CHAPTER I

1.1 Introduction

The corporation is one of the most important forms (in terms of size) of business organization in every country now a days. ‘A corporation is a legal “entity” separate and distinct from its owners, and it has many of the rights, duties, and privileges of an actual person.’ The sector of an economy consisting of the corporate houses is known as the corporate sector. In India the companies that are registered under the Companies Act 1956, together are known as the corporate sector. The Indian corporate sector consists of government owned and privately owned companies and each can be classified into two categories ---public limited and private limited companies. Private limited companies, as the name suggests, are privately owned, comprise a large share of the firms in the corporate sector in terms of number, but account for less than one-third of total paid-up capital. Government owned companies are comparatively few in number but larger in size, accounting for more than 25 percent of paid-up capital.

In the context of Indian economy the corporate sector is increasingly playing an active role. 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. Even in the face of recent global recession Indian corporate sector has shown resilience. A study conducted by Confederation of Indian Industries (CII) in 2008 revealed that corporate sector performance has contributed immensely to Indian’s macroeconomic fundamentals in several ways such as employment, output growth, interest rate, exchange rate etc. As far as performance is concerned increase in productivity and efficiency have contributed to improvements in net profits of Indian corporate. Net profit margin, measured by net profits as a percentage of sales, over the last eight quarters (2006-08) have increased from 8.8% to 9%. This is accompanied by the feature that corporate tax collections have increased consistently

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2 Press Information Bureau: Government of India: Growth of Corporate Sector During October 2005
4 Paid-up-capital is the equity capital which has been issued by the companies and is fully subscribed by the individual or institutional investors.
upwards and for the year 2007-08, the net corporate tax collections have grown by 32.1 percent.\textsuperscript{6} With robust corporate performance there is larger room for capacity expansion, and hence the trend of investment led growth of the Indian Gross Domestic Product (GDP).\textsuperscript{7}

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 in the case of corporates, the cost associated with it can be substantial. More importantly, cost of capital will naturally vary depending upon the source of financing. For example, if investment is financed through internal source (i.e. retained profit, reserves and provisions) then the cost would be less as compared to the other external source of financing through debt or equity (Myers & Majluf 1984). Advent of globalization has made available a plenty of choices of financing instruments such as cumulative and non-cumulative preference shares\textsuperscript{8}, convertible debentures, Eurobonds, warrants, employee’s stock options, American Depository Receipts (ADR), Global Depository Receipts (GDR), Indian Depository Receipts (IDR) etc. for Indian firms through the development of corporate debt market and a fast developing equity market. The innovations of new financing instruments have modified the risk-return trade-off of the corporate sector as well as of the investors. Therefore, the decision regarding the ways of procuring funds becomes a tricky one. Right decisions are critically important as they impact profitability.

Given this background, the current research wishes to make a careful analysis of the financing options and financing behavior of Indian corporate sector, particularly Indian manufacturing sector as the capital structure of service sector such as financial sector is regulated, and to identify the determinants of capital structure of the corporate sector with special emphasis on the capital market regulation. It is also important to examine the impact on performance due to selection of a particular financing instrument. We also intend to analyze the payout policy of the Indian corporate sector.

\textsuperscript{6} India Inc to drive GDP growth: CII study: Asian economy Watch: Tuesday, June 10, 2008.

\textsuperscript{7} India Inc to drive GDP growth: CII study: Asian economy Watch: Tuesday, June 10, 2008.

\textsuperscript{8} A preferential issue is an issue of shares or of convertible securities by listed companies to a select group of persons under Section 81 of the Companies Act, 1956 which is neither a rights issue nor a public issue. This is a faster way for a company to raise equity capital.
There are two sources of funds for investment of corporate sector viz. internal and external funds. Internal funds consist of reserves and surpluses and external funds come in two forms: debt, which is nothing but borrowing from private (banks and financial institutions) and public sources (capital market) and equity, which is owners’ capital. The sources from which debt and equity are raised are being controlled by regulatory institutions such as central bank i.e., Reserve Bank of India (RBI) and Securities and Exchange Board of India (hereafter referred to as SEBI). Hence, a proper understanding of the regulatory framework will help to get an in-depth idea of the various practices of the Indian corporate sector regarding financial or capital structure decisions. This calls for a need of discussion of the key institutions that are in charge of these regulations. We will begin with the regulations concerning the equity market.

1.2 Institution and Regulatory Framework: Role of Securities & Exchange Board of India (SEBI):
The responsibility of regulating the securities market in India primarily rests with the SEBI, which was set up in 1988 and was made a statutory body in 1992. The objective of SEBI is to protect the interest of the investors, ensure the fairness, integrity and transparency of the securities market, and reach best international regulatory practices. Under the SEBI Act 1992, SEBI was supposed to regulate the securities market by such measures which reduce fraudulent and unfair trade practices relating to securities markets.

In order to protect investors from fraudulent activities just after the scam in 1990s, SEBI introduced the Prohibition of Fraudulent and Unfair Trade Practices (FUTP) laws relating to Securities Market Regulations in 1995, which was repealed in 2003. The scope of the definition of “fraud” was broadened in the new laws (SEBI, 2003), which now includes “any act, expression, omission or concealment while dealing in securities, committed deliberately or not, by a person or with his connivance (or by his agent) in order to induce others to deal in securities”.

