FINANCING OF THE PRIVATE CORPORATE SECTOR IN INDIA: 1984-85 TO 1997-98

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CERTIFICATE

This is to certify that this dissertation entitled **'FINANCING OF THE PRIVATE CORPORATE SECTOR IN INDIA: 1984-85 TO 1997 -98'** submitted in partial fulfilment of the requirements for the award of the Degree of Master of Philosophy has not been previously submitted for any other degree of this university or any other University and is my original work.

Sapna Suryavanshi
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We recommend that this dissertation may be placed before examiners for evaluation.

20.7.01

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LIST OF TABLES AND GRAPHS

ABBREVIATIONS

BSE	-	Bombay Stock Exchange
CICA	-	Capital Issues Control Act
DCFM	-	Discounted Cash Flow Method
FDI	-	Foreign Direct Investment
FERA	-	Foreign Exchange Regulation Act
LIC	-	Life Insurance Corporation
MNCs	-	Multinational Corporations
MRTP	-	Monopolies and Restricted Trade Practices Act
NAS	-	National Accounts Statistics
NEP	-	New Economic Policy (1991)
PSUs	-	Public Sector Units
P-U-C	-	Paid Up Capital
RBI	-	Reserve Bank of India
R&D	-	Research and Development
ROW	-	Rest of the World
SBI	-	State Bank of India
SCBs	-	Scheduled Commercial Banks
SEBI	-	Securities Exchange Board of India
TLIs	-	Term Lending Institutions
UTI	-	Unit Trust of India

CHAPTER I

INTRODUCTION

All economic enterprises can be classified either as public sector, private sector or as household sector. Public sector comprises of government administrative departments and departmental and non-departmental enterprises (including public corporations which are wholly or mainly owned and/or controlled by the public authorities).

Private corporate sector comprises of corporations, joint stock companies (public limited and private limited – distinguished by pattern of ownership and control), cooperatives, limited liability partnerships and other financial and non financial enterprises which by the virtue of legislation, are recognized as business entities independent of their owners. The private corporate sector enterprises are further classified first by the nature of the enterprises, i.e., public and private limited joint stock companies, cooperatives, limited liability partnerships, etc., and then cross-classified by the nature of the business, i.e. non-financial and the financial with further sub classification by kinds of economic activities or industries.

Household sector comprises of the enterprises which are not regulated by any legislation and do not necessarily maintain any annual accounts and balance sheets are classified as unincorporated: these, together with the household industries are owned and operated by household members jointly or singly and do not come under any legislation.

The present study covers non-financial joint stock companies in the private corporate sector for which the basic data becomes available annually through the sample surveys undertaken by the *Reserve Bank of India* (RBI). As the basic source of data comes from a single source, the results are expected to be consistent.

Table 1.1

Share of Public and private sector in the GDP at current market prices.

Plan Period	Public Sector	Private Sector
First Plan (1951-56)	1.6	8.1
Second Plan (1956-61)	2.0	9.8
Third Plan (1961-66)	3.0	10.1
Annual Plans (1966-69)	2.2	11.4
Fourth Plan (1969-74)	2.8	13.5
Fifth Plan (1974-79)	4.4	16.2
Annual Plan (1979-80)	4.3	17.3
Sixth Plan (1980-85)	3.6	15.6
Seventh Plan (1985-90)	2.3	18.6
Annual Plans (1990-92)	1.5	22.0
Eighth Plan (1992-97)	1.5	22.6

The private corporate sector has been playing an important role in the industrial development of the Indian economy. Although the public sector continues to be at the "commanding heights", the share of the private corporate sector in the total plan outlays has been increasing in recent years. The share of the private corporate sector in the GDP has been consistently increasing as is also seen from table1.1. The share of the private sector in the GDP was only 8.1 percent in the first plan and it has increased to 26.6 percent. Moreover the performance of the private corporate sector with respect to sales, value of production, gross profit etc has also improved remarkably. The policy initiatives taken since the early eighties towards 'liberalization' (e.g. delicensing, broad banding, automatic expansion etc.) also have provided ample opportunities to the entrepreneurs to expand their business activities. With this expansion, mobilization of adequate resources by the private corporate sector has become crucial. The issue becomes all the more significant, as the private corporate sector is required to raise a substantial amount of funds from the market. It is, therefore, of analytical and policy interest to know as to how are resources being mobilized by the companies and how it has influenced the pattern of financing of the private corporate sector.

The private corporate sector is important as far as the channelizing of the resources are concerned. As industrial development takes place, new sources of loan able funds are tapped and different mechanisms are used to mobilize them. There are two views with regard to the role of financial markets in the economic development.

According to the traditional view, the financial markets play a more or less a passive role in the economic development. It is "demand following" i.e. financial development through the creation of modern financial institutions and diversification of financial assets, as a consequence of development in the real economy. The other view put forward in recent years is that policy makers should move towards "supply lending" phenomenon in the sense of deliberately creating financial institutions, instruments and services in advance of demand. India has followed the supply lending approach and strengthens the financial system through deliberate steps like establishment of development banks, nationalization of commercial banks etc[1].

Along with the development of the financial system, the capital market in India has become very active, particularity in the recent years. Capital raised by companies in the private sector through the issues of shares and debentures has shown a sudden spurt in the 80s after remaining stagnant in the 70s.

Pattern of financing refers to the raising of resources from different sources and through different instruments. Each source and instrument has its own significance and influence on the functioning of the corporate sector. The main sources of finance are (I) internal (ii) external.

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1. N.A. Majumdar (1989)

To the extent that the financial requirement of a firm cannot fully be met by its internal sources, recourse to external sources becomes necessary. External funds can be raised from the household sector, public financial institutions or ROW (foreign sources). The household sector may provide capital to the private corporate sector either through direct flows in terms of shares/debentures and public deposits or through indirect flows in the form of bank deposits, LIC and units with UTI or in the form of trade credit. Of the modes of flow of funds from the household sector to the private corporate sector

The direct flow assumes relative importance as greater degree of discretion is exercised by the household sector in deciding to save through these instruments.

Recourse to the capital market helps the companies to be self-reliant. An active capital market with a wide variety of instruments would enable the corporate sector to raise funds on its own and also would serve augment the flow of savings in the economy in the financial forms. Share capital (equity) is known, as risk capital and an increase in its importance would mean that the flow of risk capital to industrial ventures is increasing. Equity capital plays a pivotal role in the initial formation and subsequent growth of the business entities in a free enterprise economy.

Debentures as a source of finance impose a definite liability on the company to pay fixed rate of interest and an increase in the reliance placed on the debenture by the companies would indicate that the solvency of the company is going down. Same is the case with public deposits also. Borrowings from public sector lending institutions have certain advantage in as much as thereby the investment projects are required to go through some rigorous scrutiny and satisfy certain criteria viability and social priority[1].

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1. Rangarajan Committee Report (1982) p-51.

It is worth mentioning here that there are no fixed norms on the optimum proportions between internal finance and external finance and between debt and equity. Such proportions depend on the type of industry, the phase of cycle in which the industry finds itself, local financing habits and the criteria applied by the banks and financial institutions to borrowings. Factors, such as, large growth in the number of industrial units and increase in industrial production have led to private corporate sector in India to mobilize a substantial amount of financial resources.

A detailed study of the financing of the corporate sector is needed to understand the trends in the mobilization of financial resources by the corporate sector, to comprehend the changing composition of different sources of funds and to bring out the economic significance of the changing composition. The present study is an attempt in that direction.

Objectives

1. To have an aggregate overview of the capital structure of Industrial Corporate sector (confined to large and medium sized public limited companies) and to identify trends overtime (growth, decline or stability of industrial sources of finance) or in industrial groups (both overtime and for individual sources) during the period of study.

2. To discover whether the pattern of finance for the corporate sector has changed overtime and whether there are ostensible shifts in favour of one/more sources and against others. More particularly, the efforts shall be directed to assess the changing positions of internal sources and external sources.

3. To identify the factors those have induced shifts in corporate financing patterns over the period.

4. To study the behavior of retained profits and borrowings by the Private Corporate Sector.

5. To study the impact of aggregate macro variables and interest structure on the aggregate corporate financing behavior.

6. To study the recent changes and developments in the corporate sector in the new reformed economy.

The Data

The source of data has been Reserve Bank of India- Monthly Bulletins; various issues. Since the source of data remains the same, the results are expected to be uniform. This study covers the non-government non-financial public limited companies and hence, largely reflect the private corporate sector engaged in the manufacturing activity. The government companies, as defined in section 617 of the Companies Act, 1956, banking, insurance and other financial and investment companies, companies and associations not functioning for profit, and companies limited by the guarantee have not been taken in the study. The coverage of the study is comprehensive both in terms of number of units and industries studied, representing the prevailing composition of the corporate sector, and hence, the pattern based on the sample would be representative of the entire medium and large public limited company sector.

According to the RBI, 'criterion for selection of the company for different studies is their amount of paid-up-capital. The main objective is to have maximum coverage and to include as many representative units as possible of all industries'.

The data derived from the RBI bulletins have been converted into percentage form to make the comparison overtime valid as it would have been difficult to ascertain the trends if the data for different periods was in absolute amounts. Moreover the pattern of financing in these companies show the various sources from where the funds are secured, i.e. either external or internal. This classification is again based on the RBI classification as presented in the studies of Finances of Public Limited Companies.

The financial data on sample companies are reported by RBI in the form of (i) statement on combined balance sheet of assets and liabilities (ii) statement of sources and uses of funds (iii) statement on combined income, value of production, expenditure and appropriation accounts. The balance sheet presents various components of assets and liabilities as at a point of time. The increases/decreases in the various items of assets and liabilities during the year represent the uses and the sources of funds under the respective heads and as such this statement is completed from the combined balance sheet of the two consecutive years, with certain adjustment due to revaluation of foreign currency. The statement of sources and uses of funds intended to show the accretion of total funds of the companies and the assets in which these funds are invested during the year. The statement of income and expenditure presents the combined income, value of production, expenditure and appropriation. These give in summary form the financial transactions of the companies during the year. The analysis of trends and pattern of financing are mostly based on the statement of sources and uses of funds.

Apart from the RBI monthly bulletins, which constitute the core source of data for this study, various other RBI publications like Report on Currency and Finance, National Accounts Statistics, Banking Statistics, Handbook of Statistics on Indian Economy etc. have also been consulted from time to time.

Limitations:

1. The statement on basic data presents viz. profit and loss account, balance sheets and sources and uses of funds, show only the combined position, and not the consolidated position, for the group of companies for which the data are presented as inter-corporate transaction are not adjusted while combining the data.
2. Some of the results in the study also include estimated figures. The estimates had to be made because of the non-availability of particulars of some items in the profit and loss account, balance sheet, revaluation of fixed assets, inventories and investment etc. These gaps have been filled up with estimated figures computed on the basis of the proportions revealed by the corresponding figures pertaining to other units in the same industry.
3. The classification of companies engaged in more than one type of businesses, is based on their predominant activity, which has been determined on the basis of supplementary formation obtained from the companies on the relative importance of the work of different departments. In spite of the main activity criterion the industry group as a whole is bound to include many subsidiary activities. Moreover, if the products of one department in such companies are used as inputs in other departments, the inter-departmental transfers have been ignored in the processing of statements.
4. RBI company finance studies are not based on random sample method, rather it is a selective sample. However, this drawback might to some extent be compensated by its large coverage.

The above limitations would not, however, materially affect the trend analysis in terms of financial ratios.

Methodology

The study covers the time period of 1984-85 to 1997-98. The broad trends and patterns of financing of the private corporate sector is done through ratio analysis. The statement on sources of funds have been used for this purpose. The percentage ratio of different components of sources to total sources has been worked out for the entire period. For the sake of illustration, the ratios have been worked out for the periods 1984-85 to 1990-91 and 1991-92 to 1997-98. The ratios have also been worked out for individual industries i.e. tea plantations, sugar, tobacco, cotton textiles, engineering, chemicals, cement, rubber and rubber products, paper and paper products, electricity and construction.

Plan of Study

This study is divided into **six** chapters. The chapter wise details are presented here. Chapter I is the introduction, which summarizes the various sectors in the economy along with the importance of the private corporate sector. It also gives an insight to the several views held for the pattern of financing of this sector and the various sources of finance, which make the funds available. Further, the objectives of this study are also listed in this chapter. Thereafter the source of data is mentioned and the limitations of the data are also listed, which is followed by the methodology. In the end a chapter wise details are discussed in the plan of study.

Chapter II gives a brief literature review with respect to the capital structure in the private corporate sector . After the literature review, is the summary of a few empirical studies conducted in India in the same field. In this the work of other authors is reviewed along with the conclusions drawn by them.

Chapter III is based on the analysis of the study conducted. The analysis gives us the various trends and patterns of financing. An aggregated analysis for the whole economy was conducted. For this firstly the flow of funds account of the country were studied and analyzed. Later on the RBI company finance data was analyzed. In this chapter we study in details the various sources of funds and the extent to which they meet the requirements of the private corporate sector in India. Moreover, this chapter also analyses the various ways in which the funds are used up by the private corporate sector.

Chapter IV is based on the analysis of the financing pattern in different industries. It talks about the trends and patterns of financing in the different industries with respect to the different sources of funds. In the second section of this chapter, an attempt is made to study the impact of some macro economic variable on the financing pattern of the private corporate sector. In this section, the structure of interest rates is also analyzed which plays a very significant role in choosing from an array of securities and claims.

Chapter V talks about some recent developments that has taken place in this field. It also mentions some recent reforms and the changes made and the impact of these changes on the corporate investment, the change in the capital structure and the capital market.

Chapter VI is the summary of the findings and the conclusions drawn thereafter.

CHAPTER II

LITERATURE REVIEW

Corporate Capital Structure

The composition of the long-term sources of financing is called its capital structure. The capital structure decision involves choosing whether and how much debt to be used to finance the operations of a company.

According to Gerestenberg, "capital structure of a company refers to the composition of its capitalization and it includes all long term capital sources viz., loans, reserves, shares and bonds."

According to Schwarty, "the capital structure of a business can be measured by the ratios of various kinds of permanent loan and equity capital to total capital."

1. Retained Earnings: It is the most important source of internal financing. It also represents reserves and surpluses in a company. The retained earnings are the part of the surplus profits set aside by the company for its financial requirements. It is also known as ploughing back of profits. Generally, the entire portions of the profits are not distributed to equity shareholders. A certain percentage of profits are reserved and will be utilized for investment purposes in the later stages. Hence, it is also known as internally generated source of funds. 'The surplus of a company represents the excess of assets over the sum total of all outside liabilities and capital stock[1].

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1. E. F. Donaldson (1959) p 584 'Corporate Finance'.

Dobrovolsky tried to establish in the framework of Ordinary Least Square Regression that retained profit varied directly with current net income (profit after tax) and inversely with preceding year's net income and surplus. However, he subsequently established that retained profit/earnings depends upon three variables viz. current net income, dividend in the preceding year and operating asset expansion[2].

2. Borrowings: Short-term borrowings offer the benefit of reduced cost due to reduction of idle capital. The use of long-term borrowing has also the necessity on many ground. Long-term borrowings are less risky that short-term borrowings and the firm would not have to meet the cash obligations of and on.

3. Equity Capital: It can either be raised by equity shares or preference shares. Equity share is an instrument issued by the company to mobilize capital. These are issued in the primary market or new market by the companies. It represents owner's capital of a company. Company need not assure the equity shares about the dividend at the time of issue. In case, company incurs loss, these will not be any obligation on the part of the management to declare dividend. Therefore, the holders of these shares are always called the real owners of the company. The repayment of this capital arises only after the repayment of capital on the preference shareholders. These shareholders shall have special powers of voting and can become a director of a company. It is a permanent source of long-term finance to the company.

   Preference shares are generally issued to meet the medium term requirement of finance of a business unit. Preference shares will have two types of special preference over the equity shares. They are, the holders of these shares will get first preference in getting the dividend and in withdrawing the capital from the company. The percentage of dividend will be decided at the time of issue of these shares in the primary market and therefore these instruments are called the preference shares.

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1. S. P. Dobrovolsky (1951)

It also has its role to play in the financing of working capital in the Indian Corporate Sector. At the initial stage of a firm, fixed assets as well as current assets have to be financed by this equity capital, since other sources may not be easily available at that time. Subsequently, when the firms get momentum, several lenders may stretch their hands for advancing loan, but the importance of equity capital does not end all together. On the ground of stability and security, each firm is to maintain "equity-cushion".

Another way in which finance can be raised from the capital market can be by issue of debentures. They are bonds, secured by general credit of the firm, with a maturity greater than 15 years. Debentures are an acknowledgement of debt, carrying a fixed rate of interest for a specific time period. The holders of these instruments are generally called the creditor of the company.

The major distinction between equity and debt can be; debt claim entitles the holder to a contracted set of cash flows (usually interest and principal payments), whereas equity claim entitles the holder to any residual cash flows left over after meeting all other promised claims. Moreover, debt has a prior claim both on cash flows on a period-to-period basis, (for interest and principal payments), and on the assets of the firm, (in case of liquidation). The tax laws have generally treated interest expenses, which accrue to debt holders, very differently and often much more advantageously than dividends on other cash flows that accrue to equity.

Debt-Equity Mix: the decision to utilize whether one type or the other of external financing is determined by a variety of factors viz – expectations of future profits and future dividend payments, interest rates on loans, investor preference, reluctance to incur fixed indebtedness and the cost of floating different types of securities.

In the theory of corporate finance, the issue related to debt Vs equity finance in the capital structure of a firm has received a good deal of attention. The interest in this area was stimulated by the path breaking paper of Modigliani and Miler[1]. They presented a logically consistent proof that, in a perfect capital market, in absence of risk (arising out of the possibility of the firms going bankrupt) and of no corporate taxes, the firms were indifferent between equity and debt in their capital structure. The controversy was heightened by the fact that under the assumption that the corporate tax rate is positive and that interest payments are deductible from taxable income, the Modigliani – Miller analysis implies that an optimal capital structure consists entirely of debt. However an infinite debt-equity ratio is inconsistent with both common sense and established practice. Indeed even Modigliani – Miller did not advocate the exclusion of equity financing and argued that a number of considerations external to their model render such a policy unsuitable.

Miller's famous paper on " Debt and Taxes" cut us loose from the extreme implications of the original Modigliani – Miller Theory, which made internal taxes shield so valuable that we could not explain why all firms were not awash in debt[2]. Miller described an equilibrium of aggregate supply and aggregate demand for corporate debt, in which personal income taxes paid by the marginal investor in corporate debt just offsets the corporate savings. However, since the equilibrium only determines the aggregate, debt policy should not matter for any simple tax-paying firm. This explanation works only if we assume that all firms face approximately the same marginal tax rate, which is very restrictive assumption.

