CHAPTER IV

CAPITAL STRUCTURE OF CENTRAL GOVERNMENT COMPANIES AND ITS CHANGE OVER 1960-61 AND 1969-70 - A GENERAL STUDY
In the previous chapter a comparative study of the various forces that operate in the formulation of the capital structure of the Central government companies vis-a-vis those that operate in the formulation of the capital structure of the companies in the private sectors was undertaken. The said study revealed that:

(a) Capital structure of the Central government companies cannot be the outcome of managerial decisions as called for by the interplay of the forces like current economic and market conditions or prevention of dilution of control over the companies. Unlike the companies in the private sector the capital mix, i.e. the proportions of the different components of capital viz., the share capital, borrowed capital and retention, is not decided in case of the Central government companies, by the internal management at the enterprise level. The same is rather the result of the managerial actions as dictated by the administrative ministries in accordance with the guide lines laid down by the government.

(b) Secondly, non-commercial obligations streaming off from the concept of a welfare state, often predominate in the operational side of these companies. Consequently on the operational side also the internal management of the Central government companies find them bound by the regulations and control of the Government. As a result the internal
management of the Central government companies cannot decide or control the IRR of their respective companies. The same is also decided by the government though not always directly, via media the control of the price or service policies of the Central government companies either as required by the extent to which the general principles of financing public sector undertakings were accepted or out of its zeal to satisfy the non-commercial obligations of the Central government companies. The over-all effect of this state of affairs is that the management of individual Central government companies has no freedom not only in deciding upon a particular capital mix but also in adjusting operational activities to a given capital mix.

(c) Thirdly, as the internal management of the Central government companies can neither decide their capital mix nor adjust operational activities to a given capital mix it cannot exercise any influence on the determination of the 'cost of capital'.

(d) Fourthly, the cost of capital, that ultimately comes out on account of this situation, is an artificial one emanating from government action. For instance, where the current revenue flow of the Central government companies was found insufficient to absorb the fixed charges in respect of the debt capital received from the Central Government, the government in many cases forgone either wholly or partially the interest charges or allowed its capitalisation as will be seen later on. So far as the cost of equity and retained profit
is concerned, it varied evidently from no-cost to nominal or low cost depending on the surplus of revenue flow.

Some of the other peculiarities noted earlier in the discussion that may be recalled in this connection are:

(a) The Central government companies are comparatively of recent origin, compared to companies that are in operation in India in the private sector. An investigation into 91 Central government companies, as on 31st March, 1970, with reference to their dates of registration disclosed that 27.9% of them belonged to the age group between 1 to 5 years; 29.7% between 6 and 10 years; 24.2% between 10 and 15 years and the balance that is 13.7% belonged to the age group above 15 years. Needless to say that, these 13.7% of the companies were either taken over by the government from private ownership by way of nationalisation or they were established prior to the commencement of the Companies Act, 1956, with share capital contributed mainly by the Central Government. Such companies naturally got the status of the Central government companies after the commencement of Companies Act, 1956, by virtue of Section 617 contained therein.

(b) Secondly, the objective before the Central government companies being held as the laying down the base for a rapid industrial development of the country, the bulk of the investment in the Central government companies

between 1960-61 and 1969-70 had gone in favour of Steel, Engineering and Shipbuilding, Chemical, Mining and Minerals, Aviations and Shipping and Promotional and Developmental Companies, including Financial institutions. Many of these companies, which confining themselves to the arena of basic and key industries, had, therefore, been characterised by long gestation lag and low profitability as indicated earlier.

(c) Thirdly, most of these individual units required in each case extra investment of a huge amount of money for the construction of an infrastructure consisting of development of roads, means of transport, township etc. which had usually not been required by private sector companies.

(d) Fourthly, as already stated the government was keen after the fact that its financial contribution to the capital of the Central government companies were such that they were able to make each capable of maintaining a fixed ratio of 1:1 between debt and equity.

In the aforesaid circumstances the Central government companies naturally attained a given frame work of their capital structure. It took a particular shape at the initial stage and over the period of the present study the said capital structure of the Central government companies underwent a change that must have depended on this frame work of the contributory factors described above.

