CHAPTER - 1

INTRODUCTION

CHAPTER CONTENTS

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INTRODUCTION

This chapter provides a brief background of the problem - the importance of a firm's Capital Structure decision on its value, growth and survival. The Capital Structure decision remains one of the most controversial subjects in the world of finance. Capital Structure refers to the mix of debt and equity which a company uses to finance its long term operations. Role of Capital Structure decision in maximizing the value of the firms with Foreign Direct Investment cannot be underemphasized. Hence the importance of Capital Structure decision and the rationale for selecting Foreign Direct Investment (FDI) Companies in India for the purpose of studying the Determinants of Capital Structure has been stated in the chapter. In addition, the contribution of this study and organization of study with the detailed study plan have been discussed.

1.1 Conceptual Framework

A company may have to raise capital from different sources such as Common Equity and Preferred Equity, Long-Term Debt, specific Short-Term Debt to finance its assets. Each source of fund has its charge. Dividend is paid to suppliers of Equity and Preference Share capital and interest is paid to lenders of Debt capital. Debt financing creates a fixed charge on profits of the company. Although the dividend on Preference Share Capital can be postponed in absence of profits in a particular year, both Debt capital and Preference Share Capital create a fixed charge and this charge is in the form of interest or dividend which has to be paid irrespective of the amount of earnings. The term Capital Structure refers to the way a company finances its assets through some combination of Equity, Debt, or Hybrid Securities. It is also referred to as the financing decision (Capital Structure decision) of a company. This entails the choice of a right/suitable mix of different sources of financing namely owner's funds and lender's funds. The term Capital

Structure refers to financing strategy adopted by a firm- how a firm finances its overall operations and growth by using different sources of funds.

An appropriate Capital Structure is a crucial decision for any firm. Capital Structure decisions assume vital significance in corporate financial management due to their influence on return and risk to the shareholders. The term Financial Leverage is related to the financing activities of a firm. It denotes the ability of a firm to use funds obtained at fixed costs to magnify the return to shareholders. As tax savings are generated due to Debt, it is considered as a cheaper source of finance compared to Equity, but at the same time, increase in Debt Funds increases the risk of bankruptcy or financial risk. Any increase in Financial Leverage increases the financial risk - the risk of the firm's inability to repay its fixed financial costs. This gives rise to the risk of bankruptcy – the possible insolvency arising out of inability to pay the fixed charges of Debt Funds or inability to repay the debt on time. The objective of any firm should be to use the most appropriate financing mix which will maximize the value of firm, minimizing the overall cost of capital. The optimum financing mix which is that combination of Debt-Equity mix that leads to maximization of shareholders wealth is referred to as optimum Capital Structure. Thus the decision about how to finance its long term operations and what should be the proportion of Debt-Equity mix which will maximize firms value is the crux of Capital Structure decision. Does an optimal Capital Structure really exist and what should be the right proportion of Debt and equity mix that will really enhance the value of a firm is a puzzle yet to be solved.

Various conflicting theories of Capital Structure like the Tradeoff Theory, Dynamic Tradeoff, Signaling Theory & Asymmetric Information, the Pecking Order Theory, the Market Timing Hypothesis have been proposed since the seminal work by Modigliani &Miller (1958)[1]. They introduced the Capital Structure irrelevancy propositions in their work on the "Cost of Capital, Corporation Finance and the Theory of Investment". The literature on Capital Structure has been extended by several studies since then.

Chirinko & Singha (2000)[2] found out that their empirical evidence could evaluate neither the Pecking Order nor Static Trade-Off models and they felt the need of alternative tests to identify the Determinants of Capital Structure .

Mayer & Sussman (2003)[3] in their study found that a combination of the Pecking Order and Trade-Off Theories provided a good description of short-run and longer run dynamics. Drobetz & Fix (2003)[4] confirmed the Pecking Order model but contradicting the Trade-Off model in context of Swiss firms and also found out that Swiss firms tend to maintain target leverage ratios.

