The relationship between finance capital and industry dates back to the origin of modern industrialisation, and has been shaped by the way investment patterns and financial systems evolved. Although the nature of financial systems vary at different stages of economic development, they are always of cardinal significance in the process of capital formation in a country. The financial system itself is influenced by the respective socio-economic and political attributes prevalent within the political boundaries of a country.

Each economy does have its own financial system. However, two broad systems of productive financing are identified in the literature. In Britain and the United States, capital markets play a major role in financing industrial investment and growth. On the other hand, in countries like Germany and Japan, banks and financial institutions play a major role in financing investment, and influence the resource allocation in the country broadly in accordance with the objectives and policies of the state for attaining equity in growth and development. Thus, there exist two broad systems of industrial financing: a credit-based system and a capital market-based system. However, for most developing countries, a prominent role for the capital market in the allocation of financial resources is a recent phenomenon. This movement, even if marginal, away from a credit-based financial system to a capital market-based system, was partly the result of a shift from policies of ‘financial repression’ to ‘financial liberalisation’ in these countries.

In India, too, a predominantly credit-based system existed in the heydays of planning. In the process of evolution of that system, three distinct landmarks can be identified: independence from colonial rule and the launch of a state-led industrialisation strategy in 1947; nationalisation of 13 major private banks in 1969; and a shift in policy emphasis to export promotion and liberalisation of industrial policies in the mid-1980s. But, it was in the nineties that the government unveiled its detailed plans on liberalisation focused on the financial market. Thus, the nineties can be considered as a period when a

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1 Many economists have credited the capital market as the catalyst which speeded up the process of industrialisation in Britain in the initial phases, by enabling various innovations in the industrial sector to reach commercial production status.

2 Through the use of various direct and indirect tools like subsidies, trade credits, priority sector loans, guarantees by the government for loans by banks and financial institutions, etc.
shift from a credit-based system to capital market-based system is being experimented within the Indian context.

Following liberalisation, two broad phases can be identified in the growth of capital markets in India, based on the various initiatives of the government to promote this market. In the first phase, a remarkable growth in the new issue market (NIM)\(^3\) was observed in the 1980s. This followed the relaxation of controls on various capital market activities in different stages during this decade, leading to a greater role for market forces. The proposed investments by private corporate sector firms through the NIM increased to Rs. 23,357 crores in the 1980s when compared with the total of Rs. 992 crores in the 1970s and Rs. 285 crores in the 1950s. In the second phase (1991-92 to 1996-97), NIM showed a further vigorous expansion in activities, following some major structural changes in the policies influencing its functioning. The proposed investments by private corporate sector firms through NIM rose massively from the level of the eighties, to Rs. 98,648 crores in the period 1990-1996. Thus, asset intermediation by the capital market as a percentage to incremental deposits of commercial banks, which was a meagre 3.4 per cent in the 1970s and had grown to 22.7 per cent in the 1980s, showed a staggering rise to 56.40 per cent in the period 1990-91 to 1995-96. This shows a movement in the financing of private corporate firms away from term loans and bank loans to stock market-based funds, suggesting a process of disintermediation.

To assess the implications of such structural changes in industrial financing in India, we require a greater understanding of the operations of various financial intermediaries\(^4\) and the capital market. In general, the nature of financial intermediaries tends to change over various phases of development, with an increasing specialisation in operations related to financial transactions in an economy. With financial liberalisation come many new financial intermediaries\(^5\), and new financial instruments\(^6\) (even in an

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3 The stock market has two segments in it. The primary market is the segment where only new securities of equities, debentures, etc. are issued by companies. Such public issues are further classified into initial public issues and ‘further public issues’ (seasonal equity offerings - SEOs), based on whether the company is making a public issue for the first time or not. The secondary market is the segment which provides liquidity to the investors in the primary market, through trading in the existing stocks of companies.

