# CHAPTER – 1

# INTRODUCTION

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## 1.1. Background of the Study

The theoretical framework of corporate finance proposes three functional areas of financial management; financing decision, investment decision and dividend decision or decision relating to distribution of profit. Financial management of a firm revolves around these three major decision areas with maximization of shareholders wealth being the principal purpose.

Financing decisions involves a great deal of activities which includes deciding on the sources and methods of raising investable funds or capital for the company, determining different sources, relative proportion and cost involves with different kinds of funds. In brief, financing is a process which involves determination of, the sources of funds considering economy, convenience, cost and the judicious mix of different kinds of funds for a company. After deciding the financing aspects of a company a finance manager needs to think one investment of the raised fund. It involves two major areas of decisions, one is relating to investment decision on fixed assets, another is on current assets. The former process is called capital budgeting whereas the latter one comes under working capital management. Capital budgeting is also termed as investment appraisal. It deals with a whole gamete of activities which includes the allocation of investable funds in different projects or fixed assets considering their earning potential, calculating the payback period, Net Present Value (NPV), Internal Rate of Return (IRR) etc. and finally ensuring highest return on investment for the firm. The driving objective of capital budgeting is to ensure optimum utilization of investable funds raised by the company. Again, decision relating to investment on current assets or management of working capital is another crucial function of finance manages. It involves deciding on the investment on different current assets and maintaining a trade-off between liquidity and profitability aspects of the company.

Finally, the finance managers have to take the decision relating to distribution of dividends. The dividend decision involves deciding on what portion of the earning available to equity shareholders would be distributed as dividends and the portion should be kept as retained earnings. A good dividend policy equally contributes towards achieving the objective of wealth maximization.

Therefore, it is quite clear that, the process of investment in assets, capital budgeting, management of working capital, decisions on dividends and retain earnings all begin after a successful financing decision. Therefore, decision on financing should be the first and foremost concern for a finance manager. However, all the above functional areas of financial management are closely interrelated and deeply interdependent but the process starts with financing decision. In fact, the objective of wealth maximization could not be achieved until and unless the management takes a rational financing decision which involves the sources and mix of capital (Chakraborty, 1981). Hence, a finance manager has to formulate financing plans and policies keeping in mind the wealth maximization objective of the business concern. It is often observed that, business corporations which fail to design a formal plan of their capital and ownership structures are likely to face tremendous financial challenges arising out of uneconomical and imbalanced financial structure.

A major part of financing decision involves the decision on capital structure i.e. the judicious mixture of owners and borrowed capital, and also the ownership structure i.e. the composition and concentration of ownership. According to Pandey (1984), a firm always needs to design a formal plan regarding the sources and mix of its fund to be raised to stay away from complications in raising it on favourable terms in the long-run and to abstain it from having a costlier and imbalanced capital structure.

Theoretically, the capital structure of a firm is known to be the proportion of debt, preference and equity shares in its balance sheet, which reflects the way a firm finances its total investments or assets (Saad, 2010). Looking at the typical capital structure theories we see the relationship between the capital structure and firm value has been framed under different approaches. The Net Income (NI) approach gives a positive relationship between these two whereas the Net Operating Income (NOI) approach suggests no relationship. However, the Modigliani and Miller (MM) hypothesis supports the NOI approach that the levered firm and the unlevered firm would have same value, but as the interest on debt is tax deductable so the levered firm gets a tax deduction benefit known as *interest tax shield* where the value of the levered firm increases by an amount which is equal to the total amount of debt capital issued by the firm multiplied by the corporate tax rate. So, Modigliani and Miller have developed a behavioral justification which to a large extent supports the net operating income approach and argued that, without taxes the cost of capital and market value of the firm remain constant throughout all degrees of leverage (Modigliani and Miller, 1958). Another approach which is known as Traditional approach is basically a modified form of the Net Income approach. This approach suggests that the value of the firm increases along with decreasing cost of capital initially up to a reasonable limit after which further increase in leverage reduces the firm value and increase the cost of capital. We will discuss each of these approaches to capital structure in the second chapter which would basically deal with the theoretical framework of the study.