Naturally as already indicated, this capital structure of Central government companies both initially as well as in respect of the changes that would occur to it subsequently
would differ from the same in respect of private sector companies. Let it now be studied how far the hypothesis stated above may come to be true. Table 10, 11 and 12 of the present chapter deal with the aforesaid various aspects of the capital structure of the operating Central government companies covering all industries for the period between 1960-61 and 1969-70 as covered by the Reserve Bank study on the finance of government companies.

In Table 11 an analysis of the relative proportions of the share capital, borrowed capital and retention in the capital structure of Central government companies covering all industries have been attempted.

In Table 12, the capital structure of the Central government companies have been studied with reference to the relative proportions of external and internal sources in it. In this connection it has to be mentioned that share capital and borrowed capital are usually designated as external capital. But a part of share capital has in course of time, come to be made of retained profit capitalised into bonus shares. Therefore, in the preparation of this table, external capital has been got rid of the portion consisted of such bonus shares and the same has naturally been added to the internal capital (The note given under the Table 12 may be consulted). Whereas Table 13 depicts the relative importance and changes of share capital and borrowed capital among external sources in the capital structure of Central government companies over the decade between 1960-61 and 1969-70.
Table 11 shows that in the year 1960-61 the proportion of share capital in the capital structure of Central government companies had been 63.7%. From the year 1960-61, however, its proportion in the capital structure began to decline rather rapidly with slight reversal trend in consecutive two years of 1963-64 and 1964-65. As a result of the trend towards decline in the proportion of share capital its share in the capital structure of Central government companies came down from 63.7% in 1960-61 to 39.6% at the end of 1969-70 after the adjustment of accumulated losses arising out of the operation of the companies against equities. Thus, over a span of 10 years the decline in the proportion of share capital had been 37.8%. Initially, high percentage of share capital in the Central government companies can be ascribed to the fact that most of the companies were relatively new units in the arena of basic and key industries which calls for capital free of fixed cost. The relative decline of the share capital in the capital structure of the Central government companies since 1961-62 is mainly due to the government decision, as mentioned earlier to meet the capital requirement of the Central government companies in the ratio of 1:1 between debt and equity.

In consequence, the borrowed capital which accounted for only 25.5% of the total capital mix in the Central government companies in the year 1960-61 began to increase by leaps and bounds in the capital structure of Central government companies since 1961-62. And at the end of 1969-70
the proportion of borrowed capital in the capital structure of Central government companies had been found to be 60.4% of the total capital mix. Thus, over a span of 10 years the borrowed capital in the capital structure of Central government companies increased by 127.3%. Not only that, initially, among the external sources, it was the share capital which had the lion's share of them as detailed out in Table 13. But consequent to the rapid increase in the proportion of borrowed capital, share capital gradually lost its importance. And after 1965-66 it found itself relegated to the second place among the external sources in the capital structure of Central government companies. What is more significant is that this increase in the proportion of borrowed capital in the capital structure of Central government companies occurred in many cases when the company concerned had been in the red. For instance, in case of the Hindustan Steel Limited, in the year 1961-62, there was 15.9% increase in the borrowed capital of the company though the enterprise concerned suffered a loss of Rs. 1947 lakhs in the same year. Similarly, increase in the percentages of the borrowed capital of the company also occurred in the years between 1966-67 to 1969-70 in the wake of its comparatively adverse operating results. Other instances on the point were found in the activities of the Heavy Electricals (India) Ltd., and the Heavy Engineering Corporation Ltd. In case of Heavy Electricals (India) Ltd., borrowed capital increased by 359.3% of what it was in 1961-62 despite heavy losses suffered the company in that year.
Similarly, Heavy Engineering Corporation Ltd., increased its borrowed capital from ₹ 67 lakhs in 1960-61 to ₹ 15057.0 lakhs in the year 1969-70 in the very face of its substantially adverse operational results. Here it may be noted that all these had been giant companies and their net results from operation had significant impact on the over-all performances of all Central government companies taken together.

