Leverage and its impact on shareholders profitability and wealth of pharmaceutical companies in India

Sharma S.[1], Agarwal M. L.[2]
Research Scholar, MDS University, Ajmer. Rajasthan 305001

Abstract- Business enterprises are an integral part of a nation. The enterprise must fulfil its obligations towards society in return for the rights and facilities which the society or the government gives them. They have a significant impact on that society as a result. The company's management are aware of the significant impact their work has on welfare of the society. Therefore, they give this information in their Annual Reports. In today's market conditions when the expectations of the Equity shareholders are rising, a company has to be able to determine a judicious mix of debt funds and owned funds. It must determine whether or not the use of debt financing helps the business achieve its desired objectives. After all, leverage has a significant impact on a company's overall financial performance, profitability, and liquidity. The pharmaceutical industry is destined to change in the future. In this area of the health industry, businesses large and small are coming up with creative new strategies to stay relevant, frequently by shifting focus. Therefore, the future of the Indian pharmaceutical business appears to be an exceedingly attractive investment opportunity with such amazing effort and vision. Pharmaceutical firms offer solid long-term returns for investors. The time seems ripe to invest in pharmaceutical companies. Stock exchanges provide as a conduit for investments, and the Indian pharmaceutical industry is a popular investment target. By pooling funds, distributing risk, and transferring wealth, stock markets serve as a bridge between savers and capital users.

Keywords: Leverage, pharmaceutical companies, shareholder, accounting, profitability, debt, financial

INTRODUCTION

The goal of accounting is to create an effective information system that can meet the informational needs of various users and decision-makers. Business organisations are regarded as open systems which interact dynamically with the environments from which they draw resources and where they deliver their goods and services. Business enterprises are an integral part of a nation. The enterprise must fulfil its obligations towards society in return for the rights and facilities which the society or the government gives them. They have a significant impact on that society as a result. The company's management are aware of the significant impact their work has on welfare of the society. Therefore, they give this information in their Annual Reports.(1)

All of the company's stakeholders, including owners, creditors, suppliers, managers, employees, tax authorities, and others, are curious about how the business is performing and what its financial situation is. Trade creditors and short-term lenders are mostly concerned with the company's short-term liquidity and its capacity to settle its due within the next six to twelve months. Term lending institutions and debenture holders have a relatively longer time horizon and are concerned about the ability of the firm to service its debt over the next five to ten years. Long-term shareholders and managers interested in a career with the company are concerned with the company's profitability and growth over a substantial period of time.(2)

RATIONALE FOR THE SELECTION OF THE PROBLEM & SIGNIFICANCE OF THE STUDY

A company must take into account all available options when deciding how to finance its operations. The type of project to be financed, the nature of the capital required, the company's earning ability as well as its debt repayment capacity, and the current market conditions, among many other factors, all have a significant impact on the decision to choose a particular source of finance.(3)

The management of a company goes through many brain-storming sessions before deciding on a particular capital structure- Equity dominated or Debt-dominated or trade-off between the two etc. the main goal is to raise the share's market value and provide investors with respectable returns.(4)

In today's market conditions when the expectations of the Equity shareholders are rising, a company has to be able to determine a judicious mix of debt funds and owned funds. It must determine whether or not the use of debt financing helps the business achieve its desired objectives. After all, leverage has a significant impact on a company's overall financial performance, profitability, and liquidity.[5]

Capital structures and its types

Any company can obtain finance primarily from two sources: equity and debt. The phrase "capital structure" refers to the financial resources that a company has used to meet its capital needs. It is a collection of sources or securities used to raise funds. It is often referred to as a debt and equity financing mix.[6]

A capital structure is essentially a combination of different financial sources. These funding sources include Equity Share Capital, Retained Earnings, Preference Share Capital and Debt funds including debentures.[7]

In contrast to a leveraged firm, which includes some element of debt in its capital structure, a non-leveraged firm has a distinctive capital structure that is characterised by the total absence of borrowed funds. For the purpose of examining the effect of leverage on capital structure, let's use both a non-leveraged base and a leveraged base.[8]