In the correlation to the Modigliani – Miller Theory, any tax paying corporation gains by borrowings; the greater the marginal tax rate, the greater the gain. In Miller Theory, the personal income taxes on interest payments would exactly offset the corporate interest tax shield, provided that the firm pays the full statutory tax rate. However any firm paying the lower rate would see a net loss to corporate borrowing and a net gain to lending.

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1. F. M. Modigliani and M.H. Miller (1958) pp 261-297.
2. M. H. Miller (1977) pp 261-297.

According to the static trade – off hypothesis, a firm's optimal debt ratio is usually viewed as determined by a trade-off of the costs and benefits of borrowings, holding the firm's assets and investment plan constant[1].

The firm is portrayed as balancing the value of internal tax shields against various costs of bankruptcy or financial embarrassment, of course, there is controversy about how valuable the tax shield are, in which if any, of the costs financial embarrassment are material, but these disagreements give only variations on a theme. The firm is supposed to substitute debt, until the value of the firm is maximized.

According to the Pecking Order Theory, the debt is preferred to equity as it is less risky[2]. Of course, debt should be default risk-free. As the amount of debt increases the costs of financial distress i.e. legal and administration costs and agency costs increase.

4. Bank Credit: It has been working since long as a major source of finance in India and abroad. In 1970s the use of bank credit in Indian corporate sector became so excessive that the desired correlation between bank credit and the holding of inventory and book debts was hampered in most cases. Hence attempt was initiated to bring in a check on the use of bank credit and several study groups (Dehejia Study Group, Tandon Study Group) were set to find out a way in this regard. All the study groups gave recommendation in favour of providing a 'restraint' on the use of bank credit. Moreover the importance is declining because of the upcoming of the other financial institutions.

5. Public Deposit: Public deposits are raised by the company from general public as a means of borrowings assuring them a fixed percentage of interest for a specific period of time. Public deposits are highly flexible which can be raised without complex procedures. It serves as a finance for medium term requirement and permits the management to exploit the debt-equity ratio in the capital market. This source emerged in India in 1930s. In 1950s there became a downfall in use of it. This source emerged in India in 1930s. In 1950s there became a downfall in use of it. In 1970s it again came into prominence.

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1. S.C. Myers (1977) p 577.
2. S.C. Myers (1984) p577-581.

6. Trade Credit: It refers to the credit extended by the supplier of raw materials. At present all the business houses are expected to operate their selling activities competitively. This forced the corporate to extend credit facility to sell their products and to increase their market share. It is in this context, credit offered by the suppliers to the business houses is called trade credit. Trade credit is a popular source of free credit to buying company for a period of 30, 60, or 90 days. It is considered to be formality–free, security-free and interest-free source of finance. Due to the above advantage, trade credit has been practically a common source of working capital to almost all enterprises; not withstanding the fact that there is some implicit cost associated with trade credit and the explicit cost is also originated when cash discount offer is foregone.

7. External Financing: There is a limit to internal financing and therefore it is important to resort to the external finance.

Myers throws some light on this aspect in his famous article
"The Capital Structure Puzzle [1] ". He speaks of a "Pecking Order Theory" according to which the firms financing follow an order or sequence of sources as below.

I. Firms prefer internal finance.
II. They adapt their target dividend payout ratios to their investment opportunities, although dividends are sticky and target payout ratios are only gradually adjusted to shifts in the extent of valuable investment opportunities.
III. Sticky dividend policies plus unpredictable fluctuations in profitability and investment opportunities, mean that internally-generated cash flows may be more or less than investment outlays. If it is less; then the firm first draws down its cash balance or marketable securities portfolio.
IV. If external finance is required firms issue the safest security first. That is, they start with debt, then possibly hybrid securities such as convertible bonds, then perhaps equity as the last resort.

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1. S.C. Myers (1984) p 581.

Fazzari[1] and others described the Pecking Order Theory in terms of financing hierarchy. They presumed that the cost of capital differs by sources of funds, cost of internal funds (retained profit) being the lowest followed by the new debt financing and new equity financing. They ascribed the difference in cost between internal and external sources of funds to transaction costs, tax advantages, agency problem, cost of financial distress and asymmetric information.

According to Dobrovolsky[2], both large and small corporations showed a tendency to increase the use of external as well as internal funds, with increase in the rate at which their assets expanded. At low asset expansion rates income retention provided, in general, a sufficient amount of funds or even more than what was necessary to meet a company's investment requirements. At higher asset expansion rates, external finance was resorted to and the relative importance of external funds rose continuously, as the rate of expansion increased.

According to Kuh[3], the internal investment policies of the firm permit a limited rate of growth which can only be exceeded by the resort to external funds* When the profits foregone become so large 'that it hurts', business will overcome their reluctance to borrow or acquire additional common stock. According to him the enterprise resorting to external funds can react more rapidly to a given discrepancy between actual and desired capital stock than the firm which deliberately restricts itself to internal funds only.

Dhrymes and Kurz[4] have explained the behavior of external finance as residually determined through the budgetary requirements that investment expenditure must equal retained earnings plus depreciation allowances plus external finance*. Thus external finance would depend upon investment and dividend.

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1) S. M. Fazzari et al (1980) pp 148-157.
2) S. P. Dobrovolsky (1951) pp 4-6.
3) E Kuh (1971) pp 27 and 38.
4) Dhrymes and M. Kurz (1967) p 429.

The financial environment in India has changed enormously in the recent years which has also brought about considerable changes in the capital market. The industrial enterprises mobilize funds through sale of equity shares, preference shares, debentures, acceptance of deposits, loan from various financial institutions and ploughing back of profits. Financial experts advocate for greater reliance on debt for trading on equity, on account of financial leverage benefits, as a result, there is generally greater use of debt capital than equity capital by industrial enterprises. A significant proportion of total debt capital is raised through issuing debentures both convertible as well as non-convertible. Debentures especially those carrying conversion covenants have become more popular form of industrial security with the investors, both institutional as well as individual. The convertible debenture holders have advantage of the certainty of income, the priority of claim as to income and assets and the opportunity of sharing in the profits as the company prospers.

Review of Empirical Studies in India

The first important study on Financing of the Private Corporate Sector was done by A. K. Bagchi. The study was based on the RBI company finance data and covered the period 1950-60. Analyzing the pattern of financing, he concluded that the supply of finance from external sources did not appear to have reduced gross fixed investment seriously; when profit failed to expand as much as gross investment, external sources made up for the shortfall in internal savings. He further concluded that profit and internal savings were not an important limitation on the supply of finance; the major reason why past profits influenced gross investment was that it was taken by businessmen as an index of the future rate of profit. In connection with his size wise analysis, Bagchi spoke of a kinked supply curve for external finance; for a particular size-group of firms, the supply of finance remained constant at the rate of interest normally applicable to loans given to them, but only up to a certain limit; then the rate of interest charged increased steeply. With the rise in the size of firms (in terms of paid-up-capital) the supply curve of external finance shifted downwards and the kink moved rightwards. He visualizes the kink as a recurrent deterrent to investment for the smaller firms but not for the bigger ones. Rosen in his earlier study had pointed out that the larger firms could mobilize funds from banks, deposits from public or through debenture/stock issues where as these alternatives were far less open to smaller firms[1].

In the sphere of enterprise finance, the two studies by Krishnamurthy and Sastry[2] are pioneering. They for the first time discussed the issue of investment and financing in a detailed manner. The first study was a cross-section analysis of the behavior of the investment dividends and enterprise financing for chemical industries covering the period 1962-67. The behavior of net flow of debt was explained in terms of gross retained earnings, fixed and investment and lagged debt (stock) through OLS. Fixed investment expenditures significantly influenced the demand for external finance. The flow of internal savings was found to be inversely related to demand for external funds. The second study was more comprehensive, comprising of a cross-section part (based on a sample of finance related to seven industries) and a time series part (based on the RBI company finance data). Their objective was to establish a relationship between investment, dividend and external financing. They developed three equations for three variables and estimated the equations both through OLS and 2SLS. They reported that the result obtained by both the methods was very much similar. In the time-series section, the equation for external finance was estimated for seven industries i.e. cotton textile, jute, sugar, paper and paper board, chemicals, engineering and cement. The variables were current year's retained earnings, fixed investment, investment and outstanding debt of the previous year. The flow of external finance seemed to be influenced by both fixed investment and inventory. Fixed investment was larger in cotton textiles, engineering and cement, while the impact of inventory investment was relatively greater in chemicals. Inventory investment was alone important in jute and sugar, while fixed investment alone important in paper and paper board.

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1) G. Rosen (1962) pp 40 – 49 and A. K. Bagchi (1962) pp 153 – 177.
2) K. Krishnamurthy and D. V. Sastry (1971) and (1975)

Pandey[1] analyzed the effects of financial policy variables on growth of firms of six individual industries and came to the conclusion that the main source of financial growth in Indian industries was long term borrowings against the mortgage of fixed assets, unsecured loans and debentures were also used for financing growth. But source of finance was a dominant factor for positive growth of firms.

Divatia and Shankar[2] in their paper discussed the role of internal and external sources of funds and their components in financing capital formation of the private corporate sector. The study was based on the RBI company finance studies, relating to medium and large public and private limited companies and covered the period 1961-76. They also discussed the trends and patterns of financing four individual industries viz. cotton textiles, jute textiles, sugar and cement. The study was in a way, first of its kind, analyzing the pattern of finances over the period. But they offered no explanation on the changing pattern of finance.

Rao[3] in his article on " Structure of Corporate Finance" made a descriptive analysis of the changing pattern of financing of the private corporate sector through the 70s. He analyzed the pros and cons of different sources of funds and discussed some of the policy issues like the impact of corporate taxation, regulation of interest rates on debentures, convertibility clause with the financial institutions etc. It was emphasized that industrial expansion must rely on raising more capital from the market, particularly through equity and debenture.

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1) D. P. Pandey (1977
2) V. Divatia and K. Shankar (1979)
3) D. C. Rao. (1980)

M. Y. Khan[1] conducted study in the area of Indian securities market and the growth and changes therein after independence, the information for which was obtained from widely scattered original sources. Khan found that the whole financial system in India has come under the ownership and control of public authorities. Another significant development has been the emergence and participation of Financial Institutions in the management and control to which finance is provided. The rigorous exacting, detailed objective and impersonal appraisal by the development banks form an integral part of term lending which not only tones up the quality of projects but also ensures developmental uses of available resources. These banks, by providing funds for industrial development, sub serve the basic economic objectives of balanced regional development, growth of new entrepreneurs and small enterprises and development of indigenous industrial technology and thus contributes to the emergence of a diversified and egalitarian structure of industrial growth.

The magnitude of funds provided by the banks has been considerable. The underwriting of the corporate issues of capital by the development banks, however, is of limited magnitude. But, their participation in the system of underwriting lends prestige to issues and conveys an implicit guarantee to the investors regarding the soundness of issues. From the viewpoint of the type of assistance, they provide financial assistance to

(i) new projects

(ii) for expansion and diversification

(iii) for modernization and rationalization to meet over running cost.

The researcher also pointed out the need of developing an organic link between the distribution mechanism and ultimate pool of savings to the community, widening the range of eligible securities for pension and provident and other trust funds, reviewing the present regulations governing investment of LIC funds, and growing the unit trusts and investment companies.

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1. M.Y. Khan (1980) : Indian Financial System; Theory and Practice.

Braj Kishor[1] in his book, 'Corporate Capitalization in India', analyzed the trends and patterns of financing in the private corporate sector over the period 1951 – 74. He used the RBI Company Finance data and analyzed the patterns of financing of the broad growth industries, i.e., agriculture and allied activities, mining and quarrying, processing and manufacturing (3 categories) and 'others' as well as the aggregate corporate sector. He analyzed the trends of financing through different plan periods. However the study suffers from two limitations. The blocking of data of different sample series of the RBI so as to make plan-wise analysis of pattern of financing is questionable, because of changing size of the sample. Similarly the analysis of financing for the broad categories of industrial groups would not indicate to any industry-specific financing pattern.

The study on "Resource Mobilization in the Private Corporate Sector", by Lall, Madhur and Atri[2] under the auspices of NIPFP is unique in nature. They not only used the RBI company finance studies relating to medium and large public limited companies but also compiled a sample data of 99 large public limited companies covering the period 1961-76. The analysis of there sample was made for five industry groups viz. , chemicals, engineering, textiles, food products and miscellaneous industries. They traced the trends and patterns of financing of the private corporate sector and offered an economic interpretation of the changes in the structure pattern of resource mobilization. The study covered the period 1961-76, but the trends in resource mobilization upto 1978-79 was discussed in the later section. Use of regression analysis (OLS) for a small number of observations (15 years) is the lucuna of the study.

Their findings can be summarized as follows:

1. The size-wise analysis indicated that the proportion of the corporate savings in gross resource mobilized was much higher in case of larger companies.

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1) Braj Kishor (1981).

2) Vinay D. Lall, S.Madhur and K.C.Atri (1982)

2. Age-wise analysis indicated that the new companies mobilized a larger proportion of their resources in the nature of long-term funds than the older companies. Depreciation was a relatively more important component for the older companies. Development rebate was a more important consideration for the newer companies.
3. Companies with higher rate of growth of gross fixed assets mobilized a higher proportion of the gross resources in the form of long-term funds mostly constituting institutional finance.
4. Companies with lower effective tax liability had a larger internal plough back and were, therefore, less dependent on external funds.
5. During the recessionary periods, corporate savings became less important and mobilization of resources from the stock market was also reduced. During the period of rising prices, the proportion of corporate savings in gross resources seemed to increase.
6. Contrary to the common notion, location of the industry did not influence the pattern of financing.
7. The econometric exercise to identify the factors for the corporate capital structure (ratio of debt to equity finance) indicated that monetary policy variables, such as the cost and availability of credit had no impact. However, corporate tax rate had a positive impact on debt finance. Equity finance seemed to be influenced by growth of industrial production.
8. The econometric exercise relating to ratio retention to fresh issues pointed out that increase in personal income tax tended to raise the ratio. Whereas increase in yield on ordinary shares tended to decrease it.

Uma Datta Roy Choudhary[1] in her paper 'Finances of the private corporate sector: 1955-56 to 1986-87' focuses on non-government non-financial public and private joint stock companies. In her attempt she, first obtained the aggregate estimates from the balance sheets and income and outlay accounts. Separately for the public, private and all non-government non-financial joint stock companies and then studied the trends and inter-relation between them such as profitability ratio, return to capital, availability of

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1. Uma Datta Roy Choudhary (1992)

domestic resources, dependency on borrowings, rate of savings, rate of fixed capital formation, levels and rates of depreciation, etc. The present value of capital as a sum of cash flow as expected over future years using the Discounted Cash Flow Method (DCFM) was also estimated. Finally, comparison of these estimates with those available from NAS, was made and the contribution of the private non-financial corporate sector to total gross/net domestic product was determined.

In this attempt of hers, she first adjusted the sample results in order to obtain the aggregate estimates. The adjustment for sample data is through a factor which measures the difference in the sample results. The obtained sample results had the advantage of being comparable over time having adjusted for gradual increase in sample size and having made full use of data for common years.

B. M. Patel[1] in his research paper 'Corporate Financial Objectives: Some empirical Findings', stressed on the various financial objectives aimed by the corporate sector. He says that, the financial theory recognizes one and only one financial objective, i.e. maximization of shareholders wealth. In other words, shareholders wealth maximization is the only accepted theoretical corporate financial objective. Shareholders wealth is maximized if the present value of future dividend flows is maximized.

B. M. Patel in his attempt to find out the validity of this sole objective, found out in the empirical study conducted by him, that most of the companies follow profitability related financial objective statements, like rate of interest and earning per share and also aggregate earnings. Shareholders wealth maximization is hardly followed by any company. Absolute profit or aggregate earnings was accepted as financial objective by low growth companies and also by return on capital employed companies. Companies in upper quartile of growth were concentrating on rate of interest and companies in the upper quartile of return on capital employed companies were following earning per share as their financial objective.

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1. B. M. Patel (1996)

Rakesh Basant[1] in his research paper 'Corporate Response to Economic Reforms', analyzed the corporate strategies in the post –1991 era and further made a study of the corporate decision making processes. According to him, recent economic liberalization in India has significantly changed the policy environment and has forced domestic firms to review their strategies. The success of new policy regime may well depend on the strategies adopted by these firms and the fine-tuning of policies that impinge on firm level choices.

He divided his paper into four parts. The key aspects of economic reforms and their implications for the Indian corporate sector are summarized in the first section. Corporate strategies followed by Indian firms in the 1990s are analyzed in section ii. Strategies involving corporate restructuring, alliances, technology development, manufacturing and other aspects of non-price competition are discussed here. Section III analyses the impact of policy and corporate strategies on profitability, exports, import dependence, etc. The paper concludes with a summary of major trends in corporate strategies in recent years and their implications for policy.

However, he said that, it is premature to draw any firm conclusions on the basis of the analytical description attempted in his paper, yet he concluded that:
The Indian corporate sector is vigorously restructuring itself to retain competitiveness. Restructuring is mainly geared towards consolidation in a few chosen areas to correct the inefficiencies created by over diversification in the pre-reform era.
The reliance of the Indian Corporate sector on foreign technology purchase has increased. More and more technology flows are now tied with equity. Purchase of technology is taking precedence over R & D; in-house technology generation has taken a backseat.

Firms are making efforts to improve manufacturing capability. This being done through building alliances as well as through initiatives within the firm. Quality upgradation seems to be their key priority.

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1. Rakesh Basant (2001)

Product differentiation strategy seems to be dominating over strategies of building distribution and marketing related complementary assets. Such a strategy along with inadequate attention to R & D and manufacturing may reduce competitiveness of the Indian Corporate sector apart from curtailing their bargaining power vis-à-vis MNCs.

Export based growth strategies are being adopted by some corporate sector firms but such strategies are not widespread; export orientation increased appreciably in the early years to reform but has seen a major collapse since 1997-98. Overall, exposure to the international market is still inadequate to put the Indian firms on higher Growth and learning trajectories.

CHAPTER III

TRENDS AND PATTERN OF FINANCING – AN AGGREGATE ANALYSIS

This chapter analyses the trends and patterns of financing of private corporate sector in India at the aggregate level over the period 1984-85 to 1997-98. For the same, first, the flow of funds accounts of the country is examined and then a detailed analysis of the Reserve Bank of India company finance data is done.

