

CAPITAL MARKET AND THE PATTERN OF RESOURCE MOBILISATION IN THE INDIAN CORPORATE SECTOR

Introduction

The investment behaviour of a firm depends crucially on its financial structure since apart from technology, managerial and demand problems, the only completely exogenous constraint on the diversified firm is the stock market via its impact on company valuation and cost of capital. In a developing country, the constraint is more serious because of imperfections in the capital market. The need for and design of public regulations to direct investment according to plan priorities, therefore, depends on the structure of the financial market as well as that of the product market. The purpose of this paper is to look closely at the financial behaviour of the Indian corporate sector and its impact on the investment pattern in the industrial sector, in the light of financial deepening and stock market boom in the country.

Section I sketches the pattern of resource mobilisation in the Indian corporate sector- the composition of funds raised by different sources and the effect of size of firms and their field of activity on their relative strength in tapping resources from different sources. The emerging debt-equity scenario, the effect on the capital structure (or financial structure as the two terms are usually used interchangeably¹) and the cost of capital implications will also be discussed. In Section II, we will investigate into the imperfections in the Indian capital market which have hindered a wide-based equity culture in the Indian corporate sector and hence come in the way of capital formation and faster growth in all sectors of Indian industries.

^{1.} The term financial structure usually denotes both long and short term funds raised by the corporate sector whereas the term capital structure means long term funds only. But since the usual practice of firms is to use short-term funds on a continuing basis for long-term purposes, the distinction becomes blurred.

Section I

Resource Mobilisation in the Private Corporate Sector

Before the eighties, corporate savings were the most important component of gross resource mobilisation by the private corporate sector and reliance on external resources was limited. V.D.Lall et al (1982) found that internal savings, consisting of depreciation and internal plough-back (including bonus shares) accounted, on the average, for 64.2 per cent of gross resources during the period 1962-63 to 1975-76. Such high share of internal savings was, of course, partly due to the relatively low level of capital formation in the period which implied that the corporate sector did not need to seek resources from outside. The role of the stock market was insignificant during the period. Risk, uncertainty, low returns and low capital appreciation discouraged investors from making equity investments, while the low level of capital formation and the high cost of servicing fresh equity discouraged existing companies from floating fresh issues. New companies could not attract investors because of the long gestation periods of the projects.

The scenario changed considerably in the eighties. As industrial production by the private sector picked up, and with it also the need for more funds, the importance of external sources of funds increased. As seen from Table 1, over 70 per cent of total funds for the RBI sample of large and medium public limited companies (1942 companies) was acquired from external sources in 1986-87.² The role of internal savings to finance capital formation has been diminishing, as seen from the declining ratio of gross savings, measured as retained profits and depreciation provisions, to gross capital formation. Among the different categories of external sources, bank borrowing has maintained a share of around 20 per cent in the eighties. The declining percentage of gross savings in gross capital formation was matched by an increasing share of debentures. Short-term bank borrowings, however, has been maintained at 48.2 per cent. A more recent study³ of 231 companies for 1989-90 has shown that the importance of bank borrowings has declined even for working capital financing. This is particularly true for the larger companies which finance their working capital more through debentures. The unadjusted debt-equity ratio for all companies in the RBI sample fell from 86.2 per cent in 1984-85 to 84.7 per cent in 1986-87. When equity is adjusted for revaluation reserves, the ratio works out to be 105.1 per cent in 1984-85 and 117 per cent in 1986-87.

² Limitations of the RBI data on company finances are discussed in the Appendix.

³ See Economic Times research Bureau, "Financing Working Capital: The Diminishing Role of Bank Credit", Economic Times, Jan 14, 1991.

Table 1
Key Ratios for the RBI sample (per cent)

		1984-85	1985-86	1986-87
1@	Gross fixed asset formation as % of total uses	(55.2)	43.50	53.10
2@	GCF as % of total uses	(70.2)	66.40	67.60
3@	ES as % of total sources	(58.5)	65.50	70.90
4@	Increase in bank borrowing as % of total ES	(19.3)	20.10	19.10
5	Total borrowings as % of total liabilities	38.9	38.00	39.40
6	Short-term bank borrowings as % of inventories	44.8	45.00	48.20
7	Net fixed assets as % of total net assets	44.7	45.50	45.20
8	Ratio of current assets to current liabilities	1.2	1.22	1.22
9	Debt as % of equity	86.2	77.80	84.70
10	Debt as % of equity (equity adjusted for revaluation reserves)	105.1	109.60	117.00
11	Gross saving #as % of GCF	(55.8)	53.60	48.00

Note : Figures in brackets relate to 1867 companies selected for the previous study
 \$ Net of 'rebates & discounts' & 'excise duty & cess'
 @ adjusted for revaluation, etc.
 # Gross saving is measured as the sum of retained profits & depreciation provisions
 Source: Reserve Bank of India Bulletin, 1990.