Reduction of fraudulent activities requires reduction in the problems of ‘information asymmetry’ and ‘asset-substitution’ in the capital market which is very much prevalent in the Indian capital market. In fact, regulations regarding disclosure, prevention of fraudulent activities and corporate governance reduce the information
asymmetry between firm and investors, which in turn reduce the level of risk premium demanded by investors and thereby reducing the cost of capital. Reduction in cost of capital in turn raises the firm value and hence changes the capital structure decision of the firm. There are large number of regulations which intended to reduce the problem of information asymmetry, ‘asset-substitution’, which means benefiting one stakeholder at the cost of other stakeholder and hence it becomes impossible to focus on all of them. In this study we have focused only on four such regulations which are very much important for corporate for raising funds from the capital market. These regulations are entry and public issue, promoters’ contribution and lock-in, issue of debt instrument, and issue of preference shares. To put these regulations into perspective, let us provide an instance of one important incident that occurred in the Indian capital market. Just after the establishment of National Stock Exchange (NSE) in 1994, several firms entered into the market and after raising funds they suddenly disappeared, contributing to the sufferings of large number of investors. Hence, restricting the fraudulent firms at the entry level reduces the problem of information asymmetry and thereby lowers the asset-substitution problem. Had there been a rule of promoters contribution and lock-in, which means the subscription of promoters to a certain percentage in the public issue and lock in for certain time period, those firms which had entered into the market could not have easily ran away from the market and therefore, it is understandable that promoters’ contribution and lock-in is another significant regulation that plays role in reducing asset-substitution problem. Similarly, to control the twin problems of information asymmetry and asset-substitution in the debt market, it was imperative to control the issue of debt instruments. Moreover, in the past preference share had been used by shareholders for substituting assets of other stakeholders in a corporation and therefore, regulating the issue of preference shares is an important task of a regulator. In the subsequent sections we will discuss evolution of each of these regulations one by one.

1.2.1 Regulation of Entry and Public Issue:

First, we will start with the evolution of regulation of entry and public issue. During 1996-97, it was decided that in order to deter the ingenuine firms to enter in to the market to raise capital, an unlisted company with a track record of dividend payment for at least three years out of preceding five years will only be allowed in accessing the securities markets for raising capital through equity or instruments converted into
equity. Moreover, a listed company making further issue of equity capital had to satisfy the same as it is applicable for unlisted companies. Subsequently, eligibility norms for initial public offer were relaxed during 1998-99 in order to allow greater number of firms accessing the capital market. It was decided that new companies having distributable profits in terms of section 205 of Companies Act for at least three out of immediately preceding five years and a pre-issue net worth of not less than Rs. 1 crore in three out of preceding five years were allowed to mobilize capital through Initial Public Offering (IPOs). However, the minimum net worth requirement of Rs. 1 crore is to be met during the immediately preceding two years. Further, during 2000-01, it was observed that in practice the requirement of distributable profits and appraisal of bank did not serve its intended purpose. It has again been modified that if the issuer did not have a stipulated net worth or track record of distributable profits or if the issuer is a listed company which proposed to raise more than five times its pre-issue net-worth, the revised guidelines required issue to be compulsorily made through Book building route, wherein 60 percent of the offer has to be allotted to the Qualified Institutional Buyers (QIBs). In case 60 percent cannot be allotted to QIBs, the issue will have to fail. This norm is also applicable to companies, which propose to make an offer for sale. Earlier companies could access the primary market only if they had offered a minimum of 25 percent of their post issue capital to the public as prescribed under rule 19 (2) (b) of Securities Contract (Regulation) [SC(R)] Rules, 1957. On December 12, 2000, it was modified that offering of 10 percent of post issue capital to the public was made available to all sectors subject to the minimum offering of 20 lakh shares. However, in order to ensure a wide float, it was stipulated that the minimum issue size should be increased from Rs. 50 crore to Rs. 100 crore. Companies not fulfilling the aforesaid conditions are required to make minimum public offering of 25 percent. The restriction of minimum public issue size of Rs. 25 crore in the case of an IPO through book-building was removed and all companies were allowed to make issue through book-building. However, if the track record criteria are satisfied, allocation to QIBs can be less than 60 percent. The relaxation was done to encourage the small firms to enter into the market. It is clear from the fact that number of issues in the category of less than 5 crore increased to 66 in 2000-01 as compared to 19 in the previous year. On August 14, 2003, the requirement of allotment of 60 percent to QIBs was relaxed to 50 percent, provided that issue is made through the book-building process or the project has at least 15 percent participation
by financial institutions or scheduled commercial banks, of which 10 percent comes from the appraisers. In addition to this, at least 10 percent of the issue size shall be allotted to QIBs, failing which the full subscription money shall be refunded. Moreover, the minimum post issue face value capital of the company shall be Rs. 10 crore. In case of book built issues, the QIBs such as banks, mutual funds, FIIs etc. are entitled to an allocation of 50 percent, except mandatory allocation of 60 percent in terms of rule 19(2) (b) of SC (R) Rules 1957. Within the category of QIBs, there was no specific allocation for any group. In order to increase retail participation, SEBI (DIP) guidelines 2000 were amended to introduce specific allocation of 5 percent to mutual funds within the QIB category with effect from September 19, 2005. In addition, mutual funds were also made eligible for allotment from the balance available for the QIBs.

1.2.2 Promoter’s Contribution and Lock-in Period:

In addition to the regulation of entry and public issue, the other important regulation which helps in reducing the information asymmetry and asset-substitution problem is promoter’s contribution and lock-in, which means subscription of promoters to a certain percentage of public issue and lock-in for some time period. According to Original Discloser and Investor Protection (DIP) Guidelines of June 1992, promoter’s contribution for public issues by unlisted as well as listed companies specified as 25 percent for issue size up to Rs.100 crore and 20 percent for issue size above Rs.100 crore. For unlisted companies eligible to bring out public issues at premium, the promoters’ contribution should not be less than 50 percent of post issue capital of the issuer company. In case of offers for sale of securities of unlisted companies, promoters’ shareholding subject to lock-in shall not be less than 25 percent. During 1996-97, it was specified that the promoters should bring their entire contribution before the opening of an issue in case the promoter’s contribution in the company exceeds Rs. 100 crore relaxed and the promoters allowed henceforth bringing in 50 percent of their contribution before opening of issue and balancing 50 percent in advance pro-rata before calls made on public. In case promoters’ contribution has been brought prior to public issue and has already been deployed by the company, the company shall give the cash flow statement in the offer document disclosing the use of such funds received as promoters’ contribution (August 4, 2000). It was also been provided that promoters contribution is required to be kept in escrow account with a
scheduled commercial bank and the same can be released only with the public issue proceeds.