Flow of Funds Accounts

Financial Deficit

On studying the flow of funds account of India, financial position of various sectors is observed. Table 3.1 clearly indicates that household sector was the major surplus sector and continued to be the same over the entire period of study. At the same time, rest of the world, banking institutions and other financial institutions were also showing surplus during both the periods of study. Household being the largest surplus sector, during both the periods of study showed a surplus of 15.11 percent of GDP in the period 1984-85 to 1990-91, and its share further increased to 33.45 percent of the GDP during the period 1991-92 to 1997-98. Banking and other financial institutions have also been a surplus sector showing a small surplus of 1.25 and 1.23 percent of the GDP, respectively, during the period 1984-85 to 1990-91.Their respective share increased to 4.08 and 5.25 percent of the GDP during the period 1991-92 to 1997-98. The largest deficit sector was the government sector and it still continues to be the same, where the deficit was 17.53 percent of the GDP during the period 1984-85 to 1990-91, it further increased to 28.1 percent of the GDP in 1991-92 to 1997-98. Another sector which has been the deficit sector over the entire period of study is the private corporate sector. Its deficit increased from 4.14 percent of the GDP during the period 1984-85 to 1990-91 to 16.69 percent of the GDP during the period 1991-92 to 1997-98.

Table 3.1

Financial Balances in the Flow of Funds Accounts of India

(Financial Surplus/Deficit)

(Rs. in crores)

	Items	1984-85 to 1990-91	1991-92 to 1997-98
1.	Banking	16805 (1.25)	52745 (4.08)
2.	Other Financial Institutions	16645 (1.23)	67891 (5.25)
3.	Private Corporate Business	-55630 (-4.14)	-215662 (-16.69)
4.	Government	-235451 (-17.53)	-362929 (-28.10)
5.	Rest of the World	57802 (4.30)	41774 (3.23)
6.	Households	202975 (15.11)	432076 (33.45)
7.	Sectors not elsewhere classified	-9643 (-0.71)	-372114 (-28.81)

+ = Surplus ; - = Deficit

The figures are the net figures, i.e., uses (lending's) minus sources (borrowings)

Figures in brackets represent financial surplus or deficit as a percentage of GDP at MP (old series data).

Source : RBI Monthly Bulletins and Report on Currency and Finance,
Reserve Bank of India, Bombay.

Sources of Financing

On analyzing the financial balances of the flow of funds accounts of India, we see that the private corporate sector has been a deficit sector by and large. Now, we will see how this deficit if financed by the other sectors and various instruments. Table 3.2 (a) shows the amount of financial sources and financial uses of funds of the private corporate sector during the periods 1984-85 to 1990-91 and 1991-92 to 1997-98. The private sector has been falling short of Rs 55630 cores during the period 1984-85 to 1990-91 and Rs 215662 corers during the period 1991-92 to 1997-98. We can study the financing of this deficit from two channels. Firstly, it can be financed through various instruments, such as loan and advances, securities, trade credit etc. Secondly, it can be financed through the other sectors such as government, household, banking and others.

Table 3.2 (b) and 3.2 (c) show the financing of the deficit of the private corporate sector through a variety of instruments and from the different sectors respectively. When we study the various instruments, which are used to finance the capital requirements of the private corporate sector in India, we observe that the largest share is raised through loans and advances, then followed by the securities. Loans and advances have always been regarded as the easiest way of acquiring finance in times of financial problems. At the same time, with the emergence of the developed capital market in India, finance can be raised by the issue of securities in the primary and the secondary market. Other unclassified instruments have also been an important source.

Financing Instruments

Table 3.2 (b) makes the picture very clear. This table shows that the largest deficit financing in the private corporate sector is done by raising loans and other advances. This has been the major source during the entire period of study, even though its share in the total deficit financing declined in the second period. Loans and advances financed 61.03 percent of the total deficit during the period 1984-85 to 1990-91 and their share declined to 56.69 percent during the period 1991-92 to 1997-98. The second major source of financing deficit are the securities. Their contribution to the financing of the deficit increase from 28.71 percent of the total during the period 1984-85 to 1990-91 to 40.76 percent of the total during the period 1991-92 to 1997-98. Trade credit was able to provide finance to the private corporate sector during the first period of study but during the second period of study it was the net user of funds of the private corporate sector. It financed 3.44 percent of the total deficit during the period 1984-85 to 1990-91, which declined to -2.95 percent during the period 1991-92 to 1997-98. The table further shows that the share of currency and deposits have declined from -7.75 percent in 1984-91 to -3.22 percent in 1991-98. This indicates that currency and deposits are not able to provide the finance to the private corporate sector, but rather, they are using up the resources. A further decline in their share can be explained by the present recession in the economy. Thus we see that loans and advances and securities are the major instruments of financing the deficit of the private corporate sector.

Table 3.2(a)

Financing of Private Corporate Business

(Flow of Funds Accounts of India)

(Rs. in crores)

	Items	1984-85 to 1990-91	1991-92 to 1997-98
1.	Financial sources	84563	360957
2.	Financial Uses	28933	145295
3.	Financial Balance (1 – 2)	55638	215662

Table 3.2(b)

Financing of Deficit by Instruments

(Rs. in crores)

	Instruments	1984-85 to 1990-91	1991-92 to 1997-98
1.	Currency and deposits	-4315 (-7.75)	-28513 (-13.22)
2.	Securities	15973 (28.71)	87912 (40.76)
3.	Loans and Advances	33956 (61.03)	122271 (56.69)
4.	Trade Credit	1915 (3.44)	-6380 (-2.95)
5.	Unclassified	8348 (15.00)	40369 (18.72)
6.	Total Deficit	55630 (100.00)	215662 (100.00)

Table 3.2 (c)

Financing of Deficit by Sectors

(Rs. in crores)

	Sectors	1984-85 to 1990-91	1991-92 to 1997-98
1.	Banking	21128 (37.98)	62067 (28.79)
2.	Other Financial Institutions	28812 (51.79)	111951 (51.92)
3.	Government	-234 (-0.40)	-2395 (-1.11)
4.	Rest of the World	2188 (3.93)	11001 (5.10)
5.	Household	8845 (15.90)	25460 (11.80)
6.	Unidentified	-5109 (-9.18)	7568 (3.50)
7.	Total Deficit	55630 (100.00)	215662 (100.00)

Figures in Brackets represent the percentages to total.

Source: Same as table 3.1

Table 3.2 shows financing of the deficit of the private corporate sector by the other sectors such as the financial institutions, household, rest of the world etc. The largest source of financing the deficit were the other financial institutions including UTI, Mutual Funds etc, followed by the banks and the household sector. Other financial institutions have been the largest provider of funds during the entire period of study. They financed 51.79 percent of the total deficit during the period 1984-85 to 1990-91 and it increased by a small amount to 51.92 percent of the total deficit during the period 1991-92 to 1997-98. This shows that the non banking financial institutions have always been playing a very significant role in the Indian economy, as far as, provision of funds is concerned. These institutions have grown in importance in the last two decades and have been catering to the needs of the private corporate sector. Moreover, their flexible lending policies have also been a major factor in attracting private corporate business houses to raise funds from them. The other major source of providing finance are the banks. The banking sector has financed 37.98 percent of the total deficit during the period 1984-85 to 1990-91 and 28.79 percent of the total deficit during the period 1991-92 to 1997-98. The share of the banking sector has declined during the second period of study. The household sector was able to finance 15.90 percent of the total deficit during the period 1984-85 to 1990-91 and was able to finance only 11.80 percent of the total deficit during the period 1991-92 to 1997-98. This can be because of reduction in the level of household savings during the second period of study. The contribution of the rest of the world sector in financing of the deficit was 3.93 percent of the total deficit during the period 1984-85 to 1990-91, which increased to 5.10 percent of the total deficit during the period 1991-92 to 1997-98. This was primarily due to the reforms undertaken in 1991. The globalization of the economy opened the doors of the economy for the rest of the world.

The above analysis of flow of funds points out that the internal generation of funds in the private corporate sector has not been adequate enough to finance its activities. Therefore, it has had to rely increasingly upon external sources. Non banking financial institutions and the banking sector have been providing funds to the private corporate sector through loans and advances. Another way in which the private corporate sector is raising funds is through securities in the capital market.

Thus the analysis of the flow of funds accounts has provided us with a rough sketch of the pattern of financing of the private corporate sector in India. However, the use of financial flow accounts has a serious limitation; non-availability of requisite data in the required form does not permit sufficiently detailed breakdown of borrowings and lending operations of all significant sectors. For a detailed analysis, therefore we use the RBI company Finance studies.

RBI Company Finance Data

The flow of funds from internal as well as external sources during the years 1984-85 to 1997-98, relating to medium and large public limited companies, covered by RBI company finance studies are presented in Table 3.3.

We make use of the statement of sources and uses of funds to study the trends and pattern of financing in the private corporate sector. First we analyze the various sources of funds, where the sources have been broadly classified into internal and external sources. Internal sources includes the paid-up-capital, reserves and surpluses and provisions for depreciation and taxation. External sources comprises of net issues (indicates the proportion of capital in the form of equity), borrowings from various sources such as banks, financial institutions, and other sources (includes the capital raised in the capital market by the issue of debentures) and trade dues and other current liabilities.

<u>**Table 3.3**</u>

Sources of Funds for Medium and Large Public Limited Companies.

(Percentage to total sources)

SOURCES OF FUNDS	1984-85 TO 1990-91	1991-92 TO 1997-98
I. Internal Sources	**41.26**	**46.93**
i. Paid up capital	2.08	2.02
ii. Reserves and Surpluses	15.33	21.6
a. Investment allowance Reserve	1.28	-1.26
b. Others	14.05	21.86
iii. Provisions	23.83	23.31
a. Depreciation	24.13	23.41
b. Taxation	-0.30	-0.10
II. External Sources	**58.74**	**53.07**
iv. Net issues	2.95	5.13
v. Total Borrowings	35.54	30.79
a. From Banks	12.51	9.35
b. From Financial Institutions	9.89	12.28
c. From others	13.14	9.16
vi. Trade dues and other current liabilities	20.25	17.15
a. Sundry creditors	13.46	14.62
b. Others	6.79	2.53
III. Total	100.00	100.00

Source : RBI Monthly Bulletins, Various Issues.

Flow of Funds from Internal Sources

When the statement of sources of funds was studied, it was seen that there is an increase in the proportion of internal funds used during the period 1991-92 to 1997-98 as compared to the period 1984-85 to 1991-92.

The level up to which the internal funds were used in the period 1984-85 to 1991-92 was 41.23 percent and it increased to 46.93 percent in the period 1991-92 to 1997-98. In the internal fund, even though the paid-up-capital and provisions did not show any increase (infact there was a decline in these two components in the second time period), the share of reserves and surpluses increased significantly. An important item included under other reserves is 'retained profits' which constitutes the net savings of the corporate sector. It is difficult to separate out the exact amount of profit retention from the sources and uses of funds. There was an increase from 15.33 percent during the period 1984-85 to 1991-92 to 21.6 percent in the period 1991-92 to 1997-98. This indicates that more and more of retained profits were channelized by the corporate sector during the second period of study.

Studying the internal sources again we see that provisions maintained for depreciation are also important sources of funds. Provisions made for taxation are not used by the private corporate sector but the provision made for depreciation is used for maintaining the capital stock.

Under the head provisions, depreciation provision accounted for the bulk of total funds and the share of others like taxation provision (net of advance income tax), other current and non current provisions were negligible during the entire period of study. The share of depreciation was declined despite an increase in the internal sources, during the period 1991-92 to 1997-98 as compared to the period 1984-85 to 1990-91. the question arises as to why has the share of depreciation in total sources of funds declined ? As such, depreciation is a statutory deduction allowable under the Income Tax Act for the purpose of replacement of worn out machinery and equipments. A look at the data on the uses of funds on plant and machinery in Table 3.4 would indicate that depreciation provision as the percent of expenditure on plant and machinery also followed the same trend as that of the share of depreciation in the total sources of funds. Depreciation provision declined from 24.13 percent of total sources during the period 1984-85 to 1990-91 to 23.41 percent of total sources during the period 1991-92 to 1997-98. The percentage of depreciation provision to the expenditure on plant and machinery was 63.65 percent during the period 1984-85 to 1990-91 and it declined to 38.33 percent during the period 1991-92 to 1997-98. This indicates that during the second period of study, depreciation provision has not been a major source of funds in the private corporate sector and neither has it been contributing enough in the capital formation of the same. This could either be due to conventional practice of allowing depreciation at historical costs or, the newly installed machinery of advanced technology might be subject to less wear and tear.

Table 3.4

Depreciation as a Source of Funds.

Period	Depreciation Provision	Total Internal Sources	Expenditure on Plant and Machinery	Col. (2) as a percent of Col. (3)	Col. (2) as a percent of Col. (4)
(1)	(2)	(3)	(4)	(5)	(6)
1984-85 to 1990-91	14,081	24,052	22,122	58.54	63.65
1991-92 to 1997-98	29,738	59,607	77,574	49.89	38.33

Source : RBI Monthly Bulletins, Various Issues.

Other major sources of Internal Finance were (1) Capitalized reserves through bonus issues (paid up capital) and (2) Reserves and surpluses. Strictly speaking, it would be improper to take bonus issues as a separate component of fresh resources generated, as it represents only a book entry transfer from reserves (made up of internal plough-back of earlier years) to share capital. However, by showing it separately, we get an idea of the extent of capitalization of reserves[1]. Table 3.5 gives information about bonus shares, capitalized reserves and reserves and surpluses over the entire period of study.

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1. Vinay.D.Lall et al. (1982), Page 32.

Another source that gets influenced by fiscal policies of the government would be development rebate / investment allowances. The tax concession attached to investment allowance provides incentives to corporate entities to resort to this source. During the period 1984-85 to 1990-91 this component was only 1.28 percent to the total sources, which further declined to –1.26 percent during the period 1991-92 to 1997-98. Investment allowance reserves was 3.07 percent of the total internal sources During the period 1984-85 to 1990-91 and –0.56 percent of the total internal sources during the period 1991-92 to 1997-98. We see that during the period of study the proportion of this component has been quite insignificant. Whereas the other reserves and surpluses accounted for about 14.05 percent of the total sources during the period 1984-85 to 1990-91 and 21.86 percent of the total sources during the period 1991-92 to 1997-98. Another important item under this head is 'retained profits' which constitutes the net savings of the corporate sector. It is difficult to separate out the exact amount of profit retention from sources and uses of funds. Since the net income (profit after tax) of the corporate sector is available for several competing uses (dividends, reserves, carry forward etc), the portion that has to be retained must be determined in such a way so that the interest of owners are best sub served. In other words, the amount of retained profits depend on the size of net income, the required size of reserves, the need of expansion and dividend requirements[1].

Dividend requirement is an important force which plays a major role in determining the amount of profits to be retained from net income. However strong the management's preference for the retention and inventory financing might be, a part of net income has to be distributed as dividends. The proportion of net income to be distributed may be decided on the basis of shareholders' pressure for dividends. However , the shareholders interest in dividend distribution remains stable from year to year. The management also does not change the dividend rate abruptly. They are conservative in giving effect to sizeable revisions. Dividend policies typically take the form of a relatively fixed pattern of adjusting the existing dividend payments more or less gradually to bring them in line with a stated target payout ratio, with the result that only rather small fraction of current changes in profits will be absorbed in dividends.

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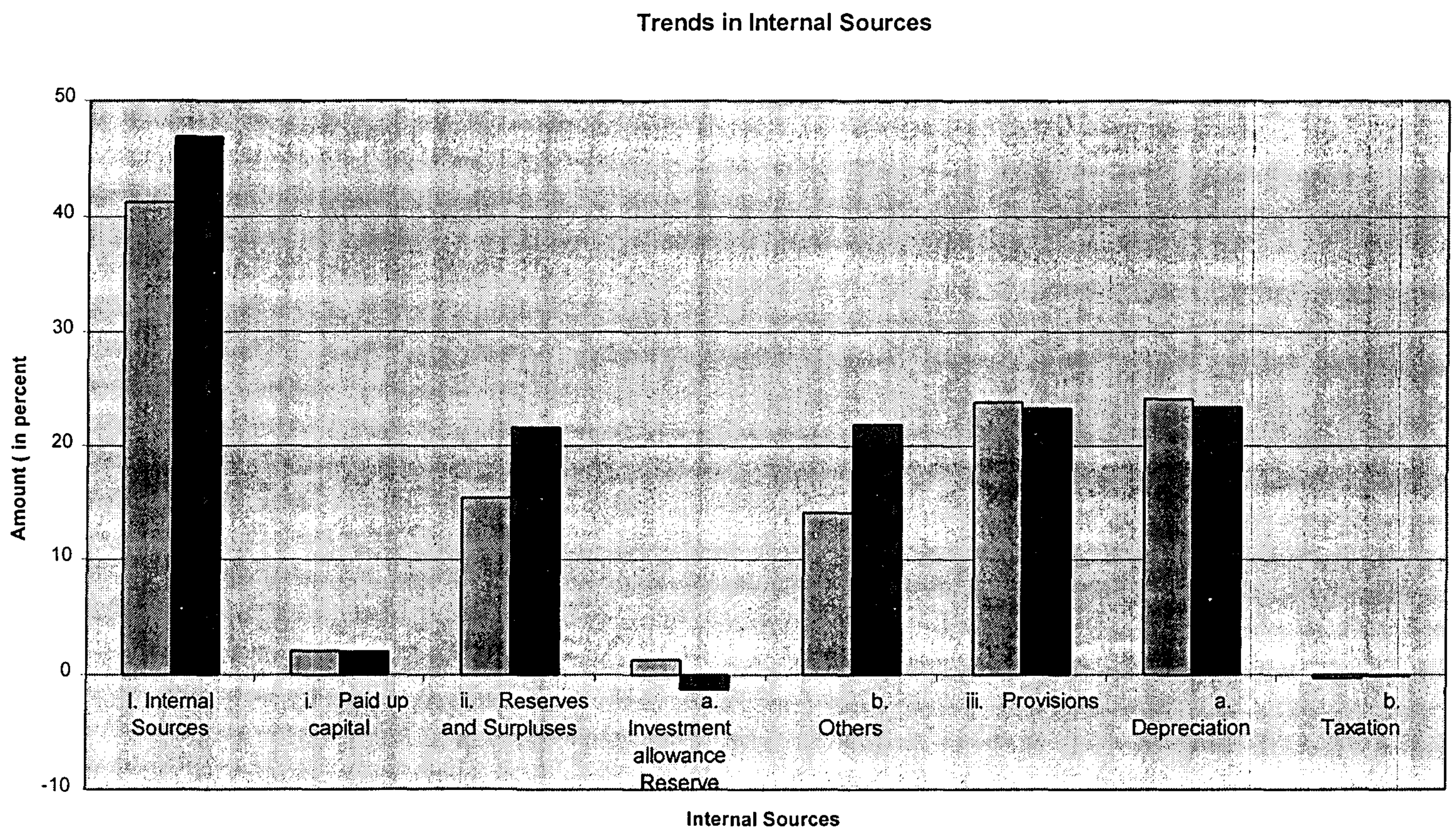
1. S.P. Dobrovolsky(1951) pp 34-36.



