV / Audio / VCR / VCP	Moulded Luggage	Domestic Appliances - White Goods
Year	Mar 13	Mar 13	Mar 13	Mar 13	Jun 13 ***	Mar 13	Mar 13	Jun 13 ***	Mar 13	Mar 13
Total Shareholders Funds	728.64	494.37	1,388.81	2,414.57	187.07	1,964.87	395.46	10,117.99	257.52	617.54
Secured Loans	55.02	173.48	233.07	2,695.26	0	0	63.09	19,464.08	0.34	0
Unsecured Loans	110.88	199.19	0	33.36	0	0	52.02	3,522.86	39.64	0
Total Debt	165.9	372.67	233.07	2,728.62	0	0	115.11	22,986.94	39.98	0
Total Assets	919.36	870.4	1,623.12	5,151.85	187.28	2,027.77	523.4	33,252.33	300.03	681.39
Net Sales	3,377.34	2,767.06	4,018.42	31,225.96	308.7	10,112.67	1,358.48	18,157.27	837.66	3,167.60
Operating Profit	152.41	135.34	501.99	791.19	94.04	1,111.40	214.36	3,462.98	72.49	242.49
Interest	68.98	49.85	127.47	299.51	0.51	50.64	20.17	2,753.15	7.33	3
Depreciation	14.45	32.9	9.99	2.06	1.31	54.49	8.99	824.35	19.8	60.32
Reported Net Profit	51.21	51.74	290.66	452.6	62.68	725.18	133.09	-71.63	31.52	127.75
Earning Per Share	4.79	5.24	16.06	15.33	16.82	7.81	114.24	0	2.06	10.07

Source: Capitaline Database

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As per the industry module in capitaline database * Financial year is different from other companies. Data available for the latest financial year end. Videocon Industries data taken from Audited Statement released for the year ended 2015

Exhibit IV

Selected Financial Data of Constituents of BSE Consumer Durables Index*for the year ended 2014 (Rs. Crores)

Company Name	Bajaj Electricals Ltd	Blue Star Ltd	PC Jeweller Ltd	Rajesh Exports Ltd	Symphony Ltd	Titan Company Ltd	TTK Prestige Ltd	Videocon Industries Ltd	V I P Industries Ltd	Whirlpool of India Ltd
Sector**	Domestic Appliances - White Goods	Air-conditioners	Diamond Cutting / Jewellery - Medium / Small	Diamond Cutting / Jewellery - Large	Domestic Appliances - White Goods	Diamond Cutting / Jewellery - Large	Domestic Appliances - Cookers / Others	Electronics - TV / Audio / VCR / VCP	Moulded Luggage	Domestic Appliances - White Goods
Year	Mar 14	Mar 14	Mar 14	Mar 14	Jun 14 ***	Mar 14	Mar 14	Dec 14***	Mar 14	Mar 14
Total Shareholders Funds	709.58	529.59	1,682.26	2,612.04	232.74	2,523.96	585.31	10,205.24	287.75	740.05
Secured Loans	278.35	121.52	1,004.21	3,044.33	0	606.27	0	Not available	10.62	0
Unsecured Loans	70.09	309.37	0	44.66	0	200	26.9	Not available	5.46	0
Total Debt	348.44	430.89	1,004.21	3,088.99	0	806.27	26.9	35,504.32	16.08	0
Total Assets	1,085.90	963.28	2,688.24	5,709.55	232.95	3,401.99	621.32	59,815.23	307.73	808.53
Net Sales	4,029.83	2,770.39	5,324.83	23,537.49	451.5	10,915.79	1,293.83	20,397.51	972.49	3,228.06
Operating Profit	97.08	160.23	633.58	618.43	136.93	1,168.63	179.99	13,996.30	101.51	239.46
Interest	78.3	49.64	151.88	343.07	0.21	87.11	13.47	4,971.77	3.96	1.42
Depreciation	24.75	34.69	12.32	2.08	1.15	65.59	14.77	1,536.48	17.05	63.83
Reported Net Profit	-5.31	75.9	356.31	226.99	98.87	741.14	111.79	5,119.64	58.39	122.91
Earning Per Share	0	7.92	19.38	7.69	26.06	7.99	92.52	160.45	3.84	9.69

Source: Capitaline Database

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As per the industry module in capitaline database * Financial year is different from other companies. Data available for the latest financial year end. Videocon Industries data taken from Audited Statement released for the year ended 2015

<i>Exhibit V</i>					
Sectoral Averages of Key Ratios for the period 2011-2014					
Sector	Year	2011	2012	2013	2014
Air-conditioners	Debt-Equity Ratio	0.54	0.62	0.67	0.78
	Long Term Debt-Equity Ratio	0.4	0.62	0.67	0.78
	Interest Cover Ratio	6.52	1.89	3.25	2.16
Diamond Cutting / Jewellery - Large	Debt-Equity Ratio	1.31	1.16	1.09	1.24
	Long Term Debt-Equity Ratio	0.2	1.11	1.07	1.24
	Interest Cover Ratio	3.33	2.5	2.22	1.01
Diamond Cutting / Jewellery - Medium / Small	Debt-Equity Ratio	1.18	1.04	0.89	0.73
	Long Term Debt-Equity Ratio	0.74	0.98	0.89	0.73
	Interest Cover Ratio	3.32	3.39	3.14	2.87
Domestic Appliances - Cookers / Others	Debt-Equity Ratio	0.26	0.27	0.26	0.2
	Long Term Debt-Equity Ratio	0.17	0.22	0.26	0.2
	Interest Cover Ratio	23.9	16.64	12.68	12.3
Domestic Appliances - White Goods	Debt-Equity Ratio	0.68	0.66	0.57	0.48
	Long Term Debt-Equity Ratio	0.55	0.66	0.57	0.48
	Interest Cover Ratio	6.48	6.09	3.72	4.8
Electronics - TV / Audio / VCR / VCP	Debt-Equity Ratio	1.33	1.44	1.44	1.64
	Long Term Debt-Equity Ratio	1.29	1.43	1.44	1.64
	Interest Cover Ratio	1.93	3.7	2.07	-1.05
Moulded Luggage	Debt-Equity Ratio	0.55	0.49	0.35	0.27
	Long Term Debt-Equity Ratio	0.08	0.49	0.35	0.27
	Interest Cover Ratio	9.92	8.81	5.06	7.88

Source : Capitaline Database