- Non-leveraged base
  When a company's capital structure contains no leverage, equity share capital may have been prominently issued as a significant source of funding. Retained earnings are also a source of finance. So, the retained earnings can therefore be included in the capital structure in addition to equity share capital. [9]
- Leveraged base
  A corporation is said to be leveraged if it uses debt in addition to equity share capital in its capital structure. The term "hybrid security" also applies to preference shares. Leverage has various benefits when applied under favourable circumstances. Leverage utilisation can be harmful and destructive to the company's financial stability under unfavourable circumstances.[10]

Leverage

The term leverage means to have fixed expenses for any business. Leverage, in the dictionary, is defined as "the power to control," "augmentation," or "dominance." Leverage is the use of debt funds or borrowed capital in terms of company finance. Although leverage is solely a financial tool, managers participating in the decision-making processes connected to capital structuring decisions, mergers and acquisitions, ascertaining the cost of capital, etc. use it immensely.[11]

A corporation must be able to choose a wise combination of owned capital and debt funds given the current market conditions and the rising demands of equity owners. It must determine whether or not the use of debt financing helps the business achieve its desired objectives. Given its immense power, leverage has a significant impact on a company's profitability, liquidity, and overall financial performance. [12]

Types of Leverage

a). Operating leverage

b). Financial leverage

c). Combined leverage

a). Operating leverage

If a business is having fixed expenses or costs it is known to have an operating leverage. Fixed costs must be utilised by the company in order to increase the impact of changes in sales on earnings before interest and taxes (EBIT). The company's main worry is that it must be able to cover the fixed costs no matter the volume.

Operating leverage helps in measuring the impact of percentage change in earnings before interest and taxes due to percentage change in Sales. [13]

$$OL = \frac{EBIT}{SALES}$$

b). Financial leverage

There are two categories of sources that a business can use to raise resources;

i). Those sources which carry a fixed financial charge

ii). those sources which do not have involve fixed charges.

Financial leverage is a by-product of using fixed-fee bearing securities or funding sources. The company's main priority in this situation is to fulfil its contractual responsibilities, although increases to earnings before interest and taxes (EBIT) should lead to higher earnings per share (EPS).

If a business is having the cost of funds in terms of interest, it is known to have a financial leverage. Financial leverage is a measure of percentage change in earning per share due to percentage change in the earnings before interest and taxes.[14]

$$FL = \frac{DEBT}{EQUITY}$$

c). Combined leverage

Sometimes, when a company uses leverage that combines characteristics of these two types of leverage, a third type of leverage known as combined leverage emerges. A company is said to have used combined leverage when it uses fixed costs in its income streams in addition to fixed-charge bearing sources of financing.[15]

$$CL = FL * OL$$

OVERVIEW OF PHARMACEUTICAL INDUSTRY OF INDIA

Pharmaceuticals are substances that are medically effective and are transformed into dose forms that patients can consume. Pharmaceuticals are characterised as bulk medications in their simplest chemical form, while formulations are the actual dose forms.[16]

Pharmaceutical firms may provide both brand-name and generic drugs as well as medical equipment. They must abide by a number of laws and rules that control the testing, safety, efficacy, marketing, and patenting of medicines. Figure below lists the four major sectors of the Indian pharmaceutical industry.[17]

The pharmaceutical sector has grown to be a significant and intricate business. The majority of the biggest pharmaceutical corporations in the world were based in North America, Europe, and Japan at the turn of the century. Many of the biggest of these corporations were international, with research, production, and sales occurring in many nations. Since the pharmaceutical industry can be extremely lucrative, several nations are working to provide the infrastructure required for drug businesses there to expand and engage in global competition. Outsourcing has also come to represent the sector.[18] In other words, a lot of businesses hire specialised manufacturers or research organisations to handle specific stages of the drug development process on their behalf. Some people attempt to keep the majority of the procedures within their own business. It is expected that the pharmaceutical industry will continue to adapt and evolve over time because it is mostly driven by money and competition, with each company vying to be the first to discover treatments for particular ailments. Companies in the pharmaceutical industry will continue to expand both organically and inorganically through partnerships and alliances. By 2025, the worldwide pharmaceutical market will be worth more than $1.5 trillion, increasing at a 3-6% compound annual growth rate. The United States and the "pharmerging" markets, with corresponding compound annual growth rates of 4-7% and 5-8%, will continue to be the main drivers of growth. One of the pharmerging markets is India.[19]

