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Financing Pattern of Companies in India

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Abstract: The objective of this paper is to present 'Financing Pattern of Joint stock companies in India' for the period 1991 to 2008. The Indian corporate sector is divided into nine broad industry groups so as to make industry-wise analysis of financing pattern. The results of the study indicate a declining trend of Debt equity ratio and Debt to total assets ratio after the initiation of financial sector reforms in India. Also a significant variation is found across industry groups with respect to financing pattern.

Introduction

Capital structure decisions are of vital significance for every company. The firm can issue many different securities in different combinations, but it attempts to find that combination which maximizes its overall market value. The choices between debt and equity to finance a firm's assets involve a trade-off between risk and return. The excessive use of debt may endanger the survival of the firm, while a conservative use of debt may deprive the firm in leveraging return to equity owners. The firms' choice of a combination of debt and equity depends on the various factors. In recent years many theories have been proposed to explain the determinants of capital structure of the firms. These theories suggest that the firms select capital structures depending on the various costs and benefits associated with debt and equity financing. The empirical research work in this area has lagged behind the theoretical work, particularly in developing countries.

Apart from financial risk-return considerations, non-financial factors are also likely to be very decisive in designing capital structure of corporate firms. For instance, use of debt, unlike equity, does not dilute the controlling power of existing owners. In brief, debt is not an unmixed blessing and, hence, a dilemma for the corporate finance managers. Corporate finance managers are expected to design such an optimum mix of debt and equity as is best suited to both the shareholders and the lenders. The capital structure decisions, thus, involves numerous issues. These are; (i) whether capital structure of the corporate enterprises in India is dominated by debt or equity? (ii) What are the major considerations in designing their capital structure? (iii) Is there any preferred hierarchy among sources of raising funds by the corporate firms?; The present paper aims to bring out financing pattern among Indian corporate sector.

Review of literature

In this part of the paper some recent studies on the financing pattern are reviewed.

Billingsley and Smith's (1996) survey of 243 firms reveals that firms use convertibles primarily as an alternative to the straight debt, employing a conversion feature to buy down the coupon rate and thus preserve cash flow. There is a steady trend towards decreasing reliance on convertibles as delayed equity financing. Barclay and Smith Jr.'s (1999) study provides strong support to the argument that a firm's financial architecture is determined primarily by its investment opportunities. The companies with high market-to-book ratio tend to use less debt than companies with low market-to-book ratios. The debt raised by growth firms also tends to have shorter maturity and higher priority than the debt issued by the mature firms. The said financing pattern is interpreted as the result of efforts to preserve financial flexibility and proper investment incentive in growth firms while providing strong managerial incentive for efficiency in mature firms.

Pandey, et al (2000) studied 221 Thai manufacturing firms listed on the stock exchange of Thailand for the period 1990 to 1995. They conducted a survey of the Chief Financial Officers (CFOs). The results of the study show that (a) The Thai firms employ more short-term debt than long term, but the share of the latter has increased in recent years; (b) the attributes of the firm's determinants in the capital structure were mostly found to be as expected for the firms in the emerging capital markets; (c) in practice, Thai managers prefer raising funds from financial institutions and are rather reluctant to make public offerings of equity or debt; and (d) nevertheless, the financial liberalization environment has a little influence on the Thai managers' attitude about equity.

Fan and So (2000) find that Hong Kong firms conformed more to the "pecking-order" principle than a target long-term debt-equity mix in their financing decisions. There is strong evidence that financing and investment decisions are made simultaneously. The firms within the same industry tend to have

more similar capital structure, though it is not a deliberate choice of the management. Firm size is found to be a determinant of capital structure. No evidence is found that managers took into consideration the proportion of intangible assets over total assets of a firm in making capital structure decisions.

Bhole and Mahakud (2004) studied the trends and determinants of capital structure of joint stock companies in India. From the econometric analysis it was concluded that the variables like the cost of borrowing, the cost of equity, the size of firm, the collateral value of assets, the liquidity, and the non-debt tax shields are the major determinants of corporate capital structure in India.

