CASELET

ET CASES
ENABLING DECISIONS

FIN-2-0019 (a) | September 18th 2015

R M FurnitureKraft Pvt. Ltd. (A): Capital Structure Conundrum

R M FurnitureKraft Pvt. Ltd. has been a successful furniture manufacture firm in India all these years. However, as the top line growth was declining of late, the company was mulling over the possible ways to improve the sales figures. Rahul Mehrotra (Rahul) had recently joined the family-owned business as Managing Director (MD) and the responsibility to regain the lustre and bring back the past glory, fell on his shoulders. Rahul felt that making the necessary captial investment would impove the business scenario. However, he was unsure which form of capital structure would be suitable for his company. As his decision to make the right financial decision involved changing the capital structure of the company, Rahul was in a fix whether his decision to bring in the debt component into an equity-based firm would actually boost up the profits. Rahul was in a predicament as he was unable to envisage the consequences of his decision.

R M FurnitureKraft Pvt. Ltd.

Rahul, a B.Tech (Mechanical) graduate from a reputed institution in India, had been an active participant in all the academic as well as cultural activities of the

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college. During the final year of the course, he was appointed as the President of the Student Welfare Association as well. Though he secured multiple sales related placement offers, he was keen on joining a manufacturing facility as his family owned a furniture manufacturing business known as R M FurnitureKraft Pvt. Ltd., which was managed by his father, Roshan Mehrotra (Roshan) and his brother, Rakesh Mehrotra (Rakesh).

Roshan was keen on Rahul gaining industry experience prior to joining their family business. So, Rahul chose to join a reputed manufacturing firm with a reasonably high package. Being a sincere and hardworking person, Rahul was elevated as the Production Manager very soon in the firm.

After his father got convinced with his experience, he invited Rahul to join the family business. Rakesh was helping Roshan from the past 3 years and he had been always very cautious and conservative in approach and thought twice before taking any financial decisions. Rakesh has been functioning as the CEO for the last 2 years, after his father handed over the reins of the business to him.

Capital Structure Dilemmas

Though the firm was running successfully past several years, lately, the business had been witnessing falling sales figures. Rakesh's efforts to improve the sales were going in vain and the firm's top line growth had been declining year after year. Sales revenues showed a sharp declining trend as the revenues which were ₹410 crore in 2013 dropped to ₹340 crore in 2014 and further witnessed a sharp decline of ₹172 crore in 2015. As Rahul joined the firm, as MD, in June 2015, the dwindling sales figure was his immediate challenge. He thoroughly analyzed the company's income statement (Exhibit I) and balance sheet (Exhibit II) for the year ending March 31st 2015. He understood that their business was lagging behind as they were still following the old methods of manufacturing at a time when the customers were on a look out for customized designs.

Being young and dynamic with progressive ideas, Rahul was keen on taking aggressive decisions in an attempt to build a profitable business. Going by the current trend, he intended to manufacture customized modular furniture of superior quality and value to boost the reputation of the company. For that to happen, he realized that a huge capital investment of ₹30 crore was required at a time when the company was facing dwindling sales revenues. Cost of Debt was 10% and Cost of Equity (K_e) was 13%. The capital expenditure was needed to buy the machinery required to manufacture modular furniture. Before the capital expenditure was made, Rahul sought to know if going the debt way would be the apposite option or was there a better option. Rahul shared his concern with one of his childhood friends, Varun Mehta (Varun) who was an MBA graduate and a well-known Business Consultant. After the discussion with Rahul, Varun promised to comeback within a week's time with a detailed note on the implications of having debt on the company's balance sheet.

Exhibit I: Income Statement (for the Year ending March 31st 2015)			
Sl. No.	**Particulars**	**Amount (in ₹crore)**	
1	**Sales Revenue**		172.78
	Less Cost of Goods Sold		87.85
	Gross Profit		84.93
	Less Expenses		
	Selling Expenses	43.04	
	Administrative Expenses	23.29	
	Less Total Expenses		66.33
	Net Operating Income		18.60
Prepared by the authors			

Exhibit II: Balance Sheet (as on March 31st 2015)			
Liabilities	**Amount (in ₹crore)**	**Assets**	**Amount (in ₹crore)**
Share Capital	249.00	Fixed Assets	264.00
Reserves and Surplus	20.00	Receivables	29.13
10% Long term Debt	0	Cash	10.00
Current Liabilities	34.13		
Total Liabilities and Equity	303.13	Total Assets	303.13
Prepared by the authors			

Assignment Questions

I. What do you understand by capital structure? Discuss its importance in any firm's sustainable growth? How can a firm aim to achieve an optimal capital structure?

II. Analyze the three capital structure theories – Net Income (NI), Net Operating Income (NOI)and Traditional approaches – with their implications on R M FurnitureKraft Pvt. Ltd.'s value.

III. Based on your previous analysis, what would be your recommendation on the preferred way of financing?

Mandatory Readings

- M. Y. Khan and P. K. Jain, "Operating, Financial and Combined Leverage", *Financial Management*, 6th Edition, McGraw Hill Education (India), 2013
- M. Y. Khan and P. K. Jain, "Capital Structure, Cost of Capital and Valuation", *Financial Management*, 6th Edition, McGraw Hill Education (India), 2013