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MANU	CONVERSATION BETWEEN MANU AND VINU ABOUT CAPITAL STRUCTURE OF BUSINESS	VINU
		

Manu	Hi Vinu! Wats up?
Vinu	Ya! I have and upgraded also!!!
Manu	Vinu!!! I think this is the greatest joke of the year.
Vinu	Come on Manu! Accept small humour from my side also. Don't be too rigid all the time.
Manu	Ok! Ok! Accepted. So, how things are moving at your end?
Vinu	Fine Manu! Now I have a new challenge.
Manu	What is that?
Vinu	I have to advice capital structure for a subsidiary to be floated by our company.
Manu	Is it? It is the beautiful part in financial structuring!
Vinu	How do you say that?
Manu	Yes! It is the beautiful part because it decides the future direction of any business entity.
Vinu	Like?
Manu	Like success/failure, Profit/Loss, Growth/ Sustainability, etc.
Vinu	But how come capital structure decides all the above? I was under the impression only profit making capability decides Success/ failure/ profit/loss, etc.
Manu	Ok! Then I'll put it like this. Capital Structure also decides factors like success/failure/profit/loss/growth/sustainability.
Vinu	It makes Some sense! Can you elaborate with some numbers?
Manu	Sure! As usual let us assume we want to start a new business.
Vinu	Ok! I'll invest Rs.100crs!
Manu	No! This Time we shall start from assets!
Vinu	Ok.

<table>
<tr><td>Manu</td><td>You have to acquire assets worth Rs.100crs</td></tr>
<tr><td>Vinu</td><td>That’s what ; said, I’ll invest Rs.100Crs.</td></tr>
<tr><td>Manu</td><td>Let me complete!</td></tr>
<tr><td>Vinu</td><td>Ok! Ok! Please proceed!</td></tr>
<tr><td>Manu</td><td>You want to acquire assets worth Rs.100crs. But you don’t have resources for Rs.100 Crs. Meaning, you cannot bring all money</td></tr>
<tr><td>Vinu</td><td>So?</td></tr>
<tr><td>Manu</td><td>So, you have to make alternate arrangements for structuring capital now!</td></tr>
<tr><td>Vinu</td><td>Ya!!! Here comes, capital structuring! So, you are trying to say, I have limited resources, but I have to take up project costing Rs.100crs.</td></tr>
<tr><td>Manu</td><td>Yes! Let us say, now you can afford for only Rs.25crs.</td></tr>
<tr><td>Vinu</td><td>It means, I have to arrange Rs.75 Crs. funds from outside?</td></tr>
<tr><td>Manu</td><td>Yes! Can you tabulate this funding structure?</td></tr>
<tr><td>Vinu</td><td>Yes!
<table>
<tr><td>Own funds
Outside funds</td><td>25.00
75.00</td><td>Assets</td><td>100.00</td></tr>
<tr><td></td><td>100.00</td><td></td><td>100.00</td></tr>
</table></td></tr>
<tr><td>Manu</td><td>Good! This table is nothing but your Projected Balance sheet where in you are showing source of funds and use of funds.</td></tr>
<tr><td>Vinu</td><td>True!</td></tr>
<tr><td>Manu</td><td>So now your business capital is structured as
• 25% of own funds and
• 75% of outsiders funds</td></tr>
<tr><td>Vinu</td><td>Correct! Debt is 75 and Equity is 25.</td></tr>
<tr><td>Manu</td><td>This gives debt-equity ratio of 75/25. i.e. 3:1</td></tr>
<tr><td>Vinu</td><td>Correct Manu! But what is the significance of this capital structure?</td></tr>
<tr><td>Manu</td><td>It has lots of significance. Your business is now funded 75% by Outsiders funds and only 25% by your own funds.</td></tr>
<tr><td>Vinu</td><td>True!</td></tr>
<tr><td>Manu</td><td>This has lots of plus and minus. Before going into that, let me ask you certain fundamental questions.</td></tr>
<tr><td>Vinu</td><td>Please Manu!</td></tr>
<tr><td>Manu</td><td>Why do you want to invest in business?</td></tr>
<tr><td>Vinu</td><td>To earn return?</td></tr>
</table>