1984-85 to 1990-91

1991-92 to 1997-98

Figure - 1

39(a)

Expansion requirements also exert influence on retained profits. The financing of asset expansion through retained profits has many advantages over external financing. It does not involve negotiations with outside agencies. It obviates the need for specific commitments about the rate of return to be paid on funds, length of time they will remain in enterprise, or the use to which they will be put. The question arises whether to relate gross retained earnings (net retained profit plus depreciation provision) with gross expansion or to relate net retained profit with net expansion. Dobrovolsky and Linther[1] both favored the later.

Figure 1 shows the various trends in the internal sources over the two time periods of study.

Overall, the analysis of RBI company finance data, indicates an increase in the importance of internal sources which was due to the increase in the share of reserves an surpluses during 1991-92 to 1997-98.

Flow of Funds from External Sources

There has been a decline in the share of external sources in the period 1991-92 to 1997-98 as compared to the period 1984-85 to 1990-91. The external sources contributed 58.74 percent during the period 1984-85 to 1991-92, which declined to 53.07 percent during the period 1991-92 to 1997-98. Moreover there was remarkable change in the composition of external sources. Within the external sources, even though the share of net issues increased but the share of total borrowings and trade credit declined. The number and the share of net issues increased from 2.95 percent during the period 1984-85 to 1991-92 to 5.13 percent in the period 1991-92 to 1997-98. The share of total borrowings declined from 35.54 percent during the period 1984-85 to 1991-92 to 30.79 percent during the period 1991-92 to 1997-98. Within the total borrowings, the amount borrowed from the banks and raised in the capital market declined but the financial institutions were found to have catered to the needs of the corporate sector. There was a

1. J.Linther (1960) pp 184 and S.P.Dobrovolsky (1953) pp 11.

decline in the borrowings from the banks from 12.51 percent during the period 1984-85 to 1991-92 to 9.35 percent during the period 1991-92 to 1997-98. There was also a decline in the share raised from the capital markets through debentures from 13.14 percent during the period 1984-85 to 1991-92 to 9.16 percent during the period 1991-92 to 1997-98. The share raised from the trade credit has declined from 20.25 percent during the period 1984-85 to 1991-92 to 17.15 percent during the period 1991-92 to 1997-98.

It appears that the private corporate sector in India, has reduced its dependency on the borrowings. In order to study the same we will now see the borrowing orientation.

Borrowing Orientation

If we now study the borrowing orientation, we realize that the level of borrowings has declined over a period of time. However, the borrowings as reported in sources and uses of funds statement are net of repayment of debt and a significant repayment in any year may affect the ratio seriously. The sharp decline in the ratio may be attributed to this factor. Another parameter to considered is the ratio of debt to equity. This ratio was significant in the mid eighties and it increased further till the nineties and it reached the maximum of 96.3 percent during 1991-92. Thereafter a decline in this ratio has been seen.

Ratio of debt to equity – An initial upward shift in the ratio of debt to equity, resulted from a combination of factors operating in the economy, particularly the industrial sector - the more important of these being interest pushing up the project cost, shift towards capital intensive projects and also projects involving high level technology, policy changes more favorable to debentures and also popularity of convertible debentures with the investing public. Allowing interest for income tax deductions and taxing of dividend would have led to a disparity between the two alternative sources of funds. Fear of dilution of control also would have induced the family controlled business houses in India to resort to less of equity finance. All these factors together would have led to the secular increase of debt equity ratio. But as we study this ratio in the second time period, especially after 1993-94 there has been a decline. A decline the debt-equity ratio indicates a decline in the debt. finance as compared to equity finance. This shows the business houses confidence being regained again in the equity finance.

The ratio of borrowings to total asset did not show nay significant trend over the period of study. During the entire eighties, this ratio increased slowly and in the early nineties it increased slightly faster but again started declining slowly. However, throughout the entire period, the ratio ranged between 38 percent to 43 percent. Thus we can say that the growth in borrowing has been matched by the growth in assets leaving the debt asset ratio essentially unchanged.

Table 3.5

Borrowing Orientation of Medium and Large Public Limited Companies

(percentages)

Year	Total borrowings as a percent of total sources	Ratio of debt ($) to equity (#)	Total borrowing as a percent of total liabilities	Interest as a percent of total value of production	Interest as a percent of gross profit	Interest as a percent of total borrowing
1984-85	31.2	86.2	38.9	3.6	43.2	9.7
1985-86	38.5	77.8	38.0	4.0	45.9	10.6
1986-87	39.8	84.7	39.4	2.8	34.5	6.9
1987-88	33.5	79.2	38.5	4.5	52.4	11.0
1988-89	35.2	82.8	39.4	4.8	45.2	10.6
1989-90	40.4	99.4	39.3	4.7	46.5	11.1
1990-91	31.3	95.4	42.6	6.4	52.4	13.8
1991-92	39.9	96.3	42.8	6.4	51.1	13.1
1992-93	36..5	94.3	43.5	4.6	40.4	8.7
1993-94	20.1	81.2	41.1	6.3	51.1	12.4
1994-95	27.2	65.5	37.8	8.2	60.9	16.9
1995-96	25.3	55.8	36.3	9.2	63.8	20.3
1996-97	43.3	59.3	38.2	7.9	57.6	14.9
1997-98	44.6	60.0	39.6	6.3	50.8	10.9

$ - Debt comprises of (1) all borrowings from government and semi government, financial institutions other than banks and other institutional agencies. (2) borrowings from banks against own debentures and other mortgages (3) other borrowings against own debentures, other mortgages, deferred payment liabilities and public and other deposits.

- Equity comprises paid up Capital (ordinary, preference, deferred etc. shares), forfeited shares and all reserves.

Source : RBI Monthly Bulletins, Various Issues.

If we look at the ratio of interest to value of production, we observe a clear upward trend till 1995-96, it has increased gradually from 3.6 in 1984-85 to 6.4 in 1990-91 and to 9.2 in 1995-96; after which it shows a slight decline. The growth in borrowings thus significantly Outstripped earnings' growth rate, leading to increased interest burdens. Interest as a percent of gross profit, has shown a slight increase throughout the eighties and reached the maximum of 63.8 percent in 1995-96, where after it has declined dramatically (private corporate sector is paying more than half of its profits before tax towards fixed interest commitments during recent years.) This may be due to increased magnitude of borrowings as well as increase in the cost of borrowings(interest as a percent of total borrowings). It is thus clear (going by the trend of all the ratios) that the private corporate sector in India was depending heavily upon borrowing during the eighties and the early nineties, but its dependence on borrowings has declined sharply after the mid nineties.

Even though the level of dependency of the private corporate sector on borrowings has declined in the last decade, but yet if we see, the maximum dependency of the private corporate sector is on the borrowings Total borrowings still constitute almost one third of the total funds used by the private corporate sector. It is time for the corporate sector to assess the viability of increasing the debt for financing its activities. If more debt is used, it may lead to financial risk and the fixed interest may swallow an increasing proportion of the gross profit which may land it in a "corporate debt trap".

The point of thought as to whether there is any norms for debt levels. At the aggregate level, some standard tests are prescribed[1] i.e. (1) absolute lending's of debt (2) debt to equity ratio (3) interest plus debt repayments to disposable incomes and (4) total debt as a percentage of GNP. The norms of debt levels are more strategic for individual firms. The conventional prescription of debt-equity ratio (2:1) seems to have outlived its utility and some additional norms like ratio of debt to net assets, ratio of interest payment to profit after tax, payout period (retained profit/stock of total debt) or earning coverage criteria (net earning before tax as a ratio of interest plus sinking fund discounted for tax rate) may be prescribed.

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1. G. Donaldson (1961) p 159.

Composition of Borrowings

Another interesting aspect is that the composition of borrowing itself has also undergone changes during the period of our study. Of the total borrowings, banks supplied a larger proportion of borrowings to the total funds in sixties and seventies. During the eighties, the banks share in total funds raised, declined to 12 percent, despite the high borrowing position of the private corporate sector. It further declined to 9 percent during the nineties. Thus, the bank borrowings is becoming less and less significant as source of corporate finance.

The decline in banking sector's lending to the corporate sector needs further examination. After commercialization of banks in 1969 and reordering of priorities in the use of bank funds an increasingly larger proportion of resources of commercial banks has been channelized to other uses such as for meeting increased reserve requirements and credit to priority sectors. The progressive reduction in corporate sector's dependence on banks is a healthy trend. This is in term of Tandon Committee norms for working capital finance.

Table 3.6

Bank Borrowings by Medium and Large Public Limited Companies

Year	Bank borrowing raised during the year	Term component of bank borrowing ($)	col.(3) as a percent of col.(2)	inventories as percent of sales	short-term bank borrowings as percent of inventories
(1)	(2)	(3)	(4)	(5)	(6)
1984-85	6038	4658	77.1	24.9	4.8
1985-86	7035	5389	76.6	25.4	45.0
1986-87	8090	6357	78.5	25.6	48.2
1987-88	8630	6830	79.1	25.0	44.4
1988-89	11066	8855	80.0	26.0	45.6
1989-90	12905	10423	80.7	24.3	51.7
1990-91	10108	8214	81.2	25.1	48.1
1991-92	11967	10028	83.7	24.5	50.5
1992-93	14105	12451	88.2	26.1	53.4
1993-94	9889	8552	86.4	21.7	50.6
1994-95	13119	11575	88.2	21.4	57.7
1995-96	18098	15531	85.8	20.9	64.4
1996-97	27980	22256	79.5	20.2	66.3
1997-98	30681	24325	79.2	20.0	69.4

$ - is estimated from combined balance sheets for the years 1984-85 to 1997-98.

Source : RBI Monthly Bulletins, Various Issues.

Broadly it can be said that the working capital requirements , to the extent they are borrowed, are met by the commercial banks, though there are other sources like public deposits and trade credit. Also, the insistence by the commercial banks on the maintenance by borrowers of a favorable current ratio of more than unity implies a part of working capital is required to be met through long-term borrowings. The commercial banks also grant term loans, but mainly medium-term loans of less than seven years duration; of late they have been encouraged to grant more of long term loans. The main contributory factor to this new role is the existence of wide new opportunities opened for the banking institutions. A shift in the pattern of deposits of commercial banks in favor of higher maturities has also helped this tendency.

Simultaneously with these development, there has been a change in the concept of liquidity of bank funds. As term lending institutional agencies, commercial banks have assisted industrial enterprises by granting term loans, subscribing to shares and debentures of corporate enterprises and underwriting security issue of these companies.

In the sources and uses of statements of RBI company finance studies, the term component of bank borrowings is not separately stated. Therefore, an effort has been made to estimate the term loan component in banks borrowings from the balance sheet data. In the balance sheet, the term component of bank credit is indicated separately in parentheses. The term component of bank borrowings has increased gradually from 77.1 percent in 1984-85 to 81.2 percent in 1990-91 to a further 85.8 percent in 1995-96.

The reasons for the decline in the share of bank borrowings in the total sources of funds raised during a year and increasing proportion of bank borrowings constituting term loans may be explained in terms of Tandon Committee Report.

Tandon Committee Recommendation – Two main recommendations are.

(i) inventory norms (ii) bank financing of inventory.

The committee felt that the levels of inventory maintained by the industries were of high level and recommended different inventory norms for different categories of industries. The committee also prescribed that at least 25% of the current assets of a firm to be raised from internal sources or through long-term debts. It can be seen from the table 3.7 that the ratio of inventory to sales was high at around 25 percent during the initial period of study, but it declined to 20 percent in the end. As regards the role of bank credit in financing inventories it has been persistently increasing. It was 45.0 percent in 1985-86 which increased to 50.5 percent in 1991-92 and 69.4 percent in 1997-98.

Financial Institutions

The other important sources of borrowings are the financial institutions. They have become competitor to commercial banks so far corporate finance is concerned, particularly in recent years. The financial institutions emerged as a significant sources of company finance for the private sector since mid seventies. The prominence of the financial institutions may be attributed to relatively lower rate of interest charged by them. They on an average charge two to four percent less that the commercial banks. Further, borrowings from public sector lending institutions has certain merits in as much as thereby the investment projects are required to go through some rigorous scrutiny and social priority.

Debentures and Public Deposits

In recent years, two sources of funds under 'other borrowings' have become very significant for the private corporate sector. They are debentures and public deposits. While both are debt capital, the former is used to arise long term funds and the later for meeting working capital requirements. Public deposits have been a traditional source of finance in private corporate sector in India, but they have come into prominence since mid seventies.

Public deposits is cheaper than borrowings from the banks or mopping of funds by means of debentures or shares. Further, in case of deposit there are no documentation formalities or creation of security. Above all, payment of interest on deposits in an admissible business expenditure. The depositors also like to invest their savings in company deposits because of attractive rate of interest, shorter maturity and convenience withdrawal of deposits. However, public deposits as a financial asset suffers from certain adverse features; it is more risky, less liquid, not favored by tax law.

Table 3.7

Public Deposits and Debentures as a Source of Finance for Medium and Large Public Limited Companies

(Rs. in crores)

Period	**Public Deposit**		**Debentures**		
	Amount	**As percent of Total Sources**	**Amount**	**As percent of Total Sources**	**Col. (3) + Col. (5)**
(1)	(2)	(3)	(4)	(5)	(6)
1984-85 to 1990-91	1113	1.90	6557	11.24	13.14
1991-92 to 1997-98	1446	1.14	10,188	8.02	9.16

Source : RBI Monthly Bulletins, Various Issues.

In the Law, fixed deposits are unsecured loans and in the event of a company going into liquidation, deposit holders rank very low in the order of priority of repayment of debt. The most important reason as to why people still choose to invest in this asset lies in that there is a substantial amount of yield differences but these deposits and there substitutes particularly, bank deposits. Companies demand for public deposits has to be explained in terms of the cost of funds availability of the alternative sources of funds and convenience in rising capital.

Debenture is another frequently used method by the private corporate sector for procuring long-term funds. The characteristics of debentures are very similar to public deposits excepting for the fact that the debentures issued to public are secured and sometimes convertible. From the point of view of the companies, debentures are very attractive means of raising long-term finance. The raising of debenture capital does not dilute control, unlike shares and unlike borrowings from term lending institutions, with a mandatory convertibility clause. That is why, debenture is a popular source of finance of private corporate sector in India. Convertible debenture is beneficial to the issuing companies as well as to the investor. The companies need not pay dividends during the initial period when the project is under construction and pay the fixed rate of interest to the holders which is deductible towards income tax purpose. After a span of time, the project starts paying and the conversion of debentures helps in widening the equity base of the companies. Similarly, the investors get assured rate of interest during the initial period and share in profit and prosperity of the companies after conversion in terms of dividend and capital gains.

However, funds raised through debentures remain borrowed funds, therefore, the liability of the companies to pay interest and repay the principal amount when due, increases with increasing amount such borrowings. Excessive debt endangers the very existence of a company in times of recession-that it cannot be serviced in the absence of cash generation. The amount raised by the debentures and public deposits as a percentage to total sources was 13.14 percent in 1984-85 to 1990-91, which declined to 9.16 percent in the period 1991-92 to 1997-98.

Trade Credit

It is the major source of short-term finance, apart from bank credits, available to business enterprises. It is extensively used for tackling seasonal and temporary fluctuations in business activities. Extension of trade credit involves a short postponement of payment after delivery by the supplier and is also termed as "supplier Credit". The movement in trade credit are significant since the borrowing units can reduce the impact of restrictive credit policies by increasing their resources to trade credit. When bank credit is restricted, the borrowers may attempt to improve their liquidity by increasing their volume of purchases on credit terms and stretching their trade creditors. Trade credit is generally used, and particularly by the small firms, when bank credit is not available or when there are difficulties in providing adequate and acceptable security. The share of trade credit to the total sources has declined from 20.25 percent during the period 1984-85 to 1990-91 to 17.15 percent during the period 1991-92 to 1997-98. even though there has been a decline in the share of trade credit in the second period of study, yet it meets a significant proportion of financial requirements of private corporate sector. The share of sundry creditors as a percentage to total sources has increased from 13.46 percent in the initial period to 14.62 percent in the second period and the share of sundry creditors as a percentage to external sources has also increased from 22.91 percent to 27.55 percent during the two periods of study. This increase in the share of sundry creditors is primarily due to its increased share in the trade credit.

Table 3.8

Role of Trade Credit in Financing of Medium and Large Public Limited Companies. **(Rs. in crores)**

	Items	1984-85 to 1990-91	1991-92 to 1997-98
1.	Trade Dues or Other Current Liabilities	11,818	21,794
	of which		
	a. Sundry Creditors	7,855	18,578
	b. Others	3,963	3,216
2.	(a) as a % of (1)	66.47	85.24
3.	(1) as a % of Total Sources	20.25	17.15
4.	(1) as a % Of External Sources	34.47	32.32
5.	(a) as a % Of Total Sources	13.46	14.62
6.	(a) as a % of External Sources	22.91	27.55
7.	(1) as a % of Loans and Advances & Other Debtor Balance	78.12	55.72
8.	(a) as a % of Sundry Debtor	89.83	86.12
9.	Sundry Debtor as a % of Sales	2.3	2.7

All figures relate to the statement of sources and uses of funds excepting sales which relates to the statement on income and expenditure.

Source : RBI Monthly Bulletins, Various Issues.

It may be mentioned here that trade credit figures both in sources as well as uses of funds. Trade credit is received and trade credit given arise out of different activities. Trade credit received originates from purchases of raw material, stores etc and serves as a source of finance while trade credit provided is essentially a method to facilitate sales, sundry creditors are source of trade credit whereas sundry debtor trade credit is provided to others. Thus, the net trade credit as indicated by the ratio of sundry creditors to sundry debtors would show the net inflow to or outflow from the corporate sector through this channel.

There has been a decline in the percent of trade credit to loans and advances. This ratio decline from 78.12 percent to 55.72 percent in the second period. Yet it indicates that there is a net inflow of trade credit in the private corporate sector. Similarly ratio of sundry creditors to sundry debtors has also declined from 89.83 percent to 86.12 percent during the two periods and this also indicates the net inflow of the resources in the private corporate sector. Increase in the percent of sundry debtors to sales from 2.3 percent to 2.7 percent indicates a higher emphasis on sales promotion through trade credit.