1.2.3 Preference Share Issue:
Another related issue which plagued the capital market is the indiscriminatory issue of preference shares at a lower price than the ordinary shares. This essentially led to asset substitution problem due to price differential between preference shareholders and ordinary shareholders. In order to eliminate the price differential between preference shareholders and ordinary shareholders, in August 04, 1994 SEBI issued guidelines for the preferential issues. The guideline issued by SEBI is under the provision of Section 81(1A) of the Companies Act 1956. It states that preferential issue of shares or warrants or fully convertible debentures (FCDs) or partly convertible debentures (PCDs) can be made at a price not less than higher of the following: The average of the weekly high and low of the closing prices of the related shares quoted on the stock exchange during the six months preceding the relevant date OR the average of the weekly high and low of the closing prices of the related shares quoted on a stock exchange during the two weeks preceding the relevant date where "relevant date" for this purpose means the date thirty days prior to the date on which the meeting of General Body of shareholders is convened, in terms of Section 81(1A) of the Companies Act to consider the proposed issue. In case of warrant an upfront payment of ten percent of the fixed price would be payable on the date of their allotment and this amount would be adjusted against the price payable subsequently for acquiring the shares by exercising an option for the purpose. The amount would be forfeited if the option to acquire shares is not exercised. In case of warrants/ FCDs/ PCDs maturity period should not exceed beyond 18 months from the date of issue. Maturity of the instruments should not exceed beyond 18 months from the date of issue of the relevant instrument. Moreover, warrants/FCDs/PCDs or any other financial instruments issued on a preferential basis will not be transferable. The shares allotted on a preferential basis will not be transferable in any manner for a period of 5 years from their date of allotment. Similarly, the shares acquired, by conversion or otherwise, would also remain locked in for a period of five years from their date of allotment. It was stipulated that action on resolution passed at a meeting of shareholders of company granting consent on preferential issue of any financial instrument shall be completed within three months from the date of passing
resolution, if not completed, a fresh resolution has to be passed. Apart from these, an
auditor has to certify that instrument is being made in accordance with the
requirements contained in these guidelines. Allotment to FIIs is subject to approval of
government of India, SEBI, and RBI.

In 2000-01 guidelines for preferential issue of securities were further modified to
enhance the disclosure level of issue process with the intention to enable the share
holders to have adequate information regarding the allotment on the basis of which
they can accord their approval for allotment. It was stipulated that notice for general
meeting shall contain the objective of the issue through preferential offer, intention of
promoters, directors and key management persons to subscribe to the offer, share
holding pattern before and after the offer, proposed time within which such allotment
would be complete and the identity of the proposed allottees and the percentage of
post preferential issue capital that may be held by them. The lock-in period for
preferential instrument has been reduced to one year as compared to the previous
period of five years except for such allotments which involve share-swap for
acquisition. During 2003-04 it was stipulated that listed and unlisted companies
issuing debt securities on private placement basis should make full disclosure on its
website or that of the stock exchange or SEBI. If such securities are not proposed to
be listed, SEBI regulated intermediaries should be discouraged from associating with
issuance and trading. Companies must appoint debenture trustees for all securities
issued through private placement and debt securities should carry a credit rating not
less than investment grade. Trading in privately placed securities should take place
between qualified institutional investors and high net worth individuals in standard
denomination of Rs. 10 lakh. Earlier it was pre supposed that company should have a
listing history of at least six months for proposing preferential allotment. During
2007-08 it was amended that companies with listing history of less than six months
will be able to raise fund through preferential allotment. Moreover, it was specified
that PAN number of the allottees should be obtained by the company going for
allotment.

1.2.4 Issue of Debt Instrument:

Apart from strengthening issue of equity in the capital market, it was also
necessary to strengthen the base of corporate debt market through reduction of
information asymmetry and asset-substitution problem. To reduce the information
asymmetry it was necessary to raise the standards of disclosure during 1998-99, and
to help investors make informed decision, every public or right issue of debt
instruments is required to be compulsorily rated by the approved credit rating agency
irrespective of their maturity/ conversion period as against 18 months. If a public or
right issue of debt security is greater than or equal to Rs. 100 crore, two ratings from
two different credit rating agencies should be obtained. During 2000-01, it was
specified that in order to provide a variety of debt instruments and to help the
development of the debt market, the SEBI permitted the issue of unsecured /
subordinated debt instruments for providing mezzanine capital, provided that these
are subscribed by the QIBs or where the debenture allottees/ holders have given their
positive consent. During 2001-02, to facilitate the resource mobilization by unlisted
companies SEBI has issued some guidelines. An unlisted company making a public
issue of NCDs, may subject to other applicable provisions of these guidelines, make a
public issue and make an application for listing its NCDs in the stock exchanges
without making a prior public issue of equity and listing. During the year 2003 it was
mentioned that in case of issue of debenture with maturity of more than 18 months,
the issuer shall appoint a debenture trustee. To overcome the ‘asset substitution’
(misuse of debt-holders money by equity holders) problem faced by debt holders, the
specification of 18 months was removed and appointment of debenture trustee was
made applicable to all debenture issues. Moreover, the responsibility of obtaining
report from lead bank regarding monitoring progress of the project and monitoring
utilization of funds raised with debenture issues lie with debenture trustees. In order to
secure the rights of the debenture holders, a debenture redemption fund was asked to
be created by all companies issuing debenture, irrespective of the maturity of the
debenture and in case the company fails to meet the obligation of interest payment on
debentures or redemption of debentures, distribution of dividend shall require prior
approval of debenture trustees and the lead institution which was earlier applicable
only to the new companies (August 14 2003).

It is evident from the above discussion that several regulatory changes have happened
in the capital market in recent past and that might have impacted the financing
decision of firms through the changes in the cost of raising capital and by changing
the transaction cost associated with fund raising. Apart from capital market regulation
there could be some other factors particularly, characteristics of firms which might
affect the costs associated with external fund raising in the forms of debt and equity. For example, high level of tangible assets of a firm can act as collateral for raising debt from private sources, such as banks and financial institutions. As we know that secured debt is less costly than that of unsecured debt, hence, a firm with high tangible assets can avail debt or loan at lower cost as compared to that of firms with low level of collateral. Another factor that can affect the financing decision is corporate tax structure. In case the corporate income tax is high, then in order to save more taxes, the firm may be inclined to debt as interest payment from debt is exempted from tax. Similarly, we can think of a number of other factors which can shape up financing decision of firms. In order to know what are the factors that can affect financing or capital structure decision, which refers to the combination of debt and equity, at this point we would like to discuss different theories of capital structure and their prediction for different characteristics of firms in shaping capital structure decision.

