Chapter-1

Introduction

The financial markets as a part of the financial system play an important role in the economic development for any nation. Until 1990’s the Indian economy was functioning in a highly protective and government regulated environment. Some reforms were undertaken in 1970’s and 1980’s, but the economy continued to be highly controlled. In the year 1991, the major economic reforms were initiated by the government to deregulate the industrial sector and to liberalise the foreign capital flows and technology imports. Some of the reform measures relating to capital market were abolition of Capital Issues control Act,1947, establishment of Securities and Exchange Board of India, electronic screen based trading on National Stock Exchange, liberalized external commercial borrowings policy and so on. These reforms were aimed at providing more competitive and market based environment for the corporate sector.

These economic reforms provided both challenges and opportunities to the corporate sector. On the one side it reduced the bureaucratic control over economic activity, but on the other side, it attracted more competition through imports. In the new regime, the corporate sector got more freedom to set up the new units, and to expand their current businesses. The financial reforms widened the scope for raising resources. The financial system either bank based or market based facilitates the movement of surplus funds from household sector (saving sector) to the corporate sector for investments.

The stock market plays a pivotal role in the growth of the industry and commerce of the country that eventually affects the economy of the country to a great extent. That is reason that the government, industry and even the central banks of the country keep a close watch on the happenings of the stock market. A developed stock market provides a platform to the corporate sector
to raise the funds required for the new investment projects. Stock market provides an additional channel along with banks and other financial institutions, for encouraging and mobilising domestic savings. It provides the basis for improved managerial efficiency through market allocation of capital. A stock market contributes to the real economy because a) it provides an additional channel for encouraging and mobilizing domestic savings b) it improves the efficiency of capital by providing market measures of returns on capital and c) it improves gearing and helps to reduce dependence on borrowing.

An efficient financial system has been identified as an important determinant in achieving long-term economic growth (Walter 1993). Recent research suggests that there may be a correlation between the level of stock market development and that of financial institutions (Demirguc-Kunt and Levine 1996), and that these components are complementary parts of the financial system.

The reform measures, set in motion in early 1991 enhanced the performance of the corporate sector and the economy. But this momentum could not sustain after 1995-96. In the year 1997, second set of financial reforms were announced by the government which showed some improvement in the economic activity. Improved business environment and the new opportunities prompted the corporate houses to raise more capital. One of the interesting decision that the finance managers had to take was regarding the debt equity mix (capital structure).

In the light of this background, it is proposed to study the pattern of resource mobilisation by the corporate sector in India. The basic purpose of the current study is to investigate whether the stock market reforms and the developed

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capital market has any relationship with the pattern of resource mobilisation by these corporate houses.

In this respect, a crucial issue is to understand how firms in developing countries finance their activities and how changes in economic policy impact these financing decisions. According to Sherai Sayuri (2004) 4 , “Well-developed capital markets enable high-quality firms to increasingly finance themselves from securities (bond and equity) rather than bank loans. In response, banks have to provide more loans to relatively low-quality firms and, thus, conduct relationship lending in order to maintain profitability. Therefore, the characteristics of firms determine corporate financing patterns and, hence, the extent of information asymmetry and agency problems. In other words, one can assess the state of financial and capital market development of a country by examining whether corporate financial patterns vary between firms of different quality.”

1.1 Financial System and its Functions

The financial system of any country consists of specialized and non-specialized financial institutions, organised and unorganized financial markets and financial instruments and services which facilitates the transfer of funds. The main role of a financial system is to bring together economic agents with surplus financial resources, such as households, and those in need of finances, such as companies and government. Financial markets as a part of financial system are classified into primary markets and secondary markets. The primary market deal with the new securities issued and is therefore known as new issues market. The primary markets mobilise the savings and provide new funds to the business houses. The secondary market facilitates the sale and purchase of the existing securities and thereby bring liquidity and provide exit route to the existing investors. When capital markets (primary and secondary) are underdeveloped, the business houses are not able to raise equity capital

and an economy functions primarily on debt financing. A well-developed capital market allows companies not to depend on debt route and they can choose to increase their equity financing. Thus if the capital market is underdeveloped, the banking institutions dominate and give rise to a more regulated environment. In a market based economy, companies cover most of their financing needs by issuing financial securities (shares, bonds, commercial paper, etc.) directly to investors.