Manu	How much?
Vinu	Some 7% - 10%
Manu	Then why are you investing in business. You can invest safely in Bank Fixed Deposits. It will give you that return without any risk
Vinu	True!
Manu	If you are investing in Business, you should be expecting more, right?
Vinu	Yes! That’s correct.
Manu	Now tell me, how much you should be expecting?
Vinu	Somewhere between 20% - 25%?
Manu	Ok! That’s a reasonable expectation on the amount invested commensurate with risk taken!
Vinu	Pardon me!
Manu	What?
Vinu	On the amount invested? I was mentioning return expected from sales!
Manu	Come on Vinu! You are getting me wrong! I asked you, ‘’Return expected for amount invested in Business”. I didn’t ask you return on Sales. Both are different!
Vinu	Ok! Ok! I got it! Return on sales is (Profit / Sales) x 100 Return on Investments is (Profit / Total Investments or Capital Employed) x 100 Ya! Both are different! Former is expressed as % against sales and latter is expressed as % against capital employed or Investment. Is that right?
Manu	Good! Return on Investment is the reward for any investor.
Vinu	But what role capital structure has to play here?
Manu	Yes! It has. Let’s say you expect 25% return.
Vinu	Ok!
Manu	Now tell me, how will you get this 25%
Vinu	Out of sales!

<table>
<tr><td>Manu</td><td>How you will achieve sales?</td></tr>
<tr><td>Vinu</td><td>By making use of assets and all facilities.</td></tr>
<tr><td>Manu</td><td>So, you will be pushing all the assets to work for your objective to earn 25%, right?</td></tr>
<tr><td>Vinu</td><td>Yes! My 100crs assets will be working for earning 25%</td></tr>
<tr><td>Manu</td><td>Fine! You said your 100crs assets will be working for 25%</td></tr>
<tr><td>Vinu</td><td>Yes! Because that is our objective and expectation.</td></tr>
<tr><td>Manu</td><td>But, your major stake holder is not expecting that!</td></tr>
<tr><td>Vinu</td><td>Who is that?</td></tr>
<tr><td>Manu</td><td>Look at your Balance Sheet!
<table>
<tr><td>Own Funds
Outside funds</td><td>25cr
75cr
100cr</td><td>Assets</td><td>100cr
100cr</td></tr>
</table>
75% of Your assets are funded by outsiders. Let’s say they are Bankers and they are expecting only 15%</td></tr>
<tr><td>Vinu</td><td>It is not my fault. Let them expect 15% But I will expect all my assets to generate 25%</td></tr>
<tr><td>Manu</td><td>Now you sound like a true business man. Here comes the play. You expected your assets to generate return of 25%, right?</td></tr>
<tr><td>Vinu</td><td>Ya! Correct.</td></tr>
<tr><td>Manu</td><td>So, 25% on total assets is 100 x 25% = 25crs.</td></tr>
<tr><td>Vinu</td><td>Ya! This is my profit generated using my assets.</td></tr>
<tr><td>Manu</td><td>Is this profit available for you in totality?</td></tr>
<tr><td>Vinu</td><td>How it can be? It is generated on total assets which is also funded by outsiders. I should give them their share of return right?</td></tr>
<tr><td>Manu</td><td>Absolutely! I am amazed with your authority! So, What is the return payable to outsiders?</td></tr>
<tr><td>Vinu</td><td>It is interest on the loan borrowed!</td></tr>
<tr><td>Manu</td><td>Very much correct! So, this return of 25% on total assets is before interest or after interest?</td></tr>
<tr><td>Vinu</td><td>Obviously, it is before interest.</td></tr>
<tr><td>Manu</td><td>So, it can also be called as ????</td></tr>
<tr><td>Vinu</td><td>Now I am getting it. It is EBIT. (Earnings Before Interest and Tax)</td></tr>
<tr><td>Manu</td><td>Good! Can you calculate the interest amount?</td></tr>
</table>