1.3 Review of Literature:
The study of capital structure attempts to explain the mix of debt and equity used by corporation to finance real investment. Literature on capital structure is vast and therefore, it is hard to review all the studies available on the topic. Hence, we have focused on those studies which are foundations of capital structure literature and relevant to the issues identified for the present study. Since this study has been conducted in the context of India, our main focus will be on literature related to India.

1.3.1 Determinants of Capital Structure
1.3.1.1 Theories of Capital Structure
The traditional theory of capital structure predicted that as debt is cheaper in comparison with other financing instruments, firms would like to finance their investment using only debt which implies the corner solution to the capital structure decision. Therefore, according to the traditional theory capital structure is determined solely by the ‘cost-of- capital’. In contrast, the modern theory started with different prediction that market value of firm is independent of capital structure and hence independent of cost of capital under the assumption of frictionless, perfect capital market (Modigliani & Miller 1958) [popularly known as MM (1958) proposition], which means that capital structure is independent of the environment in which
corporate operates. In order to disprove the famous MM (1958) proposition, a number of theoretical studies came into being, viz. Static Trade-off, Pecking Order, and Agency Cost Theory. Moving one step ahead, modern theories predict that in addition to cost-of-capital, firm specific characteristics also matter in capital structure decision.

According to static trade-off theory (Baxter, 1967, Altman 1984, 2002), firms always have a targeted or optimal capital structure which is determined by the trade-off between costs and benefits of debt, where the cost of debt is bankruptcy cost (higher and higher level of debt increases the burden of interest payment and higher the probability of default) and the benefit is tax shields (as tax is not paid on the interest amount) from interest payments. Hence, the cost of capital is in fact dependent on the environment in which corporate operates, such as interest rate prevailing in the economy and the corporate tax rate. The implication is that higher level of profits gives rise to higher level of tax shields and in order to accrue that high tax shields, firms should maintain higher level of debt. Therefore, there is a positive relation between profitability and firm leverage. However, benefits are easy to quantify but not costs. At the theoretical level, bankruptcy is defined as the state in which firms are not able to meet its debt obligation. In case a firm fails to meet debt obligation it can be met through the sale of the firm’s assets. Therefore, with high level of tangible assets firms have less probability of going bankrupt and financial leverage is positively related to the tangible assets. In other words, as the firm size increases, tangible assets are expected to grow accordingly and hence leverage of firms is expected to be positively related to size of the firm.

Another departure from the MM (1958) proposition is that capital market is imperfect. Imperfection may arise due to information asymmetry which goes in opposite direction to the assumption of perfect capital market which assumes that every participant have equal access to the information available in the market. The information asymmetry theory of capital structure assumes that firm insiders possess private information about the characteristics of firms return stream. According to Myers et.al. (1984) firms prefer to finance new investments, first internally with retained earnings, then with debt, and finally with an issue of new equity. The implication of this theory is that firms with higher profit will be able to retain more and hence less debt is used in their capital structure. But quite often the demand for
funds is much more than supported by retained earnings or internal funds. In that case firms have to go for external funds and the solution proposed by Myers et. al. (1984) is that issue of debt secured by collateral may reduce the asymmetric information-related costs in financing.

Capital structure of firms can also be explained from a different perspective, such as through the conflicts of different stakeholders in a firm. The conflicts between different stakeholders raise certain costs, which are known as the agency costs. There could be conflicts between managers and equity holders and conflicts between debt and equity holders (Jensen & Meckling 1976). Managers are motivated to consume perquisites as opposed to equity holders. In order to reduce the free cash flow in the hands of managers, equity holders have incentive to introduce debt in the capital structure, which in turn would reduce the free cash flow in the hands of managers. But the introduction of debt induces equity holders to invest in risky assets, because if investment fails, the lenders are likely to bear the costs as the shareholders have limited liability. Titman & Wessels (1988) have point out that the costs associated with the agency relationship between shareholders and debt holders are likely to be higher for firms in growing industries and hence a negative relationship between growth and financial leverage is likely. Similary, Jensen & Meckling (1976) have argued that the use of secured debt might reduce agency cost of debt.

1.3.1.2 Empirical Literature

A number of empirical studies have attempted to test the theoretical predictions of the capital structure theory for non-financial firms. The empirical literature has generally converged on particular variables that have been found to be consistently correlated with leverage: size, profitability, tangibility, growth opportunities and so on. Size has been found to be positively related to leverage (Titman & Wessels, 1988; Rajan & Zingales, 1995; Booth et al., 2001; Frank & Goyal, 2007). Larger firms tend to have higher leverage as they are less prone to bankruptcy due to higher diversification and hence fail less often. This is consistent with the static trade-off theory. Furthermore, Bevan & Danbolt (2002) reported that size is negatively related to short term debt but positively related to long term debt. Firms with higher profitability tend to have lower leverage (Rajan & Zingales, 1995, Booth et al., 2001, Frank & Goyal, 2007). This finding is consistent with pecking -
order theory—more profitable firms will prefer to use internal funds. But, this prediction goes in contrary to static trade off theory that higher profitable firms will use more debt to get the interest tax shields. Another determinant of capital structure, which is identified by the capital structure theory, namely growth opportunity has been found to be negatively related to leverage (Rajan & Zingales, 1995, Agarwal et al. 2003, Frank & Goyal (2007)). This finding is consistent with the prediction of static trade-off theory that firms with high growth opportunity have higher bankruptcy costs and therefore should be less levered.