The importance and functions of financial system in the economic development cannot be underestimated. The various theories throw light on the impact of financial development on the savings and investment. The financial system facilitates the allocation of resources across space and time in an uncertain environment. Financial system (a) facilitates separating, distributing, trading, hedging, diversifying, pooling and reducing risks, (b) allocates resources, (c) monitors managers and exerts corporate control, (d) mobilises savings and (e) facilitates exchange of goods and services, (f) enhances liquidity of financial claims through securities trading, and (g) facilitates better portfolio management.5

1.2 Relationship between Financial System and the Economic Development

It is now widely acknowledged that there is a linkage between the financial system and the economy. Walter Ingo (1993)6 notes that “the structure, conduct and performance of financial systems are highly relevant in setting the agenda of economic growth”. He further points out that “high-performance financial systems are increasingly important as determinants of sustainable economic progress and stability”. Economies with a sophisticated financial system seem to be more capable of evaluating assets whose real value is

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difficult to determine. More specifically, the role of the stock market in providing risk diversification, liquidity, information processing, and capital mobilisation, may be a factor in promoting economic growth (Demirgüç-Kunt and Levine 1996). Some theories provide a conceptual basis for the belief that larger, more efficient stock markets boost economic growth. This article examines whether there is a strong empirical association between stock market development and long-run economic growth. Cross-country growth regressions suggest that the predetermined component of stock market development is positively and robustly associated with long-run economic growth. The data suggest that stock market development is positively associated with economic growth. And this relationship remains strong even after controlling for initial conditions, inflation, and the size of the government, the black market exchange rate premium, and the predetermined component of financial depth. They have shown that countries which reduce barriers to international capital flows enjoy rapid improvements in the functioning of their stock markets. According to them, although stock market volatility may rise in the short term because of liberalisation but in the long run tend to be less volatile than those without liberalisation.

Although India had already started working on reducing the government control in 1980’s, but the economic liberalisation was formally announced in the year 1991 when the Indian economy was opened up for the global market. The foreign exchange deficit, the inefficiency of the public sector and the reluctance of the private sector due to red tapism and bureaucratic set up were the main reasons behind the slowdown of Indian economy. The foreign capital flows started

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pouring in 1990’s due to which the activities in the real sector and in the stock market increased substantially.

Foreign equity investment can be beneficial to developing countries because of its risk-sharing characteristics and effects on resource mobilization and allocation. All the developing countries opened up their economies and India also followed this path. A distinguished International Study Group for the ‘World Institute for Development Economic Research’ (WIDER) has argued that the developing countries should liberalise their financial markets in order to attract foreign portfolio equity flow. The study group’s essential argument has been that the huge amount of financial capital available in the developed countries through pension and investment funds could be attracted to the developing countries provided the latter liberalised their markets externally and developed their stock market internally. The importance of capital markets is now recognised in the developing countries’ financial system and is given a special focus in all economic policies. Now when all the economies are globally connected, developed nations find a huge scope of improving their returns by investing in these developing countries. These developing nations have now become increasingly attractive destinations for international investors due to integration with world financial markets, and this increased integration implies a lower risk-adjusted cost of capital, which is possible by diversifying the risk. According to the portfolio theory, investment in a diversified portfolio always reduces the risk provided there is no correlation among the returns on investments in the different countries. In the same manner since the correlation between returns of emerging markets (developing markets) with developed markets is lower than the return available in the developed economies, the risk can be diversified and return can be increased by investing in the financial markets of developing economies.

One should not forget that the financial markets very often fail to reduce the risk for the public. Very little of the volume of market activity of the security industry has to do with the financing of real investments. The financial markets transfer
only a small part of household savings into productive business investment. The casino effect of financial markets should not be forgotten. More recently, through the application of chaos and fractal analyses to financial markets, it has been shown that they are characterized by asymmetry, turbulence, discontinuity, stampedes, non-periodicity, and inefficiency\textsuperscript{9}.