Narasimhan and Vijayalakshmi (2004) Surveyed 478 companies and found that Indian firms have been exposed to increased competition following the economic liberalization. After controlling size, industry and payout impact on capital structure, it was found that firms increase debt to total capital ratio during the period of increased business risk.

Kuldip Kaur (2008) studied the factors that determine the extent of debt ratio mix in 70 Indian firms from three industry groups namely textile industry, engineering industry and 'chemical, dyes and pharmaceutical industry' for a period of sixteen years. The study brings to fore that the size of the firm, proportion of fixed assets to total assets, risk involved in business and the debt servicing capacity of the firms are the important factors affecting the debt ratio mix of the firm.

Objectives and Methodology

This study aims to bring out the financing pattern of select industries in India; and to study the changes, if any, in financing pattern of corporate in India since liberalization in 1991. The present study aims to test the hypothesis that there is no variation in the capital structure ratios across various industries; and there is no significant difference between the capital structure ratios for the Ist phase and IInd phase of liberalization.

Sample and Database: The financing pattern of nine industries namely Chemical, Machinery, Textile and Metal and Metal Products, Diversified, Food and Beverages, services, transport equipment and miscellaneous industries has been studied. These industries represent major part of corporate sector. The number of sample companies varies from 617 to 702 in various years. The reference period for the present study ranges from the year 1991 to 2008 (i.e. a period of 18 years). The requisite data have been collected on yearly basis for this duration. For this study, the data has been collected from the. 'PROWESS' database.

The data have been analysed by using two ratios namely: Debt Equity Ratio and Total Debt Ratio. The ratios are presented in the form of mean of the companies in each industry. T-test has been applied to examine the significance of difference of mean ratio between two phases of reforms. Analysis of variance (ANOVA) is put into use for determining the significance of variation in leverage ratios across various industries under reference of this study.

Results and Interpretation

1. Long-term Debt to Equity Ratio (D/E)

Table 1 indicates that on an average, the debt-equity ratio of the companies in Chemical industry lies in the range of .95 to 1.48 during the period 1991 – 1998 and in the range of .57 to .98 during 1999 – 2008. The mean debt equity ratio in the Ist and IInd phase are worked out at 1.15 and 0.80 respectively. The above indicates that debt is a significant source of financing for companies in India. However, the table discerns a sharp decline in the proportion of debt to equity during the whole study period and the same is even more true in 21st century. It implies that during the second phase of liberalization the importance of debt as a source of financing, in the Chemical industry, has declined sharply. In order to examine the null hypothesis that there is no significant variation between between the debt equity ratios of phase Ist and second of liberalization t-test has been applied. The results of the test shows that the null hypothesis stands rejected at .01 level of significance. Hence, the mean D/E ratio has declined significantly over the years in case of Chemical industry.

The debt equity ratio as well as the positional averages have also registered a downward trend in case of Machinary industry in the liberalized era in India. During, 1991 – 1998, and 1999 – 2008, the mean D/E stood at 1.03 and 0.62 respectivelly in Machinery Industry. Mean Debt equity ratio is found highest (1.31) in the years 1992 and lowest (0.32) in the year 2005. The null hypothesis that there is no significant difference between D/E ratio of machinery between two period 1991-1998 and 1999-208 was tested by applying independent sample t test. The result of the test rejects this hypothesis at 0.01 level of significance. Hence the debt equity ratio has declined significantly during 2nd phase of reforms in case of machinery industry.

The pattern of D/E ratio in Textile Industry indicates a lot of fluctuations. The D/E ratio stood the highest (1.99) in 2008 and the lowest(0.98) in 2005. This ratio showed a declining trend between 1999 and 2005, however increased their after. The above mentioned pattern also holds good for median and

quartiles of the D/E ratio for textile industry. The results of t-test rejects the null hypothesis and hence significant variation has occurred in D/E ratio of textile industry during two phases of liberalisation.

