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Leverage Analysis: A Study on Ambuja Cements Limited

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ABSTRACT

For every economic activity finance is the lifeblood. From the business perspective leverage refers to the use of owned or borrowed equity to finance the purchase of business assets. Leverage on one hand increases a company's return on equity on the other hand poses a threat to the company's existence in the form of liquidation; if company is unable to bear its fixed interest liabilities. Furthermore use of leverage protects dilution of owner's equity. Thus leverage is a vital decision making area of financial management. Leverage cannot be regarded as a bad practice; as it is useful to finance company's growth and development through purchase of business assets. Borrowing should be within limits otherwise can pose a threat if company is unable to pay back the borrowed debts. This paper concentrates on the leverage analysis at Ambuja Cements Limited. The objective of the paper is to study the financial performance, leverage analysis and its relationship with profitability of Ambuja Cements Limited and to provide suggestions for financial leverage benefits, further to revise its capital structure so as to maximize company's growth and shareholders wealth.

Keywords: Leverage, Degree of financial leverage, Operating leverage, Combined Leverage, profitability..

INTRODUCTION:

The term Leverage refers to the availability of fixed expenses in the smooth conduct of business operations. In other words it indicates that the financing of business assets should have been done out of the borrowed funds. Leverage or Capital structure ratios are calculated to test the long term financial position of a firm. Further the term leverage refers to a relationship between various long term sources of financing i.e. debentures, preference shares, equity including reserves and the surpluses. A proper mix of debt and equity financing is must for a smooth and efficient conduct of a business. Leverage can further be classified as of three types-Financial leverage –It is basically the use of fixed long term interest bearing debt along with preference and equity .Also called trading on equity since equity and reserves and surpluses are used as a basis for the raising of the capital. A cautious approach is required to plan the capital structure of a firm as sometimes the rate of return on long term loans may turn out to be more than the expected rate of earnings thus leverage may turn out to be adverse for the firm .Financial leverage is expressed as a relationship between Earnings before interest and taxes to the earnings before interest, taxes and preferential dividend. On the other hand Operating leverage expresses the relationship between contribution to EBIT, while combined leverage is the product of degree of financial and operating leverage.

Profile of Ambuja Cements Limited:

Ambuja Cements Limited formerly known as Gujarat Ambuja cements limited is a holding company engaged into the manufacturing of cements and clinkers. ACL was formulated in the year 1981 as Ambuja cements Private limited. In 1983 the company was rehabilitated into Public limited company. The company is into the production of cement and cement related products for both domestic and export markets. It has a wide range of products for business and retail markets. Its product Ambuja plus roof special is very suitable for construction of slabs and rooftops; Ambuja Railcem is designed for railways, Ambuja builder is meant for the housing segment, Ambuja powercem which caters to the ready-mix sector. Its alccofine range of material is very useful in the construction of metro rails, dams, flyovers, bridges and tunnels. Thus today Ambuja Cements Limited is India's major cement producing company, being first in its continent and second largest in the world.

LITERATURE REVIEW:

Alkhatib.Khalid. (2012) empirically investigated the leverage determinants in Jordan industrial and service companies listed on the Jordan Stock exchange. The results of the service sector suggested that the explanatory variables tangibility,growth,liquidity have a positive impact on leverage .The results clearly indicate that firm and the economic variables are related and have a positive impact on leverage. It was suggested that financial decision makers should work out a financial mechanism to enable them to avoid financial distress and to improve the financial security of the listed companies.

Panigrahi .Ashok. (2012) analyzed the capital structure of SAIL from 1996 to 2004.The study observed that ballooning capital charges have been a major contributor to its losses despite the recessionary conditions in the steel market at that time .Further the increasing level of debts in its balance sheet and a diminishing net worth took its debt equity ratio to an unsustainable limit.

Tayyaba .Khushbakht. (2013) studied the effect of leverage on the profitability of selected oil and gas companies and analyzed .After applying regression and correlation descriptive analysis it was concluded that DFL and ROA has a positive relationship while DOL and ROA have an inverse relationship. The study further concluded that leveraged companies were riskier with reference to return on equity and investments.