4 Financial intermediaries like banks, and development financial institutions.

5 For example, in India, institutions like the EXIM Bank (1989), Tourism Finance Corporation of India (1989), Over the Counter of Exchange of India (OTCEI, 1989), Stock Holding Corporation of India (1985), etc. were of later origin.
existing financial intermediary), which hasten the pace of changes in the existing structure of savings and investments. For example, one very important change in the structure of the Indian capital market with liberalisation was the entry and growth of non-banking financial companies (NBFCs) in the 1990s, which are far less regulated than the banks. With the changes in sources of financing and the liberalisation of controls, governmental policies, which had been formulated with balanced development objectives, have become less and less effective in regulating industrial investments.

Another significant change in the structure of the Indian capital market has been the increased role of public limited companies that began accessing funds from this market. Since public limited companies are characterised by varying degrees of separation of ownership from control, this would lead to an increase in the conflicts between owners, who include a growing share of small investors, and managers in private corporate firms. The increased significance of this form of organisation (of a public limited company) in the 1990s, is due, in part, to the decreasing role of financial institutions in the growth of equity financing in India and the growth of non-family owned business corporations. With the increase in market financed industries and of public limited companies, it becomes important to understand the direction and nature of changes in the financial structure underlying industrial development.

Along with the structural changes in the eighties and nineties, there was a sudden increase in the capital market activities, as mentioned earlier. Investment trends and decisions are influenced by a complex combination of expected earnings, changing fads and fashions and speculation, all constrained by the available information on opportunities for returns. The influence of fads and fashions increases as the direct commitment of the investor to long-term investments is diluted in favour of stock market purchases of equity issues. The latter increasingly takes the form of short-term decisions, with the movements in the demand for and supply of equities in the market, influencing share prices.

Market-based financing of industrial investments in a liberalised economy can be through the domestic capital market (mainly, the new issue market - NIM) or the external capital markets (through ADRs and GDRs issued in a foreign stock exchange or through

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6 These include instruments which are known as hybrid instruments which have the characteristics of both debt and equity. Some of these instruments are also designed to eliminate risk of variation in currency values and interest rates.
foreign investors' long-term equity investment in domestic firms - FDI). Both these markets compete in terms of cost and accessibility. Their relative shares would greatly depend upon the policies and objectives of the liberalisation process which influence the strategies of firms, and variations in them would have different economic implications. The consequence of a financial market failure for industrial development in an economy, would depend on the relative significance of these markets in the total capital formation of an economy.

Although the external markets for industrial investments are an important segment for a developing and capital scarce economy like India, the neglect of sentiments in the domestic markets could be a wrong policy in the long run. Studies on international capital flows reveal an increasing proportion of short-term capital flows relative to long-term capital flows, from the industrialised countries to the developing countries, indicating a larger proportion of capital flows in the form of portfolio funds compared to productive capital. The external markets for industrial investments are also characterised by additional risks like foreign exchange risk. Thus, in economies which have an excessive reliance on external capital markets and which are dominated by increased flow of finance capital in comparison to productive capital, a recession or a fall in confidence in the host economy could have serious implications for its industrial development. Studies on countries like Mexico and Chile have clearly shown the extent of damage this channel can cause in times of crisis and low confidence levels. With the separation of ownership and controls in the case of public limited companies, there is a greater risk of outflows in case of an expected crisis, further complicating the situation. It is for this reason that development of the domestic capital market takes on significance as an alternative investment channel for investors, and as a channel for financing industrial development.

Depending on its usually long-term nature, many developing countries have been relying excessively on foreign direct investment (FDI) to supplement domestic industrial capacity, and to further export growth. However, excessive reliance on even such external capital can also lead to adverse consequences for industrial development, as in

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8 The separation of ownership and control is core to the role of stock markets in an economy, both at the domestic and international levels. Controls, here, refer to the irreversible part, the investment decision made by the manager. Ownership level is where liquidity and irreversibility are in operation for the shareholder. Efficiency would then depend on the level of interaction between the manager at the control level and shareholder at the market level.
this case too, foreign investors look for a 'favourable' investment climate in the host countries, and may turn out to be inconsistent. To quote Patnaik:

"Capital flows are governed not just by wage differentials, but even more significantly by a host of considerations which go in to make what is called the 'investment climate'. These include political stability in the host country, the state of infrastructure, the strength of the trade unions, the degree of social turmoil, the absence or presence of terrorism, cultural attitudes, etc., apart from simply how congenial government policies happen to be. Now, most of the underdeveloped countries, by virtue of their very poverty and the associated social and political turmoil, simply cannot provide the congenial 'investment climate' needed by foreign capital for locating in them its production units to service its global market." 9