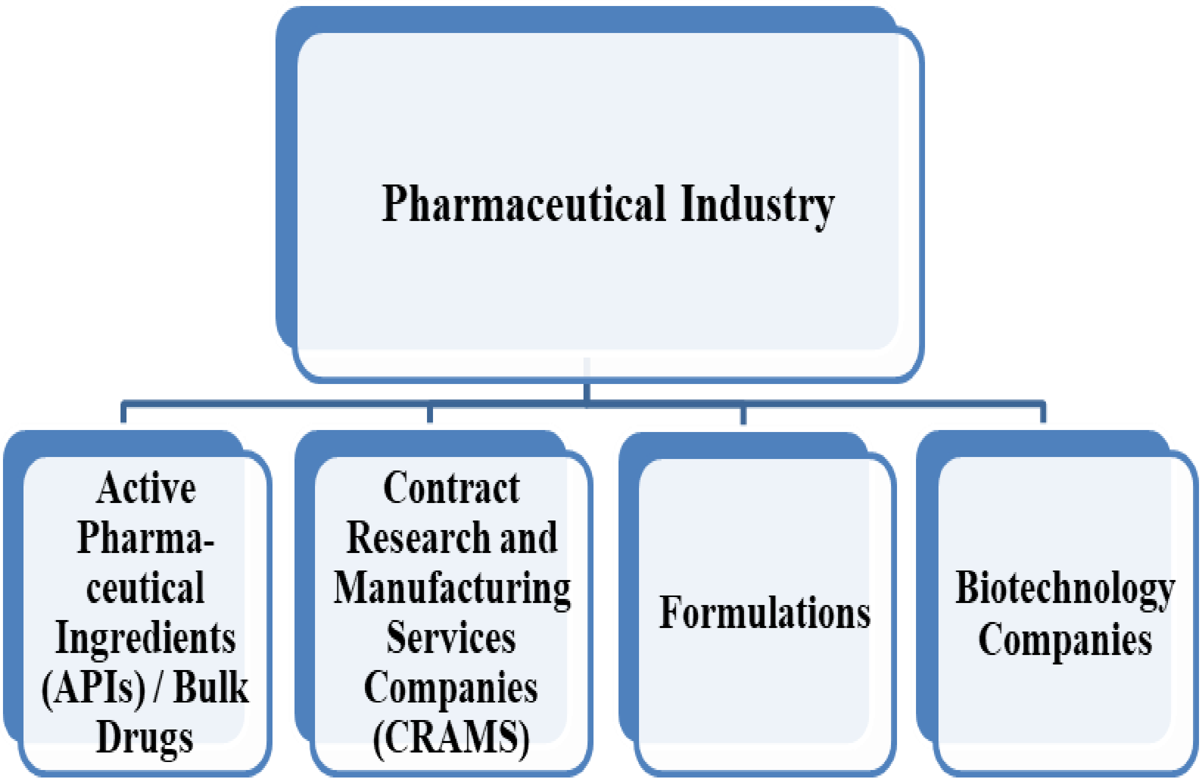

Figure 1: Four key segments in the Indian pharmaceutical industry

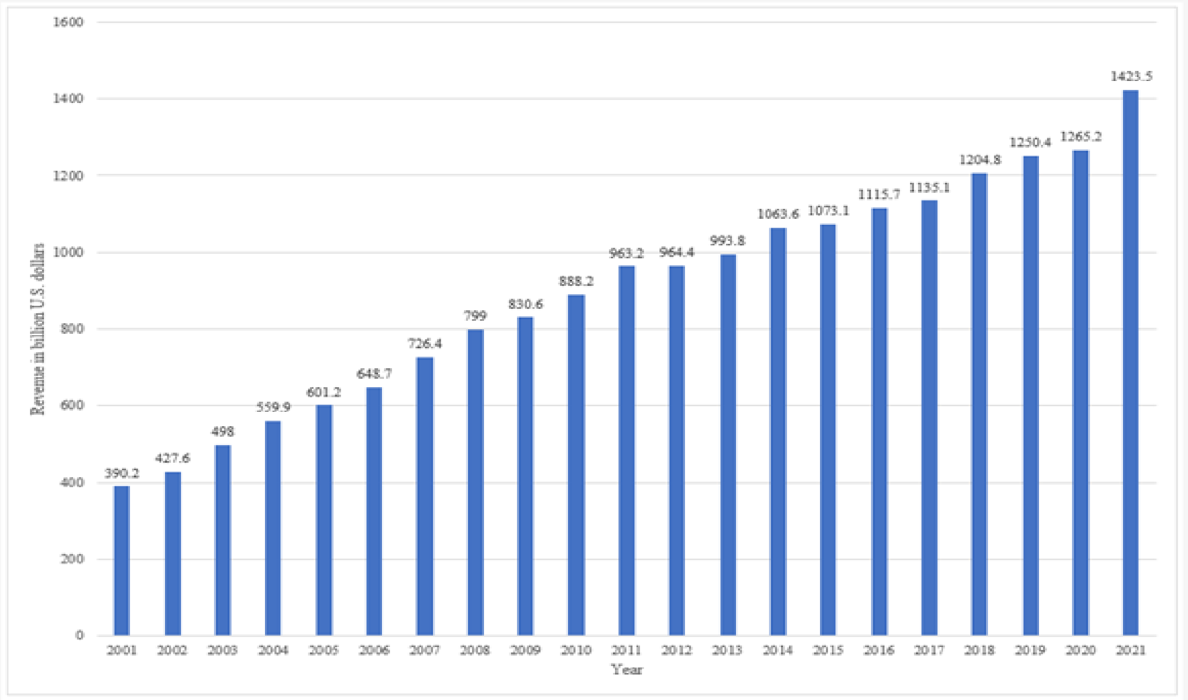

Figure 2: Pharmaceutical Market: Worldwide Revenue 2001-2021

India's position in global

India acquired 14th rank in Global Pharma industry during 2005 (6 US billion $). India is projected as 10th largest market in Pharma industry as indicated in the following table:

Table 1: India's position in global pharmaceutical market by value

S. No.	Country	Market Value
1.	US	444
2.	Japan	83
3.	France Germany	46
4.	Germany	38
5.	China	38
6.	UK	32
7.	Spain	25
8.	Italy	25
9.	Canada	25
10.	India	20
11.	Brazil	20
12.	Mexico	19
13.	South Korea	15
14.	Turkey	15

By absolute growth, India will be among the top five markets (3rd position) globally during 2005 - 2015 in terms of technology, quality and the vast range of medicines that are manufactured. It ranges from, simple headache pills to sophisticated antibiotics and complex cardiac compounds. 20,000 units are registered in this industry. [20]

In India, the pharmaceutical market was worth US$38.2 billion in the financial year 2018–19. The sector experienced a compound annual growth rate (CAGR) of 15.4% between 2014 and 2018. If quality and research and development are given top attention, the Indian pharmaceutical industry might increase from its current $15 billion size to $300 billion by 2030. India's pharmaceutical exports increased from US$ 16.8 billion in 2017 to US$ 18.5 billion in 2018.[21]

Indian pharma has improved outcomes for public health globally. India contributes 40 to 70 percent of the WHO's demand for the Diphtheria, Tetanus, and Pertussis (DPT) and Bacillus Calmette-Guérin (BCG) vaccines and 90 percent of the WHO's demand for the measles vaccine, accounting for 60 percent of the world's total vaccine output. One out of every three tablets taken in the United States, according to estimates, is made in India by a generic's producer. About 25% of the medicines used in the UK are produced in India.[22]

The Pharma products are exported to various nations by India. The details of the value of exports made to the top ten countries and their share in percentage are listed in the table below:

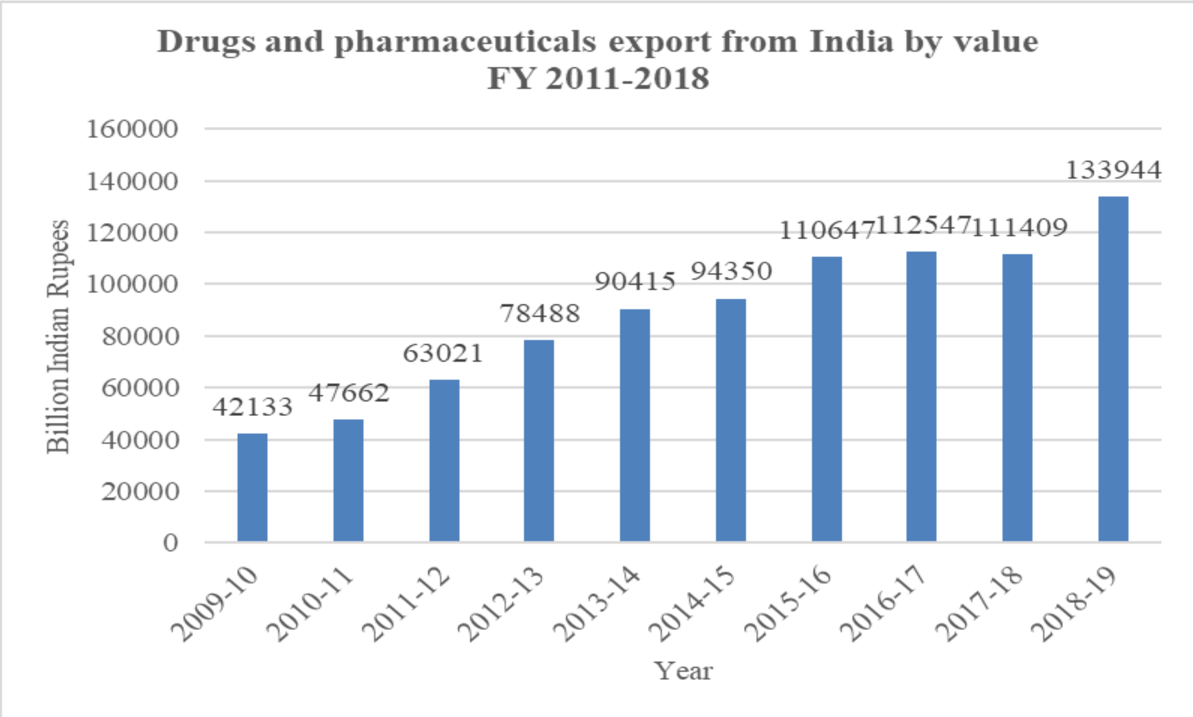

Figure 3: Export Value of Drugs and Pharmaceuticals in India from FY 2011 To FY 2018 (In Billion Indian Rupees)

Table 2: Value of exports to top 10 countries of the world and its share

Rank	Country	Value (US $)	Share (%)
1	United States	3.8 billion	32.9
2	South Africa	461.1 million	3.9
3	Russia	447.9 million	3.8
4	United Kingdom	444.9 million	3.8
5	Nigeria	385.4 million	3.3
6	Kenya	233.9 million	2.0
7	Tanzania	225.2 million	1.9
8	Brazil	212.7 million	1.8
9	Australia	182.1 million	1.6
10	Germany	178.8 million	1.5

The sector has received cumulative FDI worth US$ 15.98 billion between April 2000 and March 2019. Under Budget 2019-20, allocation to the Ministry of Health and Family Welfare increased by 3.1 per cent to Rs 63,298 crore (US$ 9.06 billion).[23]

Shareholders Wealth

The pharmaceutical industry is destined to change in the future. In this area of the health industry, businesses large and small are coming up with creative new strategies to stay relevant, frequently by shifting focus. Therefore, the future of the Indian pharmaceutical business appears to be an exceedingly attractive investment opportunity with such amazing effort and vision. Pharmaceutical firms offer solid long-term returns for investors. The time seems ripe to invest in pharmaceutical companies. Stock exchanges provide as a conduit for investments, and the Indian pharmaceutical industry is a popular investment target. By pooling funds, distributing risk, and transferring wealth, stock markets serve as a bridge between savers and capital users. [24]