Table 2 shows the size-groupwise shares of sources and uses of funds of public limited companies. In the small firms, i.e. firms with paid-up capital below Rs 5 lakh, there was net dissaving. This implies that the share of external sources work out to be over 100 per cent. The borrowings, however, comprised entirely those from banks and financial institutions and not from the capital market. The share of external sources in total was highest in the medium-sized firms, i.e. firms with paid-up capital between Rs 5 lakh and Rs 1 crore, but debentures constituted only a small share in their total borrowings. On the other hand, the share of debentures in total borrowings is highest (at around 40 per cent) for the large firms with paid-up capital of Rs 1 crore and above. It follows that small and medium sized firms rely most on funds from banks and financial institutions, while the large firms finance their investment needs more by floating shares and debentures.

Table 2
Size-wise sources and uses of funds (%)

	<u>External sources/ total uses</u>		<u>Debentures/ borrowings</u>		<u>Inventory/ total uses</u>		<u>Fixed assets/ total assets</u>	
	1985-86 1986-87	1986-87	1985-86	1986-87	1985-86	1986-87	1985-86	1986-87
Small (103*) (below Rs 5 lakh)	127.63	105.14				13.92	68.95	58.46
Medium (998*) (Rs 5 lakh to Rs 1 crore)	68.34	77.94	4.92	5.52	22.49	25.15	42.68	44.27
Large (841*) (Rs 1 crore and above)	65.14	70.21	38.81	39.05	22.97	13.37	43.59	54.03

Note: * Number of companies

Source: Reserve Bank of India Bulletin, September, 1990.

Table 3
Industry-wise sources and uses of funds (%)

	<u>External sources/ total uses</u>		<u>Debentures/ borrowings</u>		<u>Inventory/ total uses</u>		<u>Fixed assets/ total assets</u>	
	1985-86 1986-87	1986-87	1985-86	1986-87	1985-86	1986-87	1985-86	1986-87
Agriculture & allied (159*)	38.09	73.29	20.65	154.30	3.87		37.65	247.29
Mining & quarrying (19*)		63.17		0.00	33.49	22.37		55.87
Food, textiles, tobacco & leather products (426*)	64.95	83.25	56.19	16.02	11.02	14.88	59.92	45.76
Metals, chemicals & their products (831*)	68.07	68.89	34.26	37.81	31.37	17.50	35.56	49.51
Industries not elsewhere classified (267*)	58.89	53.96	10.93	45.85	16.91	7.60	54.64	72.90
Others (240*)	70.62	67.93	23.54	41.65	13.47	11.42	42.04	60.60

Source: Reserve Bank of India Bulletin, September, 1990.

Table 3 shows the industry groupwise shares of sources and uses of funds of large and medium public limited companies. External sources as percentage of total are highest

in food, textiles, tobacco and leather products while the share of debentures in borrowing is the lowest in these industries. This implies that they finance their asset and inventory formation more through banks and financial institutions. Around 38 per cent of total borrowings of metal and chemical industries are by the way of debentures. Keeping in mind the fact that most sunrise industries of the recent years are metal and chemical based, the financing behaviour of firms in these sectors and their capital market operations make an interesting study.

The relative importance of external sources, and most specifically of debentures for the large firms and bank borrowings for the small and medium firms, has meant that the debt-equity ratios have been high in most sectors of Indian industries. Table 4 shows the debt-equity ratios of industry groups. Debt-equity ratios have been over 100 per cent for cotton textiles, cement, electricity generation and shipping.⁴ The average debt-equity ratio for all industries was over 80 per cent and it was above 50 per cent for most industries.

The dominance of external funds in the total resources mobilised by the private corporate sector is evident also from the CMIE data on 648 private sector and 145 public sector companies (see Table 5). External sources as per centage of total uses rose from 45.7 in 1985-86 to 63.1 in 1988-89. Out of the external resources, the share of fresh capital issues rose from 2.4 per cent to 4.8 per cent during the same period.

The ICICI survey of finances of 417 companies give a similar picture. Table 6 shows the sources and uses of funds of these companies over the years. Table 7 shows the same for different industry groups for the year 1987-88. Interestingly, it is seen that in industries like cement, man-made fibres, electric lamps, storage batteries, machinery other than textile machinery, in which the share of external resources in total uses is over 100 per cent, the share of fresh issues to total external resources are very small. Sunrise industries like automobiles and their ancillaries, metal and aluminium products manage to raise more resources through capital issues, though more by the way of debentures. Table 8 shows the sources and uses of the same 417 companies classified according to gross fixed assets. Small companies with gross fixed assets less than Rs 5 crore finance over 97 per cent of their investment thorough external funds, mostly by bank borrowings. Other companies also get a sizeable amount of bank finances. Companies with assets between Rs 20 crore and Rs 50 crore float most of the debenture issues. Table 9 shows the debt-equity ratios according to asset sizes. They show that large companies have higher debt-equity ratios. Table 10 shows that smaller companies (with assets of Rs 5 crore and below) in general have lower debt-equity ratios, i.e. more of the small companies have debt-equity ratios of 0.32 and below. On the other hand, more of the medium companies (with assets between Rs 5 crore and Rs 20 crore) and of the larger companies (with assets

⁴ The phenomenal high debt-equity ratio in shipping is because almost the entire financing of shipping companies is through loans from the SCICI. In 1986-87, there was liquidation of shares for many companies so that the net equity participation in the industry became negative.