The implications of an excessive reliance on external capital following financial liberalisation, for industrial structure and growth, are reflected in the crises of Mexico and the Southern Cone countries and the recent crisis in Southeast Asian economies, which went ahead with further integration into the international financial markets. These events highlight the in-built tendency of market failures in such a financial system, and the possible adverse effects on production, distribution and overall welfare. A buffer to the external risks and uncertainties in a liberalised set-up could be the promotion of 'efficient' domestic capital markets. Besides, the alternative of a domestic capital market is very important in countries like India, which have a high share of 'black income' 10 and a large 'middle class'. A well-developed domestic capital market could be used to tap these large sources of capital for productive investments in a liberalised market.

Besides the external and domestic capital markets, the other distinction made with respect to 'market financed capital', is that between the primary (NIM) and secondary capital markets. With technological advancements in communication 11, financial liberalisation, and concomitant globalisation, the secondary markets show a high degree of sensitiveness. The literature on the secondary market has focused on the role of stock market prices/returns in influencing fixed investments. Keynes 12 and Tobin in his 'q' theory of investments, stated that the rate of investment is determined by the ratio of the market valuation of a firm's capital stock to its replacement cost. Further, asset pricing theories suggested that the market value of a stock depends upon the investors'

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10 Various estimates placing such income at nearly half of the total GDP of India.
11 Reduction in transaction costs is a major consequence of these technological advancements.
12 Keynes said that: "The daily revaluation of the stock exchange, though they are primarily made to facilitate transfer of old investment between one individual and another, inevitably exerts a decisive influence on the rate of current investment." Keynes, J M (1936), The General Theory of Employment, Interest and Money, London.
expectations regarding earnings and dividends. Thus, both the theories emphasise the role of speculative sentiments in secondary markets in influencing the availability of investment capital for industries.

In the Indian context, a study carried out by the RBI for a span of 30 years, i.e., 1965-66 to 1994-95 did reveal a positive correlation (0.36) between lagged stock market returns and the growth rate of private corporate investment in machinery and equipment. However, an increasing role for ‘speculative motives’ in influencing total investments could prove detrimental to the long-run growth of India’s still developing private sector. Such motives could force firms to postpone their investment plans in the case of a bearish trend in the secondary market and visa versa.

These issues could drive us to rethink the recent liberalisation and globalisation process in India and its possible effects on production, distribution and overall welfare. Therefore, while India debates further financial liberalisation, it becomes crucial to analyse and understand the implications of the first phase of Indian financial liberalisation. One question which looms large is whether the capital market is capable of ensuring the necessary checks and balances on its own. This study which pursues such issues, is an attempt to understand the changed nature of the role of capital market in industrial financing in India.

As discussed above, the increasing role of the capital market in India has seen the rise to prominence of the new issue (primary) market in the 1990s. Two deficit sectors, namely, government and the private sector showed an increasing participation in this market during the 1990s. The channels used for raising these investments have been rights and public issues. Although a third channel, private placements, exists, the study focuses on only one of these channels of investment in NIM, viz., the public issues, for two main reasons: one, greater firm-level data availability on public issues as compared with rights issues; and two, the insignificant share of the private placement channel in the total funds mobilised.

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14 State governments and municipalities have increasingly started accessing the capital market for needs of investments.
15 The private placement channel accounted for 39.3 p.c. of the total resources mobilised in 1995-96 and 49.1 p.c. in 1996-97, but this growth came mainly after the decline in the public and rights issues channels in the new issue market in 1995-96, and falls outside the period of the present study. Reserve Bank of India, 1997, “Private Placements Market in India”, RBI Annual Report, September, pp. 94.
raised through NIM by the private corporate sector during the study period, 1989-95. Thus, this work is an inquiry into one aspect of industrial investments in India, i.e., the growth and structure of investments by the private corporate sector in India through the new issue market. This growth is examined in the context of emerging equity markets world over and financial liberalisation in India.

