

**FINANCING DECISIONS IN THE NEW ERA:
A COMPARATIVE STUDY OF PUBLIC SECTOR,
PRIVATE SECTOR BUSINESS HOUSES AND
FOREIGN CONTROLLED FIRMS IN INDIA**

by

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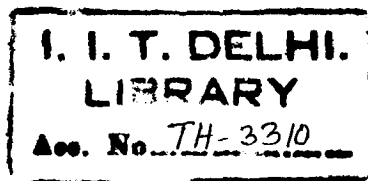
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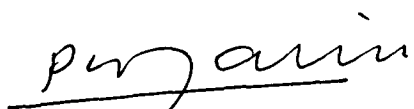
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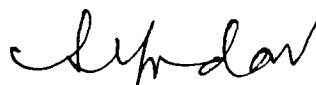
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CERTIFICATE

This is to certify that the thesis entitled **Financing Decisions in the New Era: A Comparative Study of Public Sector, Private Sector Business Houses and Foreign Controlled Firms in India**, being submitted by Ashish Kumar Rastogi to the Indian Institute of Technology, Delhi, India, for the award of the Degree of Doctor of Philosophy is a record of bonafide research carried out by him under our guidance and supervision. He has fulfilled the requirements for the submission of thesis, which has attained the standard required for a Ph.D. degree of this Institute. The results presented in this thesis have not been submitted in part or full to any other university or institution for the award of any degree or diploma.



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(Ashish Kumar Rastogi)

ABSTRACT

Financing decisions are of paramount importance for the long-term growth and survival of the firms. These are key strategic decisions and have become increasingly crucial in view of the growing economic liberalization and globalization of Indian economy. The financing decisions involve raising funds from internal sources and from sources external to the firm at the lowest long-run cost and risk so that the shareholders' wealth is maximized. Thus, financing decisions are frequently motivated by a desire to reduce risk as well as financing costs.

The introduction of innovative instruments and derivatives as well as a better understanding of derivative products has made the risk management tools and techniques more accessible. Similarly, in the area of capital structure decisions, the increasing range and volume of available financial instruments has facilitated the creation of capital structures that are more attuned to the future needs of the individual firms. These changes have also had a significant impact on the financial strategies of the foreign controlled enterprises as well as domestic firms, i.e., firms affiliated to private sector business houses/group and government owned public sector firms, in making financing decisions in the new era.

The importance of financing decisions assumes greater significance than ever before, in view of these changes in the nineties. There is no in-depth comparative study in India (to the best of my knowledge) to highlight the uniformity or divergence in corporate practices in respect of financing decisions of public sector firms, private business houses/group firms and foreign controlled firms. In the absence of a comprehensive framework, it is difficult to relate the large number of different but related environmental and organizational factors to the financing decisions of the firm. The present study is a modest attempt to fill in this gap.

This study is mainly concerned with the financing decisions of the non-financial and non-banking corporate firms operating in India and is limited to 12-year period, namely, 1992-2003. It covers a fairly large stratified representative

sample of 601 corporate enterprises, representing 148 government owned public sector firms, 231 family owned private sector business group firms and 222 foreign controlled enterprises operating in India. The sample of 601 corporate firms covers three ownership groups, fourteen industry groups, four size classes and two age categories. The study examines the effect of ownership control of the firm, industry group to which the firm belongs, size and age characteristics of the firms on the financing decisions. It also ascertains the impact of liberalization and globalization of Indian economy on the financing decisions of the sample firms.

The study has made use of primary data and secondary data. The relevant primary data pertaining to the opinion/preferences and actual practices of the corporate finance managers, related to various aspects of financing decisions were collected directly from the sample corporate firms through questionnaire. Primary data analysis is based on responses from 114 sample firms. The secondary data relates to 601 sample corporate enterprises. Annual financial statements (Balance Sheet and Profit & Loss Account) of twelve years, 1992-2003, of the sample corporate firms have been the source for secondary data.

Financial ratio analysis, a well-accepted tool in the financial management studies, has been employed for the purpose of data analysis. Statistical tools and techniques such as mean, median, quartile, proportions, paired t-test, correlation, analysis of variance, chi-square and regression analysis etc. have been used in analyzing the data for testing the various hypotheses.

The thesis is broadly divided in five parts spread over in nine chapters. The first part of the study surveys the relevant literature, identifies the scope of research, and spells out the research objectives, hypotheses and research methodology. An in-depth analysis of capital structure and debt financing decisions of the sample firms, using empirical evidence and the responses received from finance managers and policy makers has been carried out in the second part. Part three of the study has been devoted to critical examination of international financing and risk management practices of the sample firms. Part four of the study deals with the management of financing decisions and the

impact of liberalization and globalization on the financing decisions of the sample firms. Finally, part five presents the main conclusions and implications of the study regarding financing decisions of the firms in the new era in India. It also provides the limitations of the present study and suggestions for further work.