Handoo Anshu and Sharma Kapil .(2014) identified important determinants of 870 listed Indian companies comprising of both private sector companies and government companies from 2001-2010.Variables were tested through regression analysis and it was analyzed that profitability, tax rate, asset tangibility,growth,cost of debt, debt serving capacity have a significant impact on the leverage structure.

Kumar.M.Ramana.(2014) in context of leverage and profitability analysis studied a positive correlation between the degree of operating leverage and its Return on Investment; thereby indicating good position of Bata India, on the other hand the degree of financial leverage and combined leverage were not at an optimum level.so,Bata India was suggested to revise its capital structure .It was suggested to have a proper mix of debt-Equity so as to have a positive impact on its Return on Investment.

Khedkar.B.E. (2015) observed that the degree of operating leverage was significantly negatively correlated with ROI for Dr Reddy's Laboratories. The degree of operating leverage was not good but the degree of financial leverage was positively correlated with ROI.Further the degree of combined leverage was also not at an optimum level. Company was advised to include an optimum blend of owners and borrowed equity to have a positive impact on ROI.

Nandhini.M.(2015) analyzed the impact of leverage on the profitability of TVS motor company limited. In the study it was concluded that the operating and financial position of the company was improperly fluctuated, moreover a control over the fixed cost and the variable cost was required to attain an adequate profit. It was further concluded that company should increase its profit and reduce its selling price and further its cost of production for a better financial position.

Bhagyalakshmi .K. (2016) concluded that leverage analysis is must to study and assess the extent of business risk, financial risk and the overall total risk to the firm as well. A comparative study of leverage over the selected cement companies was undertaken and it was concluded that highest degree of operating leverage existed at ACC Ltd indicating lower operating fixed cost while highest degree of financial leverage existed at Madras Cements Ltd indicating high fixed financial cost increasing the financial risk.

OBJECTIVE OF THE STUDY:

1. To study the financial performance of Ambuja Cements.
2. To perform the Leverage analysis of Ambuja cements.
3. To study the relationship between leverage and profitability.

RESEARCH METHODOLOGY:

Research Design: This study is based upon secondary data .The requisite data related to the operating, financial and combined leverage have been collected from the P&l A/C and the B/S of Ambuja cements Limited. The necessary data has also been obtained from the published annual reports.

Tool Applied: To have a worthwhile analysis and interpretation of the data collected, tools like Ratio Analysis have been applied.

DATA ANALYSIS:

Degree of Operating Leverage:
It is calculated as: DOL (operating) = Percentage change in EBIT/Percentage change in Sales

Table 1

Year	Sales	Operating Profit	%EBIT	%Sales	Degree of Operating Leverage
2013	9160.35	1650.83	-	-	-
2014	9978.12	1928.44	16.81	8.92	1.88
2015	9461.40	1531.47	(20.58)	(5.17)	3.98
2016	9196.64	1692.35	10.50	(2.79)	(3.76)
2017	10446.85	1940.14	14.64	13.59	1.07

Source: Secondary data

Interpretation:
Operating leverage can be favourable or unfavourable.If the degree of operating leverage is high, it indicates higher degree of risk. Moreover increased fixed cost is a good reason behind high operating cost. Operating risk is attached with the inability of a firm to meet its fixed cost. So to cover larger magnitude of risk of increased fixed cost, larger sale volumes are required. From the above data ,in the year 2014 DOL(operating leverage)was 1.88 which rose to3.98 in 2015 due to fall in sales by 5.17% and fall in EBIT by 20.58% .Fall in sales and further in EBIT resulted in the increase in DOL to3.98%.In2016 sales decreased by 2.79%but the rate of fall in sale was lesser in 2016 than in 2015,moreover % change in EBIT recovered to 10.50 from (20.58) resulting in a fall in DOL,further in 2017 there was improvement in EBIT and Sales percentages resulting in bringing degree of operating leverage to 1.07.