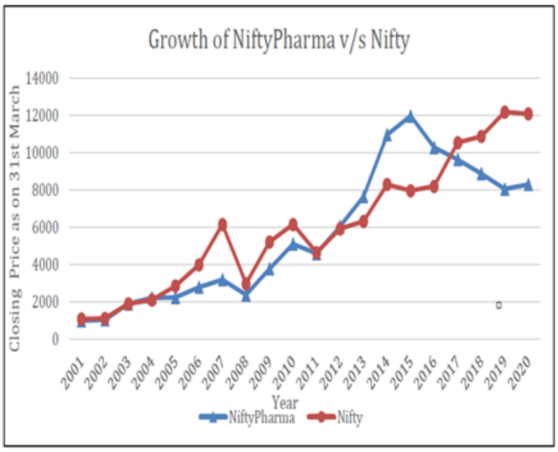

Figure 4: Growth of NiftyPharma V/S Nifty Over the last 20 years

For a variety of reasons, an individual or organisation will invest in equity securities (shares) of corporations through stock exchanges. It could be for a safety net, seasonal cash requirements, an investment seeking a return, an investment seeking influence, or a purchase seeking control. Equity share investment involves giving up certain present values in exchange for an unknown future benefit. The returns shareholders receive from their investments are used to calculate the return on their investment. The total return on investments is made up of the cash dividend, bonus shares, share price growth, and/or all of these. The wealth created by the company for its shareholders is therefore expected to be indicated by the overall return on the company's stock.(25)

Wealth, as generally represented by the market price of a firm’s common stock, is a reflection of value generated by a firm for its shareholder’s. the market price of a firm’s stock represents the collective judgement of all the market participants as to the market worth of equity holdings in a particular firm and also shareholder’s expectations about future cash flows. Market price therefore, ‘serves as a performance index or report card of the firm’s progress; it indicates how well the management is doing on the behalf of its shareholder’s. Stock price, however (or returns based on stock price), may not be a perfect parameter because it is driven by many factors beyond the control of the firm’s executives.(26)

A shareholder must therefore have a thorough awareness of the performance factors that influence wealth or, for that matter, the stock price, in order to build wealth. Any factor that significantly influences a shareholder's wealth is referred to as a wealth driver. Any organization's main goal is to maximise shareholder wealth, thus even management needs to have a thorough awareness of the performance factors that affect shareholder wealth.(27)

An organisation must increase shareholder value in order to achieve the goal of maximising shareholder wealth. Value is produced, in the economist's view, "when management generates revenue above and above, all costs including a capital charge." Management must have a thorough awareness of the performance factors that influence the value of the company in order to produce positive shareholder value. Sales growth, an increase in operating profit margin, a decrease in the cash tax rate, a decrease in the investment in working capital and fixed assets, the minimization of the cost of capital by choosing the best capital structure, an improvement in operating cash flow, an extension of the competitive advantage period, etc. all contribute to positive shareholder value. In other words, wealth creation is driven by value creation and value creation is driven by firm performance.(28)

Information from annual reports, the balance sheet, the income statement, the cash flow statement, and the statement of retained earnings, among other sources, can be used to assess financial performance. An organization's liquidity position, long-term solvency, financial viability, profitability, efficiency, growth, and prospects for the future can all be identified through financial performance analysis. Financial Performance, then, is the blueprint for a company's financial operations and shows how a company has thrived and added value under the direction of its management team. A corporation with strong financial results will naturally see an increase in its share price, which will boost shareholder wealth.(29)

CONCLUSION

As long as people continue to take more medications as a result of rising health concerns and pandemics, the pharmaceutical business will continue to expand. The current investment opportunities in the pharmaceutical industry and the changes in the financial markets have made shareholders, investors, analysts, management experts, researchers, stakeholders, and managers more aware of the need to assess the performance of their companies and determine whether their goal of wealth maximisation has been achieved.

When it comes to the outcome of the financial performance evaluation, each stakeholder has different interests; for example, equity investors are more interested in the expansion of dividend payments and the organization's long-term earning power, whereas creditors want to make sure they receive their payments on time, etc. Bondholders are concerned about the firm's ability to generate cash flow, or its capital structure, and management is focused on assessing the firm's current financial situation, assessing opportunities in relation to this position, and analysing the return on investment provided by the company's various assets. Profitability, liquidity, solvency, efficiency, growth, value creation, and health ratios have been a conventional yet effective tool for decision-makers, including shareholders, business analysts, creditors, investors, and financial managers, to assess the performance of the company. Comparisons between companies, at the micro and macro levels of an industry, between industries, and inside a firm can all be done using these financial measurements.

As a result, it is imperative to investigate how well financial performance drivers explain shareholder value for pharmaceutical companies. The wealth of shareholders can then be predicted using these sets of variables.

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