1.1 INTRODUCTION

The chemical industry is a key contributor to the world economy. It is a knowledge-based industry with significant investments in Research and Development. The industry supplies product to virtually all sectors of the economy. In India, this sector occupies central place of the economy and also it is one of the oldest domestic industries contributing significantly to both industrial and economic growth of the country. The Indian chemical industry is an integral component of the Indian economy, contributing around seven per cent of the Indian Gross Domestic Product (KPMG, 2010). This industry is a vital part of the agricultural and industrial development in India and has key linkages with several other downstream industries such as automotive, consumer durables, engineering, food processing and the like. The Indian chemical sector has grown a long way since the early days of independence. In India, this sector has grown small scale sector to multidimensional sector which is taking on the challenges of globalization and holds recognized position in the global map. India is the 12th largest producer of chemicals in the world and the third largest in Asia, growing at more than 10 per cent yearly (Indian Chemical Council). The Indian chemical industry has a strong and diversified base encompassing many areas such as organic and inorganic chemicals, plastic fibers, dye stuff, intermediates plants, pesticides, insecticides, specialty chemicals, drugs and pharmaceuticals. The total investment in Indian chemical sector is almost US $60 million and total employment generated is about one million. The sector accounts for 13-14 per cent of the total exports and eight to nine per cent of total
imports of the country in terms of volume. This industry manufactures more than 70,000 products. In the post WTO Era, Indian chemical industry is undergoing a massive expansion.

Globalization poses several challenges to this industry that has predominantly developed in a protected environment. Opening of the Indian markets to Foreign Institutional Investors (FII) and Foreign Direct Investment (FDI), gave rise to the opening up of the Indian chemical industry to a host of untapped opportunities. Introduction of economic liberalization has brought about dramatic changes in the manner in which Indian companies raise resources to meet their need. Such an environment has forced the corporates to overhaul their technology, diversify and increase the size so that the effect of large scale economics can be felt. The process of globalization has also been felt by the Indian chemical industry. The chemical industry of India is at par with the world standard and it shares a good portion of chemical business in world market. Asian countries, African countries and Arab countries buy Indian chemical products. The demand for Indian chemical products is high across the world and the reason for this popularity is high quality and competitive pricing. India’s low cost and high-end chemical products, manufacturing expertise coupled with world class manufacturing infrastructure are the main leveraging factors for the rise of this industry. India offers higher class chemical products at a substantial discount than those of its western counterparts while delivering the same grade of outputs.

In a globalized economy, finance may be defined as provision of money at the time it is needed. It is undoubtedly the life blood of business. The ambitious plans of a businessman would remain a mere dream unless adequate money is available to convert it into reality. The sources of funds to an individual are often limited but a firm can raise money from various
sources such as public deposit, long term loan, deferred credit, debenture, preference shares, equity shares, retained earnings, depreciation, investment allowance and finance re-engineering etc. The prime objective of corporate manager is to raise the right quantum of fund from appropriate sources with a resulting minimal, average cost of the resources. However, when mobilizing all the resources from cheap sources, the question of risk arises. Cheaper sources need not necessarily be the safest sources. Therefore the task involved in mobilizing resources for a corporation involves a judicious balance between costs and a risk thereby ensuring that the firm has the lowest of cost of capital in line with the level of risk the firm is willing to bear. Among the various sources of funds available to a firm, the cheapest source is debt capital. By maximizing borrowed capital, a firm could reduce cost of capital and thereby contribute to the welfare of the equity shareholders.

1.2 STATEMENT OF THE PROBLEM

The corporate sector is increasingly depending on external sources for meeting its fund requirements. The capital structure of any company invariably includes long-term capital in the form of debentures as well as long-term loans from banks. Value of a firm can be increased through judicious mixing of debt and equity capital. In order to reduce the cost of capital, every financial manager would like to make use of borrowed capital because effective cost of capital of debt is relatively low. This leads to a considerable reduction in the overall cost of capital. If borrowed capital can reduce the cost of capital, then to what extent the Indian chemical companies are engaging leverage in their capital structure?. Do all such companies make use of similar level of leverage? Is there any variation among the companies?.
Gordon (1962) found that return on investment was negatively related to debt ratio. Pandey (1985) reveals that the levels of leverage in the Indian industries is moving upwards and that the large majority of companies leverage decisions seem to be independent of their size, profitability, growth and industrial variations. In a subsequent study (2002), he has found that capital structure and Tobins’q have a cubic relationship that is at lower and higher ranges of Tobin’s q firms employ higher debt and reduce their debt at intermediate range. This is due to the complex interaction of the market conditions, agency problems and bankruptcy. What are the variables that actually determine the level of leverage? To what extent do the variables account for the variations in the level of leverage?.

Modigliani and Miller (1958) theorem report that level of liabilities does not affect corporate investment behavior in a perfect market conditions. On the other hand, it has negative impact on investment. Corporate investment is found to be influenced by the availability of internal funds by Fazzari et al (1988) and Hoshi et al (1991). Hart and Moore (1995) argued that the liabilities effectively restrain over investment. This raises question. Is there any direct relationship between a firm’s investment and leverage? In order to find solutions to these questions, the present study has been undertaken.

1.3 OBJECTIVES

The following are the broad objectives of the study:

1. To examine the extent of financial leverage
2. To study the determinants of corporate financial leverage
3. To examine the impact of leverage on investment.
1.4 METHODOLOGY

Data for the current study have been collected from the data base PROWESS maintained by Centre for Monitoring Indian Economy (CMIE).

1.5 SAMPLE

The sample units have been drawn from the list of chemical companies for which data are available in the PROWESS data base provided by CMIE. For the present study 24 companies representing basic and specialty chemical groups of chemical industry have been considered. Judgment sampling method has been followed.

1.6 PERIOD OF STUDY

The study stretches for a period of 16 years from 1995-96 to 2009-2010

1.7 FRAMEWORK OF ANALYSIS

Data collected have been analyzed by making use of (i) Financial Ratios (ii) Correlation Analysis (iii) Multiple Regressions (iv) Path Analysis.

1.8 SIGNIFICANCE OF THE STUDY

This study is very useful for the financial manager to know the variables, which affect the debt equity mix of the chemical industry in India.

The result of this study is significant to the lending institutions to prevent and to reduce non-performing assets, while granting loans and advances to companies belonging to chemical industry in India.
Shareholders too stand to gain out of the results of the study. They can understand the magnitude of leverage engaged by the Chemical Companies and accordingly reshuffle their portfolio.

1.9 LIMITATIONS OF THE STUDY

The present study suffers from certain limitations, which are unavoidable. The financial statements have their own limitations. All limitations applicable to financial statements are applicable for the study also.

1.10 CHAPTER SCHEME

The report of the thesis is presented in seven chapters.

Review of studies conducted earlier in India as well as abroad forms chapter Two. It also explains how the present study is unique.

Chapter three deals with the research methodology describing in detail the data and sources of data as well as method of sample selection.

Trends in corporate leverage are traced in Chapter Four. Levels of debt employed by companies, and differences among them in terms of leverage are explored here.

Chapter five finds out the determinants of corporate leverage. Factors that are associated with the level of leverage and the extent to which they determine the level of leverage are clearly brought out in this chapter.

Chapter six makes an attempt to examine the impact of leverage on investment. Random and Fixed effect models have been deployed to gauge the impact.
The last chapter summarizes the findings of the study.

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REFERENCES


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