<table>
<tr><td>Vinu</td><td>Yes!<table><tr><td>Total Outside funds</td><td>75 Cr</td></tr><tr><td>Rate of Interest</td><td>15%</td></tr><tr><td>Interest on Outside funds</td><td>11.25 Cr</td></tr></table></td></tr>
<tr><td>Manu</td><td>How much you have invested?</td></tr>
<tr><td>Vinu</td><td>I have invested – Rs.25crs.</td></tr>
<tr><td>Manu</td><td>What was your Expectation?</td></tr>
<tr><td>Vinu</td><td>I was expecting 25% on Rs.25crs
25crs x 25% = 6.25cr</td></tr>
<tr><td>Manu</td><td>Now see the Wonder!
You expected your business to earn 25%. If it earns 25%, return will be 25cr of which 11.25 cr will be used for paying outside fund (Banker) as interest.</td></tr>
<tr><td>Vinu</td><td>So, it will have balance of Rs.13.75cr.<table><tr><td>EBIT</td><td>25.00</td></tr><tr><td>Less: Interest (75 x 15%)</td><td>(11.25)</td></tr><tr><td>PBT</td><td>13.75</td></tr></table>
Am I Correct?</td></tr>
<tr><td>Manu</td><td>Yes! But don’t forget the tax on your profits.</td></tr>
<tr><td>Vinu</td><td>Ok! I’ll assume average tax of 30% on profit.</td></tr>
<tr><td>Manu</td><td>In that case, your tax will be Rs.4.125 cr.<table><tr><td>PBT</td><td>13.75</td></tr><tr><td>Less: Tax @ 30%</td><td>(4.125)</td></tr></table></td></tr>
<tr><td>Vinu</td><td>And my Profit after tax will be<table><tr><td>PBT</td><td>13.750</td></tr><tr><td>Less: Tax@30%</td><td>(4.125)</td></tr><tr><td>PAT</td><td>9.625</td></tr></table>
Is it correct?</td></tr>
<tr><td>Manu</td><td>Yes! Here comes the role of capital structuring! You expected a return of 25% on your Rs.25crs. Investment which was only Rs.6.25 Crs. You pushed your business to earn 25%. But your other Stake holders expected only 15%. So after paying them their interest and also after paying taxes, you have balance profit of Rs.9.625. Who is entitled to this profit?</td></tr>
</table>

