CHAPTER 1 – INTRODUCTION

INTRODUCTION

This research provides a critical analysis of Investment decisions made by Pharmaceutical companies during the period 1997-2007. Investment decision is a very crucial and vital decision of any organization. The term “investment” is used by various streams offering various perspectives. For Accountancy it is the money invested in fixed assets and current assets. From the economists point of view it is the savings of the organization left after the consumption of resources. Financial Management looks at Investment as “Commitment of resources made in the hope of realizing the benefits that are expected to occur over a reasonable long future period of time”\(^1\). The combined reading of all the three perspectives given, deduce that Investment is allocation of funds into fixed assets for long term, current assets for short term, and of excess funds into strategic and tactical investments.

INVESTMENT DECISION

Investment Decision is the decision related to asset allocation. It encompasses the following aspects

1. What is the organization’s long term goal?
2. To achieve the organizational goal what strategy is the company going to follow?
3. To implement the strategy what type of investment the company is required to make in long term assets?
4. How the balance between long term assets and short term assets can be maintained?
5. How fast can the investments yield the return?
6. How the excess funds be optimized?
7. What are the ways to employ the excess funds in the best possible way to gain higher value for the organization?

\(^1\) Harold Blerman, Jr and Seymour Smidt, *The Capital Budgeting decision*, 2\(^{nd}\) Ed. ( New York : The Macmillon Company, 1966 ), pp. 4
8. At what rate the investments need to grow?
9. Is there any right time for investment?
10. What changes need to be done in strategies of investments with changing circumstances?

SIGNIFICANCE OF INVESTMENT DECISION

Investment decisions are vital and crucial for the organization because they have a long term effect on the working of the organizations. The decision demands the commitment of funds today, in the hope to generate income. The word “hope” signifies that the generation of income is uncertain. It is futuristic estimation. Therefore, risk involved is very high. The risk gets magnified if the environment is dynamic and expecting major changes in the policy decisions in the industry. Investment decisions would be like entering into rough waters which are never tested before.

Investment decisions are not just outflow of cash but it is the overall philosophy and a pathway of the organization to be followed in future. It involves an elaborate thought process, collaborative decision making and brain storming evolving out of past experience and future opportunities. Therefore, making abrupt changes in the philosophy is many a times not only difficult but detrimental to the value of the organization. Therefore, taking a investment decision quickly and once taken, reversing the decision both the things are very difficult.

Investment decisions are the major contributor to the growth/decline of the company. Mergers, takeovers, establishing the subsidiaries, taking over the brands are like a two edged sword. If proven to be successful, they would bring wealth to the organization. But a wrong estimation or wrong timing of the decision can put the company into a disaster. Locking of funds in inventories and receivables can put a pressure on the liquidity of a company which in turn will affect its profitability badly.

Funding of investments is also a critical issue. What types of funds are used to make further investments will impact the cash flows of the company. The theory says that the debt is the cheapest source of finance and increases the
wealth of the company. But does it happen in practice as well? Do the companies having better liquidity and solvency position enjoy more flexibility as compared to leveraged companies? Do debt free companies add more value to the organization? Many such questions arise when one looks at the investment decisions critically.

CRITICAL ANALYSIS OF INVESTMENT DECISION

Critical means judicious. Therefore, judicious analysis means to find out how the investment decisions made by the company affected the growth of the company.

The first and foremost question of analysis would be, If one needs to evaluate the investment decisions what would be the judicious parameters? There are various tools available like Net Present Value (NPV), Internal Rate of Return (IRR), Average Rate of Return (ARR) which evaluate the stand alone long term project before investment is done. However, the researcher did not use any of these tools due to following reasons

a. The researcher was interested in exploring the effects of overall investments on the growth of the firm. “Overall investments” mean investment in fixed assets, investment in current assets and investment in other investments. In short, it would cover investment in all types of assets of the organization. Therefore, one must have a parameter which would take into account income generated from all the investments.

b. Secondly these tools evaluate the project based on the future estimations of the cash flows. But in the study the researcher was interested to know about the investment decisions already taken.

c. The tools require the project specific inflows and outflows of cash. But from the annual reports one would get only the consolidated information. Therefore, finding out NPV was not feasible.