With this purpose, the study undertakes a detailed analysis of the new issue (primary) market in India for the period January 1989 to December 1995. This period consists of two separate and distinct phases: the first, the years 1989 to 1991, when the Controller of Capital Issues (CCI) still regulated the new issue market and secondly, the years 1992 to 1995, characterised by the liberalisation of pricing of equities under a new regulatory framework provided by the Securities and Exchange Board of India (SEBI).

Methodology

a) Rationale for the Approach
In a market economy, expectations combined with policy changes in promoting such expectations, can cause changes in the structure of firms' financing pattern. In the context of capital markets, one such change is in the extent of financing of investments via NIM. Thus, an analysis of trends in the NIM is essential to understanding the change in industrial financing pattern. It is with this objective that a detailed study was carried out on the role of NIM during 1989-1995.

The approach adopted in this thesis for analysing the financing pattern of firms differs from that of existing studies. Industrial financing has been popularly analysed using two different tools: a) a macro approach, which examines the flow of funds across the different sectors in the economy to understand the pattern of flow between sectors; and b) a micro approach, which takes the balance sheet and funds flow statement of firms as important indicators of industrial investment patterns. However, these studies have certain inherent limitations in explaining the role played by the stock market in private corporate financing. The former approach would provide a broad macro picture and miss various micro specificities and the second approach would only highlight trends in investment and financing of existing companies, and hence, would not capture what is happening at the margin with regard to proposed investments in new projects, or proposed
expansion and diversification by existing firms.\textsuperscript{16} As a result, micro aspects such as changes in financing preferences of firms and the associated changes in the structure of investment cannot be studied using the above two approaches. This study is also undertaken with a micro approach, similar to the second of the existing methods mentioned above. However, the source of data for the analysis would be the prospectuses\textsuperscript{17} of firms at the time of public issue, rather than the balance sheet, as the former provides detailed and specific information on the plans of each issuing company. Given this approach of using the "prospectus" to understand the financing of firms in the category of "public limited companies"\textsuperscript{18}, when references are made to investment, production, employment etc., the reference is to planned or proposed investment, production or employment, as revealed in the prospectus. This is true throughout the thesis, except when otherwise mentioned.

b) Objectives of the Study

The general objective of this study is to understand the characteristic features of the new issue market over the years and to analyse the role played by this market in financing private corporate firms in India. The specific objective is to understand the structure and characteristics of NIM during the liberalised phase, and to look into the effect of the disintermediation process (since 1992) as revealed by the firm-level financing pattern. The study is carried out for the period 1989-1995\textsuperscript{19}. The analysis would attempt to provide a broad picture of the pattern of investment financing in a market-oriented economy, which would highlight the in-built instability of an unregulated new issue market.

\textsuperscript{16} The balance sheet, which is taken for various analytical purposes, does not provide a detailed picture on the existing public limited companies' plans of expansion, diversification, etc. It provides only aggregates under various heads like share capital and debt components and hence, lack detailed break-ups.

\textsuperscript{17} Prospectus document is a legal requirement on the part of a new or existing company, while making a public issue. It contains a detailed description about the project, capital structure, promoter details, past performance and future projections and the risks involved. It is a complete document which provides all the vital information to an investor. A prospectus is certified by a Chartered Accountant and a merchant bank for its feasibility and genuineness.

\textsuperscript{18} The Public Limited Companies are defined under Indian Company Act as:
A Public company means a company which is not a private company. A private company are defined by its articles:
(a) Restricts the rights to transfer its shares, if any;
(b) Limits the number of its members to fifty not including - i) persons who are in employment in the company, and ii) persons, who having been formerly in the employment of the company were members of the company while in its employment, and have continued to be members after their employment ceased; and (c) Prohibits any invitation to the public to subscribe for any shares or debentures of the company.

\textsuperscript{19} Data collected is based on the calendar year.
The specific objectives are:

1. To study the growth of the New Issue Market (NIM) during the phase of financial liberalisation, to analyse the contribution of NIM to the total finance of the private corporate firms in India, and also to highlight the various phases in its growth, by examining the various trends in the market.

