CHAPTER VII
CONCLUSION

7.1 Conclusions

The contribution of Indian corporate sector in its Gross Domestic Product is substantial. Therefore, creating a self-sustaining growth process necessitates both the survival and well functioning of the corporate sector. We know that in the last two decades the Indian corporate sector has witnessed several changes in its working environment, particularly in respect of regulation and sources of financing and availability of various new financing instruments. In this changed environment task of managers’ have become difficult as they have to simultaneously take care of several things. In this context the present study have attempted to depict the managerial decision making process for financing and dividend decision of Indian corporate sector and measure its outcome on the economic performance of the firms. Since there were capital market and other financial market regulatory changes, for example changes in the interest rate regime along with availability of several financing instruments, this might have impacted the financing behaviour of the corporate sector. Hence, we have looked at the trend of financing behaviour over the last two decades.

The analysis of trend of financing carried out at the macro level reveals that capital market activity is on the rise because the amount mobilized through public issue, right issue, and private placement have increased substantially. Amongst these, private placement of equity and debt, which means ‘negotiated sales of chunks of new equity in firms not listed in the stock market to financial investors of various kinds such as merchant banks, hedge funds, and private equity firms’, dominate all other activities. It implies that ownership of listed and unlisted corporate firms is being concentrated in the hands of few investors and particularly in the hands of foreign institutional investors and venture capitalist firms and the moment the restriction of foreign institutional investment, which is currently maximum 24 percent, in any company is removed, there is a possibility that ownership will be in the hands of foreign investors. We have observed that corporates are using capital market for short term borrowing as the short term financing instruments such as commercial paper rises significantly. It means that unlike earlier situation, when working capital loans from banks was the only source of short-term finance, recently
corporates have managed to find another source of short-term finance. Diversification of the sources of funding reduces the risk of being excluded from obtaining finances for the purpose of working capital and at the same time pricing of working capital becomes competitive to some extent that it may reduce the cost of short-term finance. Accessing capital market, which is a public source of funding for short-term finance, raises the accountability of corporations. Industry level analysis considering the indicators of financing such as debt to total asset, liabilities to total assets, long term debt to total assets have been declining over the last two decades. The implication is that corporate sector has managed to build substantial internal reserve which makes them less dependent on external funds, such as debt and equity. and this makes them less vulnerable to fluctuations of local and global economic conditions. At the same time, the declining interest coverage ratio, which measures ability of firms to service debt, the chances of default by the corporate sector is going down.

The share of bank borrowing in total borrowing has gone up meaning that Indian corporations are moving towards private debt instead of public debt. The accumulation of corporate debt by the banking sector raises threat for the banking sector in terms of accumulation of non-performing assets in future. This might have happened due to stringent regulatory framework put forward by the capital market regulator, SEBI, to protect the interest of investors. Stringent regulations raise the transaction cost and time taken for public borrowing. For example, borrowing from capital market requires firm to submit an offer document with the SEBI along with credit rating from credit rating institutions and when SEBI approves, it has to hire an underwriter which will take care of the issue process. Moreover, for debt issue it has to appoint a debenture trustee which will be responsible in case of default. It means that corporations go through a lot of scrutiny before it can actually float debt or equity in the capital market which is time consuming as well as imposes certain transaction cost on firms. Therefore, there is a need to reduce dependence on banking sector for debt by making a way for capital market which can be done only by making the fund raising from capital market faster and less costly. At the same time borrowing from financial institution has gone down as most of the development financial institutions have been shutting down and getting converted into retail banking in recent times. Not only financial institution borrowing, borrowing from the public in the form of deposits, debentures is also declining. Within bank borrowing, share of short term
Bank borrowing has increased. This may be due to the fact that in the long term possibility of fluctuation of interest rate is much higher than in the short term and this interest rate uncertainty may be inhibiting financial managers’ to issue long term debt as correct pricing of borrowing instruments becomes a challenging job.