Moreover, there are sufficient empirical evidences endorsing the relevance of capital structure towards firm operational efficiency, performance and valuation. For instance, Grossman and Hart (1982) see the use of debt as a regulatory instrument in disciplining management and reducing wasteful use of cash flow by creating a threat of liquidation. Besides, According to Jensen (1986) when a firm contracts more debt, this will limit the amount of money available in the hands of firms' managers and thereby curtail managerial discretionary expenses which lead to better firm performance.

Again, the ownership of companies may take different forms and most of the prominent literatures (Berle and Means 1932; Fama 1980; Chakrabarti 2005; Kaur and Gill 2009) in this field identified a number of forms like concentrated ownership or block- holdings, promoters' ownership (domestic and foreign), institutional ownership, insider or managerial ownership etc. which affect firm performance. One of the important perceptions behind the favorable impact of different forms of ownership and firm performance in almost all the literatures are routed to efficient monitoring hypothesis. According this hypothesis, when the substantial fraction of share is hold by professional bodies like institutions and even big promoters (having substantial voting rights) they are supposed to monitor the firm and actively take part in firm's business decision, activities, designing of plans and proposals etc. (Shleifer and Vishny, 1986; Friend and Lang, 1988). However, the literature on corporate finance and governance also suggests unfavorable impact of ownership structure especially of ownership concentration and firm performance under expropriation hypothesis. We will discuss all these hypotheses in detail in the subsequent sections.

Therefore, looking at the empirically endorsed theoretical acceptance of the relevance of capital and ownership structure towards firms' performance, this study makes an attempt to extend and enrich the existing set of literatures with some empirical insights from Indian manufacturing firms. However, we confine our study to manufacturing firms mainly because, the financial statements as a whole, capital structure, assets structure, working capital requirement etc. of service sector firms, especially, financial institutions are substantially different from that of other firms. Hence, inclusion of such firms would reduce uniformity and comparability of financial data across firms and results obtained thereby can't be logically generalized for all the firms. Secondly, unlike other emerging Asian economies, concentration of ownership is much more prominent in manufacturing sectors in case of India (Selarka, 2005; Altaf, 2016). Hence, studies on ownership structure and especially on concentration reasonably prefer manufacturing firms as the study sample. Notably, for the sake of convenience, the terms firm, company, business corporation and business enterprise etc. are synonymously and interchangeably used throughout this study.

## 1.2 Capital Structure and Ownership Structure in Indian Manufacturing Companies

Determining the optimum capital structure which represents a judicious blend of owners' and borrowed fund has remained a challenging job for the finance managers of manufacturing companies in India. Most of the time it is found that, business firms in India have to pass through liquidation process due to improper capital structuring (Chadha and Sharma, 2016). Actually, the financing decision is an indispensible part of financial management and a firm has to plan on it much before it initiates its capital budgeting processes. The capital structure is called optimum when it maximizes the market value and minimizes the weighted average cost of capital of the issuing company. The capital structures of Indian manufacturing firms mostly contain longterm debt, equity capital and preference share capital. The Indian manufacturing firms commonly maintain more equity than debt capital however; an aggressive approach of financing has been observed in manufacturing sector as a whole during last couple of years (Chadha and Sharma, 2016).

Therefore, the manufacturing companies in India are gradually increasing their financial risk to take the advantage of financial leverage or the process of trading on equity. Notably, unlike United States (U.S.) and United Kingdom (U.K.), the Indian publicly held companies in general are less suffering from conflict of interest between managers and shareholders i.e. type 1 or vertical agency crisis (Morck and Yeung, 2003) than between minority and dominant shareholders (type 2 or horizontal agency crisis). Hence, the increased fixed financial obligation through issue of debt capital may further normalize the former kind of agency problem in Indian manufacturing sector.