Table 4
Ratios of liquidity and debt-equity (RBI sample)

	Current assets* as % of total net assets			Ratio of Current assets* to current liabilities@			Debt# as % of equity+		
	1984-85	1985-86	1986-87	1984-85	1985-86	1986-87	1984-85	1985-86	1986-87
Tea	61.1	57.2	52.2	1.22	1.28	1.46	25.4	28.6	34.2
Sugar	71.6	70.4	69.4	1.07	1.21	1.24	105.8	93.6	71.1
Tobacco	62.2	63.3	58.8	1.08	1.08	1.12	38.5	41.5	35.1
Cotton text	49.4	45.6	51.2	1.12	1.24	1.09	103.9	112.7	128.8
Jute text	47.8	42.5	39.0	0.68	0.59	0.53	62.2	56.1	64.5
Silk& rayon text	44.8	43.1	46.2	1.10	1.12	1.34	86.4	82.6	90.4
Aluminium	52.9	40.3	42.8	1.24	1.19	1.40	40.7	25.0	49.5
Engineering of which	61.6	60.4	60.2	1.26	1.23	1.24	72.9	69.6	74.0
i. Motor vehicles	55.5	56.7	55.0	1.41	1.24	1.18	66.8	67.9	72.2
ii. El mach,etc.	70.6	69.6	69.6	1.36	1.34	1.41	53.8	48.3	57.8
iii.Mach exc tran,el	64.3	60.2	60.8	1.21	1.20	1.20	77.3	73.2	81.4
iv. Found.& engg	50.5	51.4	52.8	1.10	1.12	1.12	104.8	91.8	84.6
v. Metal Prod	59.1	60.9	60.3	1.14	1.20	1.22	88.7	83.7	77.4
Chemicals of which	54.4	53.9	52.4	1.40	1.46	1.43	74.7	63.1	73.6
i. Pharmaceuticals	65.2	66.7	65.3	1.41	1.45	1.49	40.6	47.6	48.7
ii. Paints	82.4	75.8	77.0	1.33	1.39	1.53	38.0	36.9	46.3
iii.Basic ind chem	48.1	47.5	46.0	1.41	1.48	1.43	87.6	67.7	84.0
of which									
fertilizers	51.7	52.3	54.1	1.78	1.60	1.57	110.6	71.6	76.7
Cement	35.9	35.9	33.8	1.05	1.16	1.11	101.8	110.1	123.4
Rubber & prod	59.7	58.8	55.7	1.04	1.10	1.16	100.0	89.7	78.6
Paper & prod	38.4	34.3	36.4	1.12	1.14	1.12	158.4	85.4	95.4
Construction	82.6	83.2	83.3	1.23	1.20	1.22	37.9	39.3	46.7
Electricity gen	27.0	31.4	30.3	1.05	1.18	1.09	127.3	109.9	100.5
Trading	86.3	84.6	83.9	1.20	1.19	1.19	51.5	47.5	37.4
Shipping	11.5	12.7	13.1	0.38	0.39	0.36	1079.5	1890.3	\$
Total	53.4	52.2	52.2	1.20	1.22	1.22	86.2	77.8	84.7

Note: * Current assets comprise (1)inventories,(2)loans & advances & other debtor balances (3) book values of quoted investments,(4)cash & bank balances & (5)advance of IT in excess of tax provisions

@ Current liabilities include (1) tax provisions in excess of advance of IT & other current provisions, (2) borrowings from banks other than those against own debentures & other mortgages (3)other borrowings other than (i)those against own debentures,other mortgages,deferred payment liabilities & (ii)public & other deposits & (4) trade dues & other current liabilities.

Debt comprises (1) all borrowings from FIs ,(2)from banks against debentures & mortgages & (3) other borrowings

+ equity comprises PUC, forfeited shares & all reserves

\$ denominator negative

Source: Reserve Bank of India Bulletin, 1990.

Table 5
Key Ratios # (percentage)

	Private Sector	1985-86	1986-87	1987-88	1988-89
a.	Internal sources/Total uses	54.3	35.4	40.7	36.9
b.	External sources/Total uses	45.7	64.6	59.8	63.1
c.	Fresh capital issues/ External sources	2.4	5.6	6.6	4.8
	Public Sector				
a.	Internal sources/Total uses	19.6	38.6	46.3	36.3
b.	External sources/Total uses	60.4	61.4	56.4	60.7
c.	Fresh capital issues/ External sources	20.0	31.1	41.0	17.0

Source: Trends in Company Finance 1984-85 - 88-89, Centre for Monitoring Indian Economy, Bombay (January, 1990).