The last two decades have seen a huge change in the financial markets. The functioning of the market has completely changed due to technological advances in computers and telecommunications and the integration of the banking and commerce worldwide. The increased competition throughout the world has resulted in a much more efficient, internationally linked market, but far more complex. The positive developments of the financial markets have improved efficiency but at the same time increased complications for the policy makers.

The integration of the world markets has necessitated the greater cooperation among regulators at the international level. The various committees formed at the different platform are working towards better functioning. Individual countries are reluctant to give up control over their national monetary policies. Still regulators are unanimous about the need to close the gap in the supervision of worldwide markets. The recent global financial crisis of 2007-08 has been an eye opener for all the policy makers. This sub-prime crisis in U.S. has shaken the economies of all the nations worldwide. It is only the coordinated efforts of all developed and developing nations that the economies are recovering from this economic disaster.

An important development in the Indian financial market was the introduction of derivatives in the year 2000. A derivative is any security whose value is derived from the price of some other underlying asset. Derivatives allow the investors to hedge their positions and an easy entry and exit from the market. The derivatives market also allows for the speculation by the traders in the

market. The derivatives market on the one hand helps in the better price discovery, at the same time allows shifting the risk from risk aversers to risk takers. The size and complexity of derivatives transactions concern regulators and academics. Currently the focus of the traders is largely shifting from delivery based transactions to derivatives markets. Now all the financial markets- capital market segment, derivatives segment, commodities market, currency market and the foreign exchange market are inter connected.

Financial globalization has caused dramatic changes in the structure of national and international capital markets. Another significant change in the financial system was in the banking system, which went through a process of dis-intermediation. This transformation of fundamental nature reduced the time lag in banking transactions significantly and made it more transparent and efficient.

The economic reforms initiated by developing countries bring both benefits and challenges to the corporate sector. On the one side, it allowed the corporates to take the benefit of increased capital availability through international channels for the new investment opportunities but on the other side they had to compete in a highly competitive environment with the international players. Other benefits include knowledge spillover effect, improved resource allocation through the financial markets, the increasing safety of financial operations, and strengthening of domestic financial markets through the financial sector reforms. The recent trend in the international financial markets has also led to the development and growth of the primary and secondary capital market of India. However these need to be managed properly. In the absence of safeguard in place, the events like Lehman Brothers failure can take place in India also. The volatility of Indian financial market may also increase due to reversals of capital flows by foreign institutional investors.

Up to 1970s, there was virtually unconditional protection provided to domestic industry in India. This led to a high cost industrial structure that was
inefficient in the utilisation of resources and internationally non-competitive. As an attempt to address these economic problems, the government adopted an economic reform programme in 1990s with the aim of raising savings, investment and economic growth.

Some reforms were undertaken during 1970s and 1980s, but the economy continued to be highly controlled. The decade of 1980s witnessed a rapid expansion of the industrial activity which can be attributed mainly to the reforms undertaken in both industrial and trade policies in the early and mid-1980s. Further, policy changes have become necessary for accelerating the industrial growth in the 1990s in order to consolidate the achievements of the last decade. Since July 1991 Indian industry has undergone a sea change in terms of the basic parameters governing its structure and functioning. The New Industrial Policy of 24th July 1991 sought substantially to deregulate the industrial sector and liberalising foreign direct investment and technology imports so as to promote the growth of a more efficient and competitive industrial economy and abolition of licensing system.

The economic reforms have been directed towards making the corporate sector more competitive and efficient. The new measures spanned a wide area covering industrial and import licensing, taxation, foreign investment, financial markets and exports. Reforms have been manifested in physical as well as financial aspects. The physical changes have essentially revolved around providing a better environment for investment, including measures such as delicensing, public sector dereservation, easing of Monopolies and Restrictive Trade Practices Act (MRTP), import delicensing, reduction in import tariff. Also, restrictions on the import of technology have been eased and the foreign investment regime liberalised. Lastly, the corporate tax rate has also been gradually reduced. Financial reforms included measures such as opening up of the capital market with the abolition of the Capital Issues Control Act 1947, giving way to free pricing of capital issues and making equity finance an attractive source of funds.
for the corporate sector. Foreign institutional investors have also been allowed to invest in both equity and debt markets. The exchange rate regime eventually led to a market – determined exchange rate, and current account convertibility facilitated a more liberal exchange control system. Access to foreign funds has also been increased through a liberalised External Commercial Borrowings (ECB) policy and allowing recourse to Global depository receipts (GDR), American depository receipts (ADR) and Foreign currency convertible bonds (FCCB). This enabled enterprises to take advantage of interest rate differentials between domestic and global markets and raise cheaper funds.