In case of Machinery industry the mean D/E ratio in the 2nd phase is observed lower (0.87) than that in the 1st phase (1.30) in case of Metal and Metal Products industry. On an average this ratio stood at 1.07 for the entire period (1991-2008) in case of metal and metal products as compared to 0.81 in machinery industry and 0.97 in Chemical Industry. The value of t-test is found significant at 0.001 level of significance. Hence, D/E ratio in metal and metal products industry during the 1st and 2nd phase of liberalization differs significantly.

The debt-equity ratio of Diversified industry lies in the range of .67 to 1.58 during 1991 – 1998 and in the range of .64 to .91 during 1999 – 2008. The mean debt equity ratio in the 1st phase and IInd phase and at overall level are worked out at 1.09, 0.83 and 0.95 respectively. The above indicates that debt is a significant source of financing for diversified companies in India. While, the table discerns a sharp decline in the proportion of debt to equity up to 1994, but it gets momentum again in 1995 and maintains it up to 1998. However, after 1998, it has shown mix trend of ups and downs. This ratio continues to remain below 1.0 since the year 1999. Thus, during the second phase of liberalization in India the importance of debt as a source of financing is seen declining in case of Diversified industry. However, statistically no significant difference is observed in D/E ratio of two phases (i.e. 1991-98 and 1999-2008).

The debt-equity ratio of the companies in Food and Beverages Industry lies in the range of 1.02 to 1.23 during 1991 – 1998 and in the range of .44 to 1.55 during 1999 – 2008. While the mean debt equity ratio in the Ist and IInd phase are worked out at 1.19 and 1.02 respectively. The same is found at 1.09 for the entire period of the study The above indicates that debt is a equally preferred source of financing in case o f food and beverages companies in India. The table discerns a sharp decline in the proportion of debt to equity in 1994. But in 1995 it captured upward trend trend again and maintains it up to 1997. After that it has shown almost mix trend of ups and downs. The difference between the debt equity ratio of 1st phase and 2nd phase is found significant at 0.072 level of significance but not at .05 level.

D/E ratio in case of service industry excluding banking industry, lies in the range of 0.65 to 1.26 during 1991 – 1998 and in the range of .61 to .97 during 1999 – 2008. The mean debt equity ratio in the Ist phase and IInd phase and the whole period are worked out at 0.93, 0.77 and 0.84 respectively. The above indicates that debt is a significant source of financing for service industry in India. However, its proportion has declined to some extent over the yearas. The above mentioned condition is supported by t-test which indicates the difference between the D/E ratio for the 1st phase and second phase are statistically significant at .012 level of significance.

In case of Transport Equipment industry this ratio lies in the range of 0.96 to 1.63 during 1991 – 1998 and in the range of 0.61 to 0.97 during 1999 – 2008. While the mean debt equity ratio in the Ist and IInd phase are worked out at 0.71 and 1.14 respectively the same is worked out at 1.06 for entire period of the study. The above indicates that similar to other industries debt is an important source of financing for transport industry in India. However, the table discerns a sharp decline in the proportion of debt to equity up to 1999 and after that it has shown a mix trend of ups and downs. The t-value (3.17) turns significant at .011 level. It means the average D/E ratio of two phases differ significantly in case of Transport Equipment industry. The D/E ratio, in case of miscellaneous group of industries, lies in the range of 0.79 to 1.78 during 1991 – 1998 and in the range of 0.37 to 0.66 during 1999 – 2008. The highest D/E ratio is seen in the year 1994 (1.78), the lowest ratio workout for the year 2007(0.33). The mean debt equity ratio in the Ist and IInd phase are worked out at 0.96 and 0.48 respectively. The above indicates that Debt equity ratio has remained just half in the 2nd phase as that of 1st phase. On the whole , D/E ratio has declined by 0.21(0.96-0.75) in the second phase as compared to 1st phase. The significance of the difference between the D/E ratio of two phases was examined by using t-test which confirm the declining trend of D/E ratio in case of miscellaneous group of industries.