Huang & Ritter(2004)[5] wanted to test whether the time series variations of financing decisions of publicly traded U.S. firms are explained by Static Trade-off Theory or the Pecking Order Theory or the Market Timing Theory. They could find that neither the Static Trade-Off Theory nor the Pecking Order Theory provided an adequate explanation for these variations. The Market Timing Theory could provide some explanation for observed time-series patterns of external financing decisions of U.S. publicly traded firms.

Bunn & Young (2004)[6] concluded in their study on companies in United Kingdom, that companies appeared to have target levels of gearing. The gearing target appeared to be responsive to tax advantage of Debt and the risk of bankruptcy thus providing empirical support for the Trade-Off Theory.

Brounen *et.al* (2005)[7] confirmed the presence of Pecking Order Theory and Static Trade-Off Theory but did not find convincing evidence of Agency problems or Signaling Theory in their international survey on Capital Structure choice.

Using a panel data of 787 Indian firms for the study periods from 2000 to 2005, Mahakud (2006)[8] concluded that Pecking Order Theory is not followed by the Indian companies.

Mihalca & Antal (2009)[9] found that Pecking Order Theory could be successfully applied to the Romanian market.

Haye& Hecht (2009)[10] found the broadest support for the Static Trade-Off hypothesis of Capital Structure across all three global regions- American, Asian (Chinese, Indian, Japanese), and European (French, English, German) companies.

Every enterprise makes its own decisions regarding Capital Structure. However, there seem to be some general factors that appear to influence the Capital Structure of a firm which help the firms in designing their target Capital Structure. The Capital Structure of a firm is supposed to be determined by these factors which are believed to be the Determinants of Capital Structure. Different Capital Structure theories suggest different factors which may affect a firm's financing decision. Each of the above discussed theories can be tested using these factors which determine the Capital Structure of a firm. Supporting the assumptions of theories of Capital Structure and on the basis of earlier empirical research in this area, these determinants or factor can be divided into firm specific determinants and country specific determinants (macroeconomic factors). The companies will have to choose the best financing mix (Capital Structure) keeping in view these factors thereby targeting that Debt-equity mix which enhances firm value while minimizing costs.

Several contributions have been made in this area and several authors have tried to test whether the Determinants of Capital Structure are able to explain the financing behavior as explained by various Capital Structure theories. There has been continuing theoretical debate over this issue and a number of studies have been undertaken on various aspects of Capital Structure. Still no convincing test yet has been found as regards to which theory and which determinants best explain a firm's Capital Structure decision.

1.2 Rationale of the Study

In the post liberalization era, FDI flows are playing active role in developing countries like India. All developing countries are placing very high emphasis on attracting FDI as it is perceived as major vehicle for growth of an economy. Several initiatives and measures have been taken to encourage flow of FDI in the country.

According to AT Kearney's 2007 Global Services Location Index, India ranks second in the world in terms of financial attractiveness, people and skills availability and business environment. India is proving to be an attractive destination for investments due to its financial stability in spite of current economic meltdown.

After the financial liberalization which started in India in 1991, several restrictions on FDI were relaxed and government started making efforts to attract FDI. Along with this, due to the capital market reforms initiated in India, Indian companies could now raise capital abroad as well as multinational companies started investing in India. There are several sectors which have been opened up by government in India where 100% FDI investments are allowed. So studies on FDI investments have become important in this scenario and the aspect of the Capital Structure of companies where there is FDI does become an important issue to be researched. Now an interesting question is, what is the Capital Structure of companies attracting FDI flows and what are the Determinants of Capital Structure of these companies? How do FDI Companies determine the proportion of their financing mix?

Studies formulating and testing the Determinants of Capital Structure have been plentiful in the last decade. One of the classical researches on Determinants of Capital Structure was conducted by Titman &Wessel's (1988)[11]. Making an international comparison, Rajan & Zingales (1995)[12] stated that the Determinants of Capital Structure (such as size, growth, profitability, and asset structure) are important for the G7 countries. Booth *et al.* (2001)[13] identified similar Determinants of Capital Structure for ten developing countries. Baral (2004)[14] examined the Determinants of Capital Structure of the companies listed in Nepal Stock Exchange Ltd. Song (2005)[15] investigated Capital Structure determinants of Swedish firms. Jong *et.al* (2005)[16] tested the importance of firm-specific and country-specific factors in explaining the leverage choice of firms from 42 countries around the world. Dragota & Semenescu (2008)[17] tested the Capital Structure determinants of Romanian listed companies. Mahmud *et.al* (2009)[18] examined whether country's economic factors play a significant role in determining Capital Structure using data of firms from three Asian countries- Japan, Malaysia and Pakistan.