Finally, tangibility of assets has been found to be positively related to leverage (Titman & Wessels, 1988; Rajan & Zingales, 1995 and Frank & Goyal, 2007). High tangibility means that more assets can be used as collateral which limits the ability of shareholders to engage in risk-taking behavior. This will significantly reduce the debt holders’ exposure to the ‘asset substitution effect’ and hence increase leverage. The positive relation between tangibility and leverage is also consistent with pecking - order theory.

The factors that affect the capital structure choice of Indian industries are not much different from the factors that have been identified by the different empirical studies of capital structure. These studies have found size, profitability, tangibility, growth opportunity, uniqueness of product affects firm’s financial or capital structure decision (Kakani, 1999; Babu, 1999; Bhaduri, 2002a; Bhole et.al. 2004). In addition to these, the other firm specific factors that have been identified are capital intensity of firms (Kakani, 1999), non – debt tax shields (Kakani, 1999, Bhole et al, 2004), industry characteristics (Bhaduri, 2002a, Babu, 1998), cash flow (Bhaduri, 2002a), net exports (Kakani, 1999). However, the process of globalization has its impact on the capital structure decision of firms. Process of globalization has made increase the earnings risk (Kakani, 1999), financial risk and operational risk (Babu, 1998).

Each firm has a different set of characteristics in terms of tangibility, profitability, size etc. and based on these characteristics, it can support a particular combination of debt and equity i.e., capital structure which maximizes the value of firms and thereby minimizes the cost of capital. Any deviations from the optimal value will raise the cost of capital and hence reduce the value of the firm. Hence, there might be a tendency for the firms to get back to their optimal values. To what extent
they can adjust to their optimal capital structure depends on the level of market
imperfections. In the next section, we have focused on those studies which have
captured the speed of adjustment of the firms to their optimal capital structure.

1.3.2 Optimal capital structure and speed of adjustment
Trade-off theory predicts that there is an optimal or targeted capital structure which is
being determined by the trade-off between benefits and costs of debt. Jalilvand and
Harris (1984) have also pointed out that presence of adjustment cost, a variant of
market imperfection prevent firms to adjust completely towards a targeted capital
structure and thereby allowing for partial adjustment in each time period.

Taggart (1977), Jalilvand and Harris (1984) examined two important issues
viz., -issuance of long-term debt, equity, short-term debt and maintaining corporate
liquidity and the validity of the theoretical prediction that financial managers have a
targeted level of debt-equity ratio while taking capital structure decision. Both the
studies have provided evidence in favour of targeted capital structure and partial
adjustment towards it due to presence of adjustment cost. It has also been found that
adjustment towards equity is slower than adjustment towards long term debt.
However, larger firms appear to adjust more slowly to targeted equity as compared to
smaller firms (Jalilvand and Harris, 1984). Ozkan (2001), considering 390 firms for
the period of 1984-96 has shown that the adjustment towards the target level of capital
structure is relatively fast for United Kingdom’s firms. Gaud et al. (2003) and Dorbetz
et al. (2003) have examined the issue of optimal capital structure in the context of
Switzerland. The issue of adjustment towards optimal capital structure has been
examined by Bhaduri (2002b) and Chakraborty (2010), Mukherjee et al. (2010, 2012).
Whereas the speed of adjustment is much lower than the Switzerland and Spain
(Drobetz et al. 2003, De Miguel et al. 2001). The capital market regulation is crucial
for capital structure decision as it lowers the cost of capital by reducing directly
‗asset-substitution’ problem and information asymmetry which once again tries to
eradicate the problem of ‘asset-substitution’ and thereby providing a platform for
raising capital from the market. Studies of Demsetz (1968), Copeland and Galai
(1983), Glosten and Milgrom (1985), Amihud and Mendelson (1986) and Diamond
and Verrecchia (1991) have shown that higher disclosure reduces cost of equity
capital for U.S corporations.
However, capital structure decision is not a standalone decision made by financial managers. It is accompanied by dividend decision or payout policy of firms as investment through retention and payout are two competing uses of funds. Therefore, in the next section we have reviewed studies on dividend payment.

1.3.3 Dividend Policy and interaction with investment decision

There are two contrasting views on the relationship between firm value and dividend policy. The first set of argument is that dividend payment increases firm value which is based on ‘bird-in-hand’ argument of Graham and Dodd (1951). They argued that “the sole purpose for the existence of the corporation is to pay dividends” (cited in Frankfrurter et. al. 2002:202 & Malkawi et al. 2010:174). Therefore, high dividend paying firms should sell their shares at high price. On the other hand, Modigliani and Miller’s (1961) ‘dividend irrelevance proposition’ says that value of a firm cannot be affected by dividend payment. The reason behind this is that as the market value of a firm is the discounted value of future cash flows therefore, value of a firm is only affected by the income generated from investment decision of firms and not by how the distribution takes place. In fact, determination of dividend policy is one of the unresolved issues in corporate finance literature. In the words of Black (1976:5) “The harder we look at the dividend picture, the more it seems like a puzzle, with pieces that just don’t fit together”.

There are five theories which try to explain the dividend policy of corporate firms namely, transaction cost theory, tax theory, signaling theory, bird–in–hand theory, and agency theory. Each of these theories tries to explain the relationship between market value of firm and dividend payment. They argue either in favour of or against dividend payment. Transaction cost theory argues that dividend payment makes firm to raise external funds and raising external funds has some transaction cost which reduce the value of firm. Therefore, transaction cost theory argues against dividend payment. There are two opposing views in tax theories of dividend policy. One strand of literature argues that tax cannot affect market value of firms and the opposite camp argues that taxation is capable of affecting market value of firms. Modigliani & Miller (1961) belongs to the first camp in which they argue that ‘tax induced clientele effect reduces the tax cost of dividends’. They further argued that there are clienteles based on tax positions such as high tax bracket and low tax
Those who are in the high tax bracket will prefer firms with low payout policy and those who are in the low tax bracket will prefer firms with high payout policy. Thus, no firms can increase its value by changing dividend policy.