For evaluation of working capital the various liquidity ratios and funds flow statement can be useful for analysis. But it would not give holistic view of investment decisions. It will also not reflect the role of other investments.
Therefore, the researcher has not considered liquidity ratios for the purpose of evaluating investment decisions.

Profit After Tax (PAT) without considering extraordinary items would consider income from sales, income from interest, dividend and income from other sources and also all the expenses accrued for generating such income. Therefore, PAT can be one of the parameters of evaluation of investment decision.

All the classical financial theories say that profit is an ambiguous concept. Therefore, the firm should be interested in knowing how much cash is generated from the investments. Considering this view the researcher has put more emphasis on analysis of cash flow statement of the company. The benefit of using cash flow statement is getting a fair idea about

1. How much cash is generated from main business i.e by deployment of fixed assets and working capital
2. How much cash is generated by way of other investments in the form of interest, dividend or trading of shares and other financial securities.

**INDIAN PHARMACEUTICAL INDUSTRY**

The Indian Pharmaceuticals sector has come a long way, being almost non-existing during 1970, to a prominent provider of health care products, meeting almost 70% of the country’s pharmaceutical needs. The Indian Pharmaceutical Industry today is in the front rank of India’s science-based industries with wide ranging capabilities in the complex field of drug manufacture and technology. From simple headache pills to sophisticated antibiotics and complex cardiac compounds, almost every type of medicine is now made indigenously.

The Indian Pharmaceutical Industry is estimated to be worth Rs.22500 crores, growing at about 8 to 9 percent annually. Globally, the Indian pharmaceutical industry ranks 4th in terms of volume and 13th in terms of value. Indian pharmaceuticals industry has over 20,000 units. Around 260 constitute the organized sector, while others exist in the small scale sector.
The Indian pharmaceutical industry is a success story providing employment for millions and ensuring that essential drugs at affordable prices are available to the vast population of this sub-continent.

MARKET SHARE

The Indian Pharmaceutical sector is highly fragmented with more than 20,000 registered units. It has expanded drastically in the last two decades. The leading 250 pharmaceutical companies control 70% of the market with market leader holding nearly 9% of the market share. It is an extremely fragmented market with severe price competition and government price control. The pharmaceutical industry in India meets around 70% of the country's demand for bulk drugs, drug intermediates, pharmaceutical formulations, chemicals, tablets, capsules, orals and injectables.

These units produce the complete range of pharmaceutical formulations, i.e., medicines ready for consumption by patients and about 350 bulk drugs, i.e., chemicals having therapeutic value and used for production of pharmaceutical formulations.

Exports constitute almost 40% of the total production of pharmaceuticals in India. Out of the total exports, formulations contribute nearly 55% and the rest 45% comes from bulk drugs. Export revenue now contributes almost half of the total revenue for the top 3 pharmaceutical majors: Dr Reddy's, Ranbaxy and Cipla. The other major exporters are Wockhardt Limited, Sun Pharmaceutical Industries Ltd. and Lupin Laboratories. The formulations and exports are largely to developing nations like South East Asia, Africa, and Latin America. In the last 3 years generic exports to developed countries have picked up.

EVOLUTION OF PHARMACEUTICAL INDUSTRY

The Indian Pharmaceutical Industry is considered as a success story globally. The secret of this success is the Indian patent law of 1970. India had entered independence with the patent system of the British colonial masters. This secured the Indian market for the British industry; pharmaceuticals were largely imported from abroad and local production was minimal. The 'architect'
of the patent law of 1970, S Vedaraman, then director of the Indian Patent Office, summarized the principle as follows: “We are not against patents. And we are prepared to pay decent license fees. But we in India cannot afford monopolies.” Since then, India has done without product patents for pharmaceuticals, with the exception of production processes that may be patented for seven years. These moves did not find much favour with the multinational pharmaceutical industry.