2. To study the sources of finance of the private corporate firms which came for public issue from this market, in order to understand the dependency of firms on stock market funds in an emerging equity market like India.

3. To analyse the regional concentration of the issuing firms, the reasons behind it, and its possible implications for industrial investment in certain regions of the country.

4. To analyse the structural pattern of investments in the NIM and to examine the various changes that have taken place in this pattern. These are analysed in terms of type of issue with respect to objectives and instruments of issue, as well as the size, age and industrial category of the firms and various other structurally important factors.

5. To analyse demand and supply situation in the NIM in order to gauge its capacity to finance the private corporate firms in India, and to study the factors which influence the response trends in the NIM.

6. To analyse the recent growth of premiums charged on issues and to identify possible factors that influenced the rise in premium issues.

7. To suggest policy measures, the study will look at the liberalised policies of the government with respect to the capital market and especially NIM, which has a direct effect on the investment scenario of the whole nation, and especially, on domestic industrial investment.

c) Scope of the Study

A study of this nature is warranted for the following reasons:

1. It will reveal the economic factors which influence the new issue market and also the effect of the latter on industrial investment, production and concentration of investment in certain regions,

2. It will reveal changes in the structure of savings and consumption, which are considered to be key variables for inducing investment in the future,

3. It will bring to light the influence of the cost of financing on the pattern of financing of firms.

d) Sources of Data

The data for the study was collected from various sources. These sources can be classified into two major categories based on the characteristics of the data collected. For
the macro analysis of NIM, the data was collected from three different sources depending upon on the availability of data. The data used in the first part of the analysis in Chapter II, which analyses the structure of NIM till 1988, was collected from various reports like *The Report on Currency and Finance*, and the monthly and annual reports published by Reserve Bank of India (RBI). The other source is *Prime Data Base*, a data source on the primary market compiled and published by Praxis Information Pvt. Ltd., New Delhi. Praxis Information is a private organisation which provides information relating to the new issue market in two different reports, PRIME : The Public Issue Monitor and PRIME Annual Report. These reports provide complete information on public, rights and other issues made in India. However, a comparison of the two data bases existing on NIM in India (Appendix II) reveals that there is incomplete information in the *Prime* database for the initial years of the sample analysis period, while it provides wider coverage for the nineties. This is possibly because the data base was started in 1989. Thus, this thesis uses the *RBI* data on NIM for the macro analysis, and the *Praxis* data, for a monthly analysis of the 1990s. The last source of macro data was the Centre for Monitoring India Economy (CMIE), Mumbai, whose reports for the respective years have been consulted when necessary.

The main analysis of the new issue market in Chapters IV to VIII was carried out from the data collected by the researcher from the Delhi Stock Exchange library for 3127 public issues resorted to by firms. The information on these firms was collected from individual prospectus documents which the firms brought out at the time of public issue, making sure that no repetition was made in this collection process. Hence, the sample data set consists of 3127 individual firms. This data is the complete set of prospectus information available at this library, and thus, no specific sampling procedure was used for the collection. An yearly distribution of the sample firms in comparison to the total population is given in Table 1.1 below.

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20 Refer Appendix I for details on the sample firms taken for the study.
Table 1.1 The Year-wise Distribution of Sample Size to Population

<table>
<thead>
<tr>
<th>Year</th>
<th>Sample Selected</th>
<th>Population</th>
<th>% to Population</th>
</tr>
</thead>
<tbody>
<tr>
<td>1989</td>
<td>111</td>
<td>189</td>
<td>59.0</td>
</tr>
<tr>
<td>1990</td>
<td>102</td>
<td>142</td>
<td>72.0</td>
</tr>
<tr>
<td>1991</td>
<td>130</td>
<td>168</td>
<td>77.4</td>
</tr>
<tr>
<td>1992</td>
<td>298</td>
<td>405</td>
<td>73.6</td>
</tr>
<tr>
<td>1993</td>
<td>507</td>
<td>607</td>
<td>83.5</td>
</tr>
<tr>
<td>1994</td>
<td>880</td>
<td>1130</td>
<td>77.8</td>
</tr>
<tr>
<td>1995</td>
<td>1099</td>
<td>1445</td>
<td>76.1</td>
</tr>
<tr>
<td>Total</td>
<td>3127</td>
<td>4086</td>
<td>76.5</td>
</tr>
</tbody>
</table>