Table 6
Sources and Uses of Funds of 417 public limited companies, 1984-85 to 1987-88

Sources	1984-85		1985-86		1986-87		1987-88	
	Rs. crore	%	Rs. crore	%	Rs. crore	%	Rs. crore	%
Internal								
Depreciation	1034.11	27.1	1062.05	19.7	978.12	17.5	1418.3	29.4
Reserves and surplus	644.01	16.8	919.49	17.1	753.99	13.5	1168.29	24.2
External								
Paid-up Capital	93.58	2.4	111.82	2.0	237.27	4.2	405.59	8.4
Debentures	590.10	15.4	858.23	15.9	1230.40	22.1	88.67	1.8
Long-term Borrowings	269.06	7.0	284.74	5.2	592.68	10.6	629.18	13.0
Loans from Financial Institutions	156.28	4.0	172.30	3.2	351.78	6.3	341.72	7.0
Loans from Banks	27.54	0.7	124.04	2.3	21.39	0.4	90.26	1.8
Deferred Credit	52.24	1.3	-4.72	-0.1	-4.87	-0.1	-12.14	-0.2
Others	33.00	0.8	-6.88	-0.2	224.38	4.0	209.34	4.3
Bank Borrowings for Working Capital	273.80	7.1	461.84	8.5	453.23	8.1	343.91	7.1
Unsecured Loans and Deposits from Creditors	132.34	3.4	315.43	5.8	288.94	5.1	137.25	2.8
Others Current Liabilities	636.61	16.6	1288.13	23.9	612.34	11.0	614.48	12.7
Total	141.74	3.7	71.02	1.3	416.99	7.4	9.95	0.2
Total	3815.35	100.0	5372.75	100.0	5563.96	100.0	4815.62	100.0
Uses								
Gross Fixed Assets	2071.30	54.2	2524.02	46.9	3135.12	56.3	3462.63	71.9
Inventories	619.72	16.2	1183.08	22.0	704.11	12.6	572.9	11.8
Other Current Assets	1124.33	29.4	1665.65	31.0	1724.73	30.9	780.09	16.1
Total	3815.35	100.0	5372.75	100.0	5563.96	100.0	4815.62	100.0

Source: Financial Performance of Companies, ICICI Portfolio, 1987-88

Table 7
Select Ratios for Industry Groups, 1987-88 (per cent)

	No of cos.	ES/TU	CI/ES
Automobiles & cycles	28	45.14	125.11
Sub-group: Automobiles	11	45.35	163.12
Automobile ancillaries	15	36.51	58.52
Cement	11	108.92	11.33
Chemicals & Petrochemicals	77	70.69	16.45
Sub-group: Caustic soda	3	41.55	-60.75
Thermoplastics	9	70.95	0.10
Pharmaceuticals	8	61.55	0.17
Basic petrochemicals	6	22.76	0.07
Man-made fibres	9	114.99	0.30
Dyestuff	4	98.30	0.14
Fertilizers	8	65.71	0.06
Power generation & distribution	6	115.42	-0.05
Electrical equipment	44	87.11	18.48
Sub-group: Cables	10	53.17	18.30
Electric lamps	8	139.69	8.80
Dry cells	2	69.73	17.55
Storage batteries	2	120.91	54.97
Food products(except sugar)	12	74.83	10.46
Glass & pottery	11	45.26	19.88
Sub-group: Ceramics	3	63.07	0.22
Refractories	2	1.99	0.00
Abrasives	3	33.03	57.99
Machinery	54	65.57	32.86
Sub-group: Material handling equipment	4	62.32	11.48
Diesel engines	3	123.66	35.27
Machine tools	4	63.53	34.22
Textile machinery	5	157.38	0.00
Small tools	3	10.50	-278.87
Bearings	6	77.03	6.16
Machinery fabrication(except text mach)	3	251.27	-0.10
Tractors	2	-227.30	3.45
Metal products(non-ferrous)	8	16.57	332.94
Sub-group: Aluminium	2	18.76	326.82
Metal products (ferrous)	41	69.74	19.43
Sub-group: Steel forgings	2	74.72	47.31
Steel castings	4	3.15	100.00
Steel tubes & pipes	5	11.09	100.00
Pulp, paper & paper products	16	19.72	100.00
Rubber products	9	14.05	100.00
Sub-group: Tyres & tubes	8	14.11	100.00
Sugar	6	-0.12	100.00
Textiles	45	-42.77	78.26
Sub-group: Spinning Mills	9	78.26	7.59
Composite Mills	36	-53.86	109.76
Diversified	27	88.37	25.07
Miscellaneous	22	-55.20	-99.13
Sub-group: Hotels	5	68.18	81.25
Woollen textiles	3	98.71	139.91
Total	417	59.35	17.29

Note: ES denotes external sources
TU denotes total uses
CI denotes capital issues

Source: Calculated from Financial Performance of Companies, ICICI portfolio, 1987-88.

Table 8
Sources and Uses of Funds of 417
companies according to Gross Fixed Assets, 1987-88

	Companies with Gross Fixed Assets			
	Rs. 5 crore and below	Between Rs 5 cr and Rs 20 crore	Between Rs 20 cr and Rs 50 crore	Rs. 50 cr. and above
Number of Companies	40.00	168.00	112.00	97.00
Sources				
Internal				
Depreciation	6.32	127.46	209.43	1075.09
Reserves and Surplus	-5.58	0.42	105.96	1067.49
External				
Paid-up Capital	3.20	24.12	47.09	331.18
Debentures	0.93	21.62	62.2	3.92
Long-term Borrowings	9.71	46.24	103.57	469.66
Loans from Financial				
Institutions	1.72	-13.95	88.51	265.44
Loans from Banks	4.07	15.61	-8.24	78.82
Deferred Credit	1.43	-1.89	-2.01	-9.67
Others	2.49	46.47	25.31	135.07
Bank Borrowings for				
Working Capital	5.14	87.61	68.84	182.32
Unsecured Loans and				
Deposits	-2.68	-22.65	-11.71	174.29
Creditors	9.12	12.22	177.26	415.88
Other Current Liabilities	3.72	91.07	51.48	-136.32
Total	29.88	388.11	814.12	3583.51
Uses				
Gross Fixed Assets	7.20	191.02	366.65	2897.76
Inventories	-2.06	127.82	166.07	281.07
Other Current Assets	24.74	69.27	281.4	404.68
Total	29.88	388.11	814.12	3583.51
ES/TU97.52	67.05	61.26	5.16	