The ownership of Indian manufacturing firms mainly composed of share held by domestic and foreign promoters, institutional investors, public, governments etc. Indian promoter group has four prominent constituents, which are Individual / Hindu Undivided Family, Central / State Government (s.), Bodies Corporate and Financial Institutions including banks. The domestic class of promoters holds a significant proportion of shares in Indian companies. Likewise, foreign promoters are also one of the important constituent of ‘promoters’ group and it is composed of three main parties, individual (non-resident / foreign), bodies corporate and institutions. In most of the well- known Indian companies foreign promoters are having good proportion of shareholding. Another prominent category of investors in Indian firms are the banks and non- banking financial companies, mutual fund companies, insurance companies etc. These are also the important constituents of institutional investors in Indian manufacturing sector. Besides, corporate ownership in India is traditionally found to be concentrated with family business owners and promoter groups since the time of British Managing Agencies. It has been also somewhat concentrated in the hands of institutional investors and the state (Balasubramanian, 2010). In many developing countries including India, concentrated ownership is also gradually considered as a part of important internal governance mechanism (Abbas et al., 2013) for limiting agency crisis between owner and manager and for mitigating many other governance issues in widely-held corporations. In Asian economies including India, the degree of type I agency crisis considerably differs among the firms according to concentrated and diffused ownership patterns (Sarkar, 2010). However, in India where concentrated ownership especially in the hands of promoters has become a norm rather than exception, there is reasonable degree of likelihood of a horizontal or type-II agency problem (Morck and Yeung, 2003; Roe, 2004) to arise between minority and large shareholders. In fact, the shift from democratic to plutocratic voting rights, moving away from one vote per shareholder to one vote per share has really changed the mechanism of corporate governance and status & power of large shareholders in public limited companies in many countries (United States, France, Germany, Britain etc.) including India.

Therefore, the various forms of ownership and its concentration or dispersion has significant implications for firms' overall corporate governance, performance, valuation and investors' interest protection etc. not only in the manufacturing category but in almost all joint stock corporations in India.

### 1.3 Research Motivation

The motivation behind this empirical study has come from the felt need to address a couple of research problems. First of all, deciding on a judicious mix of debt and equity capital has always been a managerial challenge for finance managers and the Indian firms are not an exception of this issue. The decision on capital structuring has become so crucial and important because of its theoretical acceptance and high empirical endorsement as one of the critical factor to firm operational efficiency and performance. However, the evidences on capital structure and firm performance are mostly inconclusive and equivocal. Therefore, under a circumstance of gradually increasing concerns over capital structure decisions, we think it is very much needed to produce some fresh insights and evidence on this issue.

Secondly, the topic relating to the effect of ownership structure on firm performance and value is much more debated in developed markets of United States and United Kingdom and very limitedly in emerging markets like India. Indian manufacturing sector is featured with a traditionally concentrated ownership pattern along with large diversion in forms of ownership. Hence, the sector needs special research attention from the part of scholars.

Thirdly, understanding the role of majority shareholders in Indian manufacturing sector is matter of great concern. This is because, the concentrated ownership is considered as a part of important internal governance mechanism (Abbas et al., 2013) towards mitigating principals-agents agency crisis and for mitigating other governance issues through efficient monitoring of the management. On the other way, it is also assumed that, these large owners are supposed to be self-servicing who expropriate the minority shareholders and consequently cause unfavourable impact on firms' financial performance. Therefore, we think it is sensible to examine the actual role that these large shareholders play in the manufacturing firms in India.

### 1.4 Objectives of the Study

This empirical investigation is carried out with the broad objective to add incremental value and thereby qualitatively extend the existing set of literatures in the domain of corporate finance and governance in general. To be more specific, the main objectives of this study, based on which the whole research is carried out is outlined as below:

*1. To explore the relationship between capital structure and corporate performance in the context of Indian manufacturing companies*

*2. To inquire the effect of ownership structure and financial performance of Indian manufacturing companies*

*3. To establish the empirical relationship between ownership concentration and corporate performance of the selected companies.*

*4. To forward some important suggestions and policy recommendations of high value and practical implications.*

### 1.5 Hypotheses of the Study

Keeping in mind the above set of objectives, the study frames the following hypotheses to be tested:

***Hypothesis – I:***

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| *Null Hypothesis ($H_0$):* | *There is no relationship between capital structure and corporate performance.* |
| *Alternative Hypothesis ($H_1$):* | *$H_0$ is not true.* |

***Hypothesis – II:***

*Null Hypothesis ($H_0$):* *There is no relationship between the ownership structure and corporate performance.*

*Alternative Hypothesis ($H_1$):* *$H_0$ is not true.*

***Hypothesis – III***

*Null Hypothesis ($H_0$):* *Ownership concentration does not significantly affect corporate performance*

*Alternative Hypothesis ($H_1$):* *$H_0$ is not true.*

**1.6 Scope of the Study**

The present study covers a crucial area in the domain of corporate finance and governance. The study basically deals with the two major aspects of financing i.e. deciding on the composition of owned and borrowed funds, what we call capital structuring and the distribution of owners fund among different kinds of owners i.e. deciding on the ownership structure. More specifically, the study makes an attempt to interlink the capital structure or degree of financial leverage and ownership structure with firm financial performance. Notably, the financial performance is further segregated into accounting performance and market performance. The study reasonably considers (the justification behind selecting manufacturing sector is provided in the Chapter IV) Indian manufacturing companies to establish the relationship between capital structure, ownership structure and financial performance. To be more specific, it chooses a sample of 91 manufacturing companies form BSE 200 Index of Bombay Stock Exchange of India. Therefore, the inferences that could be drawn from the study would be highly relevant and useful for Indian economic context. Specially, the study findings would represent the status of manufacturing sector of the economy for the period of 2009 to 2016. However, the key findings and thereby drawn inferences of this study are expected to be replicated for other emerging market economies with similar corporate legal structure. Notably, the findings and suggestions relating to ownership concentration would have considerable relevance and implications for the corporate policy makers of other Asian countries where ownership concentration has become a common phenomenon like India.

### 1.7 Outline of the Study

The thesis is composed of six broad chapters and each chapter of the thesis further comprises of several sections and sub-sections.

***The first chapter of this thesis*** is labelled as 'Introduction' wherein the researcher attempts to introduce the whole study. This chapter of the study presents a detail description on the study background, relevance and motivation behind this investigation, the driving objectives of the study, formulation of research hypothesis and a chapter plan of the study.

***The second chapter*** of the study which is entitled as 'The Theoretical Foundation of the Study' would present the theoretical foundation of this empirical research. The chapter would provide a lucid view of the theoretical and conceptual aspects relating to capital structure, ownership structure, agency crisis and also the hypothetical relationship of all these variables with firm performance. This chapter would develop the theoretical understanding of the readers and would be immensely useful and worthy to read before going to the empirical part of this study.

***The third chapter*** of this study, which is entitled as ‘Literature Review’ is equally important as the first and second one. It presents a detailed review of the existing empirical evidences produced by different literatures in the domain of corporate finance and governance and especially ones which deal with the relationship between capital structure, ownership structure and firm performance in emerging as well as emerged market economies. The chapter ends with the statement of the critically identified research gap that is found out after a rigorous review of extant literatures on capital structure, ownership structure and firm performance.

***The fourth chapter*** of this thesis involves detailing of the methodology used for the empirical investigation. It contains a detail description on the type and nature of dataset used, selection of sample, construction and description of variables, statistical and econometric tests adopted to arrive at the results and test for robustness.

***The fifth chapter*** presents the most vital part of the study. It involves estimation of a range of statistical tests and econometric analyses to test the hypothesis developed and establish the empirical relationship. The chapter largely deals with drawing meaningful inferences based on its empirical results and findings.

Finally, ***the sixth chapter*** of this study being the last chapter would conclude our empirical research and attempt to provide highest possible suggestions and policy recommendations which would be immensely useful for the corporate policy makers, business analysts specially ones who are dealing with corporate finance and governance and the corporate regulatory institutions. The chapter would also present the main limitations of the study and draw the directions for future research initiatives.