Some of the important Indian studies where Determinants of Capital Structure were tested are Bhat (1980)[19], Mittal & Singla (1992)[20], Kantawala (1997)[21], Kakani (1999)[22], Bhattacharyya & Banerjee (2001)[23], Garg & Shekhar (2002)[24], Bhaduri (2002)[25], Bhole & Mahakud (2004)[26], Gupta(2004)[27], Khasnobis& Kar(2006)[28]. Although several studies have been carried out to examine the financing pattern and to study the Determinants of Capital Structure of firms across the globe, major empirical research on Capital Structure and its determinants is available from developing countries and relatively less work has been undertaken in a developing country like India. Even in India, despite the available research carried out in corporate finance examining the Capital Structure of Indian firms, very few of the studies have actually assessed Capital Structure policies of FDI Companies in India.

Most of the recent studies on Foreign Direct Investment have focused on issues such as Trend and Determinants of Foreign Direct Investment or policy suggestions to attract more Foreign Direct Investments. One of the interesting studies was conducted by Rajakumar (2005)[29] who observed performance differentials between Indian and FDI Companies in India. In another significant study, Babu & Jain (1998)[30] had examined the Capital Structure practices followed by private corporate sector firms in India during the period 1980 to 1994. The study was divided into four major parts and in one of these sections they had undertaken a comparative study on the Capital Structure practices of foreign controlled firms in India verses the domestic companies. Their study was mainly based on comparisons using two sample 't' test of various ratios: Debt-equity ratio, Total Debt to Assets ratio, Net Worth to Asset ratio, Short Term Debt ratio, Long Term Debt ratio, Long Term Debt to Total Asset ratio, Short Term Debt to Long Term Borrowings, Interest Coverage ratio and observation of financial and operating risk characteristics of foreign controlled and domestic firms in India. They had not studied the Determinants of Capital Structure of foreign controlled companies but had emphasized on profile of debt financing of foreign firms. They had found out that foreign controlled companies had lower Debt-equity ratio as compared to domestic companies.

The other notable studies in the area were, Akhtar (2005)[31] who had undertaken research on Determinants of Capital Structure on a sample of Australian multinational and domestic corporations, or Lee & Kwok (1988)[32] who tried to find out differences in Capital Structures of U.S based multinational corporations (MNCs) and U.S domestic corporations (DCs), or Boateng (2004)[33] who studied the Capital Structure of international joint ventures (JV) of Ghana. Desai *et.al* (2006)[34] examined how exposures to political risks influence the financing choice of

American multinational firms. They explored the relationship between Capital Structure and risky investments. The analysis revealed that foreign subsidiaries located in politically risky countries were highly levered than other foreign subsidiaries of the same multinationals. Firms facing higher foreign political risks also reduced domestic leverage and thereby reduced their overall leverage.

Yasuhiro *et.al* (2006)[35] reviewed the characteristics and strategy of Capital Structure choice of the Asian affiliates of Japanese multinational companies, in comparison to those of western counterparts. They believed that, "Capital Structure choice of foreign affiliates is particularly important for multinationals because the capital markets differ among countries with respect to the degree of development. A multinational firm should maximize its consolidated firm value under such difference. In particular, it should raise necessary capital in a country where capital cost is low, and optimally allocate the fund to the firms that provide it with the highest value", Yasuhiro *et.al* (2006, page 1)[35]. They concluded that foreign affiliates of Japanese multinational firms, in comparison to U.S counterpart, relied heavily on internal capital market and borrowings from parent company.