An inter-industry comparison shows that the capital structure ratio has a downward trend in all nine industries under reference of this study. A close watch of the table provides that the mean debt equity ratio is the highest in both the phases in case of Textile industry followed by Food and Beverages, Transport equipment Industry. It is the lowest in case of Misc Industry. Four industries namely textile, metal and metal products , food and beverages and transport have D/E ratio higher than one at the overall level. However, during the 2nd phase of reforms none of the industries is found having this ratio greater than1.0. In contrast , during 1st phase mean D/E ratio was seen above 1.09 in seven industries out of nine industries under study. The above mentioned phenomenon has also been supported by the result of t-test wherein the null hypothesis of no difference between the D/E ratio of two phases has been rejected. An attempt was also made in this study to test the hypothesis that there is no variatind phase on across the industry in terms of mean debt equity ratio during the, in contrast, he study has

brought out that the hypothesis stands rejected at 1 percent level of significance meaning thereby there is a significant variation across the various industries in so far as the average level of debt equity ratio is concerned.

Table 1: Debt Equity Ratio in various industries during 1991-2008

Year	**Chemical**	**Machinery**	**Textile**	**Metal and Metal**	Diversified	F&B	Service	Transport	Misc	Overall
1991	1.47	1.27	1.51	1.58	1.20	1.29	1.26	1.63	1.43	1.38
1992	1.48	1.31	1.73	1.45	1.58	1.23	1.18	1.63	1.29	1.42
1993	1.35	1.22	1.37	1.52	.88	1.29	1.11	1.33	1.19	1.23
1994	1.09	1.04	1.26	1.22	.67	1.08	1.13	1.19	1.78	1.14
1995	.97	.85	1.13	1.02	1.03	1.16	.79	1.04	.98	.99
1996	.97	.83	1.37	1.25	1.11	1.19	.71	.96	.82	.96
1997	.95	.81	1.20	1.11	1.20	1.23	.65	1.04	.79	.94
1998	.96	.96	1.33	1.25	1.01	1.02	.70	1.02	.99	.98
1999	.87	.97	1.39	1.33	.87	.94	.61	.98	.53	.86
2000	.98	.78	1.20	1.02	.83	.84	.68	.87	.39	.81
2001	.96	.73	1.10	.89	.77	.97	.73	.94	.37	.83
2002	.86	.77	1.14	.70	.89	.90	.97	.94	.47	.84
2003	.87	.66	1.07	.71	.75	1.03	.82	.83	.49	.80
2004	.66	.47	1.05	.87	.64	1.25	.79	.71	.66	.75
2005	.57	.32	.98	.72	.79	.99	.79	.88	.51	.68
2006	.67	.41	1.10	.87	.90	.96	.71	.91	.52	.73
2007	.78	.44	1.34	.68	.88	.98	.86	.84	.43	.77
2008	.79	.62	1.99	.92	.91	1.55	.76	1.14	.38	.99
1991-98	1.15	1.03	1.36	1.30	1.09	1.19	.93	1.23	.96	1.12
1999-2008	.80	.62	1.22	.87	.83	1.02	.77	.91	.48	.81
1991-2008	.97	.81	1.28	1.07	.95	1.09	.84	1.06	.75	.96
t-value	3.762	4.071	1.106	4.57	2.678	1.957	1.79	3.17	6.22	4.76
Sig. (2-tailed)	.003	.001	.286	.000	.028	.072	.107	.011	000	.000
ANOVA (F) = 6.625 ; Significance = .000										

The study indicates that the importance of ownership capital has increased among Indian companies during the liberalized era. This may be attributed to the numerous reforms in the stock market in India. The reforms process has eased the process of raising fresh equity capital as well promoting the use of retained earnings for the new opportunities created by the liberalization process.