Patent protection mainly benefits technology exporters. It protects them from low-cost competition. Technology importers on the other hand, want access to technical innovations as freely and cheaply as possible. Therefore, most of the developing nations are against the patent protection which creates monopolistic barriers.

In spite of this, patent protection has gained the upper hand against the interests of developing countries. One of the WTO agreements (the Agreement on Trade-Related Aspects of Intellectual Property Rights - ‘TRIPS’) prescribed worldwide minimal standards for patent protection.

India, too, became a WTO member in 1995 and TRIPS rules for medical drugs in its national patent legislation came into effect by 1 January 2005. Till then, India was known as a ‘centre of commercial piracy’. By issuing the patent ordinance, India met a WTO commitment to recognize foreign product patents from January 1, 2005, the culmination of a 10-year process. In this new scenario, the Indian pharmaceutical manufacturers were not allowed to manufacture patented drugs.

Till that time India was mainly into formulations and bulk drugs. India was known for its cost effectiveness, strong manufacturing base and pool of highly trained scientists. But Indian pharmaceuticals were not known for new molecule discovery, new patents till 2003. It was only after 2000, companies started facing threat for new patent regime. Companies felt the need of searching for new business models. Their existing models of reverse engineering were at stake. Therefore, there was an urgent need to shift from the traditional revenue models to some new business development.
NEED FOR THE STUDY

The period of 1997-2007 underwent many changes in the pharmaceutical industries. There were geographical and product expansions. Companies like Ranbaxy (see annexure 99-IBDF12, Ranbaxy from volume II, page 378-385), Aurbindo (see annexure 88-IBDF1, Aurbino from volume II, page 290-297) were heavily investing in subsidiaries. Companies like Dr. Reddy’s were coming up with huge capacity expansions. Many companies were going vertical integration with a view to achieve better premiums. This was the period when consolidation was taking place in the industry. A Company like Zydus Cadila was very active in mergers and acquired major pharmaceutical giants like German Remedies. During this period company like Biocon has come with breakthrough biotechnology and made a mark globally. The capital market performance was also impressive. A Number of capital issues were coming up from pharmaceutical companies. The assets were growing so also the profits. Following chart gives a fair idea about how the overall industry was growing in terms of sales as well as Profit margin over the years.

Table No. 1(1)

Table showing increase in sales in pharmaceutical industry during 1998-2007

<table>
<thead>
<tr>
<th>Particulars</th>
<th>97-98</th>
<th>98-99</th>
<th>99-00</th>
<th>00-01</th>
<th>01-02</th>
<th>02-03</th>
<th>03-04</th>
<th>04-05</th>
<th>05-06</th>
<th>06-07</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales Rs. In crores</td>
<td>17596</td>
<td>20390</td>
<td>22843</td>
<td>26222</td>
<td>28846</td>
<td>32058</td>
<td>36633</td>
<td>39953</td>
<td>43146</td>
<td>59981</td>
</tr>
<tr>
<td>NP ratio</td>
<td>2.4</td>
<td>2.2</td>
<td>3.8</td>
<td>5.8</td>
<td>8.6</td>
<td>8.8</td>
<td>10.3</td>
<td>9.0</td>
<td>10.1</td>
<td>12.1</td>
</tr>
<tr>
<td>% change in Sales</td>
<td>NA</td>
<td>16%</td>
<td>12%</td>
<td>15%</td>
<td>10%</td>
<td>11%</td>
<td>14%</td>
<td>9%</td>
<td>8%</td>
<td>39%</td>
</tr>
</tbody>
</table>

There was clear fear in the minds of the pharmaceutical companies that the new patent regime would create problems for their business. The researcher

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found that many companies had expressed their concern about the same at the beginning of the new millennium.

Some companies like Cadila, Cipla started looking for different strategies like Contract manufacturing, contract research. Some companies like Ranbaxy have adopted the methods of co-alliances for marketing.