Another important aspect that is disclosed from the analysis of the data furnished by Table 11 is the poor role that retention played in the capital structure of the Central government companies between 1960-61 to 1969-70. Before proceeding further, the term retention, as used in this discussion requires a bit of elucidation. It goes without saying that retention means retention of profit. But unlike the practice that is followed in many cases, it does not include 'depreciation'. It is a fact that each time by writing off depreciation, other things remaining the same, the ratio between fixed assets and current assets decreases. But that cannot possibly be due to the addition of a new source of capital. In that context depreciation rather maintains the value of the ownership capital. A detailed discussion of the topic, however, will follow in a latter chapter. As understood in this meaning retention of profit contributed to


* A giant company means a company having a paid up capital of ₹ 20 crores and above (Vide Reserve Bank Bulletin September 1965).
9.8% of the total capital mix of the Central government companies in the year 1960-61. The same increased to 11.1% in the year 1961-62. Thereafter, i.e. from 1962-63 it is most surprising to note that, there was not only a sudden disappearance of retention but its share even turned into a negative one also as a component of capital mix in the capital structure of the Central government companies. The extent of such negative share of retention being - 8% of the total capital mix in these companies at the end of 1969-70.

In consequence, the share of external sources in the capital structure of Central government companies, which had always been higher than the internal sources, gained absolute command in the capital structure of Central government companies from the year 1962-63. And this was visible till the end of 1969-70. Table 12 of the present study goes to corroborate this aspect of the capital structure of the Central government companies, where the capital structure of these companies have been analysed in terms of relative share of external and internal sources. Comparatively better share of the retention as a source in the capital structure of Central government companies in the initial two years and not only its abrupt disappearance but conversion also as a negative item as a source from 1962-63 may be attributed to many factors. One of them was that many Central government companies operating in these years had been established much before the commencement of the Companies Act, 1956, which for the first time, gave the recognition of the government companies as a separate distinct class. With good performance results to their credit having no, or relatively smaller amount of capital with fixed
charges in their capital structure those companies were able to have a surplus after payment of dividend or after adjustment in respect of deferred revenue expenditure. For instance, Bharat Electronics Limited, which was established in April 1954, had no borrowed capital in the year 1960-61. The net profit of the company in that year amounted to Rs.15.8 lakhs, out of which Rs. 6.5 lakhs had been used to write off deferred revenue expenditure leaving a balance of Rs. 9.3 lakhs towards retention. Similarly, Hindusthan Antibiotics Ltd., established in March 1954 with no borrowed capital, could apply the whole of its profit of Rs. 81.2 lakhs earned in the year 1960-61 towards retention. And in the year 1961-62, out of a net profit of Rs. 76.6 lakhs, it used an amount of Rs. 15.5 lakhs towards payment of dividend, the balance of profit amounting to Rs. 61.1 lakhs being retained by the company as additional capital.* Another instance on the point was provided by the Hindusthan Insecticides Ltd., established in March, 1954. It had a borrowed capital of Rs. 28 lakhs in the year 1960-61 representing only 12.5% of the total capital of the company. The profit of the company in the year 1960-61 was in the order of Rs. 18.4 lakhs. It applied Rs. 0.8 lakh towards writing off its deferred revenue expenditure. The balance of the profit was retained in the business. Again in the year 1961-62, with borrowed

capital of Rs. 25 lakhs representing only 10% of the total capital, it earned a profit of Rs. 16.1 lakhs. The whole amount of this profit was applied towards retention to serve as additional capital. In the same way Hindusthan Machine Tools Ltd. established in March 1953, had a borrowed capital of Rs. 227 lakhs in 1960-61 representing 24.8% of its total capital. It used Rs. 2.8 lakhs of its profits towards retention in 1960-61 after it had applied Rs. 17.5 lakhs towards writing off deferred revenue expenditure and Rs. 53.1 lakhs towards payment of dividend. In the year 1961-62 the borrowed capital of the company was 26.7% of the total. As against that, it applied Rs. 64.3 lakhs of its profit towards retention, after payment of dividend amounting to Rs. 53.1 lakhs and writing off deferred revenue expenditure to the tune of Rs. 10.1 lakhs. Instances can be multiplied.