2. Total Debt to Assets Ratio

Another ratio analyzed is- total debt to assets ratio. Total debt (sum of long term and short term sources) constitutes an important source of financing the business assets in Indian corporate sector as is visible from the data presented in this regard in tables 2. It shows clearly that on an average the external borrowings have been a source of financing as high more than 47 percent and 40 percent of the total assets in case of the chemical industry companies during the 1st phase and 2nd phase of economic reforms respectively. In the Entire period of the study (1991-2008) the total debt ratio worked out 0.43 which implies that , on an average, borrowings and debebtures are used to finance 43 percent of the total assets of chemical Industry. Similarly, 43 percent, 38 percent, 55 percent, 50 percent, 37 percent, 35 percent, 30 percent of the total assets is financed by external finance in Chemical, Machinery, Textile and Metal, Metal Products, Diversified, Food and Beverages and Misc industries respectively. However the proportion of external finance has declined significantly during the IInd phase of liberalization in case of Chemical and Machinery industries. No significant difference is found in total debt ratio of Textile and Metal and Metal Products companies between the two phases. On the whole mean debt ratio has come down 0.37 in IInd phase from 0.33 in Ist phase and the difference is found

statistically significant. Inter-industry comparison in terms of total debt ratio reveals a significant variation, as F value is significant at 1 percent level. For the entire period, the total debt ratio is the highest in case of Textile followed by Metal and Metal Products, Chemical and Machinery and Diversified industries. The above phenomenon also found good in both the phases.

Table 2 also shows that upto 1993 more than half of the total assets of chemical companies, on an average, was financed through borrowed funds. During 1996 and 2001, total dent ratio remained 0.43 in this industry. However, after 2001, the share of debt financing declined below 40 percent. An attempt is made to examine the null hypothesis that there is no significance difference between the total debt ratio between 1991 -1998 and 1999-2008. The t- value (4.49) gets rejected. It refers that the dependence on borrowed funds has declined significantly.

Total debt ratio in machinery industry depicts a declining trend. The mean value of this ratio works out 0.41, 0.35 and 0.38 for 1st phase, 2nd phase and the entire period respectively, in recent years. The null hypothesis that there is no difference between total debt ratio of 1st and 2nd phase is rejected at 0.01 level of significance. The textile industry shows neither increasing nor decreasing trend in so for as the total debt ratio is concerned. The mean values of this ratio workout 0.55 and 0.56 during 1st and 2nd phase of reforms respectively. The t- test applied to examine the significance of difference between the total debt ratio of two phases indicates the total debt ratio of two phases accept hypothesis of no difference. On an average, this ratio works out 0.51, 0.47 and 0.50 for the 1st phase, 2nd phase and the whole period of study respectively in case of metal and metal products industry. Financing through debt in metal products and metal producing corporate registered a down trend after 1991 when mean value of this ratio stood at 0.57 and this trend continued upto year 1996 with total debt ratio 0.45. In the year 1997 the financing assets through debt rose to 47 percent and in 2000 to 50 percent. However, after year 2000 debt financing are observed declining in almost each year. The same remained only 40 percent during 2008 as compared to 50 percent in 2000 and 57 percent in 1991. The null hypothesis that there is no difference between the total debt ratios of the two phases of reforms stands rejected at 0.05 level of significance.

