ABSTRACT

Indian corporate sector is playing an active role in the context of Indian economy. If we take organized sector’s contribution as a proxy for output produced by the Indian corporate sector it is almost fifty percent of India’s Gross Domestic Product. Sustained growth in net profits and gradual increase in productivity and capital efficiency have enabled the Indian corporate sector to cut costs and be globally competitive. Corporate sector performance has contributed immensely to Indian’s macroeconomic fundamentals in several ways such as employment, output growth, interest rate, exchange rate etc. However, successful existence of the corporate sector depends on capability to earn profits. Amongst a number of factors, cost of financing is an important one. As the amount of capital to be invested is usually high for corporates, the cost associated with it can be substantial and cost of capital will naturally vary depending upon the source of financing. Therefore, the decision regarding the ways of procuring funds particularly, capital structure decision becomes a tricky one as it has impact on profitability. In this background the present study attempts to answer the following questions with respect to Indian manufacturing sector. First, we have tried to see the nature of capital structure of Indian manufacturing sector. Second, we have made an attempt to find out the factors that determine capital structure decision with particular emphasis on capital market regulation. Third, effort has been made study the adjustment process of firms, if any, towards optimal capital structure. Fourth, an attempt has been made to study the dividend payment behaviour of firms. Fifth, we look at the impact of capital structure decision on performance of firms.

Studying the nature of capital structure for a period of 1990-2009, we have seen spectacular rise in the amount mobilized through public issue, right issue, and private placement. Amongst these private placement of equity and debt dominates all other activities. In case it is allotted to foreign institutional Investors or private equity firms through private placement and their limit of holding increases to a substantial amount there is a possibility that ownership of Indian firms will be in the hands of foreign investors. It is interesting to note that corporates are using capital market for short term borrowing as the short term financing instruments such as commercial paper rises significantly. Debt to total asset, liabilities to total assets, long term debt to total
assets have been declining over the last two decades. Evidence shows small firms are capital constrained.

Analysis of financing pattern of Indian corporate sector over a period of time raises an obvious question what are the factors that help in the determination of the capital structure decision. We have found that the impact of capital market regulations on debt is significantly negative. It implies, regulations have adverse impact on the use of public debt. On the contrary, capital market regulation has miniscule positive impact on the use of equity capital. This indicates that the regulation has been, to some extent, successful in reducing ‘information asymmetry’ as well as ‘asset-substitution’ problem in the capital market and thereby to ensure a level playing field for outside investors. The concerns of ownership dilution have led to a positive relationship among debt, age and size of firms. Evidence is also obtained in favour of the pecking order hypothesis as profitability is negatively related to equity as well as debt.

To see if there is any tendency to adjust to their optimal capital structure and measure the speed of adjustment we have estimated partial adjustment model using dynamic panel data model following Arellano & Bond (1991). We have seen the adjustment process for two indicators such as long-term debt to total assets and equity to total assets. The speed of adjustment is lowest (0.37) in case of long term debt to asset ratio which means on an average a firm in the Indian corporate sector takes almost three years to get back to the optimal level. The speed of adjustment is similar to that of market dominated system.

Capital structure policy accompanies the dividend or payout policy. Analysis of dividend policy reveals that dividend paying firms in Indian corporate sector is declining. For some of the industries, there was a sudden increase in the payout during 1996-00 which may an outcome of capital market regulatory changes. Evidence is also obtained in favour of the fact that dividend is being used as a signal to convey information regarding future performance. Studying the interaction between payout and investment for various growth oriented firms, it is found that low and high growth firms behave in the same manner to attract funds from capital market.
The study of interaction between performance and capital structure reveals that leverage which is an indicator of capital structure has mixed impact on the efficiency of firms. The positive impact explains the disciplining role of debt on the performance of managers. On the other hand, negative relation may be an outcome of various subsidies given to certain industries which prevents managers to behave in an efficient manner.