Therefore, in the year 2002, the researcher felt that the pharmaceutical industry would undergo major strategic changes which would have long lasting effects on the performance of the companies. The way in which the business is done would change, the scale of operations would change, the focus of the companies would change from manufacturing to research based companies, more alliance and partnerships would emerge, the companies would become more competent and efficient in terms of working capital management.

Therefore, the researcher felt that studying this dynamic industry during the most vibrant period would throw some light on the fundamental issues in Investment decisions.

**PURPOSE OF THE STUDY**

The researcher was curious to understand what is the impact of the investment decisions on the growth of the company? How frequently the companies would change their basic strategy? Does the composition of investments in long term assets and short term assets make the difference to the value of the organization? What is the role of other investments in the organization? Are the investment decisions different for different companies within the same industry? Or whether the companies follow the industry cycle norms? Whether the strategies followed by Indian Pharmaceutical companies and Multinational companies differ? Whether investment in research and development really help in long term?

In a nutshell the researcher was interested in knowing how the investment decisions affect the companies’ performance and growth? Therefore, the
researcher has decided to undertake the critical analysis of investment decisions.

CHAPTER SCHEME

The following chapter scheme has been adopted to present the outcome of the research.

CHAPTER TWO

This chapter contains the review of earlier literature available on Investment Decisions. The literature has been reviewed from 1966 to 2007 i.e. for the period of 41 years. This chapter contains a summary of earlier literature available from the following four sources

1. Books
2. Journals
3. Newspaper articles
4. Digital Database

Books were reviewed from the period 1966 to understand how the concepts of finance in general and of investment decision in particular have undergone a change. 24 different authors were studied and their thoughts on the concept of investment decisions are summarized in the chapter.

Journals provide the information about the concurrent issues in management. Main journals in the field of finance were studied for the period from 1995-2007.

The researcher has summarized and regrouped the literature reviewed in following five major parts

1. The concept of an Investment
2. The Role of the Investments
3. The Decision
4. The concept of Investment Decision
5. The scope of Investment decision in Financial Management
CHAPTER THREE

The third chapter contains the methodology adopted in the thesis. The methodology contains the following aspects like nature of data, objectives of data, purpose and scope of the study, type of sample and the method of sampling, sample size, method adopted in collection of data, classification of data, method employed for interpretation of data, method adopted in presentation of data, limitations of data and limitations of research study.

CHAPTER FOUR

The fourth chapter is the backbone of the study and details the analysis of the data. The analysis is done keeping in view the hypothesis of the study. The primary hypothesis was to explore whether the investment decisions of the companies are reflected in the growth of the company. Therefore, three parameters are considered for growth

1. Growth in sales
2. Growth in Profit after tax
3. Growth in Operating cash flows

While analyzing the investment decisions following aspects are taken into consideration

1. The increase / Decrease in various types of assets
2. The Change in the composition of assets
3. Change in the Other investments
4. Financing of the assets

The researcher has studies the impact of the later on the former. Further the researcher has classified the companies under the study into four main categories

1. Pharmaceutical Indian Bulk Drug and Formulations (IBDF)
2. Multinational Companies (MNC)
3. Pharmaceutical Indian Bulk Drug Companies (IBD)
4. Health care companies. (HC)
Each of the parameters mentioned above were thoroughly analyzed for the
group of all the companies as well as for individual groups.

All the tables and observations form part of chapter Four

CHAPTER FIVE

On the basis of the analysis done under various categories and various
observations made in chapter four, the researcher has drawn the conclusions.
This chapter established the link amongst various factors of the research as
mentioned below

1. It would summarize the need and purpose of the study
2. It would review the hypothesis and objectives in the context of analysis
done
3. It would provide conclusion with reference to the hypothesis and
objectives set.

BIBLIOGRAPHY

VOLUME II

Volume II contains the all the annexures. The researcher has derived various
statistical tables from the basic data picked up from the annual reports of the
various companies. The annexures provide the information about the basic
data and tables derived from the same.

In the thesis the researcher has provided the findings and conclusions group
wise. But before doing the analysis for the group the researcher has done the
in depth study of each company which also forms the part of volume II.