The economic reforms, set in motion in the early 1991, improved the external environment of the corporate sector and have resulted in an enhanced performance by the sector. These reforms lead Indian Industries away from a regulatory and protective regime to a free market oriented, competitive and globalised environment. With the announcement of these measures, structural reforms of the Indian Industrial policy has taken place, which prompted us to study the changing pattern of resource mobilisation by the private corporate sector as a result of stock market development and other economic reforms.

1.3 Sources of Corporate Financing

The new investment by the company can be arranged either through internal or external sources or both. Internal sources refer to the funds generated by the company from retained earnings, reserves and accumulated depreciation provision kept by the firm. The external sources of finance are the funds raised from outside the company by way of new securities issued in the money and capital markets and the borrowings from banks and different financial institutions.

In raising the funds from external sources, the main issue before the corporate enterprises is to determine the proportion of debt and equity. The ratio or the proportion of debt and equity is known as firm’s capital structure/financing
mix. As the changing proportion affects both risk and return to the investors, a proper balance between the debt and equity is necessary.

In some instances, promoters may choose consciously to forgo growth to retain control over their venture. Apart from risk of losing control, it may not be economically viable to raise outside equity because the perceived cost is too high relative to debt.

The debt which is considered as a cheaper source of finance due to its tax deductible nature and the lower risk attached to the suppliers of funds is preferred by the promoters over the issue of equity. Apart from being economical for the enterprise, debt also allows the entrepreneurs to retain the control. This was the reason why most of the Indian corporates used the global liquidity via external commercial borrowings to finance their operations in the period 2004-2007. But this increased leverage posed many complications and huge risk before them in the period of slowdown 2008-2011. Hence, choosing appropriate financial structure is important so that the interest of all the stakeholders is aligned to the greatest extent possible.

In view of the above the present study is intended to analyse the pattern of resource mobilisation by the sample companies in terms of debt-equity mix. What is the right combination of debt and equity is an important question before the finance managers. Is there any flexibility available to the corporate firms in designing their financial structure? Whether the private corporate financial structure is predominantly debt or equity dominated? Have any major changes taken place in the financial structure practices of the private sector, given the economic liberalization in India? These and many other related issues constitute the subject matter of the present study.

The financing of a project is an intricate and complex process and it has been one of the most tedious puzzles for the financial managers to arrive at the economic rationale for investment and financing decision particularly when the economic environment in the country is undergoing a major re-
structurisation. It is prudent for a company to have a long term view before deciding on a financing pattern for a project.

Sound financing decisions of a firm basically should lead to an optimal capital structure. Capital structure represents the proportion in which various long term capital components are employed. The decision regarding capital structure is one of the important decisions that a firm has to take as it affects the cost of capital, net profit, earning per share, dividend-payout ratio and liquidity position of the firm. These variables coupled with a number of other factors determine the value of a firm.

The capital structure of a company is the make up or composition of capitalisation i.e. the type of securities to be issued and the relative proportion of each type of security in the total capitalisation. In Corporate finance, capital structure of the firm seems to include only those sources of funds which are represented by securities ( Guthann and Dougall)\(^{10}\).

In a broader sense, the term capital structure, often used synonymously with financial structure denotes the permanent financial mix of an enterprise. Broadly, it covers long term debts, short term debts (because they are increasingly being used on permanent basis) and net worth, the latter comprising capital contributions of equity holders, preference capital and earned surpluses and net worth surpluses. In other words, capital structure of a firm means total of all liabilities and ownership claims, the sum of what is usually the credit side of balance sheet.