We have also seen that large firms are highly leveraged as compared to the small sized firms and their short-term borrowing is much higher as compared to that of medium and large firms. On the contrary, public borrowing of small firms is substantially lower than that of large firms. It is indicative of the fact that small firms are credit constrained and reputation matters in case of borrowing. Since small firms are comparatively young as compared to their large counterparts, it takes time for them to build reputation in the market. Hence, there is a need to protect these small firms by making provision for appropriate sources of financing in the early stage of their operation.

Now the obvious question that arises is that what are the factors that could be held responsible for such a financing trend in the Indian corporate sector? Capital market is a major source of financing for corporate sector and as it operates under a regulatory framework, therefore, any change in the capital market regulations might exert some impact on the financing behaviour of corporate firms along with other firm specific factors. Hence, we have tried to gauge the impact of capital market regulation on financing and particularly on capital structure decision. It has been observed that capital market regulations have adverse impact on the use of public debt, probably because of increased cost of transaction in the public sphere in comparison to the private debt. At the same time, it points out that reduction in public debt has not been compensated by private debt. This indicates that there is borrowing constraints which might be because of lesser supply of loanable funds. On the contrary, capital market regulation has had favorable impact on the use of equity capital which indicates that regulation has been to some extent successful in reducing information asymmetry as well as asset substitution problem in the capital market and thereby ensuring a level playing field for outside investors. However, even though it is impossible to say to what extent these regulations are successful in reduction of information asymmetry and ‘asset substitution’ problem, we expect that in the long run there will be a positive feedback of regulations, at least for good quality firms.
We have also observed that older and larger firms make more use of debt instead of equity. This may be an outcome of ownership concentration in the hands of family. Large and older firms are mostly dominated by family ownership; dilution of ownership is a matter of serious concern. The dilution of ownership is necessary to protect the interest of minority shareholders from the expropriation of family owners. Concentration of ownership in the hands of few investors can be a threat to corporate governance and thus leads to the possibility of various malpractices like manipulation in the accounts, appointment of board of directors etc.

We have seen that as firms become profitable, they accumulate reserves, which in turn reduce their dependency on equity and debt. This is consistent with the idea of pecking order hypothesis which predicts that as there is information asymmetry between insiders and outside investors, firms try to finance investment first through internal capital, then by debt capital and their last resort is equity. Moreover, the positive association of tangibility and liquidity with the use of equity once again emphasizes that they are capable of reducing information asymmetry in the market. In this context it is worth mentioning that in contrast with market dominated system, where liquidity figures are thought to be manipulated, economies dominated by banks values liquidity figures because of long term relationship with borrowers, which reduces the problem of adverse selection and information asymmetry. The positive association of liquidity with equity implies that liquidity acts as a credible signal to the investors in mobilization of resources from the equity market. Therefore, corporations should have a strong liquidity if it wants to mobilize funds from capital market. The interaction of employment decision and capital structure decision disproves the Modigliani and Miller’s (1958) ‘Capital Structure Irrelevance Theorem’. Hence, it can be concluded that there are imperfections in the market which cause an interaction among the various decisions of the corporates. Therefore, it can be said that in a developing economy like India, institutional factors, such as capital market regulation, matter greatly in deciding the financing policy of the corporations.

Moreover, following trade-off theory we know that there exists optimal capital structure, meaning maximum value of firm which can only be obtained by minimizing the cost of capital. As the deviation from optimal capital structure raises the cost of
capital, there might be a tendency of firms to get back to their optimal values. In this context an attempt has been made to study the adjustment of capital structure for corporate firms in India. It has been found that there is an optimal capital structure and there is a tendency to adjust to their optimal values. The speed of adjustment of long term debt is similar to that of developed countries which is dominated by market based system. This might be due to the changed lending pattern of commercial banks or probably because of the market timing strategy of financial managers. The partial adjustment behaviour recognizes the fact that there is transaction cost for restructuring of capital. It seems to be the highest in case of equity. Moreover, lowest adjustment speed of equity may be due to the nature of ownership pattern of corporations in India. Since most of the firms in India are family owned firms, they are reluctant to raise capital from the primary market as it would cause a loss of control for them. The little evidence in favour of adjustment may be because of the mandatory regulations of the SEBI, which made it mandatory for every listed company to have at least 25 percent of public shareholding. Those companies, who had less than 25 percent shareholding, were asked to raise public floating by 5 percent every year till they achieve 25 percent shareholding. The smaller adjustment tendency for equity shows that it is the last resort for the firms to raise capital. This is more due to concern of ownership rather than due to problem of information asymmetry. Therefore, pecking order theory holds in the Indian context due to the concentration of family ownership and not because of the problem of information asymmetry.