The second factor that may be held responsible for the phenomenon had been the pre-dominance of the equity capital in the Central government companies in the initial years of their operation on which the government forgone current dividend earnings. For instance, Hindusthan Antibiotics Ltd., transferred the whole of its profit in the years 1959-60 & 1960-61 for the purpose of retention. Similarly no dividend was declared prior to the transfer to reserve, by way of retention of the entire amount of current profits earned in 1959-60 respectively by the Hindusthan Aircrafts Ltd. and the National Coal Development Corporation Ltd.

The third factor that may be invoked to explain the phenomenon was the inauguration of the government policy in June 1961 for financing the capital requirement of the public sector undertakings including the Central government companies on the basis of maintaining a debt-equity ratio of 1:1.

But the government in the issue of the above guideline on the debt-equity mix in the capital structure of Central government companies, totally ignored the circumstances under which a higher proportion of the borrowed capital is warranted in case of an operating enterprise of the private sector. In consequence, not only the amount of borrowed capital increased in the total capital mix as well as in the total external sources in the capital structure of Central government companies as indicated earlier. Interest charges also gradually tended to rise with the increase in the amount of borrowed capital in the capital structure of the Central government companies covering all industries. It evidently lead to curtailment of profit that was, in its natural course, followed by more and more poor or negative retention as a part of capital mix in the capital structure of the said companies. For instance interest charges on government loan alone increased from Rs.1746 lakhs in 1962-63 to Rs.2891.8 lakhs in 1969-70 in case of Steel industry; from

Rs. 18 lakhs in 1960-61 to Rs. 2778.2 lakhs in 1969-70 in case of Engineering and Shipbuilding industries; from Rs. 43 lakhs in 1960-61 to Rs. 924.4 lakhs in 1969-70 in case of Chemical industry; from Rs. 50 lakhs in 1960-61 to Rs. 1237.1 lakhs in 1969-70 in case of Mining and Minerals; from Rs. 9 lakhs in 1960-61 to Rs. 738.2 lakhs in 1969-70 in case of Petroleum and Oils and from Rs. 5 lakhs in 1960-61 to Rs. 160.8 lakhs in case of Miscellaneous group of industries. It has rightly been pointed out by one author that, but for the interest obligation of the Central government companies, their performance in terms of profit earned would have been altogether different.

The last but not the least important factor that has contributed to the obliteration of the role of retention of profit as a positive part of the capital mix in the capital structure of the Central government companies from the year 1962-63 had been the absence in general of any well-defined financial and economic objective prescribed or accepted for the public sector undertakings in the country. As mentioned earlier, unlike the nationalised undertakings in Great Britain till recently, there was no attempt in India to spell out in clear terms the financial and economic obligations of the public sector undertakings. There was in fact hardly any realisation that profitability is not an evil of the capitalist society. On the contrary, it is a very important

social objective in itself. It is specially so far as a country like India which, for scarcity of capital, cannot afford the wastage of public fund through losses suffered by the government concerns. This is all the more true when India is supposed to aspire for a self-reliant economy. Thus, the lack of initial directives from the government regarding the role of profit earned or to be earned by the public sector undertakings is no less a way contributed to the withering away of the retention as a positive source of capital in the capital structure of Central government companies since 1962-63.

From the discussion that has so far been made the following in a nutshell may be stated as the redeeming features of the trend of changes in the capital structure of the Central government companies over the period under study:

(1) Change in the proportion of share capital in the total capital mix from 69.7% in 1960-61 to 39.6% in 1969-70. Therefore, it amounted to a decline by 30.1% over its share in 1960-61. The said decline was not however uninterrupted as there had been reversal trend of the same in the years 1963-64 and 1964-65.