The growth in the use of trade credit as a source of finance by itself need not cause undue concern. In the developed countries, trade credit is the most important source of short-term finance. As our economy advances, the use of trade credit would also therefore increase. But if, increasing resort to trade credit is for compensating the shortfalls in bank credit and tends to reduce the impact of restrictive credit policies, the trends in trade credit may have to be watched closely. The increasing net flow of funds through trade credit to the corporate sector has to be realized in the context of the parallel or 'black' markets and unorganized markets in money and credit existing in the country.

The last source (external) is equity capital (new issues) ; infect in figure first in the sources of funds statements. Equity capital also known as risk capital, enables the industrial enterprises to provide for and protect against numerous uncertainties, which are inherent in business environment. The table 3.10 shows capital raised and debentures during the entire period of study. The share of ordinary shares in raising the capital had increased from 34 percent of the total in 1984-85 to 61.8 percent of the total in 1987-88. it again declined to 30 percent of the total in 1991-92 and once again increased to 74.3 percent of the total in 1995-96. This shows a cyclical trend in the share of ordinary shares to the total amount raised from the capital market.

Preference shares which accounted for almost 10 percent of the total capital raised in the capital market in the early sixties and seventies became insignificant during the early eighties and were virtually wiped out during the eighties and the nineties. It is remarkable to see that only .002 percent of the total capital raised was from the preference shares in 1992-93. The preference shares in India have not been able to satisfy the investor's expectations namely regularities of income or safety of capital. As regards regularity of income, preference shares do not compare with bonds or debenture at all; because preference dividends have been skipped too often and by too many companies. The frequent non-payment of preference dividends affect both income and capital values of these securities and their marketability.

Besides ordinary shares and preference shares, resources are also raised in the capital markets in the form of debentures. It may be observed that debentures have steadily emerged as a major instrument of raising resources in the capital market especially during the eighties. In 1989-90 the debentures accounted for 81.3 percent of resources raised from the capital market indicating a poor performance of equity finance. Debenture is debt capital and to the extent it is resorted to debt and equity mix of the firms get affected. In respect of convertible debenture, however, the debt is automatically converted into equity after a specific period.

Table 3.9

Capital raised and Debentures during the year (new issues)

(Rs. in crores)

Year	Ordinary Shares		Preference Shares		Debentures		Total
	Amount	Percent of total	Amount	percent of total	Amount	percent of Total	Amount
1984-85	363.0	34.37	0.1	-	693.3	65.62	1056.4
1985-86	898.4	51.46	1.2	0.06	845.7	48.48	1745.3
1986-87	1007.5	39.05	0.7	0.20	1573.2	60.94	2581.4
1987-88	1105.2	61.80	6.8	0.38	675.7	37.80	1787.7
1988-89	1033.6	32.03	3.3	0.10	2187.9	67.86	3224.8
1989-90	1220.1	18.71	7.9	0.12	5281.9	81.13	6509.9
1990-91	1284.3	29.72	13.1	0.30	3014.8	69.92	4312.2
1991-92	1916.2	30.94	1.5	0.02	4275.4	69.02	6193.1
1992-93	9952.6	50.25	0.5	0.002	9850.3	49.73	19803.4
1993-94	9959.7	51.52	0.3	0.001	9370.3	48.47	19330.3
1994-95	17414.4	65.92	131.4	0.49	8870.9	33.58	26416.7
1995-96	11954.5	74.36	150.1	0.93	3970.1	24.69	16074.7
1996-97	6101.4	58.64	74.9	0.71	4233.2	40.66	10409.5
1997-98	1162.4	37.02	4.3	0.13	1971.6	62.84	3138.3

Source : RBI Monthly Bulletins, Various Issues.

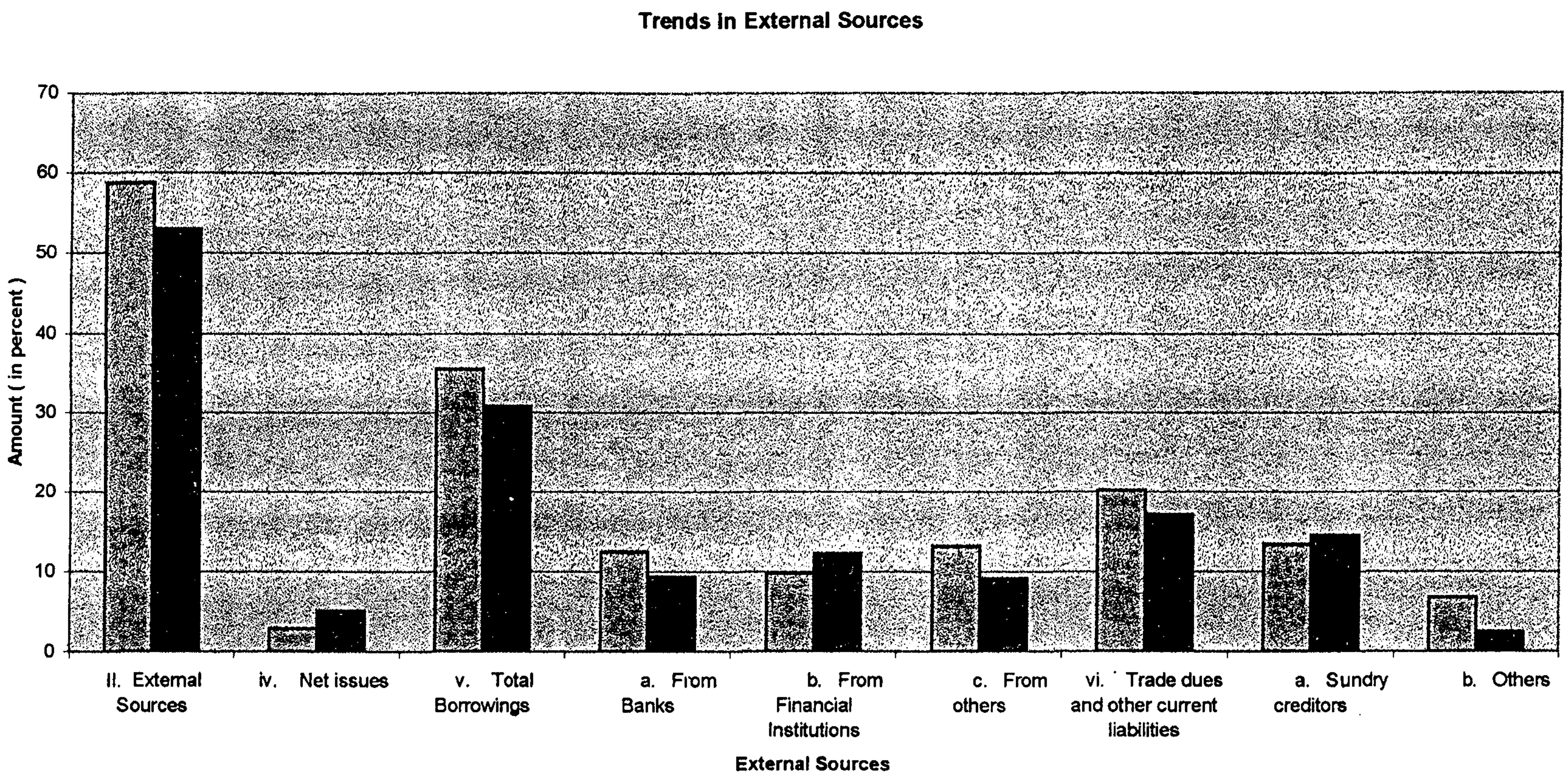

Figure - 2

1984-85 to 1990-91

1991-92 to 1997-98

Broadly speaking the forgoing analysis of the RBI data on sources of funds during the period under study reveals some basic changes in the pattern of financing. In particular the shift from the external to internal sources, and from the debt to equity within that of the external financing have been the major features of structural change taking place in the Indian corporate sector.

Patterns of Uses of funds for Capital Formation.

So far, we have been dealing with the relative movement of different sources of finance. As there is close correspondence between the sources and uses of funds, it will be rewarding to look at the use side as well. An analysis of the uses of funds for the different purpose will provide a deeper insight into the financing of the capital formation in the corporate sector.

Category of Asset Formation

Table 3.11 presents in a nutshell the uses of funds for different categories of asset formation by the medium and large public limited companies over the period of study. On seeing the table it is clear that the gross fixed assets, constitute the major head of uses of funds, which also includes the plant and machinery which is the largest user of funds, followed by the buildings. The share of land is marginal. The major component of financial asset is in the form of loans and advances and other debtor balances.

Uses of funds for the gross fixed asset formation (capital formation) constitutes the highest proportion. Fixed asset formation included the formation/maintenance of plant and machinery, buildings etc. The formation of plant and machinery used up 38.37 percent of the total funds during the period 1984-85 to 1990-91 and 44.22 percent of the total funds during the period 1991-92 to 1997-98. The amount spent on the maintenance of land during this period of study was marginal, as its share increased from 0.56 percent to 1.15 percent in the second period.

On the other hand, uses of funds for financial asset formation has gradually declined, mostly due to the decrease in the level of loans and advances and other debtor balances. This has a close correspondence with the observed decline in the trade dues and other credit liabilities in the sources of funds. An interesting aspect of the financial asset formation is the increasing share of investment in the nineties. This might be due to the fact that the corporate sector is investing in securities on a n increasing scale. This can be either to use the surplus funds available with them or due to a deliberate attempt of investing in profitable companies. Also investment in UTIs and government securities may have been raised to take advantage of tax benefits.

Table 3.10

Uses of Funds by Medium and Large Public Limited Companies

(Percentages to total)

	Uses of Funds	1984-85 to 1990-91	1991-92 to1997-98
A	**Gross Fixed Assets**	**46.05**	**52.95**
	1. Land	0.56	1.15
	2. Buildings	5.46	5.29
	3. Plant and Machinery	38.37	44.22
	4. Others	1.66	2.29
B	**Inventories**	**17.64**	**8.91**
	5. Raw Materials	6.87	2.30
	6. Finished Goods	5.53	4.10
	7. Work in Progress	4.71	2.10
	8. Others	0.53	0.41
C	**Loans and Advances & Other Debtor Balances**	**26.24**	**22.30**
D	**Investments**	**7.05**	**10.00**
E	**Other Assets**	**0.49**	**1.28**
F	**Cash and Bank Balances**	**2.53**	**4.56**
	Total	**100.00**	**100.00**

Source : RBI Monthly Bulletins, Various Issues.

Degree of Finance

Having found that the funds are mostly used for financing physical capital formation, we may attempt to estimate the degree of self finance of private corporate sector in India. The term "self finance" may de defined as that part of a firm's capital formation (acquisition of physical assets and changes in inventories) during a period of time which is financed out of its own sources. Two alternative methods may be applied for this estimation. In method I, the proportion of the total capital formation is financed by internal savings taken as the degree of self finance, on the assumption that all internally generated funds are used for this purpose[1].

In the method II, the degree of self finance is obtained by subtracting the percentage of external finance from capital formation. It is assumed that external funds are used entirely to finance capital formation[2].

Table 3.12 shows the degree of self finance in the medium and large public limited companies. This table gives the total resources and the allocation of those resources for capital formation and financial asset formation. The analysis indicates that gross capital formation was higher then the financial asset formation during both the periods of study. But there has been a decline in the level of gross capital formation and there has been increase in the level of financial asset formation during the second period of study. Following the first method of self financing, we see that the level of self financing has increased in the second time period. Similarly, following the second method of self financing again an increase in the level of self financing is seen. Thus we can say that results of both the methods indicate the same trend.

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1) V. Divatia and Kripa Shankar (1979) p 121.

2) This method has been uses by the Economic Commission in its Economic Survey of Europe 1955 with a few differences. UNO used this method in Toto in its publication' Aspects of Finance of Development' ECAFE Growth Series No. 4 pp 49-50.

Table 3.11

Degree of Self Finance Medium and Large Public Limited Companies

(Percentages)

	Items	1984-85 to 1990-91	1991-92 to 1997-98
	Total Resources	**100.00**	**100.00**
A	Internal Sources	41.26	46.93
B	External Sources	58.74	53.07
	Allocation	**100.00**	**100.00**
C	Fixed Assets	46.05	52.95
D	Inventories	17.64	8.91
E	Gross Capital Formation (C+D)	63.69	61.86
F	Financial Asset Formation	36.31	38.14
G	Self Financing Method I (A as a % of E)	64.78	75.86
H	Self Financing Method II (E – B)	4.95	8.79
I	Self Financing of Fixed Assets (A as a % of C)	89.60	88.63

Source : RBI Monthly Bulletins, Various Issues.

Table 3.12

Financing of Inventory Accumulation of Medium and Large Public Limited Companies

(Percentage to Total Uses/Total Sources of Funds)

		1984-85 to 1991-91	1991-92 to 1997-98
1	Inventory Accumulation	17.64	8.91
2	Total Borrowings from Banks	12.51	9.35
3	Short-term from Banks	8.57	7.47
4	Net Trade Credit	5.99	5.15
5	3 + 4	14.56	12.62
6	1 – 5	3.08	-3.71
7	Borrowings from Other Sources	13.14	9.1

Source : RBI Monthly Bulletins, Various Issues.

Normally fixed asset formation is financed by internal generation of funds and long term borrowings, whereas inventory financing is done through short term sources of which bank credit is the most important source. As for the financing of inventory accumulation it is evident from Table 3.13, that short term bank credit fell short of inventory accumulation throughout the period of study. Net trade credit which was positive during the entire period of study was also unable to meet the gap between short term bank credit and inventory accumulation during 1984-85 to 1990-91, but it could meet the gap in the period 1991-92 to 1997-98. In case of the first period where there is a gap between inventory accumulation and bank credit and trade credit, this gap has to financed by borrowings from the other sources.

Summary of Findings

The foregoing analysis of the capital structure of the private corporate sector brought out some interesting characteristic trends and patterns of financing during the period 1984-85 to 1997-98. They are as follows :

1) The flow of funds accounts analysis indicated that the private corporate sector

has been a deficit sector by large and this deficit is financed through various instruments and other sectors. Other financial institutions and the banks were the major sectors which have been providing finance to the private corporate sector through loans and advances. Securities raised in the capital markets have also been an important instrument.

2) The sources of RBI company finance studies pointed out the following :
    a) The share of the internal sources to the total sources has increased over the period of study and there has been a decline in the share of external sources to the total sources of funds.
    b) Within the internal sources the share of reserves and surpluses has increased substantially and that of the provisions maintained has declined across the period of study.
    c) Within the external sources the share of the net issues has increased remarkably and the share of total borrowings and that of trade credit has declined significantly.
    d) Within the total borrowings the share of the bank borrowings has declined and that of the non-banking financial institutions has increased, which also indicated the role played by these financial institutions in India.
    e) The share of public deposits and debentures in the total borrowings has also indicated a declining trend.
    f) There has also been a decline in the level of trade credit used by the private corporate sector during the period of study. But, this trade credit has been largely contributed by the sundry creditors.

g) Another significant characteristic which has emerged is the change in the debt-equity ratio. This ratio was very significant till the early nineties, but, thereafter there has been a substantial decrease in it, indicating the preference of equity to debt.

3) The analysis of the uses of funds indicated that funds utilized for the gross fixed assets has increased and for the financial assets have declined during the second period of study.

CHAPTER IV

FINANCING PATTERN – A INDUSTRY - WISE ANALYSIS

Section I

In the previous chapter, the trends and pattern of the private corporate sector as a whole are studied. The general trends observed at the aggregate level, however, may not hold good for individual industry-groups. Inter industry variation in the pattern of finance is likely to arise due to such facts as differences in their capital requirements, the rate of growth, image in the capital market and credit worthiness. Similarly, differences may exist in the pattern of financing among different size groups of firms. In this chapter an attempt is made to study the trends and the patterns of financing in the different industries. The industries, thus selected, are based on their importance and also on the availability of data.

Industry Wise Analysis

An examination of sources of funds statement of major industries brings out that, by and large, the patterns observed in most individual industry-groups are broadly in line with the aggregate picture. Table 4.1 and 4.2 are used for this analysis. Certain industries like tea plantations, sugar, tobacco, cotton, engineering goods, chemicals, cement, rubber and rubber products, paper and paper products, electricity generation and supply and construction are taken into consideration. The internal and the external sources of each of these industries are studied and the trends and patterns of financing in each of these industries is analyzed.

Tea Plantations

In tea plantation industry the share of internal sources declined from 1984-85 to 1990-91 in 1991-92 to 1997-98. and same was the case for the external sources also. But, the decline in case of the internal sources was less as compared to that of the external sources. Moreover, what is worth nothing is that, tea plantation industry has always been making use of its internal sources as compared to external sources. There dependence on the external sources has been quite less.

Sugar

In the sugar industry, there was a small decline in the level of the internal funds used as compared to the external funds. The decline in the external funds was relatively more significant. The dependence of sugar industry on the external funds was much more than that on the internal funds. This was the trend in the both the periods of study. In spite of, a sharp decline in the external funds in the second period of study, yet the proportion of the external funds were more than that of the internal funds.

Tobacco

The trends in the tobacco industry are in correlation with the trends exhibited by the aggregate industry. There is an increase in the proportion of the internal funds used and a decline in the proportion of the external funds during the second time period. But, another aspect of the tobacco industry is that, this industry has been making use of more external sources as compared to the internal sources. And this was consistent in both the periods of our study.

Cotton Textiles

There has been a drastic decline in the internal sources used by the cotton textile industry. This industry has also exhibited a marked decline in the proportion of the external sources used. But, the decline in the internal sources is less than that of the external sources. This could be due to the existing recession in the industry. But, one significant aspect of this industry is that its dependence on external sources is much greater than on its internal sources. And this is the trend exhibited during both the time periods of our study.

Engineering

The engineering industry comprises of other important industries also, such as , motor vehicle, electrical machinery, machinery excluding transport, foundries, ferrous and non ferrous etc. the trend in the aggregate engineering industry indicates a small decline in the proportion of the internal sources used and a significant decline in the external sources used. As for the motor vehicle industry its dependence on internal sources increased slightly and its dependence on external sources increased significantly. This could be due to the expansion of motor vehicle industry during the nineties. The electrical machinery industry used less of its internal sources and also the external sources. In this case, the decline in internal sources used was more than the decline in external sources used. Machinery excluding transport also showed a decline in the use of their internal sources and also the external sources. But the decline in the external sources was much more than the decline in the internal sources. Foundries depended less on the internal sources and more on the external sources throughout the period of study. There was a small decline in the proportion of the internal sources used. But, there was no significant change in the proportion of the external sources used. Within the external source, though, there was a remarkable shift from the use of trade credit to borrowings. Ferrous and non ferrous industry did not exhibit any significant change in the proportion of the internal sources used but showed a significant decline in the proportion of the external sources used.