The two sources of finance - bank financing and market financing differ on the basis of cost, volume and flexibility. The companies can borrow from the banking system exactly according to their requirement. Generally the transactions are processed much faster and it takes lesser time to raise the funds. Though the cost is comparatively higher but there is always a scope for negotiation. In contrast to it the primary market financing is governed by

market forces. The companies come in direct contact with the investor without transiting through a financial institution’s balance sheet. The volume of funds to be raised may differ from the exact requirement and the preliminaries for floating an issue take several weeks. Bank loans impose greater constraints on the company with covenants and guarantees to their loans. For small and medium sized companies, the choice between bank financing and market financing is skewed in favour of bank financing.

The company has various choices to raise the funds such as equity, preference, bonds, bank borrowing, public deposits and the short term sources. An entrepreneur has to make a choice whether to borrow more long-term, short term or issue equity. The ratio of equity and borrowing is to be set. To choose the right financing mix, the enterprises make the cost benefit analysis in terms of risks and returns of various types of securities. The different proportion of debt and equity are preferred in the different situations according to the predetermined objectives and the acceptable levels of risk. Therefore it is difficult to say that which combination of debt and equity is best. It can be said though that in terms of issuance costs (which is one of the key factors under normal conditions) retentions are the cheapest, then come trade credits, then short-term credits, then bank loans, then private issues of bonds, convertible bonds, and finally public issues of bonds, convertible bonds and equity, in that order. This generally corresponds to the pecking order described in Chapter III.

Capital structure is an important area of financing decision making that has direct bearing on the cost of capital, market value of shares, and capital budgeting decisions. One of the main objectives of this work is to study the pattern of resource mobilisation or capital structure. A study of pattern of capital structure is an examination of the changing proportion of the different components of the liabilities. The factors influencing the capital structure can be classified as external and internal factors. Size, age, nature of the industry, legal characteristics of enterprise, profitability and growth rate are considered as internal factors determining the capital structure of a company. External
factors include Government-regulation and policy, market conditions and also norms and nature of industry. In the present study, the focus has been on external factors only as it is difficult to identify and quantify all the company specific factors.

1.4 Rationale of the Study

Most of the foreign studies during 1980’s are related to agency and asymmetric information theory of capital structure. Review of empirical studies suggests that a trend in financial structure of Indian industries is studied in detail by previous studies but in aggregate terms only. No detailed firm level study has been conducted so far which can focus on impact of changes in stock market growth on the financing pattern of Indian Corporate sector. So the attempt has been made in this study to see the changes (if any), in financing pattern of sample companies after liberalisation. This study attempts to find out how the growth of stock markets due to reforms and financing pattern of Indian Corporate sector are related to each other. Most of the studies are done focusing on industry wise analysis of the Indian Corporate sector but in this study the focus is on company wise analysis along with sector wise and industry wise analysis.

The study is timely in the sense that all the global financial markets are facing the heat of sub-prime crisis. In such an uncertain environment, how the corporates are changing their financing pattern is quite relevant to study. The government regulatory authorities and SEBI has introduced a number of policy initiatives and guidelines for improving the operational and allocative efficiency of Indian stock market for the easy and cheaper access of funds for the corporate houses. These reforms are expected to have a positive effect on equity as the financing choice of the Indian corporate sector.

For the present study, the growth of the market due to reform measures has been examined empirically. Further the impact of stock market development
1.5 Objectives of the Study

The basic objective of the study is to examine the relationship between stock market reforms and the pattern of resource mobilisation of Indian corporate sector. Under the guideline of this primary objective, the specific objectives set in the study are:

1. To assess stock market growth in terms of market size, liquidity and volatility.
2. To evaluate the pattern of resource mobilisation of Indian corporate sector.
3. To analyse the relationship between stock market reforms and corporate financing pattern in India.
4. To examine impact of corporate characteristics such as industry, sector, size and age on the aforesaid relationship.

Hypotheses

As regards the first objective of the study the following hypotheses have been formulated:

1. To examine the first objective, the study will test the following null hypotheses:
   1.1 Ho: The market capitalisation as a percentage of GDP has not increased over the period of the study.
   1.2 Ho: The liquidity of Indian stock market as measured by value traded ratio and turnover ratio has not increased.
   1.3 Ho: The volatility in Indian stock market has not increased over the study period.