Dividend decision of corporate firms are interrelated to capital structure decision because if payout is more, then that reduces the availability of internal funds for investment and makes firm dependent on external funds in terms of debt or equity, thereby altering the capital structure of firms. Therefore, we have studied the payout policy of Indian corporate sector over the last two decades and also how payout and investment decisions are interrelated for different growth oriented firms. Analysis of payout policy shows that number of dividend paying firms in the Indian corporate sector is declining. It might be due to the fact that by not paying dividend, the corporate sector is trying to build internal reserve so that it can protect itself from external fluctuation in the need of investment. We have also observed that few industries have reduced payout during the period from 1990-95 to 1996-00. The result may be an outcome of SEBI listing regulation. In the year 1996-97, to deter ingenuine
firms to enter into the market to raise capital, SEBI mandated that unlisted company should have a track record of dividend payment of at least three years out of preceding five years. However, in between 2000-05 and 2006-09, payouts of all industries have gone up marginally. This may have occurred because in the year 1998-99, SEBI decided that firms having distributable profit of at least three years out of preceding five years are eligible for fund raising from the capital market. Hence, it can be said that regulatory changes also have an influence on the dividend payment behaviour of the corporate sector. Analysis of the signalling hypothesis consistent with Healey and Palepu (1988), by considering the earning patterns of firms initiating and omitting dividend for three years before the year of event and three years after the event, reveals that initiators have started becoming profitable before initiation of dividend and started growing up in the subsequent periods while those in the omission category consistently experienced decline in profitability prior to omission and in the subsequent years. Hence, it can be argued that dividend acts a signal of changing firms’ profitability. We have seen that most of the dividend paying firms is large and high growth oriented firms. Moreover, it has been observed that investment and dividend decisions are interrelated in the same manner for high and low growth firms. This is an indication of the fact that for both high and low growth firms need for external funds are much more than it can be accommodated through internal funds. Hence, in order to develop and maintain good capital market relationship and signal future earnings potential so that external funds are more obtainable, the firms pay higher dividends. Therefore, high growth firms should try to distinguish themselves from low growth firms using some other signals which may prove to be costly for low growth firms.

Different combinations of financing instruments produce conflicts among different stakeholders which in turn raises agency costs. Jensen and Meckling (1976) suggested that when there is conflict between managers and shareholders debt can act as a disciplinary instrument, as creditors put pressure on managers for servicing of debt which in turn enhances the efficiency of the managers to perform better. To what extent debt can act as a disciplining instrument to enhance the efficiency of firms is a matter of concern for Indian corporate sector. So, we have measured the impact of capital structure on the performance of firms. The positive association between technical efficiency and age emphasizes the fact that staying in a particular line of
business, firms acquire greater knowledge about the technology and market characteristics and these results in larger efficiency of firms. In particular, the meaning is that specialization is important in any line of business to become most efficient. We have also observed that labour intensive techniques are less efficient than industries with capital intensive techniques and hence the implication is that industries like food and beverage can achieve higher level of efficiency by technological up-gradation. The positive association between research and development and technical efficiency emphasizes that innovation is necessary for attaining higher level of efficiency. Therefore, corporation should invest more in research and development to enter into a higher growth trajectory.

The mixed impact of leverage on the technical efficiency of firms across industries has been observed. However, positive association of leverage and technical efficiency establishes the disciplining role of debt in the context of Indian corporate sector. This finding once again emphasizes the fact that in the context of emerging economies, where corporate governance system is not up to the mark in comparison with developed economies, debt can be used a signaling tool for the outside investors. The negative association of leverage on technical efficiency underscores the fact that there is problem of underinvestment by the risk-averse managers. The negative impact may be an outcome of subsidies given in various form to firms in few industries such as cement, textiles etc. Therefore, subsidy needs to be removed to put firms in these industries to a level playing field.