(2) Change in the proportion of borrowed capital, which had its effect specially from 1962-63 after the issue in June 1961 by the government of the guidelines on the capital mix of the Central government companies occurred.

from 26.5% in 1960-61 to 60.4% in 1969-70. Therefore, an increase in the proportion of borrowed capital was affected by as much as 127.9% over a span of 10 years. What is most significant to note in this connection is that the said increase in the proportion of borrowed capital occurred in the wake of incurring heavy losses by many of the operating Central government companies.

(3) Like the change in the proportion of share capital, the change in the proportion of borrowed capital also suffered from interruptions in the years 1963-64 and 1964-65.

(4) Obliteration of retention as a positive part of capital mix in the capital structure of Central government companies from the year 1962-63 to 1969-70 covering the major part of the period of the present study.

(5) As a sequel to the withering away of the retained profit as a positive part in the capital structure of the Central government companies, external sources which had already been in high proportions in the capital mix in the capital structure of the Central government companies got the absolute command of the same from the year 1962-63. This feature of the capital structure of Central government companies was maintained even at the end of 1969-70. There was no change in the position even when the retained profit in the form of capitalised reserves was brought into the picture as would be evident from Table 12. Again in the face of declining share of share capital, absolute command of external sources over the capital structure of Central government companies was rendered possible by the increase in the percentage of borrowed capital alone.
The aforesaid trend of changes in the capital structure of Central government companies between 1960-61 and 1969-70 have been reflected in graphs marked A, B and C that follow:

Graph A has been drawn on the basis of the data contained in Table 11, wherein yearwise proportions of different sources in the capital structure of Central government companies between 1960-61 and 1969-70 have been shown.

Similarly Graph B corresponds to the Table 12 showing the relative shares of external and internal sources in the capital structure of Central government companies and

Graph C represents the data in Table 13 depicting the behaviour of share capital and borrowed capital inter se the external sources in the capital structure of Central government companies in the aforesaid period.

Conclusion:

In the foregoing discussions it has been stated (1) that Central government companies that had been established before 1956 and got the status of government companies after the commencement of the Companies Act 1956 had good performance record to their credit. They had relatively smaller amount of capital with fixed charges in their capital structure. As such they were capable of retaining a part of their operating surplus even after the payment of dividend and/or adjustment of deferred revenue expenditures, (2) that in the initial years it was the equity capital which dominated the capital structure of Central government companies enabling them to forgo current dividends in favour of retention in many
Relative shares of different sources in the capital structure of central Govt. companies.

Along x-axis: 5 small squares (or units) = 1 year.
Along y-axis: 1 small square (or unit) = 2%.

- Borrowed capital
- Share capital
- Retained profit

Years:
- 60-61
- 61-62
- 62-63
- 63-64
- 64-65
- 65-66
- 66-67
- 67-68
- 68-69
- 69-70
Relative share of the share capital and borrowed capital among the external sources in the capital structure of central govt. companies.

Along x-axis: 5 small squares (or units) = 1 year
Along y-axis: 1 small square (or unit) = 2%
cases, (3) that following the setting of 1:1 debt-equity ratio, as attainable capital mix in the capital structure of Central government companies, there had been addition to the borrowed capital of the Central government companies even when the companies concerned were in the red. As a sequel of this there was a perceivable metamorphosis in the capital structure of Central government companies specially since 1962-63 when, with the gradual rise in the proportion of borrowed capital retention as a segment of capital was not only completely obliterate but its share even turned into negative component also. The causes that have been ascribed above to the attainment of the initial position and future changes of the capital structure of the Central government companies were evidently not initiated by the management of the individual companies. They were not the results of such management intentionally trying for, unlike that of private sector companies, an optimum capital structure at which cost per unit of different categories of capital is the same at the margin. Nor did the activities of the managers of the individual Central government companies warrant a wilful attempt for adjustment of operational activities in each case to a given capital mix in order to attain the same objective by an alternative means. It, therefore, remains to be seen if, after more detailed studies to be made in the
following chapters, the hypothesis that Central government companies will differ from private sector companies with regard to their respective initial position and future growth of capital structure really stands.