2. To examine the second objective, the study will test the following null hypotheses:
2.1 Ho: The External finance is not more important as a source of finance for Indian firms.
2.2 Ho: The proportion of capital market has not declined as a source of finance over the study period.
2.3 Ho: The importance of equity finance has not declined over the study period.
2.4 Ho: The proportion of external debt in total finance has not declined over the study period.
2.5 Ho: An inverse relationship does not exist between contribution of external debt and external equity in the financing requirements of the Indian corporate sector.

3. To examine the third objective, the study will test the following null hypothesis:
   Ho: There is no relationship between the stock market development and the pattern of resource mobilisation of the Indian corporate sector.

4. To examine the fourth objective, the study will test the following null hypotheses:
   4.1 Ho: Financing pattern of companies across industries and sectors do not vary significantly.
   4.2 Ho: Equity financing is not more important for large companies than small companies.
   4.3 Ho: Debt financing is not more important for new companies than old companies.

1.6 Research Methodology

In order to accomplish the objectives of the study, a number of statistical tools are used. The details of the data and methodology used in the study are explained in the following section.
The basic data for the study is secondary in nature. The data about the financial statements and the financial structure is being collected from ‘Prowess’ data base available in the public domain and maintained by Centre for Monitoring Indian Economy (CMIE). This data base has collected information for thousands of companies from regulatory reports, official websites and the press releases from the respective companies. The other sources used to supplement the basic data are the various publications and the respective websites of the regulator of capital markets (SEBI), the Reserve Bank of India (RBI), other institutions and intermediaries (NSDL, CDSL etc.).

To avoid the impact of temporary factors and the business cycle, a longer time frame of study of 22 years period i.e. 1990-91 to 2011-12 has been used. The significance of the period chosen lies in the fact that the Indian economy witnessed major structural reforms during this period. It is only during this period that the Indian industries and the stock markets grew at a very fast pace.

A sample of 208 companies from BSE 500 index listed on Indian stock exchanges is considered. The data of all companies belonging to all sector of the economy has been analysed. An attempt has been made to have as large a number of companies as possible with complete information and whose equity shares are regularly listed on Bombay Stock Exchange. The financial ratios, a widely accepted tool of financial analysis, and statistical tools (explained in later chapter) have been relied upon to analyse the pattern of resource mobilisation and the financial structure of sample firms in post liberalisation period.

1.7 Organisation of the Study

The present chapter which is introductory in nature highlights the circumstances which necessitated the reform process. The chapter also covers the Indian financial system and the importance of stock market for the economic development of the country. It also includes the objectives, hypothesis and relevance of the present study.
The second chapter provides a brief review of literature relating to stock market development and financing pattern of Indian corporate sector by other researchers both in and outside India.

The third chapter discusses in detail the sample used, source of data and research methodology (also the statistical tools used) adopted during the study. The fourth chapter provides an overview of the structural stock market reforms undertaken by the government. This chapter also depicts the development and growth of stock market through selected indicators. The empirical investigations and findings on the development of Indian stock market are also presented in this chapter.

The fifth chapter empirically examines the pattern of resource mobilisation by the Indian corporate sector.

The influence of stock market developments on the financing pattern of sample companies is examined in sixth chapter.

The last chapter i.e. chapter seven sums up the major findings and makes some concluding observations.

1.8 Limitations of the Study

The present study on the relationship between stock market reforms and pattern of resource mobilisation by the Indian corporate sector has some constraints.

First, the study is based on a sample of 208 companies from BSE 500 whose shares are listed and quoted at Bombay Stock Exchange. Such companies are generally large compared to other unlisted and small companies. The exclusion of small sized companies renders the applicability of the findings to only a class of relatively large companies.

Second, the study is confined to external factors of the stock market development at macro level only and does not consider company specific factors affecting the capital structure decision at micro level.
Thirdly, the data is considered only for delivery based capital market segment. The derivatives market segment is becoming more popular, mainly used for hedging and speculation is not being considered. Fourthly, the National Stock Exchange data is not considered.