In effect, we can conclude that relatively less work has been done to enhance our knowledge of Capital Structure within developing countries like India and there has been relatively no empirical research on Determinants of Capital Structure of Foreign Direct Investment Companies and that too on those existing in India. It is difficult to find empirical evidence as to how FDI Companies actually make a choice between financial instruments to determine their Capital Structure and whether the choice of Capital Structure in turn determines the company's performance and extent of its foreign holdings. With globalised markets, India is attracting many global players and these companies are heavily investing in Indian market, which suggests that the Determinants of Capital Structure of Foreign Direct Investment Companies in India are becoming increasingly important, particularly in the current economic scenario. Therefore, the purpose of this study is to fill this research gap by analyzing the Determinants of Capital Structure of Foreign Direct Investment Companies in India.

1.3 Capital Structure and Financial Structure

The Capital Structure decision refers to proportion of Debt and Equity mix which a company uses to finance its long term operations. The terms 'Financial Structure' and 'Capital Structure' are sometimes used synonymously. Financial Structure although is a wider term, as it denotes the way in which a company's assets are financed, such as Short-Term Borrowings, Long-Term Debt, and Owners Equity. The difference between Financial Structure and Capital Structure is that; The Capital Structure accounts for Long-Term Debt and Equity only and mainly refers to permanent financing of a company whereas Financial Structure is referred to as the liabilities side of a firm's balance sheet, specifying how its assets are financed, including all sources of finance – Short Term Debt including Current Liabilities, Long Term Debt and Equity issues. It is generally understood that Financial Structure differs from Capital Structure as Capital Structure accounts for Long-Term Debt and Equity only and does not include short term liabilities. Financial Structure is a wider term and Capital Structure is a part of Financial Structure.

There is also the concept of leverage which has been used as synonym to denote the Debt-Equity ratio or Capital Structure by several authors. "The employment of an asset or source of funds for which the firm has to pay a fixed cost or fixed return is termed as leverage", Khan& Jain (2004,page 14.3)[36]. Actually there exist two types of leverages- Operating leverage and Financial leverage. The extent of fixed costs in operating activities of a firm determines the Operating leverage. It is defined as, "the firm's ability to use fixed operating costs to magnify the effects of change in sales on its earnings before interest and taxes." Khan& Jain (2004,page 14.6)[36]. Financial leverage is related to financing activities of the firm. "The use of fixed-charges source of funds, such as debt and preference capital along with the owners' equity in the Capital Structure, is described as Financial leverage or gearing or trading on equity".(Pandey I.M,page 290)[37].

Rajan & Zingales(1995, page 8)[12] had said that , "Given the observed differences in the composition of liabilities, before undertaking any investigation of leverage it is appropriate to define what we mean by this term. Clearly, the extent of leverage and the most relevant measure depends on the objective of analysis."

In this study of examining the Determinants of Capital Structure of FDI Companies in India, the term 'Debt Ratios' is used to denote Financial Structure or Capital Structure or Leverage. Since all the possible sources of financing mix are considered in this study and variety of Debt Ratios which include Short Term Debt and even Current Liabilities along with Long Term Debt have been employed in the study, the terms Financial Structure, Capital Structure and Leverage are used as synonyms. If the term Leverage is used, it refers to Financial Leverage.

1.4 Objectives of the Study

The study aims to investigate the Determinants of Corporate Capital Structure in India, in more detail with reference to FDI Companies in India.
The main objectives of the present study can be put as:

1. To investigate the financing pattern adopted by FDI Companies in India by examining the trends in the use of debt over the period of study.

2. To identify the major Determinants influencing the Capital Structure decision of FDI Companies in India.

3. To identify the Industry-wise Determinants of Capital Structure of FDI Companies in India and to examine the difference, if any, in the Capital Structure Determinants of FDI Companies in India on the basis of their affiliation to a particular industry group.

4. To investigate which of the existing Capital Structure theory is better to explain the Capital Structure policies and the financing behavior of FDI Companies in India.