Chemicals

Chemicals industry also includes certain basic industrial chemicals and medicines and pharmaceuticals. In the chemical industry the share of the internal sources used declined and the share of the external sources used increased remarkably. This can be explained, by the New Industrial Policy and the globalization of the Indian economy, which opened the doors of the Indian economy for the rest of the world. Chemicals industry benefited the most as the process of globalization increased the inflow of foreign capital in India. Studies have revealed that the highest proportion of foreign direct investment (FDI) was in the chemical industry. Basic industrial chemicals used less of their internal sources and more of the external sources. Moreover there has been a decline in the internal sources used and no significant change in the external sources used during the period of study. In case of medicines and pharmaceuticals there was an increase in the internal sources used and no significant change in the external sources used. But once again the dependency on external sources was greater.

Cement

The cement industry used more of external funds as compared to the internal, as revealed by the study. The trends in the cement industry were in accordance with the aggregate industry. This means that there was an increase in the level of internal funds used in the second time period and no significant change in the level of external funds.

Rubber and Rubber Products

The rubber industry includes the rubber and the rubber products. This industry showed a slight decline both in the levels of the internal and the external sources used. But, what is again important is that the dependency of this industry is more on the external funds rather than that on the internal funds.

Paper and Paper Products

The paper industry includes paper and the several paper products. This industry has been also relying more on the external funds rather than on the availability of internal funds. But, what is significant is that there has been a significant decline in the proportion of the internal funds used in the second time period, though the decline in the levels of the external funds used has not been significant. This trend further indicates the declining dependency on the internal funds.

Electricity Generation and Supply

The electricity generation and supply has also been using more of the external funds as compared to the internal funds throughout the entire period of study. But there was a significant increase in the proportion of the internal funds used in the second period of study. And also, there was an increase in the proportion of the external funds used. The increase in the internal funds used is not relatively significant as compared to that of the external funds used. An overall increase in the level of the total funds used indicates the expansion of this industry.

Construction

The construction industry was also using more of the external sources for their operations as compared to the internal sources. There was a decline in the proportion of the internal sources used in the second period of our study. Even though the proportion of the external sources declined, yet the relative dependence of this industry was on the external sources only.

Table 4.1

Sources of Finance: Industry/Industry Group-wise. 1984-85 to 1990-91

(Percentages to total.)

Industries.		Internal sources	Total borrow	Trade dues & OCLs
1	Tea plantations	3.54	1.16	1.36
2	Sugar	1.00	1.20	1.36
3	Tobacco	1.60	0.97	1.74
4	Cotton textiles	7.25	8.85	6.99
5	Engineering. (of which)	25.88	24.67	33.89
	i. Motor vehicles.	7.78	6.38	8.16
	ii. Electrical Machinery	6.40	4.97	7.04
	iii. Mach. Excl. transport	7.53	6.85	12.51
	iv. Foundries	5.16	3.63	3.40
	v. Ferrous/Nonferrous	2.22	2.82	2.77
6	Chemicals (of which)	22.08	16.56	11.20
	i. Basic Inds. Chemicals	15.51	14.47	8.61
	ii.Medicines & Pharm.	3.28	2.08	2.59
7	Cement	3.57	4.95	3.65
8	Rubber & Rubber products	2.84	2.34	3.28
9	Paper & Paper products	3.03	2.94	2.41
9	Electricity gen. & supply	3.84	3.53	2.74
10	Construction	1.31	1.79	2.60
	Total (including others)	**100.00**	**100.00**	**100.00**

Source : RBI Monthly Bulletins, Various Issues.

<u>**Table 4.2**</u>

<u>**Sources of Finance: Industry/Industry Group-wise. 1991-92 to 97-98**</u>

(Percentages to total.)

Industries.		**Internal sources**	**Total borrow**	**Trade dues & OCLs**
1	Tea plantations	2.1	0.91	0.71
2	Sugar	0.79	0.87	0.60
3	Tobacco	1.76	1.31	1.63
4	Cotton textiles	1.96	1.87	2.43
5	Engineering. (of which)	22.52	23.69	26.84
	i. Motor vehicles.	8.58	8.98	9.75
	ii. Electrical	3.67	4.39	6.89
	Machinery	4.43	2.50	2.88
	iii. Mach. Excl.	3.34	4.34	2.58
	transport	2.16	1.93	1.42
	iv. Foundries			
	v. Ferrous/Nonferrous			
6	Chemicals (of which)	19.27	21.99	15.15
	i.Basic Inds. Chemicals	13.98	14.18	8.80
	ii.Medicines & Pharm.	3.83	2.07	2.00
7	Cement	5.84	4.27	4.05
8	Rubber & Rubber products	2.35	2.15	2.96
9	Paper & Paper products	1.95	2.60	1.46
9	Electricity gen. & supply	4.88	5.29	3.28
10	Construction	0.78	0.67	1.40
	Total (including others)	**100.00**	**100.00**	**100.00**

Source : RBI Monthly Bulletins, Various Issues.

The objective of this section was to find out whether or not significant differences existed among the individual industry-groups so far as the capital structure was concerned. The analysis indicated special characteristics in some industrial-groups. The specific nature of the industry groups, their profitability etc, could explain the observed differences in the financial pattern among different industry groups.

More over it can be said that due to the existence recession in the economy and the industrial sector, by and large the proportions of the various funds used has declined. There has not been a clear picture to depict the change in the financing pattern of the various industry groups. There has been an overall decline in the proportions of funds used by the various sources, though it can be said that the decline in the share of the internal sources has been less as compared to that of the external sources. But, there are some exceptions to this, for example, chemical industry. The share of funds from the external sources has increased dramatically in the post liberalization period, this is mainly due to the inflow of the FDI in this industry. It could be concluded from the above analysis that difference did exist across industries but those were more in terms of magnitude rather than the direction of change in the pattern of financing.

In terms of general conclusion, we mention that the private corporate sector in India operated under the institutional framework of government control and regulation. These control instruments not only guide and direct the course of industrial development but also to a large extent, determine the financing pattern of the corporate sector. In particular, fiscal policies(e.g. tax rates and tax concessions), monetary policies(e.g. selective credit control and interest rates) and capital control rules, can be used to influence changes in the capital structure of the private corporate sector in desirable direction.

Section II

So far, the focus of the focus of the study has been on tracing the changes in the capital structure of the private corporate sector, in India, during the period 1984-85 to 1997-98. The analysis in the previous chapter has brought out the changing pattern of financing in the private corporate sector. But, some variables in the economic system must have activated the changes in pattern of financing. Our endeavour in this section is to examine the role of some macro economic variables and interest rate structure in shaping the pattern of corporate financing in India.

Macroeconomic Trends and Patterns of Financing

Some important economic variables capable of exerting influence in the pattern of financing are (I) growth of industrial production, (ii) inflation. In this section, the impact of each of them on shaping the pattern of financing of private corporate sector is analyzed.

Industrial Production

The level of production in the industries indicates the performance on the private corporate sector. In order to study the industrial production over the period of study we refer to Table 4.3. The table indicates that the average growth rate of the manufacturing sector during the period 1984-85 to 1990-91 was 7.44 percent and during the period 1991-92 to 1997-98 it was 6.78 percent. This indicates that there was decline in the average growth rate of industrial production during the second period of study.

Table 4.3

Gross value added in manufacturing sector. **(percentages)**

Period	Average Growth Rate
1984-85 to 1990-91	7.44
1991-92 to 1997-98	6.78

Source: Report on Currency and Finance, RBI.

When we study the broad pattern of financing of the private corporate sector on the pattern of industrial growth, some interesting point emerge. Internal sources as a proportion of total sources was low during the period 1984-85 to 1990-91 and high during the period 1991-92 to 1997-98. External sources were high during the period 1984-85 to 1990-91 and low during the period 1991-92 to 1997-98. Internal sources increased from 41.26 percent of the total sources during the period 1984-85 to 1990-91 to 46.93 percent of the total sources during the period 1991-92 to 1997-98. It may be mentioned here that a substantional part of the accrual during the above period came from reserves and surpluses and depreciation provisions. Depreciation provisions are tax-free and interest free funds. The decline in the external sources was primarily due to decline in the share of total warrants and trade credit.

The changing pattern of financing in the private corporate sector can be explained with the rational of demand of funds. This means that, during recession, net expansion of industries was low and therefore demand for external funds was also low. On the other hand during high growth of industries, net expansion of the private corporate sector was high and therefore the demand for external funds was also high.

Thus we can say that during the period 1984-85 to 1990-91 when the industrial production was growing at the rate of 7.44%, it require larger amount of funds for its expansion purposes. And these funds were provided to them by the external sources during this time period. And during the period 1991-92 to 1997-98, when the industrial production was growing at the rate of 6.78 percent, the funds used by the industries were provided by their internal sources. We conclude that external funds were raised when market opportunities warranted a faster rate of growth than possible with the internal funds.

Inflation

Inflation is also a potential factor of determining proportions of corporate financing. It particularly explains why the corporate sector preferys debt to equity from among the external sources of funds. One line of argument is that inflation enables corporations to repay their debt with cheaper rupees, but inflation may also lead to the rise of nominal interest rates. A refined argument revolves among the fact that as it causes the interest to rise, inflation increases the effective real tax deductions associated with debt[1].

Given the deductibility of interest payments against income for tax purposes, the after tax real interest rates faced by the corporate sector would have been negative during the period of higher inflation. The interest rates have been very stable in India as they are administered and raised in a manner without a direct correspondence with inflation. Hence the first argument is more appropriate to India

By comparing the debt equity ratio and inflation rate in the economy over the entire period of study, we can study the trends in the debt equity ratio. The ration of debt to equity continues to increase till 1991 – 92 where it had reached the maximum of 96.3 percent. Thereafter the ratio of debt equity started declining. Similarly the inflation rate also continued to increase and reach the maximum of 13.74 percent in 1991 – 92, after which it also gradually declined. This indicates that, debt is preferred at the time of high inflation rate and equity is preferred when inflation rates are low in the economy. This is in accordance with the argument, that inflation enables corporation to repay their debt with cheaper rupees.

Our analysis in this section brought out that macroeconomic variables like growth of industrial production and inflation exerted influence on the pattern of financing of the private corporate sector, while the growth of industrial production explained the proportion of internal versus external sources, inflation explained the proportion of borrowings in total sources and the preference for debt or equity.

The effective nominal rates faced by the corporate sector = nominal roi*(1-corporate tax rate). For reaching at real interest rate it has to be netted for rate of inflation

Choice of securities and structure of rates

In a free economy, capital is always attracted to avenues, which offers attractive rate of returns. The choice of securities by investors (lenders) is determined by the desire to maximize the yield on the portfolio. By the same token choice of securities by the corporate bodies (borrowers) will be determined by the desire to minimize the interest outflow. However the choice of securities to borrowers is more restricted than to lenders. This is so, because considerations involved in borrowing short and borrowing long are related not so much to the rate of interest as to the uses of funds. Short-term loans generally finance short-term uses and long-term loans finance long-term uses. If the availability of funds for any use is not adequate or if the interest differentials between short-term and long-term loans are excessive, it is possible that the borrowers may shift from one source to another to finance the same use.

The long-term securities have an inherent advantage over short-term securities from companies' point of view. While long-term funds can be used for short-term uses, its not possible to use short-term funds for long-term uses.(One exception is the instance when short-term loans used to finance long-term operations is allowed to 'roll over' by banks or other agencies) The companies can issue long-term securities for short-term uses if the short rate is higher than the long rates. After the short period, they can buy back the securities. In this way, they can lower their total interest burden.

The structure of corporate assets also indicate that corporate growth creates a relatively greater demand for capital for long-term rather than short-term uses. The demand for capital by the corporate sector is thus weighted in favor of long-term funds. Actual demand for short-term and long-term funds may be different because the corporate sector may be substituting, within limits, one type of funds for another, depending upon the conditions in the financial markets. However, corporate sector's demand for long-term funds is generally predominant because of the inherent advantages of long-term capital over short-term capital. Hence the corporate sector would be willing to pay a higher rate of interest on long-term loans than on short loans[1].

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1. D. H. Pai Panandikar (1973) p 38.

Structure of Rates

Usually, the rate of interest on short-term loans are lower than long-term loans according to the principles of time preference. When the short rate is equal to the long rate, preference of he companies will be weighted in favor of long securities and the preference of the investor will be weighted in favor of short securities. Thus, in a perfectly competitive market, the interest rate structure will be determined by demand and supply forces as expressed in the company of short-term and long-term securities which is again determined by the preferences of lenders(investors) and borrowers(companies)[1].

The structure of interest rates regulates the flow of funds from investors in the form of different instruments to the corporate sector. Ordinarily, the rate of interest(return)of a security will be higher:

i. The greater the element of lender risk
ii. The less marketable is the security or claim and
iii. The longer is the period of maturity.

Ordinary shares have an indefinite period to maturity and subject to risk with regard to payment dividend and as such will rank lower in the scale of preference of the investors unless they earn a very high rate of return. Preference shares, which are akin to ordinary shares but are not strongly subject to investor's risk, will earn less than ordinary shares but more than debentures. Debenture have fixed maturity period and also entail lender's risk and should earn more than the public deposits of shorter maturity.

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1. In India the interest rate structure is administered by the RBI and Government of India.

It is instructive to look at the structure of interest rates in India to find out whether they follow the expected pattern as discussed. There exists a bewildering variety of rate of interest in the financial markets[1]. Some of the relevant rates of from the point of view of the private corporate sector are presented in Table 4.4. The interest rate structure in table 4.4 indicates that all the interest rate have increased significantly during the period of our study. The increase in d\different rates is reflected in the increase in the interest cost of the medium and the large scale industries as a proportion of total borrowings.

The average lending rate of the commercial bank have increased throughout the period of our study. It increased from 9.95 percent in 84-85 to 19.59 percent in 91-92 but has declined thereafter. The increase in it was further significant in 95-96 than it reached 17.73 percent, thereafter, which it further declined. Similarly the prime lending rate of term lending institutions increased from 14 percent to 20 percent in 1991 – 92 after, which it declined. Thereafter it showed an increase again in 1995 – 96. The advanced rate of SBI remained at 16.5 percent till 1991 – 92 and it increased to 19 percent in 1992 – 93, where after it declined to 14 percent. The trends in the interest structures of the debentures increased from 10.5 percent to 14.2 percent in 1996 – 97.

In the organized sector, the slower rise in the long rates may be attributed mainly to two reasons[2], firstly, fixed asset formation has been regarded as desirable for the economy, and as such, the cost of long-term investment has been deliberately kept low. Secondly, the setting up of a number of term lending institutions facilitated the availability of long-term finance at lower rates. they obtained concessional finance from the government and RBI for their operations and profitability had not been a predominant consideration for their lending. At the same time, short-term rates had been stepped up as it was found that short-term finance was being used for holding excessive inventories which among other factors caused inflationary pressures. The increase in short rates has thus been regarded as an institution to fight inflation in the country.

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1) L. M. Bhole (1982) pp. 321-322.

2) L. M. Bhole (1982) p 343.

The rate of interest on public deposits are administered since 1971-72. They are in the form of different ranges for different maturity period. The interest rates are fixed to encourage competition among the companies an the company with better finance standing maybe able to at least deposit at lower rate of interest. The interest rates of public deposits of three years maturity are presented in the table. This interest increased till 1991 – 92, where it reached 12 percent it declined slightly between 1992 – 95 and increased further in 1995 – 96.

When we compare the interest rate structure of the commercial banks with that of the term lending institutions we see a high rate of disparity. Over the entire period of study the interest rate of term lending institutions was much higher than that of the commercial banks.

Table 4.4

Interest rate structure of different sources of funds for private corporate sector in India

(percent per annum)

Year	Debentures	Public deposits	weighted average lending rate of SCB	advance rate of SBI	Prime rate of TLIs ($)	Interest cost as a percent of total borrowings
1984-85	10.5	8.0-9.0	9.95	16.50	14.00	9.7
1985-86	11.5	8.5-9.0	10.00	16.50	14.00	10.6
1986-87	11.5	8.5-9.0	9.99	16.50	14.00	6.9
1987-88	11.5	9.0-10.0	9.88	16.50	14.00	11.0
1988-89	11.7	9.0-10.0	9.77	16.50	14.00	10.6
1989-90	11.8	9.0-10.0	11.49	16.50	14.00	11.1
1990-91	12.0	9.0-10.0	11.49	16.50	14-15	13.8
1991-92	12.3	12.0	19.59	16.50	18-20	13.1
1992-93	12.4	11.0	14.42	19.00	17-19	8.7
1993-94	13.4	10.0	6.99	19.00	14.5-17.5	12.4
1994-95	13.4	11.0	9.40	15.00	15.00	16.9
1995-96	13.0	12.0	17.73	16.50	16-19	20.3
1996-97	14.2	11-12	7.84	14.50	16.2	14.9
1997-98	13.1	10.5-11	8.69	14.00	13.3	10.9

SCB – Scheduled Commercial Banks, SBI – State Bank of India, TLI – Term Lending Institutions

$ - Data relates to IDBI; Since the ranges of interest on public deposits are different according to the maturity period, only interest range for maturity of three years is mentioned.

Source : Handbook of Statistics on Indian Economy, RBI – 2000.

The return on ordinary shares, is not strictly comparable with interest rates on other financial claims. Yet, since shares represent an alternative method of investment, investors compare the yield on shares with interest rates on other financial assets. The total rate of return on ordinary share is composed of (i) gross yield and (ii) capital gains.
Thus, we see that interest rate policy plays an important role and can effectively utilized for discerning of any component in the capital portfolio of the corporate sector.

To conclude we can say that, the changing pattern of finance from internal to external sources and within external sources, a tendency of declining borrowing proportions have been explained in terms of macro economic variables and interest policies in this section. Whereas, the periods of high growth of industrial output tended to induce the corporate sector more of external sources; internal sources constituted a higher proportion of total sources during sluggish growth. Inflation and proportion of borrowings in the capital structure of the corporate sector appeared to move in the same direction barring a few exceptions. Interest rate policy appeared to influence the holding of different corporate securities – claims. The higher rate offered on debentures and public deposits might have induced the investor to hold them on a larger scale where as a lower interest charged by the term landing institutions might have prompted the corporate sector to rely on them for increasing proportion of funds.

Thus the management of macro economic policies exerts its influence on the capital structure of the private corporate sector. Growth inducing policies, which ensures high growth rates of industrial outputs may prompt the private corporate sector to go for increasing proportion of external finance. The management of inflation will also have its impact on borrowing orientation of the private corporate sector. Investing public and the corporate sector also take into account will revealing their preference for any form of security – claim. Thus, interest rate policy plays an important role and can be effectively utilized for discerning of any component in the capital portfolio of the corporate sector.