Source: Financial Performance of Companies, ICICI Portfolio, 1987-88

Table 9
Debt Pattern of 417 companies, 1986-87 and 1987-88

Assets	No. of Cos.	Debt-Equity Ratio		Total Debt as % of Net Worth		Borrowings from FIs as % Net Fixed	
		1986-87	1987-88	1986-87	1987-88	1986-87	1987-88
Total Sample	417	0.94	0.87	162.5	149.4	19.9	19.5
Profit-making Companies	321	0.91	0.79	154.8	135.3	18.6	17.7
Non-profit-making Companies	96	1.25	1.92	226.3	335.1	27.8	31.1
Companies with Gross Fixed Assets:							
Rs. 5 crore and below	34	0.69	1.00	223.1	269.7	36.3	38.8
Between Rs. 5 crore and Rs. 20 crore	162	0.87	0.93	208.2	219.0	40.9	37.1
Between Rs. 20 crore and Rs. 50 crore	117	0.64	0.68	141.9	142.2	24.9	27.5
Rs. 50 crore and above	104	1.03	0.91	162.0	143.8	17.1	16.7

Source: Financial Performance of Companies, ICICI Portfolio, 1987-88.

Table 10
Frequency Distribution of Debt-Equity Ratios, 1986-87 and 1987-88

	No. of Cos.	0.32 & below		0.33 to 0.99		1.00 to 2.32		2.33 & above	
		1986-87	1987-88	1986-87	1987-88	1986-87	1987-88	1986-87	1987-88
Total Sample	417	97	90	177	166	90	93	51	66
Profit-making Cos.	321	88	82	143	146	65	69	25	24
Non-profit-making Cos.	96	9	8	34	20	25	24	26	42
Companies with Gross Fixed Assets:									
Rs. 5 crore and below	33	17	14	6	7	4	4	7	8
Between Rs. 5 crore and Rs. 20 crore	161	35	31	67	62	32	37	26	31
Between Rs. 20 crore and Rs. 50 crore	117	28	28	60	55	23	22	6	12
Rs.50 crore & above	104	17	17	44	42	31	30	12	15

Note: The number of companies in the different ranges would not add up to the total for groups/sub-groups, since companies where losses exceed equity or there is no debt component in one of the years, have been excluded from this Table.

Source: Financial Performance of Companies, ICICI Portfolio, 1987-88

of Rs 50 crore and above) have debt-equity ratios between 0.33 and 0.99. The hypothesis that smaller companies are more debt-ridden than bigger ones, then, does not seem to be valid. Companies with greater asset bases seem to be borrowing as much, if not more than the smaller ones. While it has to be conceded that this finding is based on a small sample of companies, it is indicative of the phenomenon of debt-intermediation in small as well as big firms. It is possible that the reasons behind such a scenario are the liberalised debt-equity norms and the imperfect nature of the capital market in the country, the details of which will be discussed later. Table 11 shows that debt-equity ratios have been generally high in industries like caustic soda, fertilisers, power generation and distribution, ceramics, refractories, metal products, pulp and paper, rubber products, tyres and tubes and woollen textiles. By and large, traditional industries have higher debt-equity ratios than modern industries. It has been suggested that public financial institutions should gear their lending policies in a manner such as to channelise private investment in desirable directions through policies governing debt-equity ratios. It has been observed of late that many new floatations in the capital market rely more on the lure of quick capital gains rather than on the long-term profitability of investments. Market prices of most shares have no relation to earning capacity. The debt-equity norms for share and debenture floatations could be an instrument to check this unhealthy trend.

Capital Structure and Cost of Capital to Firms

According to the principle of "**financial leverage**" or "trading on equity", a firm can obtain debt funds at an interest rate lower than its internal rate of return, thus increasing the rate of return on its equity capital. But this may not result in a corresponding rise in the value of the firm's stock because of the risk involved. As the debt-equity ratio is raised, the financial risk associated with holding the firm's shares tends to become greater and investors are likely to use a higher capitalisation rate in determining the present value of the expected revenue stream. As a firm expands through borrowing, the marginal rate of return declines and its marginal interest rate increases. It will maximise its total profit on equity by extending borrowing only to the point at which the two marginal rates are equal. However, if the firm aims to maximise the value of its equity, it has to stop borrowing at an earlier point where the marginal rate of return is still above the marginal rate of interest. This is so because of the risk factor, which raises the capitalisation rate applicable to the firm's stock as the amount of debt increases the optimal combination of profitability and risk. If

capital expenditures are financed with new stock issues, the value of the firm becomes important as the investors take this into account. The total cost of capital, then, is the weighted average of equity and debt costs, both of which are affected by the risk factor involved with high debt-equity ratios.