<table>
<tr><td>Vinu</td><td>Obviously, me!</td></tr>
<tr><td>Manu</td><td>Can you tabulate your expectation and actuals?</td></tr>
<tr><td>Vinu</td><td>Ya ! I’ll do that.
<table>
<tr><th>Particulars</th><th>Expected</th><th>Actual</th></tr>
<tr><td>Profit</td><td>6.25 Cr</td><td>9.625 Cr</td></tr>
<tr><td>Capital Employed</td><td>25 Crs</td><td>25 Crs</td></tr>
<tr><td>Return (%)</td><td>25%</td><td>38.50%</td></tr>
</table>
Wow! I have earned 38.50% against my expectation of 25% How did this happened?</td></tr>
<tr><td>Manu</td><td>It happened because of your capital structure. You funded major portion of Assets with low cost funds. But pushed all the assets to earn returns as if funds are high cost. So your assets earned, 25% on all the assets where 75% of the assets deserved only 15%</td></tr>
<tr><td>Vinu</td><td>Now I am getting it. Debt funded assets also earned 25% whereas cost of debt funds are only 15% So they gave me a bonus of 10% (25% - 15%)</td></tr>
<tr><td>Manu</td><td>That’s true. Debt funded assets worked more for you and gave you handsome returns. Apart from saving you from major tax out flow as well.</td></tr>
<tr><td>Vinu</td><td>What’s that? I couldn’t get it!</td></tr>
<tr><td>Manu</td><td>I said debt funds are cheap at 15%. It is not mere 15%. It is even far below because of tax effect.</td></tr>
<tr><td>Vinu</td><td>How that works?</td></tr>
<tr><td>Manu</td><td>Imagine that entire Rs.25 crs was earned by you without debt funds. In that case, you won’t be paying interest right?</td></tr>
<tr><td>Vinu</td><td>Yes!</td></tr>
<tr><td>Manu</td><td>Please tabulate your profit (with and without debt) and Tax.</td></tr>
<tr><td>Vinu</td><td>Ok!
<table>
<tr><th>Particulars</th><th>With Debt (Rs. In Cr.)</th><th>Without Debt (Rs. In Cr.)</th></tr>
<tr><td>EBIT</td><td align="right">25.00</td><td align="right">25.00</td></tr>
<tr><td>Less: Interest</td><td align="right">11.25</td><td align="right">-</td></tr>
<tr><td>PBT</td><td align="right">13.75</td><td align="right">25.00</td></tr>
<tr><td>Less: Tax @ 30%</td><td align="right">(4.125)</td><td align="right">(7.50)</td></tr>
</table></td></tr>
<tr><td>Manu</td><td>Now look at your Tax</td></tr>
</table>

	Tax (without debt) 7.500 Tax (with debt) (4.125)
Vinu	Ya! If I have debt, my tax is only Rs.4.125cr. whereas without debt, my tax is Rs.7.50 cr. I would pay additional tax of Rs.3.375 cr, If I don't have debt.
Manu	Rather, put it in this way! Debt fund will save your tax by Rs.3.375cr.
Vinu	Correct!
Manu	What was your interest cost?
Vinu	Rs.11.25 cr.
Manu	What is your savings in Income Tax?
Vinu	Rs.3.375 cr.
Manu	So, what is your effective interest cost?
Vinu	I got it: My effective Interest Cost Interest 11.25 Less: Tax Benefit (3.375) Effective Interest 7.875
Manu	Can you Express that in percentage?
Vinu	Ya! (7.875 / 75) x 100 = 10.50% Wow ! It is very cheap fund @ 10.50%
Manu	Yes! Debt funds were earning 25% through assets but have taken only 10.50% for them and have given the balance to you.
Vinu	Cho Chweet!!!
Manu	Even though you were expecting only 25%, debt funds made you to receive more. It all happened because of your capital structure!
Vinu	Ya! Understood the importance of capital structure! So do you mean to say we should have more debt fund?
Manu	No! I never said that! Your capital structure should depend on circumstances!
Vinu	Meaning?
Manu	Everything depends on your ability to earn EBIT. If you are in a position to earn good EBIT, then you can have debt funds. Because, EBIT is not decided by your capital structure by your business efficacy, efficiency and environment.
Vinu	I could understand!

	EBIT is decided by my business whereas PBT & PAT is decided by Interest cost.
Manu	True! If you have low EBIT or negative EBIT, debt will kill you.
Vinu	Understood! EBIT less Int. gives PBT <table><tr><td>EBIT</td><td>XXX</td></tr><tr><td>Less: Interest</td><td>(xxx)</td></tr><tr><td>PBT</td><td>XXX</td></tr></table>So, if my EBIT is low, I should try to reduce Interest cost otherwise, PBT will be low or will become negative and no returns will be available to me.
Manu	You got that straight! If you have more EBIT, you can have more debt funds and vice versa to ensure returns for owners.
Vinu	Ya! After all, at the end of the day, returns available for the owners is the crux in any business. Thanks Manu! Now I could appreciate the importance of capital structure!
Manu	I am glad Vinu! Have a good day!

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