On the other hand, opposite camp argues that dividend policy is being determined by the differences between corporate tax on distributions and tax on retained earnings as well as tax on dividends in the hands of shareholders and tax on capital gains. For example, if corporate tax on distributions is higher than those on retained earnings, it may reduce expected earnings of a firm that pays dividends relative to a firm that does not. Similarly, if dividends in the hands of shareholders are taxed higher than capital gains, investors should evaluate expected returns on an after tax basis and share prices will vary inversely with the firm’s payout level. The basic tax hypothesis supports a conservative dividend policy, and proposes that if the firm wants to return cash to shareholders, then this should be done through share repurchases.

The idea of bird-in-hand arguments was put forward by Graham and Dodd (1951) and Gordon (1959). This theory argues that a firm can increase its value by paying higher dividends. It can be explained by the fact that the value of a firm can be defined as the discounted value of dividends. Therefore, as the retention ratio increases it raises the expected future dividends. At the same time, the required return i.e. discount rate demanded by investors increases but the increase in discount rate is much more than that of expected increase in future dividend.

In addition to bird-in-hand theory, signaling theory of dividend argues in favour of paying dividend. The signaling theory of dividend was put forward by Bhattacharya (1979) and subsequently by Miller & Rock (1985), John and Williams (1985) among others. The idea behind this theory is that as there are information asymmetries between market participants particularly between managers and investors, managers use the costly dividend payment to signal prospects of firm in the market. John and Williams (1985) argue that when a firm is temporarily undervalued, it needs to pay dividend. The reason is that if an investor sells the undervalued stock to meet its liquidity needs that makes a wealth transfer from the existing to the new shareholders. Hence, by paying dividends firm can save losses to the existing shareholders.
A corporation can be thought of combination of principal and agents. In corporations separation of ownership and control gives rise to agency conflicts (Jensen & Meckling, 1976). Following this, it can be argued that managers may not always act in favour owners’ wealth maximization objective. Therefore, as the levels of retained earnings increases, managers are expected to misuse those funds, either investing in bad projects or by consuming perquisites. Hence, generous dividend policy enhances the firm’s value because it reduces the amount of free cash flows in the discretion of management and thus controls the over investment problem (Jensen, 1986).

Barring a few, studies in Indian context have primarily deals with the identification of the factors that determine the payout policy of the Indian corporate sector (Majumdar. 1959; Rao & Sharma, 1971; Murthy, 1976; Mishra & Narender. 1996). Apart from identification of factors influencing payout policy, researchers have tried to gauge the impact of tax on dividend policy of Indian corporate sector (Narasimhan and Asha, 1997; Reddy, 2002; Narasimhan & Krishnamurti, 2004; Sharma, 2007). The studies on determinants of payout policy reveal that profitability is considered to be an important factor in the determination of payout policy. There are inconclusive effects of tax on payout policy of Indian corporate sector. On one hand, Narashiman & Asha (1997) found that lower tax on dividend as compared to that of higher capital gain tax induced investors to move in favour of high payout firms. On the other hand, Reddy (2002), Narasimhan & Krishnamurti (2004) did not find any conclusive evidence for the fact that introduction of corporate dividend tax has altered payout policy of the corporate sector in India. Moreover, signaling hypothesis has been tested by Sharma (2006) and he found that dividend is being used as a signaling tool to convey the performance of firms in the capital market. Pandey et al. (2004) examined the dividend behaviour of Indian companies. The study found that the Indian firms have lower target ratios and higher adjustment factors. Further it has been found that the restricted monetary policies have significant influence on the dividend behaviour of Indian firms, causing about 5-6 percent reduction in the payout ratios. The significance of macroeconomic policy variable suggests that monetary policy restrictions do have impact on the cost of raising funds, and as the information asymmetry between lenders and borrowers increases, it forces companies to reduce their dividend payout.

Different combinations of debt and equity i.e., capital structure may alter the role of various stakeholders. For example, a firm with high level of debt might be closely
monitored by debt holders and they put pressure on managers to perform better so that they receive timely repayment of their debt. Hence, a firm with high level of debt has to generate higher cash-flow than that of low debt firms. Therefore, there could be a relationship between capital structure and performance of firms. In the next section, we have focused on those studies which have looked into the relationship between capital structure and performance of firms.

1.3.4 Capital structure and performance of firms

The relationship between financial development and growth at the macro level was first studied by King & Levine (1993) followed by Arestis and Demetriades (1997), Levine (1997), and Levine and Zervos (1998). They showed that performance of firms and aggregate growth are affected by a country’s financial development. However, there are limited number of studies which have looked into the relationship between leverage and performance of corporate firms.

The major difference between those studies is found in the definition of corporate performance. One series of papers uses basic accounting measures of performance. Majumdar and Chibber (1999) have tested the relationship between leverage and corporate performance on a sample of Indian companies. Adopting an accounting measure of profitability, return on net worth, in order to evaluate performance, they have observed a significant negative link between leverage and corporate performance. Kinsman and Newman (1999) in their study have used various measures of performance on a sample of United States’ firms, based on accounting or ownership information (firm value, cash-flow, liquidity, earnings, institutional ownership and managerial ownership). They performed regressions of leverage on this set of performance measures and concluded that there exists robust relationship between leverage and some of the measures of performance.

Pushner’s (1995) study aimed to investigate the relationship between leverage and corporate performance in conjunction with the influence of equity ownership in Japan. In this study, corporate performance has been measured by total factor productivity. The study concluded that a negative relationship exists between leverage and corporate performance. Two studies [Nickell and Nicolitsas (1995); Nickell et al. (1997)] have tested the role of financial pressure on corporate performance, which is a closely related issue. Both have analyzed data on the United Kingdom and measured
corporate performance as total factor productivity. Nickell et al. (1997) have observed a positive link between financial pressure and productivity growth, while Nickell and Nicolitsas (1995) found some evidence of a small positive effect of debt pressure on labor productivity. They interpreted this result as consistent with the hypothesis of Jensen (1986) that if managers loose more than shareholders in the event of bankruptcy, a higher debt position may cause a reduction in investment and an increase in the effort to raise efficiency which, in turn, results in a positive link between debt and productivity. The study of Mallick et. al. (2011) have dealt with the relationship between sources of financing and performance of firms in terms of profitability and productivity across developed and emerging economies. Their results have shown that firms in emerging economies with a low level of leverage i.e., leverage below 50 percent face lower risk of financial distress and thereby have less adverse effect on firms’ profitability and productivity, relative to their counterparts in advanced economies. Schiantarelli et. al. (1997), studying a sample of United Kingdom’s firms and a sample of Italian firms, found a positive relationship between labor productivity and leverage and a negative relationship between labor productivity and debt maturity. In another study, Nucci, Pozzolo and Schivardi (2005) considering a sample of Italian firms, concluded that there exists a negative relationship between leverage and productivity, depending on some firm specific factors, like propensity to innovate etc. Firms with higher propensity to innovate are less leveraged and their higher propensity to innovate results in higher productivity.