Table 11

Debt-Equity Ratios of 417 Companies, 1983-84 to 1987-88

Industry Group	No. of Cos.	1983-84	1984-85	1985-86	1986-87	1987-88
Total Sample	417	0.74	0.79	0.83	0.94	0.87
Automobiles & Cycles	28	0.54	0.57	0.63	0.66	0.79
Sub-group : Automobiles	11	0.62	0.65	0.73	0.77	0.93
: Automobile Ancillaries	15	0.28	0.29	0.28	0.31	0.35
Cement	11	0.85	1.11	1.33	1.37	1.69
Chemicals & Petrochemicals	77	0.69	0.65	0.60	0.70	0.72
Sub-group : Caustic Soda	3	1.10	0.77	1.10	1.19	0.79
: Thermoplastics	9	0.41	0.44	0.40	0.48	0.61
: Pharmaceuticals	8	0.22	0.26	0.32	0.38	0.36
: Basic Petrochemicals	6	0.93	0.92	0.75	0.60	0.46
: Man-made Fibres	9	0.32	0.49	0.46	0.68	0.93
: Dyestuffs	4	0.36	0.66	0.70	0.55	0.70
: Fertilizers	8	1.37	0.93	0.85	0.83	0.81
Power Generation & Distribution	6	1.82	1.79	1.35	1.16	1.30
Electrical Equipment	44	0.41	0.49	0.58	0.70	0.76
Sug-group : Cables	10	0.50	0.58	0.77	0.83	0.55
: Electric Lamps	8	0.51	0.65	0.82	0.98	1.49
: Dry Cells	2	0.31	0.22	0.30	0.26	0.24
: Storage Batteries	2	0.44	0.38	0.29	0.22	0.22
Food Products (other than Sugar)	12	0.28	0.28	0.34	0.38	0.38
Glass & Pottery	11	0.63	0.76	0.68	0.66	0.60
Sub-group : Ceramics	3	1.23	1.47	0.98	0.93	1.00
: Refractories	2	1.11	1.52	1.47	1.14	0.56
: Abrasives	3	0.36	0.49	0.54	0.53	0.47
Machinery Manufacture	54	0.63	0.75	0.85	0.95	1.00
Sub-group : Material Handling Eqpt.	4	0.47	0.58	0.63	0.57	0.46
: Diesel Engines	3	0.27	0.25	0.25	0.26	0.31
: Machine Tools	4	0.48	0.49	0.68	0.68	0.71
: Textile Machinery	5	0.92	0.93	3.70	*	*
: Small Tools	3	0.25	0.23	0.13	0.52	0.39
: Bearings	6	0.53	0.75	0.65	0.58	0.68
: Machinery Fabrication (other than Textile Machinery)	3	0.24	0.29	0.14	0.22	0.21
: Tractors	2	0.42	0.45	0.42	0.60	0.45
Metal Products (Non-ferrous)	8	0.48	0.54	0.51	0.88	0.81
Sub-group : Aluminium	2	0.20	0.34	0.36	0.87	0.83
Metal Products (Ferrous)	41	1.06	1.09	0.91	0.92	0.86
Sub-group : Steel Forgings	2	0.92	0.83	0.89	0.90	1.18
: Steel Castings	4	0.26	0.31	0.49	0.61	0.91
: Steel Tubes & Pipes	5	0.91	0.84	0.80	1.08	0.99
Pulp, Paper & Paper Products	16	1.02	1.05	0.92	0.93	1.22
Rubber Products	9	1.05	1.59	1.92	1.54	1.03
Sub-group : Tyres & Tubes	8	1.04	1.59	1.92	1.52	1.03
Sugar	6	0.93	0.80	1.05	0.99	0.88
Textiles	45	0.90	0.86	1.32	1.89	0.81
Sub-group : Spinning Mills	9	0.69	0.69	0.63	0.59	0.66
: Composite Mills	36	0.93	0.88	1.39	2.00	0.81
Diversified	27	0.49	0.56	0.64	0.73	0.83
Miscellaneous	22	0.67	0.83	0.77	0.95	0.81
Sub-group : Hotels	5	0.79	0.66	0.81	0.65	0.93
: Woollen Textiles	3	1.06	1.79	1.09	0.98	1.23

Note: * Losses exceed equity in this group.

Source: Financial Performance of Companies, ICICI Portfolio, 1987-88.

In industrialised economies, firms tend to supplement their equity funds with borrowings for their additional capital expenditure to hedge against the risk of ownership dilution. The traditional view is that the cost of capital depends crucially on the debt-equity ratio. Higher gearing, i.e. increasing the ratio of equity to the total of debt and equity finance, increases the variability of the return on equity and chances of default on debt. Modigliani and Miller (1958), however, held that under certain assumptions, "the average cost of capital to any firm is completely independent of the capital structure and is equal to the capitalisation rate of a pure equity stream of its class". These assumptions were

- (1) perfect capital markets,
- (2) rational behaviour of investors,
- (3) perfect certainty on the part of all investors regarding future investment and profits.