The study shows that the sample corporate sector enterprises in India have shown a marked reduction in dependence on debt in designing their capital structure during the years 1992-2003. Both the univariate analysis and regression analysis have shown that ownership control, industry and size of the firm are significant determinants of the capital structure, while age is not. Despite the decline in interest rates, the dominance of debt in the capital structure has declined and equity is gaining strength. The data also reveals that many of the sample firms in India have been successful in reducing the financial risk. Economic and financial reforms in India have caused significant changes in the debt financing of the sample firms.

A notable finding of the study is that there is a shift towards preference for short-term debt over long-term debt. In contrast to banks, the share of financing by financial institutions as a percentage of total-borrowings has declined sharply. Ownership control has significantly influenced the debt financing decisions in terms of its maturity structure, sources and servicing capabilities. Industry factor has been observed to influence the composition of debt and its sources (banks and financial institutions) in a significant manner. While size has been observed to be a significant variable in determining the debt financing as well as servicing capabilities, empirical evidence does not support that the debt financing decisions vary across age categories.

The foreign borrowings (debt raised abroad) have increased significantly due to the liberalization and globalization policies of the Government of India. The magnitude of foreign-currency borrowings (debt in foreign currency) has been relatively higher than foreign borrowings, which may be attributed to the fact that many firms may have raised foreign currency loans in India. It may be concluded that the importance of foreign debt in financing the needs of the sample firms has increased as a result of liberalization and globalization process.

In terms of sourcing of international finances, a majority of the firms in India have preferred foreign banks. Ownership control significantly influences the sources of international financing and as expected foreign banks are more popular among foreign controlled firms whereas public sector firms and private sector business group firms have shown greater preference for Indian banks. Global Depository Receipts, American Depository Receipts, EURO issues, Foreign Currency Convertible Bonds have also been a popular choice in raising finances.

The findings indicate that sample firms are exposed to higher degree of business risk. The economic liberalization process has also contributed significantly towards higher business risk. Hence, the firms should focus on reducing risk, in particular, business risk that has shown a rising trend.

The study reveals that foreign exchange transaction risk is the most widely managed risk by the sample corporate enterprises in India. This is followed by interest rate risk and economic risk. The study also establishes a significant role of ownership control on the importance accorded to all the four risks, namely, foreign exchange transaction, foreign exchange translation, foreign exchange economic and interest rate risk. Whereas foreign exchange transaction risk and interest rate risk have been considered more important by private sector business group firms, foreign exchange translation risk and foreign exchange economic risk are perceived more important by foreign controlled companies. Public sector firms have lagged behind in terms of the importance they have for these risks; it may not augur well for public sector firms. On the whole, the study suggests that firms do not manage all risks and the risk management is in infancy in India. A widespread and prominent reason as to why firms do not manage risks is that exposures are not large enough.

Firms are more likely to sell the local currency forward to cover them against anticipated depreciation of local currency. Contractual commitments such as account receivables/payables are the most frequently hedged exposures. A vast majority of firms in India are likely to use 'forward contract' in the management of foreign exchange transaction risk. Besides this, 'netting' is also

popular. The most popular use of interest rate risk derivative is lock-in rate for future financing. Interest rate risk is most likely to be managed by swaps. The survey also corroborates that many firms do not manage the economic risk due to its insignificant impact.

The study reveals that the principle, 'maximize the rate of return on investment in assets' has been accorded top priority as an objective of financial decisions by the sample firms. The next financial goal pursued by firms is to 'minimize the cost of capital' followed by 'maximizing earnings per share'. Cost reduction stands out as the most prominent reason for enhanced emphasis on the financing decisions among the foreign controlled as well as private sector business group firms.

The study shows that the ascendancy of equity in the financing of the sample firms in India is significant in the post-liberalized era. It implies that corrective action to rectify the deficiency of lopsided (debt denominated) capital structure has been initiated by the corporate finance managers in the new era. In operational terms, it is likely to enable the firms to raise long-term finances with ease. The empirical data has shown that international financing has increased and this trend is likely to continue.

In the present economic scenario, the findings are likely to prove useful to practitioners/managers of the corporate firms, term lending institutions/financial institutions, commercial banks, capital market regulatory authorities like Securities and Exchange Board of India and other agencies such as Foreign Investment Promotion Board etc.

This study is a modest attempt in one of the important areas of financing decisions. It will serve as a catalyst to frame other studies in this area. The study reveals many important issues and their implications, which may go a long way in devising financial policies and decisions of the public sector firms, private sector business group firms and foreign controlled firms in India in the liberalized era.

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