Apart from productivity, another economic measure of performance is efficiency, which has been considered by Weill (2003), Mok et al. (2007). Weill (2003) concentrated on seven European countries to study the relationship between corporate performance, measured by cost efficiency, and leverage. The study found positive relation in five countries, whereas negative relationship is found in case of two countries. The difference in result has been due to the impact of institutional framework, which suggests that there could be differences in accessing bank credit and efficiency of the legal system. The study of Mok, Yeung, Han and Li (2007) have used technical efficiency as a measure of performance, for 238 largest foreign invested toy manufacturing companies in southern China, to investigate the relationship between leverage and performance. This study found that leverage has positive impact on technical efficiency. It has been further found that one percent
increase in leverage increases its level of technical efficiency by 0.078 percent. However, the above-mentioned two studies differ methodologically in terms of constructing efficiency scores. While the former used parametric approach i.e. Stochastic Frontier Analysis (SFA) to construct efficiency scores, the latter used non-parametric approach i.e. Data Envelopment Analysis (DEA).

1.4 Research Gaps
From the review of the existing literature, one observes certain research gaps:

Prior to the financial sector liberalization the long term source of external funds to the Indian corporate sector was the Development Financial Institution (DFIs) and the for short term funds, the firm had to depend on the public sector commercial banks. The chance of obtaining funds from DFIs and banks was contingent upon several factors, such as relationship of the firm with banks and DFIs, the activities of the firm, as for example, whether there was rule of priority sector lending and so on. Therefore, the availability of funds became the major constraint to the development of Indian industries. However, after the financial sector liberalization several new measures came into being to boost the economic activity of firms and to encourage the new firms to enter in to the industry which was earlier restricted by the laws. The interest rate deregulation, development of stock market and abolition of the Capital Control Act of 1947, entry of foreign funds, the innovation of new financing instruments according to the need of the investors and corporate can be regarded as major steps towards the process of liberalization. The overall developments in the equity market development have put forward plenty of choices in front of the firms. Although the globalization of capital market has made increase the availability of funds, it is accompanied by numerous hazards like recession in the global economy, which causes downturn in the flow of funds as well as loss of investors’ confidence, causing an obstacle to the firms in raising funds. Not only with regard to equity funds, firms also face constraints raising resources through debt. Therefore, how the financing pattern of the Indian corporate sector is changing in recent years calls for an immediate study.

The studies of capital structure of the Indian firms, as for example, Singh (1995), Cobham and Subhramaniam (1995), Cherian (1996), Booth et al. (2001), suffer from ‘poor cross-sectional variation’. The study of Bhaduri (2002a) can be
considered as an improvement in terms of cross-sectional variation as it has considered a sample of 363 manufacturing firms across nine broad categories. Although the cross sectional variation is appreciable, it fails to capture the variability of capital structure decision of firms over a long period of time as well as the major institutional changes because the period under consideration is 1989-1995. Indian capital market underwent major changes after 1994 particularly with the establishment of the National Stock Exchange (NSE) and the full-fledged operation of the SEBI as a statutory body. Hence, as the study was conducted under the regime of banks and financial institutions, one can expect biasedness towards debt in the absence of well developed capital market. But, the picture is quite different in recent years as the stock market activity is much more. This is evident from the fact that ratio of India’s market capitalization to GDP is 68.6 percent as compared to 3.5 percent in early 1980’s. Moreover, several studies (citations) have pointed out that Indian corporate sector has shown much more dependence on the equity financing. Therefore, there is a need to set up a detailed study of the determinants of capital structure of firms for a much longer period of time 1989-2008 in the changed market set-up which will enable us to take care of the impact of the capital market liberalization on capital structure decision of firms and major regulatory changes like the abolition of the Capital Control Act of 1947. Moreover, the absence of any systematic study on the impact of regulatory changes on the capital structure decision of the firm over such a longer horizon of time, calls for a need to study the achievements that have been made due to the various regulatory changes.

The capital market regulation is crucial for capital structure decision as it lowers the cost of capital by reducing directly ‘asset-substitution’ problem and information asymmetry which once again tries to eradicate the problem of ‘asset-substitution’ and thereby providing a platform for raising capital from the market. Studies of Demsetz (1968), Copeland and Galai (1983), Glosten and Milgrom (1985), Amihud and Mendelson (1986) and Diamond and Verrecchia (1991) have shown that higher disclosure reduces cost of equity capital for United States’ corporations. Any estimation without considering capital market regulation as one of the determinants of optimum capital structure, leads to a biased estimate of the speed of adjustment.
Most of the studies in the Indian context have attempted to find out factors affecting the dividend policy. It has been found that profitability, size, cash flow, growth opportunity etc. are main factors which determine dividend policy in India. Moreover, attempts have also been made to test the validity of tax theory, signaling theory. The validity of Lintner (1956) model of target payout policy has also been tested. Our review of literature tells us that most of the studies are decade old and in the last decade Indian economy has entered into high growth trajectory which has been possible due to the well performance of the Indian corporate sector. This calls for an update on the dividend payment behaviour of Indian corporate sector. Second, we have seen that capital structure or financing decision varies with the ownership structure i.e., among government owned, private Indian, private foreign, and group firms in India. A great matter of concern is to find out whether this ownership structure is affecting the dividend payment behavior of the firms. is a matter of concern. Third, none of the studies, to our best of our knowledge, have considered investment as a potential determinant of dividend policy. Fourth, dividend payment decision cannot be expected to remain uniform across different growth -oriented firms. For example, for high growth firms the need for funds is more than that of low growth firms, as investment opportunities are more for high growth firms. Apparently, since dividend payments and investment decisions are two competing uses of funds, this interaction needs to be investigated for different growth oriented firms.