Table 2: Total Debt Ratio in various Industries during 1991-2008

Year	Chemical	Machinery	Textile	Metal and Metal	Diversified	F&B	Service	Transport	Misc	Overall
1991	.52	.44	.55	.57	**.39**	**.35**	**.34**	**.44**	**.45**	.44
1992	.51	.44	.56	.55	**.41**	**.35**	**.36**	**.44**	**.39**	.44
1993	.50	.45	.55	.54	**.42**	**.36**	**.32**	**.42**	**.36**	.43
1994	.46	.41	.52	.53	**.40**	**.35**	**.30**	**.37**	**.36**	.40
1995	.44	.38	.54	.47	**.37**	**.35**	**.29**	**.33**	**.35**	.38
1996	.43	.38	.55	.45	**.38**	**.36**	**.26**	**.32**	**.30**	.37
1997	.43	.39	.53	.47	**.39**	**.37**	**.26**	**.33**	**.27**	.36
1998	.43	.38	.56	.49	**.38**	**.37**	**.25**	**.35**	**.33**	.37
1999	.43	.37	.55	.50	**.36**	**.35**	**.27**	**.32**	**.28**	.36
2000	.43	.35	.56	.50	**.35**	**.35**	**.25**	**.32**	**.25**	.35
2001	.43	.37	.58	.49	**.36**	**.36**	**.26**	**.33**	**.22**	.36
2002	.40	.35	.55	.48	**.38**	**.35**	**.27**	**.31**	**.25**	.35
2003	.39	.34	.55	.49	**.36**	**.33**	**.27**	**.27**	**.25**	.34
2004	.39	.34	.56	.49	**.37**	**.35**	**.30**	**.25**	**.26**	.35
2005	.36	.34	.56	.46	**.33**	**.34**	**.27**	**.25**	**.23**	.33
2006	.37	.33	.57	.43	**.33**	**.32**	**.26**	**.26**	**.20**	.32
2007	.37	.35	.58	.43	**.31**	**.31**	**.30**	**.27**	**.21**	.33
2008	.35	.33	.58	.40	**.30**	**.35**	**.24**	**.27**	**.20**	.32
1991-98	.47	.41	.55	.51	**.29**	**.36**	**.29**	**.37**	**.38**	.38
1999-2008	.40	.35	.56	.47	**.35**	**.34**	**.27**	**.28**	**.23**	.33
1991-2008	.43	.38	.55	.50	**.37**	**.35**	**.28**	**.33**	**.30**	.37
t-value	4.49	5.717	-3.00	2.23	**4.42**	**2.61**	**1.98**	**4.61**	**5.88**	4.87
Sig.	.000	.000	.008	.040	**.000**	**.019**	**.064**	**.000**	**.000**	.000
ANOVA (F) = 77.280 ; Significance = .000										

The diversified industries also show any significant difference from majority of industrial groups as regards the financing of assets through borrowings and debentures is concerned.

Total debt ratio declined to 0.30 in 2008 from 0.41 in year 1992 in case of Diversified Industry. In this industry on an average, this ratio stood at 0.39 for the period 1991 to 1998, 0.35 for the period 1991 to 2008. In case of this industry also the null hypothesis of no difference between the total debt ratios of two phases of reforms is rejected at 0.01 level. Hence, the financing through debt has declined significantly in diversified industry. In Food and beverages industry the mean debt to assets ratio declined to 0.34 for the period 1999-2008 from 0.36 during 1991-1998. Moreover, the difference between the above mentioned average value of total debt ratio was found statistically significant at 0.02 level. In case of transport equipment industry, indicates a continuous down trend in borrowings. It declined from 0.44 in 1991 to0.35 in 1998 and further to 0.25 in 2004 and 2005. The mean total debt ratio, works out at 0.37, 0.28 and 0.33 for the 1st phase, 2nd phase and the whole period. The null hypothesis that there is no significance difference between the total debt ratio of the two phases is found false and hence rejected at 0.01 level of significance. Thus, the financing through borrowed funds has also declined significantly in case of transport equipment industry.

Miscellaneous also do not indicate any divergence from the majority of other industries in so far as the pattern of total debt ratio is concerned. It is clear that the financing assets through borrowed funds in the industry went down to 30 percent in 1997 from 45 percent in 1991. Further, the debt financing works out only 30 percent as compared to 38 percent during 1st period (i.e. 1991-98). During second phase of reforms, the average proportion of debt financing reduced to 23 percent. The difference between the total debt ratio of two phases is found significant at 0.01 level in case of Miscellaneous Industry group.

Conclusion

The study brought out that the importance of ownership capital has increased among Indian corporate sector during the liberalized era. This pattern may be attributed to the numerous reforms in the stock market in India. The reforms process has eased the process of raising fresh equity capital as well promoting the use of retained earnings for the new opportunities created by the liberalization process. The above may be attributed to higher cost of borrowing as well as new and innovative ways of financing assets in the liberalized Indian economy. The increasing efficiency of Indian stock market and retail investor's interest in equity investments are also responsible for the changing pattern of financing over the years.

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