Note: # = Data is from January to December. @ = financial year (April to March).
Source: # = Sample data, @ = Prime database.

e) Data Description

The prospectus gives a brief sketch of the past performance of the firm, project to be started, risk factors, composition of capital structure and future prospects of the firm. It also provides information on the capital structure of the issue, cost of project, sources of financing, means of financing, age of the firm, product details, location of the firm, and employment.

f) Limitations of the Study

1. The whole study is based on an assumption that the proposed investments made by the firms were carried out in accordance with the prospectus guidelines. No analysis of the actual post-issue performance of the firms can be attempted, due to serious limitations in data availability on this account and also due to time limitation.

2. Since the analysis was carried out based on the ASI classification of industries and location of firms, the industrial and yearly aggregates in this study may not tally with those in the CMIE reports. Besides, all the aggregates are arrived at from the sample as mentioned under the source of data, and so, is limited by the sample size.

3. Rights issues are not dealt with in as much detail as public issues, because of the lack of data on this channel of NIM. As rights issues are directly channelled to shareholders, the market has only a broad understanding of this channel.

4. Non-availability of complete data on various firm-level characteristics limited the study at various places, reducing the sample further to ‘sub-samples’ in many cases.

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21 Both the sample and population are aggregation of public issues and do not include rights issues.
g) Chapter Schemes

The thesis consists of three broad sections. In the first section, consisting of Chapters I to III, the researcher has tried to understand the relevance of existing theories on financial liberalisation and investment, government policies and historical factors, and the various stages of development of the new issue market in India till the early nineties. The second section is an analytical section based on the sample survey of 3127 firms, which called for public issues between January 1989 and December 1995, and covers five chapters (Chapters IV to VIII).

The first section in Chapter I reviews some of the major theoretical discussions on financial liberalisation, covering both indirect funding activities through banks and development financial institutions, and direct funding activity i.e., via stock markets. The second section provides a synoptic view of industrial policy and financial liberalisation measures in India.

Chapter II provides a historical view of the capital market and investment activities in India and is divided into three broad sections. The first section provides a sketch of the macro trends in the capital market in India during 1858-1995, under five phases. The second section focuses on the structure of the New Issue Market (NIM) in India, during the three phases covering the period 1951-1989. The third section is a detailed analysis of the NIM and its changing macro significance till 1990.

Chapter III analyses the structural changes in NIM during the 1990s, and examines the various factors that affected its performance during this period. The first section mainly focuses on the socio-economic and institutional factors which helped in the growth of the NIM in the 1990s. The second section of this chapter looks at the macro characteristics of the NIM.

Chapter IV is based on an analysis of the prospectus of 3127 firms which came out with issues during the period 1989-1995. The chapter delineates the characteristics of the firms studied and highlights certain structural aspects of NIM like: a) investments by firms with different characteristics; b) equitisation and growth of firms; and c) dependency of firms on NIM.

Chapter V analyses the nature of participation of firms in the NIM in the 1990s with respect to some firm-level fundamentals and NIM-related characteristics of the
issuing firms. It also highlights the micro changes that the NIM has undergone between the regulated and the liberalised phases.

In Chapter VI, we examine the financing patterns of the private corporate firms that participated in the equity boom of the 1990s, as reflected in their sources and uses of funds.

Chapter VII is an attempt to examine the phenomenon of concentration in industrial investment\(^{22}\) in India, in the context of the liberalisation of the NIM.

The focus of Chapter VIII is the identification of factors which influence the subscription to a public issue, using firm fundamentals\(^{23}\). This chapter looks at the demand and supply of capital in the NIM, and analyses the subscription trends across various response categories with respect to different firm characteristics.

The thesis ends with a brief conclusion.

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\(^{22}\) Investment used in the context of NIM is the projected investment and not the actual.

\(^{23}\) Firm fundamentals refer to the information on the issuing firms as presented in the prospectus, and does not include the past performance (sales, and profit) of the company.