Degree of Financial Leverage:
It is calculated as: DOL (financial) =Percentage change in EPS/Percentage change in EBIT

Table 2

Year	Earning Per Share	Operating Profit	%EPS	%EBIT	Degree of Financial Leverage
2013	8.37	1650.83	-	-	-
2014	9.66	1928.44	15.41	16.81	0.91
2015	5.20	1531.47	(46.16)	(20.58)	(2.24)
2016	4.69	1692.35	(9.80)	10.53	(0.93)
2017	6.29	1940.14	34.11	14.64	2.32

Source: Secondary data

Interpretation:
Financial leverage is high if the amount of fixed sources of funds is higher. If the fixed financial cost is high, higher is the financial leverage and financial risk. So the level of EBIT needs to be raised to meet or cover the financial liabilities otherwise company could be forced to liquidation so company's existence is at stake. In the year 2014 the % change in EBIT is greater than the %change in EPS as a result the degree of FL is .91,further there is a fall in %change in EPS and EBIT as a result degree of FL falls to 2.24.In the year 2016 change in EBIT is greater than change in EPS leading to fall in degree of financial leverage and financial risk, further in the year 2017 change in EPS is greater than EBIT which is not good for the financial health of the concern and needs to be controlled. So the management should be cautious to avoid financial risk and high degree of financial leverage by formulating good financial planning in terms of proper mix of debt and equity in its capital structure.

Degree of Combined Leverage:
It is calculated as: DOL (combined) =degree of operating leverage x degree of Financial leverage

Table 3

Year	%EPS	%Sales	Degree of Operating Leverage	Degree of Financial Leverage	Degree Of Combined leverage=DOL*DFL
2013	-	-	-	-	
2014	15.41	8.19	2.05	0.91	1.86
2015	(46.16)	(5.17)	(3.98)	(2.24)	8.91
2016	(9.80)	2.79	3.76	(0.93)	3.49
2017	34.11	13.59	1.07	2.32	2.65

Source: Secondary data

Interpretation:
Combined leverage is a tool to measure the total risk of the firm. For keeping risk controllable and hence manageable, a firm having high degree of operating leverage should have a low degree of financial leverage and vice-versa. It indicates the impact of change in sales to the change in EPS.This ratio is also considered while preparing the financial plans for new avenues. The degree of combined leverage showed a mixed trend for the study period from 2013 to 2017.Ambuja cements limited obtained maximum degree of combined leverage of 8.91 in the year 2015 and a minimum of 1.86 in the year 2014.The firm is not maintaining an optimum combined leverage The firm should strive to maintain a moderate combined leverage which optimizes a high percentage increase in sales than the percentage increase in EPS.

FINDING SUGGESTIONS AND CONCLUSION:

Leverage analysis reflects long term financial performance of a concern. High operating leverage is attached with higher risks so, to cover larger magnitude of risk of increased fixed cost, larger sale volumes are required.Ambuja cements limited was able to increase its sales strongly in 2014 and 2017 to cover its increased fixed cost. However company needs to further improve its sales volume so as to cover up the risk and to bear increasing fixed cost.
Ambuja cements Limited should take maximum advantage of financial leverage when its revenues are on rise on the other hand company should be cautious about higher degrees of operating leverages as in the year 2015 above, as it increases the risk of future cash flows.Degree of combined leverage summarizes the combined effects that degree of financial and operating leverage have on EPS.This ratio is very helpful to the concern in maintaining an optimum level of operating and financial leverage. A high combined leverage is not preferable as it indicates risks; it means more fixed cost to the firm as in the year 2015 the degree of combined leverage was 8.91% thereby posing risk to the concern.
The degree of combined leverage showed a mixed trend for the study period from 2013 to 2017.Ambuja cements limited obtained maximum degree of combined leverage of 8.91 in the year 2015 and a minimum of 1.86 in the year 2014.The firm is not maintaining an optimum combined leverage The firm should strive to maintain a moderate combined leverage which optimizes a high percentage increase in sales than the percentage increase in EPS.

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