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A Study On EBIT-EPS Analysis

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Abstract - The EBIT-EPS approach to capital structure involves in selecting the capital structure that maximize the Earnings per Share (EPS) over the expected range of Earnings Before Interest and Tax (EBIT). This is used to find the impact of different patterns of financing with respect to the returns available to the shareholders. This paper is focusing on how EBIT-EPS analysis works, its advantages and disadvantages.

Keywords: Capital structure, Earning per Share, Earnings Before Interest and Tax.

I. INTRODUCTION

The term capital structure depicts the proportionate relationship between debt and equity. The different means of financing represent the financial structure of an enterprise. The left-hand side of the balance sheet (which is the liabilities plus equity) represents the financial structure of a company. The short-term borrowings are excluded from the list of methods of financing the firm's capital expenditure.

EBIT-EPS analysis gives a scientific basis for comparison among various financial plans and provides ways to maximize EPS. Hence EBIT-EPS analysis may be defined as 'a tool of financial planning which evaluates various alternatives of financing a project under varying levels of EBIT and suggests the best alternative which is having the highest EPS and determines the most profitable level of EBIT'.

EBIT refers to a company's earnings before interest and taxes. This metric strips out the impact of interest and taxes, making it as the synonym of the operating profit for showing an investor or manager how a company is performing excluding the impacts of the balance sheet's composition. In terms of EBIT, it doesn't matter if a company is overloaded with debt or has no loans at all. EBIT will be the same either the way.

EPS stands for earnings per share, which indicates the profitability that the company generates which includes the impact of interest and tax obligations. EPS is explicitly helpful to investors as it measures profits on a per share basis. If a company's total profit is soaring but its profit per share is declining, that's a bad thing for the investor owning a fixed number of shares. EPS captures this dynamic in a simple, easy to understand way.

OBJECTIVE:

- To study EBIT EPS Analysis.

IMPORTANCE:

The EBIT-EPS approach is one of the scientific tool, managers use to decide upon the right mix of debt and equity financing in a business's capital structure. In the EBIT-EPS approach, the business plots graphs of its performance at different possible debt-to-equity ratios, such as 40 percent debt to 60 percent equity. In a basic graph, the earnings per share as a data point is plotted for each level of earnings before interest and taxes at different debt-to-equity ratios. The graph is then analyzed to determine the ideal level of debt-to-equity for the business.

II. REVIEW OF LITERATURE

Effective business management requires careful planning and decision-making about the trade -off between debt and equity used in financing the business. The EBIT-EPS approach is one method available to managers to guide them in making decisions about capital structure. To benefit from the EBIT-EPS approach, it helps to understand the basics of how it works, as well as its advantages and drawbacks.

EBIT-EPS analysis is a very strong and important tool in the hands of the finance manager which helps in determining the most desirable profit level of EBIT. This is an alternative technique to measure the impact of financial leverage on the returns available to equity shareholders.

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Under EBIT-EPS analysis, an attempt is made to analyse the impact of change in the capital structure on earnings available to equity shareholders.

Concept of EBIT-EPS Analysis

The EBIT-EBT analysis is the method that studies the leverage composition, i.e. comparing alternative plans of financing at different levels of EBIT. Simply put, EBIT-EPS analysis examines the effect of financial leverage on the EPS with varying levels of EBIT or under alternative financial plans.

It examines the impact of financial leverage on the behavior of EPS under different financing alternatives and with varying levels of EBIT. EBIT-EPS analysis is used for making the choice of the combination and of the various sources. It helps select the alternative that yields the highest EPS.

We know that a firm can finance its investment from various sources such as borrowed capital or equity capital. The proportion of various sources may also be vary under various financial plans. In every financing plan the firm's objectives lies in maximizing EPS.

Advantages of EBIT-EPS analysis

- ✓ EBIT-EPS analysis evaluates the alternatives and finds the level of EBIT which maximizes EPS.
- ✓ EBIT-EPS analysis is useful in evaluating the relative efficiency of departments, product lines and markets. It identifies the EBIT earned by these different departments, product lines and from various markets, which helps financial planners to rank them according to profitability and also assess the risk associated with each.
- ✓ This analysis is useful in making a comparative evaluation of performances of various sources of funds. It also evaluates whether a fund obtained from a source is used in a project that produces a rate of return higher than its cost.
- ✓ It helps determining the alternative that gives the highest value of EPS as the most profitable financing plan or the most profitable level of EBIT.

Limitations of EBIT-EPS Analysis

- ✓ The EBIT-EPS approach may not be the best and correct tool for making decisions about capital structuring.
- ✓ The EBIT-EPS approach focuses on maximizing EPS rather than controlling costs and limiting risk.

III. DATA ANALYSIS & INTERPRETATION

XYZ manufacture ltd has equity share capital of Rs.5,00,000 (face value of Rs100) .To meet the requirements of an expansion programme. The company wishes to raise Rs.3,00,000 and is having four alternative sources to raise the funds.

Plan A: To have full money from the issue of equity shares at par.

Plan B: To have Rs1,00,000 from equity issued at par and Rs.2,00,000 from borrowings from the financial institutions at 10% per annum.

Plan C:Full money from borrowings at 10% per annum.

Plan D: Rs.1,00,000 in equity issued at par and Rs.2,00,000 at 8% on preference shares.

The company is expecting earnings is 1,50,000. The corporate tax is 30%. Select a suitable plan out of the above four plans to raise the required funds.

	PLAN A	PLAN B	PLAN C	PLAN D
EBIT	150000	150000	150000	150000
-INTEREST	NIL	-20000	-30000	NIL
EBT	**150000**	**130000**	**120000**	**150000**
-TAX(30%)	-45000	-39000	-36000	-45000
PAT	**105000**	**91000**	**84000**	**105000**
- PREFERENCE DIVIDEND	NIL	NIL	NIL	16000
PROFIT FOR EPS	**105000**	**91000**	**84000**	**89000**
NO OF EQUITY SHARES	8000	6000	5000	6000
EPS	**13.125**	**15.1667**	**16.8**	**14.8333**

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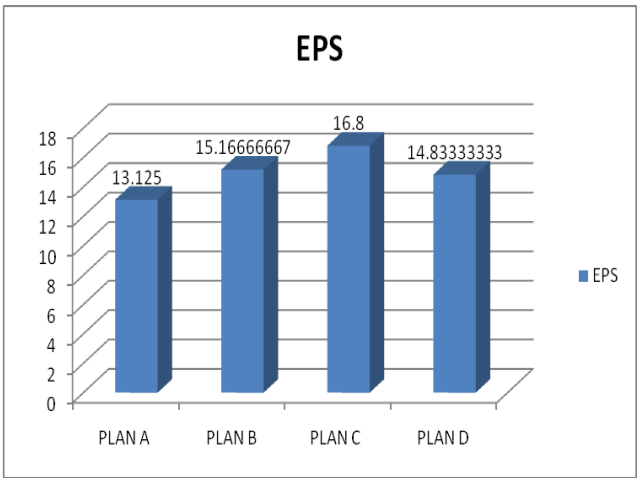

The EPS of Plan C (16.8) is higher when compared to other plans whose capital is structured with the full debt. This reveals that the debt source of financing is also good when used in right proportion.

IV. CONCLUSION

EBIT-EPS is the important approach of capital structure which identifies the best alternative financial plan which maximizes EPS. Thus, EBIT-EPS analysis shows the relationship between EBIT and EPS at various financing pattern i.e. debt –equity ratio. The financing mix, which yields the maximum EPS to equity shareholders under assumed EBIT level, is regarded as the best mix or the optimum capital structure.

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