1.5 Contribution of the Study

In the process of carrying out the literature survey, it was very difficult to find a study analyzing the Determinants of Capital Structure for FDI Companies. Hence, it is felt that this will be the study providing a detailed insight into the Capital Structure practices followed by these companies. Specific firm level data with detail accounting information for each firm have been used in the study. Apart from firm level analysis, an attempt has also been made to analyze the industry effect on firms' Capital Structure. The sample firms have also been divided on the basis of different industry groups they belong to and an attempt has been made to find out whether any differences in the Determinants of Capital Structure exist if a firm is affiliated to a particular industry.

It was difficult for the researcher to trace a study carried out of the Determinants of Capital Structure with such a large number of measures of the Capital Structure. (The study employs sixteen different measures of Debt Ratios) to capture the effect of possible Determinants of Capital Structure. The study uses variety of Debt measures dividing them on the basis of composition of debt –Short Term, Long Term and Total Debt ratios. One of objectives to do so is to find out whether determinants of Long-Term Debt and Total Debt differ from the determinants of Short-Term Debt. Based on available literature, the proxies used for each determinant of Capital Structure have been defined in several ways.

Another reason for this study being different is that it departs from previous studies by using a fixed sample of 140 companies (divided into 11 industry groups) covering a span of 18 years from 1990-91 to 2007-08. A balanced sample of 140 firms having accounting data consistently from 1990-91 to 2007-08 may provide insights into trends in financing behavior of firms over a period of time.

1.6 Organization of the Study

The study is divided in seven chapters.

The **present chapter** provides an introduction to the problem- The importance of Capital Structure decision and the rationale for selecting Foreign Direct Investment Companies in India for the purpose of the studying the Determinants of Capital Structure has been stated in the chapter. In this chapter, objectives of the study have been stated. In addition, the contribution of this study and organization of study with the detailed study plan have been discussed.

The **Second chapter** reviews some of the important studies on Capital Structure. The chapter is divided in three major sections. The first section identifies the various theories concerning the Capital Structure by surveying the various extension works conducted after the pioneering study of Modigliani & Miller[1] (1958). In the second section, contributions to the literature relating to Determinants of Capital Structure from studies done in India and abroad have been reviewed in detail. In the third section, a survey of general Capital Structure studies conducted in India and abroad has been done.

Third chapter presents the research methodology followed in the study to analyze the impact of potential Determinants of Capital Structure on Capital Structure practices of FDI Companies in India (firm wise and industry wise) and to study the trends in Capital Structure practices of FDI Companies in India. A detailed discussion on the hypotheses to be tested, procedure followed for sample selection along with the period of study, the statistical tools and techniques adopted for the analysis has been presented. The various measures of Capital Structure employed in the study have been discussed and defined. The chapter provides a theoretical background of the various Determinants that influence the Capital Structure decision of a firm. The Determinants selected for the purpose of studying their impact on Capital Structure of FDI Companies in India have been listed and the indicators for Determinants of Capital Structure employed in the study have been defined. The chapter also lists the Determinants of Capital Structure which are not selected for the study.

In the **Fourth chapter,** the trends in Capital Structure of FDI Companies in India are studied. Based on previous studies, variety of long term and short term debt measures have been used to analyze the trends and direction of changes in the Capital Structure practices of sample firms. Overall trends of the selected sample of FDI Companies in India as well as industry-wise trends in Capital Structure have been studied in detail.

The **Fifth chapter** seeks to empirically examine the relationship of Capital Structure and its Determinants with the objective of identifying the Determinants of Corporate

Capital Structure in India with reference to FDI Companies in India. Simple Linear Regressions and Multiple Regression Analysis of each Debt measure are conducted on the identified Determinants of Capital Structure. An attempt is made to analyze the impact of various variables on Capital Structure of the entire sample of 140 FDI Companies in India. Empirical analysis at firm level is undertaken to identify the Determinants of Capital Structure of FDI Companies in India.

In the **Sixth chapter**, Industry-wise empirical examination is done to examine the differences, if any, in the Capital Structure determinants of firms belonging to different industry groups.

In the **Seventh chapter** the main findings and conclusions derived from this study have been presented. Limitations of the present study have been stated and suggestions for future research work have been discussed.

This is followed by bibliography containing details of references used for the purpose of the study.

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