There have been a number of empirical studies attempting to test Modigliani-Miller's proposition for various economies. For India, Sarma and Rao (1969) studied 30 engineering companies for the years 1962, 1964 and 1965. Contrary to the Modigliani-Miller hypothesis, they found that investors prefer corporate to personal leverage and therefore, the values of a firm rises up to a leverage rate considered prudent.

The assumption of perfect capital markets, however, can be questioned in reality. Imperfections may arise in the capital market due to

- (1) transaction costs. These include legal, underwriting and administrative costs of issuing shares and the brokerage charges on buying and selling shares,
- (2) limited supply of finance,
- (3) information content of dividends. A significant rise in dividends may increase share valuation because of the higher earnings that the dividends are supposedly indicating,
- (4) effect of different tax regimes. Baumol and Malkiel (1967) showed that tax advantage of borrowing and the near zero transactions cost incurred in undoing leverage make it undesirable for the firm to employ as much debt as feasible.

In a developing economy like India, apart from these institutional constraints, there are **structural imperfections in the capital market** which further limit the equity culture in the corporate sector. Besides, the main concern here is not the opportunity cost of funds from various sources incurred by the stock holders, but long-term growth of firms and that of the economy as whole. The analysis of opportunity cost of capital is relevant not just from the viewpoint of the stockholders but also for the purpose of policy making for economic development. The dominance of **debt intermediation** (that is, high leverage of firms) implies that the firms cannot spread their risk across investors, affecting their growth in the long run. They also become vulnerable to economic downturns. As the Chakravarty Committee (1985) noted, "only when the borrowing concerns improve turnover of their capital, strengthen their equity base and obtain long-term funds from the capital market will they be able to maintain adequate working capital margins on a regular basis. These options are open more to the larger companies who have a good past record of operations

than others, including new companies who are not well known in the capital market". Similar views were expressed by A.Ghosh (1991). According to him, tax concessions to the corporate sector have not led to any visible impact on corporate savings and a high debt-equity ratio has encouraged the tendency to borrow rather than find equity funds.

It has been argued that removal of the mechanism of the administered interest rate policy will boost savings and hence investment in the economy.⁵ As a first step towards such a scenario, the budget of 1990-91 has introduced a band of interest rates for the term loans of financial institutions. Though this will have three segments related to the risk involved and a minimum of 15 per cent, the rates will be informal and floating. Besides, interest rates can now vary from one institution to another and income tax exemptions for IDBI have been abolished. In less developed economies where commercial banks are the most dominant financial intermediaries, financial liberalisation may, however, have adverse effects on the industrial sector. The term "financial liberalisation" means substantial reduction in government intervention in setting interest rates and allocating credit, either by doing away entirely with the interventionist regime as in the Southern Cone countries or by gradual phasing out as in South Korea, Sri Lanka and partly in Indonesia. Cho and Khatkhate (1989), studying the financial structures of five Asian countries (that is, South Korea, Malaysia, Sri Lanka, Philippines and Indonesia) and those of the Southern Cone countries (that is, Chile, Argentina and Uruguay), found that "financial reforms, whether comprehensive and sweeping or measured and gradual, does not seem to have made any significant difference to the saving and investment activities in the liberalised economies".

⁵. Recently, the World Bank has prescribed a strategy of financial reforms for India on such lines. It has proposed flexible interest rates and privatised banks and financial institutions in the long run.

Section II

Imperfections in the Indian Capital Market

As observed earlier, the large corporate sector has increasingly been depending for its financing needs on the capital market, mainly in the way of debentures. Table 12 corroborates the fact that there was a boom in the capital market as the consents of capital issues by the private corporate sector is seen to have jumped up in 1985-86. But since 1989-90, there has been a slack in the number of consents. In the instrument-wise composition of funds raised by the private sector, there has been a major shift in relative importance from equities to debentures. In the whole of the seventies, shares accounted for most of the funds from the capital market. Between 1982 and 1986-87, debentures accounted for about 70 per cent of the funds. This tilt in the pattern of funds raised by the private sector from shares to debentures seems to be the result of the relaxation of the debt-equity norms, the use of convertible debentures and the raising of the ceiling interest rate on debentures in the early eighties.

Table 12
Consents of capital issues of private corporate sector, 1971 to 1990-91

Year (April-March)	Shares		Debentures		Total
	Amount	%	Amount	%	
1971	60	71	25	29	85
1972	62	55	50	45	112
1973	88	80	22	20	110
1974	77	74	27	26	104
1975	123	78	34	22	157
1976	85	61	55	39	140
1977	152	82	34	18	186
1978	106	68	49	32	155
1979	120	46	139	54	259
1980	269	80	68	20	337
1981-82	205	33	417	67	622
1982-83	255	32	531	68	786
1983-84	320	34	609	66	929
1984-85	780	46	920	54	1699
1985-86	1083	37	1849	63	2931
1986-87	1600	38	2641	63	4214
1987-88	1441	67	724	33	2165
1988-89	1486	30	3445	70	4932
1989-90 @	1677	22	5879	78	7556
1989-90@	504	35	944	65	1448
1990-91@	366	20	1426	80	1792

Note: @ Data are provisional.