CHAPTER V

RECENT DEVELOPMENTS

Pre reform economy

Until early 90s, no important financial decisions were made due to simple reason that the firms were given very little freedom in the choice of key financial policies. Government regulated the price of equities, rate of interest on bonds issued by the firms and the debenture equity ratio that was permissible in different industries. Moreover, public sector institutions provided most of the debt and a significant part of the equity. Working capital was financed almost entirely by banks at the interest rates laid down by the central bank. The idea that the interest rates should be related to the credit worthiness of the borrower was still heretical. Even the quantum of working capital finance was related more to the credit need of the borrower than to credit worthiness on the principle that bank credit should be used only for productive purposes. Firms did not even have to worry about the deployment of surplus cash. Bank credit was provided in the form of an overdraft on which interest was calculated on daily balances. This meant that even an overnight cash surplus could be parked in the overdraft account where it could earn interest at the firms borrowing rate. The exchange rate of the rupee changed predictably and almost imperceptibly. Administered interest rates were changed infrequently and the changes too were usually quite small. During that period, financial genius consisted largely of finding one's way through the regulatory maze, exploiting loopholes wherever they existed instead, and above all cultivating relation ships with those officials in the banks and institutions who had some discretionary powers.

In 1991, the Indian economy was seen as having a variety of problems including an inefficient, high cost and non-competitive industrial structure; serious infrastructure related bottlenecks and significant constraints on the availability of financial capital. It was argued that policy induced micro-economic rigidities had constrained firm choices, apart from protecting Indian enterprises from internal and external competition. And if these rigidities did not exist, industrial performance would be better. A variety of micro-economic rigidities induced by industrial, trade, public sector, and foreign investment policies were identified.

Industrial policy did not encourage competition but contributed to inefficiency. Bureaucratic determination of plant capacity, product mix and location and resulted in ignoring the market processes. Industrial licensing and other controls lead to severe and exit barriers and encouraged rent-seeking and lobbying. Besides, trade in scarce materials, became more lucrative than efficient manufacturing.

Trade policy had an anti-export bias, which blunted export orientation. This bias was reinforced by curbing of imports via tariffs and quantitative controls as a part of import substitution strategy. This lead to reduction in external competitive measures and increase in inputs; the firms were denied optimization in the use of inputs. The foreign exchange policy with an overvalued rupee made Indian exports non-competitive. Markets for illegal foreign exchange transactions were emerged; and capital flight took place.

Public sector policy contributed to inefficiencies through its pervasiveness in heavy industry and infrastructure and provided monopoly power to public sector units(PSUs) in industries which were reserved for them. Entry barriers and inefficiencies in PSUs lead to higher input cost for the private corporate sector. Inefficiencies along with soft budget constraints meant low rates of return and no surpluses for reinvestment in the PSUs. Similarly lack of competition meant that PSUs had no incentives to be efficient.

Foreign direct investment (FDI) policy puts severe restrictions on portfolio and direct investment, imposed tight controls on technology transfer, licensing and consultancy, adding to the constraints faced by firms in terms of technology, international marketing and in building strategic alliances. Foreign Exchange Regulation Act (FERA) sort to control the use of scarce foreign exchange resources limiting the freedom of foreign investors. Restrictions on FDI flows combined with anti-export bias meant that internationally scales of production could not be achieved.

Financial sector policy added to capital constraints by crowding out private sector and diminished bank profits by ignoring market forces and imposing administered interest rates, directing 'policy loans' to agriculture and small industry and government. Moreover, there were restrictions on raising equity from the market; both the quantum and pricing was decided by bureaucrats.

These microeconomic rigidities did not allow firms to make rational choices. The New Economic Policy (NEP) in theory is designed to remove these policy induced distortions. Therefore, liberalization is seen as a remedy for the longer-term constraints to growth. Some salient policy changes and their implications were :

Wide spread industrial delicensing has resulted in more flexibility for firms in their investment decisions and choosing plant capacities. Delicensing also has a potential for increasing domestic competitive pressures.

Dilution of MRTP Act has removed many restrictions on corporate investments and growth.

Trade reforms lowered tariffs and removed many physical barriers on imports (such as quotas). These changes enhance import competition for tradable and permit firms to rationalize their input purchase decisions.

Many new sectors were opened up for FDI and higher equity participation. This permits MNCs to have better control over ventures through higher equity.

Changes in FERA removed shareholding and business restrictions on MNCs.

Policy related to foreign technology purchase an licensing were liberalized. This improved access to technology.

Capital market reforms coupled with the removal of restrictions on firms to tap capital markets reduced entry barriers. Earlier access to financial resources was better for business houses which had control over many 'independent' enterprises.

The new regime permits Indian Firms to access international capital markets. Inward flow of foreign portfolio investment from foreign institutions has increased foreign exchange availability as well as creating a condition in which non-performance may be severely punished.

The last few years of financial reforms have changed all this beyond recognition. Today the corporate finance managers have to choose from an array of complex financial instruments; They can now price them more or less freely, they have an access to global capital markets, they now have to deal with aggressive financial intermediaries and institutional investors, they are exposed to volatility of interest rates and exchange rates etc.

Financial Sector Reforms: A Summary.

The financial sector reforms currently underway in India must be seen as a component, of the overall scheme of structural reforms. The overall package is aimed at enhancing the productivity and efficiency of the economy as a whole and also increasing international competitiveness. The reforms are comprehensive in scope covering besides financial sector reforms, several other components of economic policy including, liberalization and deregulation of domestic investment, opening up of the infrastructure areas it had to reserve for the public and private sector participation, opening up the economy to foreign competition by reducing protective barriers such as import control and high tariff, encouraging direct foreign investment and a source of technology, upgradation and also a source of non-debt finance for investment, reform of the public sector to impart greater efficiency of operations and reform of the tax system to create a structure with moderate rates of tax, broader base of the taxation and greater ease of the administration. All these reforms are closely inter-related, and progress in one area helps to achieve objectives in others. Since the reforms are being introduced in a phased manner the extent of progress differs from area to area. Importance of the financial sector reforms in this structured package needs to be delineated clearly. Structural reforms in areas such as industrial and trade policy can succeed only if the resources are redeployed towards more efficient producers which are encouraged to expand under the new policies. This reallocation is possible only if the financial system plays a crucial supportive role. The reforms in the banking sector and in the capital market are aimed precisely at achieving this primary objective.

The Indian financial system comprises an impressive network of bank and financial institutions and a wide range of financial instruments. There is no doubt that there has been a considerable binding and deepening of the Indian financial system, particularly in the last two decades. The extension of banking and other financial facilities to a larger cross-section of the people stands out a significant achievement. As a ratio of GDP at current prices, bank deposits increased from 18% in 1969-70 to 45.3% by the end of 1994-95. all the indicators of the financial development, such as, the 'finance ratio', 'financial inter-relation ratio' and 'intermediation ratio' have significantly increased, implying the growing importance of financial institutions in the economy and growth of financial flows in the relation to economic activity.

The ongoing financial sector reform aim at promoting a diversified, efficient and competitive financial sector with the ultimate objective of improving the allocative efficiency of available resources, increasing the return on investment and promoting an accelerated growth of the real sector of the economy.

One of the early successes of the reform was the speed with which exceptional financing was mobilized from multilateral and bilateral sources. Devaluation, trade reforms and the opening up of the economy to capital inflows helped to strengthen the balance of payments position. The significant reforms in the area of exchange control and convertibility were - exchange control on current account transactions were progressively relaxed culminating in current account convertibility. Foreign institutional investors were allowed to invest in Indian equity subject to restriction on maximum holdings in individual companies, but these restrictions have been progressively relaxed. Indian companies were allowed to raise equity in the international markets subject to various restrictions. Indian mutual funds were allowed to invest a small portion of their assets abroad. Indian companies were allowed to borrow in international market subject to a minimum maturity, a ceiling on the maximum interest rate and annual caps on aggregate external commercial borrowings by all entities put together.

At the beginning of the reform process, the banking system probably had a negative net worth when all financial assets and liabilities were restated at fair market values. At the peak of the crises, the balance sheets of the banks depicted an entirely different picture. Accounting policies not only allowed the banks to avoid making provisions for bad loans, but also permitted them to recognize as income the overdue interest on these loans. The severity of the problem was thus hidden from the general public. The major banking sector reforms were – capital base of the banks were strengthen by re-capitalization, public equity issue, and subordinate debt. Prudential norms were introduced and progressively tightened for income recognition, classification of assets, provisioning of bad debts, marking to market of investments. Pre-emption of bank resources by the government was sharply reduced. New private sector banks were licensed and branch-licensing restrictions were relaxed.

As per the financial institutions, economic reforms deprived them of their access to cheap funding via the statuary pre-emption from the banking system. They have been forced to raise resources at market rates of interest. The subsidized rates at which the financial institutions used to lend to industry have given to market driven rate s that reflects the institutions' cost of funds as well as an appropriate credit spread. In the process, institutions have been exposed to competition from the banks that are able to mobilize deposits at lower cost because of their large retail branch network. Responding to these changes, financial institutions have attempted to restructure their business and move toward s the universal banking model.

A very important element of the financial sector has been the deregulation of interest rates. Interest rates were freed on corporate bonds, most bank lending, and bank deposits above one-year maturity. Administered interest rates are now confined mainly to short-term bank deposits, priority sector lending, and deposits on non-banking financial companies. Introduction of interest rates for government securities. The prices of most financial assets are determined by the more or less free play of market forces. As a result, financial market are increasingly able to perform the important function of allocating resources efficiently to the most productive sector of the economy.

The major reform in the capital market was the abolition of capital issues control and the introduction of free pricing of equity issues in 1992. Moreover, the Securities and Exchange Boards of India (SEBI) was setup as the apex regulation of the Indian Capital Markets. Some regulatory measures taken in the primary markets by SEBI are- tightening of the entry norms for capital issues, improving discloser requirements, framing of regulations and laying down the code of conduct for merchant bankers, underwriters, mutual funds, bankers to the issue and other intermediaries etc. Certain measures introduced in the secondary were online trading at all stock exchanges, margining system was rigorously enforced, dematerialization of scripts initiated with the creation of a legislative framework and the setting up of the first depository, capital adequacy and prudential regulations were introduced for brokers, sub broker and other intermediaries, settlement period was reduced to one week and carry forward trading was banned and then reintroduced in restricted form. Since the advent of reforms, the growth of the Indian Capital Market has been very impressive. The stock market index has shown a significant increase during the 90s despite several ups and downs.

In spite of the steps taken to increase competition between financial intermediaries both within and across categories; banks and financial institutions have been allowed to enter each other's territories, yet the actual progress is lagging behind the stated intent. Fields like mutual funds, leasing, and merchant banking have been thrown open to the banks and their subsidiaries. The private sector has been allowed to enter fields like banking and mutual funds, yet certain structural barriers remain; all major banks and financial institutions continue to be government owned and government managed. The entire mechanism of directed credit and selective credit controls built up over the years is still in place and is strengthened in certain areas, .insurance continues to be a public sector monopoly and the range of insurance products (life and non life) available in their country is also limited. The regulators have not yet moved to create a full fledged options and future market.

In the early 90s, the Indian debt market was the best described as the dead market. Financial repression and over-regulation were responsible for this situation. Reforms have eliminated financial repression and created the pre-conditions for the development of an active debt market. The government reduced its pre-emption of bank funds and moved to the market determined interest rates on its borrowings. Automatic monetisation of the government's deficit by the central bank was limited and then eliminated by abolishing the system of ad hoc treasury bills. Several operational measures were also taken; withdrawal of tax deduction at source on interest from government securities and provision of tax benefits to individuals investing in them, introduction of indexed bonds where the principal repayment would be indexed to the inflation rate, permission to banks to retail government securities.

Impact of the changes on the corporate sector.

Economic reforms have not only increased growth prospects, but have also made markets more competitive. This means that in order to survive, companies will need to invest continuously on a large scale. The most powerful impact of voting with the wallet is on companies with large growth opportunities that have a constant need to approach the capital market for additional funds.

Financial sector reforms have made it imperative for firms to rely on capital markets to a greater degree for their needs of additional capital. As long as firms relied on directed credit, what mattered was the ability to manipulate bureaucratic and political processes; the capital markets, however demand performance.

Globalization of our financial market has exposed issuers, investors, and intermediaries through higher standards of disclosure and corporate governance that prevail in more develop capital markets.

The increasing institutionalization of capital markets has tremendously enhanced the disciplining power of the market. Large institutions (both domestic and foreign), in a sense, act as gatekeepers to the capital market. When they vote with their wallets and pens, they have an even more profound effect on the ability of the companies to tap the capital markets. Indian companies that opened their doors to foreign investors have seen this power of the minority shareholders in very stark terms. International investors can perhaps be fooled for the first time about as easily as any other intelligent investor, but the next time around, the company finds that its ability to tap the international markets with an offering of Global Depositary Receipts (GDRs) or other instrument has practically vanished. In the mid nineties, company after company in India has woken up in this manner to the power that minority shareholders enjoy when they also double up as gatekeepers to the capital market.

Tax reforms coupled with deregulation and competition have tilted the balance away from black money transactions. It is not often realized when a company makes profit in black money, it is cheating not only the government, but also the minority shareholders. Black money profits do not enter the books of accounts of the company at all, but usually go into the pockets of the promoters.

The past few years have witnessed a silent revolution in Indian corporate governance where management's have woken up to the disciplining power of the capital market. In response to this power, the more progressive companies are voluntarily accepting tougher accounting standards and more stringent disclosure norms that are mandated by the law. They are also adopting more healthy governance practices. Nevertheless it is still true that the state of corporate governance in India remains pathetic.

Capital Structure

The Indian corporate sector was significantly over levered at the beginning of the reform process and this was due to; subsidized institutional finance which was so attractive that it made sense for companies to avail of as much of it as they could get away with. This basically meant the maximum debt-equity ratios made down by the government for various industries. In the protected economy, operating risks were lower and companies could therefore afford to take more risks on the financing side. Most of the debt was institutional and could usually be rescheduled at little cost.

The reforms changed all of this and the corporate sector was exposed to international competition and subsidized finance gave way to a regime of high real interest rates. One of the first tasks for the Indian companies was substantial deleveraging. Fortunately, a booming equity market and the appetite of foreign institutional investors for Indian paper helped companies to accomplish this. Over the longer term the economic reforms have also been reshaping the control dimension of the leverage decision. Corporate control is an important consideration in the choice of debt or equity in the capital structure. An equity issue clearly involves loss of control, similarly, a debt issue can also have control implications in the form of debt covenants, rating discipline and cash flow discipline.

The private corporate sector in India responded favorably to economic reform with larger investments in the early 1990s. The rate of growth of fixed capital formation, however, stared to decline after 1994-95. In 1995-96, gross fixed capital formation in the private corporate sector actually declined as a proportion of GDP. More recent data on actual rates of capital formation are not available. However, information on investment intentions for the period 1997-98suggest a definite downturn since 1995.

Strategies of pre reform period – Non-price competition is typical of oligopolistic market structures. Chandrashekhar (1994) has identified three phases of oligopolistic rivalry in post-independence India. Till the early 1980s, Indian Business houses sought to pre-empt entry by monopolizing industrial licenses. These Licenses provided them with significant degrees of monopoly power as subsequent entry was not possible. Even when fresh capacities were to be created in specific industries with new licenses, these ere captured by the same business houses and often not converted into actual capacities. Since gaining access to licenses in new industries had the potential of monopolizing those markets, large firms lobbing for these licenses even when the products/industries were outside the ambit of the firm's area of activity. As a result, over diversified, and fragmented but monopolistic firms emerged but monopolistic firms emerged in the Indian manufacturing sector.

Absence of mature capital markets during this phase sustained these entry barriers because capital availability was restricted to incumbent oligopolies; 'outsiders' could not access capital easily. Development of capital markets and accumulation of capital outside the domain of the traditional oligopolies (business houses), reduced entry barriers and the 1980s saw emergence of new business houses. This intensified domestic rivalry and induced some attempts at restructuring by the traditional oligopolies to face new competition. Even before this phase could get completed. economic reforms of 1991 significantly enhanced external competitive pressures. Consequently, the Indian corporate sector had to face both internal and external competition simultaneously.

Economic reforms has significantly reduced microeconomic rigidities and enhanced competitive pressures. Corporate restructuring in recent years is a response to this opportunity provided by policy in order to meet the emerging competitive challenges.

Capital Market

As a part of the process of economic liberalization, the stock market has been assigned an important place in financing the Indian corporate sector. Besides enabling mobilizing resources for investment, directly from investors, providing liquidity for the investors and monitoring and disciplining company management, company management are the principal functions of the stock market. In India, stock market development received emphasis since he very first phase of liberalization in the early eighties. Additional emphasis followed after the liberalization process got deepened and widened in 1991 as development of stock market was made an integral part of the restructuring strategy. Repealing of the Capital Issues Control Act,1947 (CICA) in 1992 made the stock market more popular as the government's prior permission was not required to have an access to the capital market. The number of issues increased steeply after this, but there was a steep decline in this in 1996-97 due to several reasons such as, stock scam, optimism generated among the entrepreneurs by the delicensing, entry of small companies with the aim of making quick money through price manipulations etc. Thus within a few years of repealing of the Capital Issues Control Act, restrictions on capital issues had to be introduced, but in a different manner, to safe guard investors money and protect the institution of stock market itself.

The aggregate market turnover is an important component in the measurement of stock market size and liquidity. The overall turnover at BSE increased significantly during the post-liberalization period, but the increase has been more substantial after 1995-96. Heavy concentration in turnover has been an important characteristics of the Indian stock market.

In the endeavor to encourage companies to raise resources directly from the investors and dismantle administrative barriers, the Indian stock market was encouraged alongside liberalization. The necessary regulatory work was , however, slow to evolve. It appears that the process of liberalization could have been gradual. The repealing of the Capital Issues Control Act was done in the face of the securities scam, the inexperience of the regulatory body, namely SEBI coupled with the government's failure to arm it with adequate powers in time, enabled the private promoters to misuse the new freedom and generated a series of scams of different types and magnitude. Sudden deregulation created chaotic conditions as private promoters tried to take advantage of the situation. The official response to the scams unfortunately was characterized by long drawn investigations, procedural delays and a slow acting judiciary. The process understandably brought a lot of discredit to the stock market.

The abrupt change to a market based system denied the general investor the time to adjust to new situations where the public financial institutions, the industrial licensing system and finally, the capital issue control mechanism could no longer be relied on to assure the viability of investment projects. The typical investors were neither in the position to understand the nuances of investing in new issues having no long term track record nor were ready to appreciate the risk factors

After experiencing a boom in the early years of liberalization, the primary market almost dried up as investors lost confidence and households shifted away from investing in shares and debentures. Companies had to once again opt for assistance from banks and financial institutions denying the stock market its role of resource allocation. SEBI had to tighten issue norms to prevent further damage. The non-responsive private market also reflected public sector divestment targets and the plans had to be deferred repeatedly.