When we look at the usefulness of regulation put forward by the capital market regulator SEBI, we observe that it has made an adverse impact on the use of public debt and miniscule positive impact on the use of equity. Overall, the SEBI has achieved little success in revamping the primary debt and equity market. This is not to say that regulations are not needed. Stringency of the regulations might have been successful in reducing the problem of information asymmetry and asset substitution problem which is very much needed to protect the interests of the minority shareholders and retail investors, but at the same time it has raised the transaction costs and time taken for floating funds in the capital market. Although efforts have been made to reduce the time taken for floating funds in the capital market, an alternative arrangement should be made to reduce the transaction costs associated
with floating as well as to resolve the conflicts of interests among different participants of the market to realize a robust regulatory framework. For example, now a days in order to float debt in the capital market firms have to obtain credit rating from credit rating institutions and as the firm is paying for its own credit rating, there is a chance that it might end up influencing the credit rating institution to obtain a high credit rating even when it is unworthy of that grade. Recent financial crisis of 2008 which manifested in the United States of America reveals that credit rating institutions were one of the culprits behind this debacle. Hence, in order to reduce these types of malpractices SEBI may ask firms to pay for its credit rating and it will delegate the credit rating to some of the credit rating institutions prevailing in the market or SEBI itself may create a wing for the purpose of credit rating of firms to evaluate the credit worthiness of firms. We have also seen that SEBI regulation has failed to realize its full impact may be due to ownership patterns of the firms, and in particular because of the family ownership nature of corporations. SEBI has tried to increase the public shareholding to 25 percent for any listed corporations and some of the corporations are still unable to achieve that level. SEBI should take a strong step to prevent the non-fulfillment of this requirement. Moreover, SEBI needs to put in more effort in this line to increase public shareholding in order to protect the interests of the minority shareholders or retail investors.

Looking from the perspective of government, we can say that efficiency of government-owned firms is lower than that of private firms. One possible way to increase the efficiency of public sector firms is to make disinvestment. Moreover, we have also seen that the subsidies given to few industries such as textiles, cements etc. create distortions in the performance of firms. Therefore, to provide a level playing field, the government can think of removing these subsidies.

7.2 Limitations and future scope of research
This study suffers from some limitations. These are as follows:

1. As the study wanted to capture the managerial decision making behaviour in normal situations, we have considered the study period from 1990 to 2009, as any period after 2009 may include the effect of financial crisis that broke out in the year 2008. Thus, moving beyond 2009 may end up showing distortion in the financial decision- making behaviour of managers. However, there lies
the scope for future research. A separate study can be taken up to find out the difference in financial decision making behaviour before and after the financial crisis.

2. It would have been better had we substantiate the results obtained from secondary data with the primary survey finding. An attempt has been made in this regard but failed as the corporate managers are reluctant to disclose any information related to financial matter as it is a part of their strategy to compete with other firms in the market.

3. Third, we have considered only four aspects of regulation to construct the regulatory index. This could have been made more comprehensive by considering other capital market regulations. As the information had cull out from large number of circulars issued by SEBI at different points of time, it became impossible to consider all regulatory aspects. Therefore, we had restricted ourselves only four main aspects of regulation which could have substantial impact on financing decision of firms. Given the time and resources, it would be good idea to construct the comprehensive regulatory index as it would help in monitoring the stringency of capital market regulations.

4. While measuring the impact of capital structure on performance of firms, we have simultaneously estimated the efficiency scores and its determinants. Since efficiency and leverage both can affect each other, the problem of endogeneity could arise. One can estimate the model in two steps to tackle the problem of endogeneity which may result in some other problems.

5. A future attempt can be made in future to provide micro foundations of the behaviour of firms regarding financial structure considering the household and production sector i.e., analysis of financial decision making in the general equilibrium framework.