Initially the study of relationship between financial development and growth started at the macro level. Gradually, researchers have started focusing on the same issue at the micro level as the prevailing relationship at the micro level determines the financial structure of the economy. However, studies at the firm level are limited in number and there are ambiguities in the observed relationship. Except a few, most of the studies have concentrated on developed markets. Moreover, existing studies differ in terms of measure of performance. Thus, given the fact that such studies in the Indian context are rare, there is enough scope to conduct similar kinds of study in the Indian context.

The above review of Indian literature has helped us in identifying the research gaps that exist in the Indian context. The review also clearly brings out the many
untouched areas pertaining to the capital structure of firms in the Indian literature, which call for an immediate study.

1.5 Objectives of the Study:
Based on the review of literature and research gaps, the following objectives have been indentified for the present study:

1. To study the nature of capital structure of Indian industries in the liberalized regime given the availability of various financing options.

2. To identify the determinants of capital structure of Indian manufacturing sector.
   (a) to study the adjustments towards optimal capital structure decision.
   (b) to study the role of regulatory changes on corporate financing.

3. To study the nature of dividend payment behavior of Indian manufacturing sector.

4. To study the impact of capital structure decision on the performance of firms.

1.6 Data sources:
To study these aspects we have collected data from two secondary sources. Aggregate level data for public, private, and right issues of equity as well as public and private placement of debt, commercial paper and qualified institutional placements has been collected from Prime Database for the period 1989-90 to 2013-14. The balance sheet information used for firm level analysis has been taken from Prowess database produced by Centre for Monitoring Indian Economy (CMIE). There are 597 sample firms over the period of 1990-2009 and total number of observations turn out to be 8477. Since this study wants 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.

1.7 Chapteriation Scheme:
Rest of the thesis is organized into six chapters. The second chapter describes the financing patterns of the Indian corporate sector at the macro and industry level. To analyze the financing pattern, we have looked both at capital market activity and firm
level financing patterns. We have seen the trend of public, private, and right issues of equity as well as public and private placement of debt, commercial paper and qualified institutional placements in order to get a clear picture of the capital market activity. To analyze the financing pattern of Indian corporate sector, we have chosen few indicators of financing, such as debt to total assets, long term debt to total assets, liabilities to total assets, interest coverage ratio, short term bank borrowing, long term bank borrowing, borrowing from financial institutions, public borrowing etc. Trends of these indicators have been observed and variations of these indicators across different size of firms, various age groups, and by export orientation are taken into consideration. We have relied on descriptive statistics and T-test to arrive at our findings.

In the third chapter we have discussed the impact of capital market regulation on the capital structure decision of Indian manufacturing firms along with firm specific factors. 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 and to what extent the predictions of different capital structure theories can explain the determination of financing decision of Indian corporate sector? Since corporate sector raises funds from capital market and capital market is regulated by SEBI, regulatory changes made by SEBI can make an impact on the financing decision of the firms. Hence, an attempt has been made in this chapter to see the impact of regulatory changes on capital structure decision. Since regulatory changes are frequent, capturing the impact of regulation using a dummy variable seems to be impossible. Therefore, we have constructed a regulatory index using factor analysis considering the changes that happened regarding entry and public issue, promoters’ contribution and lock-in period, issue of debt instrument, preference share issue, as each of these regulations aims at reducing the ‘asset-substitution’ through reduction in information asymmetry. The regulatory score has been used as a determinant of capital structure decision along with firms specific factors as proposed by various theories of capital structure. We have used panel data regression model particularly, the method proposed by Driscoll & Kray (1998) to arrive at the determinants of capital structure decision.
In the fourth chapter an attempt has been made to gauge the speed of adjustment, if there is any, towards optimal capital structure. We have estimated a partial adjustment model, following Arellano & Bond (1991) using a dynamic panel data model.

The fifth chapter focuses on the dividend policy of Indian corporate sector. Capital structure decision also accompanies the dividend or payout policy, as any new investment needs to be either financed by using internal or external finance. In case a firm chooses to finance investment through external resources, it has to be financed either by equity or debt. In case it is financed by debt, it has a fixed repayment schedule that the firm needs to follow. If it is financed by equity, then appropriate dividend decision has to be made as it may have some impact on the value of the firm. Therefore, dividend policy is an integral part of capital structure decision. In this chapter we have looked at the dividend policy of Indian corporate sector in the last two decades. Given the structural difference between developed and developing countries and nature of market imperfections, the present study intends to address three issues in the context of Indian corporate sector. First, to analyze the trends and patterns of the dividend policy of Indian corporate sector for the period under study, that is from 1990 to 2009. Second, to indicate the factors those determine the dividend payment behaviour of the Indian corporate firms. Third, to study the interaction between payout and investment policy of corporations in India.

In the sixth chapter we have discussed how capital structure and performance of firms are related. Jensen and Meckling (1976) argued that there exist conflicts between different stakeholders, as for example, conflict between managers and shareholders and conflict between shareholders and debt-holders. These types of conflicts might give rise to agency costs and in order to reduce the agency costs, arising out of conflict between managers and shareholders, debt acts as a disciplinary instrument, as it reduces the cash flow in the hands of the managers and thus prevents them to consume perquisites. At the same time, creditors put pressure on the managers to meet the obligations from debt contracts, such as servicing of interest payment and repayment of debt at maturity, and to perform better, so that firms can avoid bankruptcy (this may result in due to non-fulfillment of any debt obligations) and managers can maintain their reputation as well. Therefore, it can be argued that there is a link between capital structure and performance of firms. In this chapter we have
also examined if capital structure decision has any impact on the performance of firms.

Chapter seven summarizes the thesis and discusses the major conclusions.