Since the confidence of the general investor in the market has been shaken, the response to the repetitive attempts by the government at reviving the market proved to be short-lived. Trading got increasingly concentrated and trading volumes were increased mainly through great speculation. In the face of increasing turnover, the concentration in trading manifested itself in a number of ways; (I) nil or very infrequent trading in an overwhelming number of companies; (ii) increasing concentration both in value and number of trade terms; and (iii) dominance of a few sectors in trading. The heavy emphasis on a few companies has its reflection in the remaining ones being illiquid. Since in an overwhelming number of companies there was either nil or very little trading, investors hardly had a chance to learn the real value of their shares. Lack of liquidity also meant that the investors could not exist from a company even after realizing that the prospects of capital appreciation or dividend earnings were very poor.

There is a possibility of interpreting the lack of interest shown by the ordinary investor following the primary market scam, as a sign of his maturity and that he would be more cautious in future.

Even granting that this was a positive outcome, it should be recognized that this has been achieved at a substantial cost and brought the very concept of stock market regulation to disrepute. The recent developments, when excessive attention is being paid to the sectors like information technology, telecommunications, media and pharmaceuticals, however, throws serious doubts about the Indian investor gaining maturity. Seeing that investors were flocking to companies carrying software and information technology tags, SEBI had to caution them. Without proper education, the ordinary investors are bound to behave like a herd. Given the comparatively ill-informed investors and lack of liquidity in many shares, the investors would only concentrate on few shares.

While computer software, telecommunications, electronic media, pharmaceuticals and consumer non–durables emerged as leaders, the extent of price declines in the case of important basic, capital and intermediate goods sectors unfortunately never got reflected in the price indices referred to as barometers of the market mood. If the general lack of interest of the stock market in the latter sectors is due to the excessive attention paid to the former, serious thought should be given as to how there financing needs could be met. If the stock market does not support these industries due to investor's preference for quick returns, as is clearly evident from the low delivery ratios, the efforts of the state in the form of development financial institutions should not be undermined. If the functioning of financial institutions has also to be decided by market forces they cannot obviously undertake ventures based on the projects' long-term potential and in the interest of the economy. Given the investors propensity to seek quick returns due to the unsteady nature of the market, it is doubtful if the improvements in the form of dematerialization of shares, rolling statement, etc., would improve the situation. In this the role of foreign institutional investors and mutual funds need to be watched carefully.

The fact that 1999 proved to be different in terms of the relatively higher level of share prices and larger number of companies getting traded may give rise to a false sense of security. While the share price of a number of companies increased in consonance with sensex, not only the index for these companies remained far lower than its 1994 position, there are wide inter-sectoral differences. The concentration in trading continued to be quite high. The shareholding pattern of the listed sector does not appear to be conducive to monitoring by shareholders. Since the shareholding pattern does not seem to support stock market discipline, and investor activism is yet to take an organized form, other institutional mechanisms in the form of amendments to the Companies Act should have been given precedence over the liberalization provisions like buy-back, inter-corporate investments and enhanced shares for the promoters.

It is now well established that the process of economic development is facilitated by the existence of a well functioning financial market. Infact, development of the financial structure is seen as a necessary condition to economic growth. It is essential that financial institutions are sufficiently developed and the market operations are free, fair, competitive, and transparent. The market should also be efficient in respect of information, minimize the transaction cost and allocate capital most productively.

The financial services provided by the primary and the secondary segments of the capital market are an important source of finance for the corporate sector. Moreover, raising of funds by the companies through capital market, apart from mobilizing savings provides a mechanism for spreading the ownership of shares widely directly or indirectly through institutions and mutual funds. It is observed in the context that countries, where share ownership is widely spread, there is a need for institutional investor like financial institutions, Unit Trusts, Mutual Funds etc. to act as intermediaries for the small investors who cannot manage their investments. Competition amongst these institutional investor includes efficient working of the corporate sector and stock exchanges. Besides, it includes institutions to offer better returns to investors according to their risk-reward preference. Thus, they are able to attract more small savers into providing risk capital for industrial development.

It would be worthwhile to note that the stock market can allocate capital efficiently and consequently contributes to economic development by channelizing capital to more productive use. This function is performed in respect of the companies listed on the stock exchange through a degree of supervision over the behavior of companies by continuous evaluation of their share prices and a system of disclosure about their performance. If the share prices record of a company is weak, then it is invariably discouraged from raising new funds. Firms with high share prices are more secure and find it easier to raise equity to finance investments. Mutually reinforcing feedback effects between the securities market and the real economy exist, which propel the later of higher levels of growth. A well functioning capital market also helps in the transformation and distribution of risk and maturities, provision for professional management

and wider options for portfolio diversification. It also facilitates credible private contracting. For these reasons, stock markets serve as an efficient mechanism for allocating capital.
Capital markets also assist in the internationalization of economy by linking it up with other international markets. This linkage assists through the inflow of capital in the form of portfolio investment. Besides, a strong domestic stock market performance forms the basis for well performing domestic corporations to raise capital in the international market. This would imply that through linkage of stock markets, the domestic economy is opened up to international competitive pressures which help to raise the efficiency. The company which raises capital overseas, by competing for capital there, has to be sound performer.

Stock markets have to function in a country's social, political and economic milieu. When encouraging stock markets it is necessary to give due attention to hand and respected by the target groups on the other. Indian experience shows that evolution of such an institutional framework will most often be gradual and cannot be achieved in a swift manner and that without a suitable institutional framework in place, the cost of transition could be very high. Thus, there is need for the deeper understanding of the functioning of developing country stock markets without which inferences based on aggregate data may lead to inappropriate policy prescriptions. Such an understanding would contribute to better appreciation of the role of stock markets in resource mobilization and their contribution to economic development.

The capital market in India is bound to grow in size. With the induction of private participation, public sector companies will also come to the capital market to access funds. The growth of the corporate sector will also be in tune with the growth of the economy. Equity cult which gained immense popularity in the last half decades is becoming a permanent aspect of the Indian market. Mutual funds, foreign institutional investors and overseas country funds are new entrants to the market. Thus, both on the supply and demand sides, the market is bound to expand. The capital market is therefore, well poised for rapid growth and it is essential that we set the ground rules right so that this growth can be achieved smoothly.

Thus, we have seen the various changes made in the Indian economy after 1991. These changes made the economy more liberalized and competitive exerting an impact on the corporate structure.

CHAPTER VI

SUMMARY AND CONCLUSIONS

In concluding this study on the financing of the private corporate sector in India 1984 – 85 to 1997 – 98, we note some marked structural changes in the composition of internal and external sources in the total sources of funds. The entire study was divided into two periods, from 1984 – 85 to 1990 – 91 and period from 1991 – 92 to 1997 – 98. The entire period of study is divided in these two periods in accordance with the pre reform economy and the reformed economy.

The trends in the financing pattern of the private corporate sector indicates a shift in the favour of internal sources in the reformed economy. In the pre reform economy, the private corporate sector was relying greatly on the external sources. What is important to note here is that, the dependency of the private corporate sector has always been higher on the external sources rather than on internal sources, but the relative proportion of the external sources declined in the post liberalization period. Even though, with the new economic reforms the Indian economy was flooded with foreign investment that to more of FDI, yet the private corporate sector was unable to make use of the funds available, as is shown by the decrease in the proportion of external funds. this was explained with respect to the level of industrial production. The industrial growth was high in the pre reform economy, thereby in order to expand the operations further private corporate sector was utilizing more of external sources, where as in the reformed economy the industrial production had declined and more of the internal sources were used. This could also be due to the fact that the investors wanted to avoid risk of employing more of external sources in times of low industrial production. During a high rate, more of the external sources were used. An environmental propitious to economic growth tended to favour the use of external funds by the private corporate sector. The rationale of this is, that it would not have been possible to achieve a high rate of output growth with the resource mobilized from internal sources; higher proportion of external sources was therefore resorted to by the private corporate sector.

Among the share of internal sources, the level of reserves and surpluses increased significantly, where as depreciation provision remained by and large unchanged. One of the major components of reserves and surpluses is the retained profits, the levels of retained profit is determined by the amount which will be distributed in the form of dividends. On the other hand, retained profit exerts influence on the expansion operations of the private corporate sector. The share of retained profits has increased significantly in the second period of study. The other component of reserves and surpluses is the investment allowance reserve, which remained quite insignificant during the entire period of study. Investment allowance reserve and depreciation provision, both were fiscal related sources. The fiscal incentive in terms of steep hike in the rate of depreciation would render depreciation allowance an increasingly important instrument for internal generation of funds. Moreover it can also be expected that the enhancement of depreciation allowance would accelerate the pace of replacement of plant and machinery and induce modern technology in the industrial sector. This would reduce the demand for the external sources and induce a tilt in the capital structure in favour of internal sources.

The three main components of internal sources are total borrowings, trade credit and net issues. The share of borrowings had declined in the second period of study but what is important to note here that borrowing still continues to be a single largest source of finance. With the borrowing the share of the banks in the total sources has declined, where as the share of the financial institutions has increased. This can be accounted for the varity of the other facilities, provided by these institutions. The financial institutions are more flexible in their financial policies and meet the requirements of the private corporate sector. As for the banks the decline in their share can be attributed to their interest rate structure. The other sources of borrowings include public deposits and debentures. They also exhibited a declining trend, which indicates that the private corporate sector, is not relying on the debentures and public deposits. Apart from the declining trend in the share of borrowings to total sources, analysis has also reveal that, borrowing were positively related to capital formation in terms of fixed assets and also inventory.

The share of trade credit has also declined, but yet its composition in the total sources of funds is significant. It also seems that this trade credit is largely contributed by the sundry creditors. The share of sundry creditors to that of total trade credit, external sources and total sources has increased significantly. Another significant characteristic which has emerged is the change in the debt equity ratio. The ratio of debt to equity showed an increase till the early nineties, but there after there has been a constant decline in this ratio. This indicates that the share of debt was high during the earlier period of study, but there was an increase in the share of equity. This was also analyzed in accordance with the levels of inflation rate in the economy and the structure of the interest rates.

Apart from the aggregated analysis of the private corporate sector, an industry wise analysis was also conducted. This analysis revealed the trends in the financing pattern of each industry included in our study. The significant characteristic which emerged from this analysis was that, in most of the industries there was no increase in the proportion of internal sources used, as the aggregated analysis indicated, rather there was a decline. A decline in both the internal and external sources in these industries reveal the low production in these industries such as Tea plantation Industry, Sugar Industry, Construction Industry etc., due to the recession in the economy. Some industries, such as tobacco, electricity generation and supply, exhibited similar trends as the aggregate sector. But, what was important was the case of chemicals industry. Chemicals industry revealed an increase in the share of external funds which can be explained by the use of increased inflow of FDI. It was the largest user of FDI in the reformed economy.

The analysis has revealed that macro-economic variables like industrial production and inflation, influence the financing pattern of the private corporate sector. Industrial production helps in determining the level of internal and external sources to be used, whereas the inflation determines the level of borrowings, more so it determines the level of debt ot be raised. The high rate of inflation correlates with the high debt-equity ratio. Moreover, the structure of interest rates helps in determining the security or the claim to be used. The higher rate offered on debentures and public deposits might have induced the investor, to hold them on a larger scale, whereas a lower interest rate charged by the term lending institutions might have prompted the corporate sector to rely on them for increasing proportion of funds.

The changing pattern of financing can be attributed to the reforms that were introduced during the beginning of 1991-92. 1991-92 was the year of economic transformation of the Indian economy, when the NEP was introduced. A set of different reforms were introduced simultaneously, which changed the entire face of the Indian economy. These reforms had both, a favorable and an unfavorable impact on the corporate sector. The new economic reforms made the Indian corporate sector more competitive, with the globalization of the economy, and this has increased the level of requirement of funds. Moreover, financial sector reforms have increased the importance and dependency on the capital markets. Further the tax reforms have been successful in utilizing the surpluses in a more profitable manner. The reforms also had a very significant impact on the capital market and the capital structure of the companies.

In terms of general conclusion, it can be said that the private corporate sector in India operates under the institutional framework of government controls and regulations. These control instruments not only guide and direct the course of industrial development, but also to a large extent determine the financial pattern of the corporate sector. In part, fiscal policies (e.g. Tax rates and tax concessions), monetary policies (e.g. Selective credit control and I interest rates) and capital control rules can be used to influence changes in the capital structure of the private corporate sector in desirable direction.

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APPENDIX

Concepts and Definitions

1. Paid up capital : This term figures both in external as well as internal sources of finance. While internal sources includes the borrowings of capital, external sources includes net issue and premium on shares.
2. Reserves and Surpluses :
   a. Capital Reserves : Comprises capital reserves, profit/loss on sale of fixed assets and/or investment profit realized, on purchase of companies own debentures, profit on reissue of forfeited shares, surpluses arising on the acquisition of a subsidiary capital redemption reserves and reserves arising out of revaluation of fixed assets.
   b. Investment Allocation Reserves : It comprises all reserves set apart in terms of section 33 of Income Tax Act, 1961. It was allowed as a deduction from the business profits and was broadly in the same lines as the development rebate which had been discounted earlier.
   c. Other Reserves and Surpluses : All reserves other than capital reserves and development rebate reserves are shown under this item together with balance of profit/loss carried forward. This also includes special depreciation reserves or initial development reserve.
3. Provisions :
   a. Depreciation Provision : This represents depreciation provided on various fixed assets viz. buildings, plant and machinery and other fixed assets. This item figures in sources of funds but the accrued depreciation figures in the statement of assets.
   b. Taxation Provision : This is taken net of advance payment of income tax and includes provisions for wealth tax, income tax, capital gain tax, super tax and agriculture income tax.
   c. Other Current Provisions : This includes provisions for dividends declared, bonus to staff, employee's welfare, repairs, contingencies and provisions for obsolescence etc.

d. Non Current Provisions : This includes provisions for gratuity, pensions and super annuation benefits to employees etc.

4. Borrowings :

a. Borrowings from Banks : All borrowings from including loans against mortgages and advance against the borrowing company's debentures lodged with banks as security are included in this item.

b. Borrowings from Financial Institutions : These includes borrowings from all institutional agencies other than banks.

c. Borrowings from Government : Borrowings from central, state and foreign government are shown here.

d. Other Borrowings : This item includes all borrowings not covered under any of the above categories. Thus, it comprises borrowings from Indian and foreign companies, managing agents, secretaries and treasures and directors and also deposits from public and other borrowings not classified elsewhere such as debentures issued to public, commercial notes, sterling debt stock etc. Deferred payment credit and hire purchase liabilities are also included here.

5. Trade Dues and Other Credit Liabilities :

a. Sundry Creditors : This item comprises sundry creditors liabilities for goods supplied, liabilities for expenses and liabilities for other finance.

b. Other Current Liabilities : This includes liabilities to subsidiary companies, interest on loans, unclaimed dividends, bills payable, trade deposits, managing agents remuneration payable, share application money (including premium receipt), calls in advance, outstanding liability for expenses and other liabilities of current nature.

6. Miscellaneous Non Current Liabilities : This item includes employees contribution to provident fund and all other non current liabilities not else where classified. The following items figure in the statements of assets as well as in statement on uses of funds

7. Gross Fixed Assets : The gross value of fixed assets i.e. gross of depreciation is shown in this item. It includes the following components

a. Land : This is the gross value of freehold and lease hold land, mines, quarries, colleries.

b. Buildings : This includes factory buildings, staff and worker's quarters, go downs, hospital for staff, crèche, canteen, library etc.

c. Plant and Machinery : It includes all types of plants and machinery used in the production process, eg. , engines, generators, motors, transformers, spindles, looms, humidifiers, swindlers, boilers, foundries, kilns, electrical installations etc.

d. Other Fixed Assets : All installation and equipments used for production purposes, other than those grouped under plant and machinery are classified under this item.

8. Net Fixed Assets : This item is derived by deducting accumulated depreciation provision from total gross fixed assets. However, this item does not figure in statements on uses of funds.

9. Inventories : Inventories include the following the following components.

   a. Raw Materials : This item includes all types of raw materials used in the manufacturing of the final products.

   b. Finished goods and Work In Progress : All types of finished products of the companies and also work in progress are include in this item.

   c. Others : This includes stores and spares used by the companies for maintaince of its plant and machinery, buildings, transport equipment, etc, food stuff for canteen run for benefit of employees, tools, implements, office stationary, tins, other packaging material, building material, etc, if not included as raw materials or finished goods are included here.

10. Loans and Advances and Other Debtor Balances : This item consists of the following two components

   a. Sundry Debtors : This item is taken as net of provision for bad debts.

   b. Others : It includes all loans and advances and other debtor balances other than sundry debtors. This item covers dividend/interest accrued on invested loans and advances to subsidiaries, companies, under the same management and other loans and advances including those to staff, balances in current account with managing agents, secretaries, treasurers, bills receivables, pre-paid expenses, trade deposits with companies and others, excise duty claims, export dues claim and similar items.

11. Investment : This item includes five components

a. Government Securities

b. Semi-government Securities

c. Industrial Securities

d. Shares and debentures of subsidiary companies and

e. Others (investment in UTI, in shares of co-operative, partnership and proprietary concern)

12. Other Assets : This item includes

    a. Immovable Properties (not used directly or indirectly for production purposes)

    b. Intangible Assets (goodwill. Patent, trade markets etc)

    c. Miscellaneous Non Current Assets (assets earmarked for employees provident fund, gratuity etc)

13. Cash and Bank Balances : This item comprises fixed deposits with banks, other bank balances and cash in hand.

14. Sales : All receipts from sales of financial goods and services of the company including sale of by-products, waste and scrap are included in this item.

15. Gross Profit : It represents profit before tax provision and interest.

16. Interest : It comprises of gross interest paid on all borrowings, debentures, income tax, arrears etc.

17. Profit Before Tax : It represents total tax provision, dividends distributed and profits retained.

18. Tax Provision : This is the provision towards corporate tax liability and includes amounts set aside for meeting liability of income tax, super tax, sur tax and taxes paid during the year but excludes sales tax, cess and others

19. Profit After Tax : This is the difference between profit before tax and tax provisions and represents the amount available for transfer to reserves and for distribution of dividends to shareholders.

20. Dividends : Represents the total amount distributed/declared as dividends on ordinary and preference shares during the year and is gross of tax cut at source.

21. Profits Retained : This comprises profits retained in business in the form of transfers to various reserves (other than taxation and depreciation) and the balance of profit/loss carried to balance sheet.