Source: Reports on Currency and Finance, various issues

Out of the funds raised through fresh issues, the proportion of rights' issues has steadily increased while that through the prospectus has decreased (see Table 13). Moreover, the volume of funds raised by new companies constitute less than half of the funds raised by existing companies. It appears that the narrowness of the equity market is increasingly becoming a constraint for new companies to raise funds through public issues. The established companies can get over the constraint by raising funds through debentures and company deposits. There has, therefore, been a greater dependence on debt instruments such as loans from banks and financial institutions, debentures and company deposits instead of on equity finance.

Table 13

**Capital Issues through Prospectus and Rights by
Non-Government Public Limited Companies, 1971-1990**

(Rs. crore)

Year	Issues through Prospectus		Issues through Rights		Total issues	of which	
	Amount	per cent	Amount	per cent		New cos	Existing cos
1971	36	78	10	22	46	25	21
1972	89	91	9	9	98	60	38
1973	60	82	13	18	73	47	26
1974	46	81	11	19	57	24	33
1975	86	87	13	13	99	59	40
1976	49	83	10	17	59	37	22
1977	75	80	19	20	94	50	44
1978	80	81	19	19	99	62	38
1979	94	53	82	47	176	49	127
1980	102	62	62	38	164	58	106
1981	395	83	83	17	478	207	271
1982-83	397	56	309	44	706	215	491
1983-84	360	45	432	55	792	296	542
1984-85	396	38	660	63	1056	309	747
1985-86	878	52	825	48	1703	626	1077
1986-87	1271	52	1163	48	2434	678	1756
1987-88**	708	40	1070	60	1777	318	1459
1988-89**	1563	49	1602	51	3165	1229	1936
1989-90**	3146	49	3291	51	6437	625	5811
1989**@	653	56	517	44	1170	81	1089
1990**@	125	55	102	45	226	95	131

Notes: ** Provisional.

@ April-June

Source: Report on Currency and Finance, 1989-90.

Table 14 shows the financing pattern of project costs of companies issuing capital. It is clear that because of the narrow base of the capital market, only a small part of the project costs are equity financed. In 1989, 178 companies floated issues to finance their combined project cost of Rs 3153.48 crore. Out of this, only 22.80 per cent was equity financed while loans from financial institutions constituted 44.08 per cent and debentures and bonds had a share of 30.14 per cent. Unfortunately, the project finance data for new and existing companies separately are not available for the recent years. It is seen that till 1981, new companies which raised capital from the market floated equity shares while the existing companies relied on debentures. The Patel Committee (1985) too had observed this tendency. The existing companies issue debentures and preference shares mainly for the investment institutions. Even when they offer equity shares, it is mostly by way of rights issue. The reluctance to issue shares is probably because of the fear of ownership dilution. The Working Group on the Development of Capital Markets (1989) felt that there should be greater thrust on equity culture and the growth of risk capital, which is important for dynamism and faster growth in the industrial sector.

A **debenture** is a bond backed by the general credit of a company. Theoretically, the use of debentures as a means of raising resources from the market depends on the nature of the assets of the firm and its general credit strength. Various policy measures initiated in the eighties have contributed to the growing importance of debentures as a source of mobilising capital. In October 1980, the debt-equity ratio norms for issuing debentures was relaxed from 1:1 to 2:1. In April 1982, NRIs were allowed to invest in debentures subject to certain conditions. In 1984, the purpose for which debentures could be issued was widened. Earlier, a borrower could issue debentures only to meet long-term working capital needs. The revised list covered the financing of new projects, modernisation, merger and amalgamation of companies, restructuring of capital requirements. With the repeal of the provisions relating to mergers, amalgamations and takeovers by the MRTP companies in the 1991 industrial policy, convertible debentures are likely to become an even more crucial instruments for such purposes. Since September 1984, the issuer is permitted to raise up to 50 per cent of the issue amount (the ratio was reduced to 15 per cent since April 1988) in the event of oversubscription. Also, exemption was granted from listing for private placement of non-convertible debentures with financial institutions, banks, companies, etc. In July 1987, the convertibility guidelines were changed following the Narasimham Committee recommendations. These revisions (a) raised the threshold limit for mandatory stipulation of the conversion option from Rs 1 crore to Rs 5 crore, (b) exempted the stipulation of the clause if the combined institutional holding exceeded 26 per cent and (c) exempted sick units and projects in no-industry districts from the conversion option. The upswing

Table 14

Financing of Project Cost of Companies Issuing Capital,1971-1989

Rs lakh

Year ended	1971			1976			1981			1985\$	1986\$	1987\$	1988\$	
	1989\$ New Total Cos.	Existing Cos.+	Total	New Cos.	Existing Cos.+	Total	New Cos.	Existing Cos.+	Total	Total	Total	Total	(All Cos)	
March 31/ Item														(All Cos)
Number of Companies	21	36	57	50	33	83	95	26	121	395	676	385	119	178
Share Capital(Indian)	2062	1843	3905	5468	3357	8825	4747	2642	7389	32962	57520	73771	74647	71888
(i) Equity	1443	1271	2714	5080	3031	8111	4699	2414	7113	32802	57520	73771	74647	71888
(ii) Preference	619	572	1191	388	326	714	48	228	276	160	-	-	-	-
Share Capital(Foreign)														
(i) Equity	665	77	742	5	-	5	-	11	11	-	-	-	-	-
(ii) Preference	-	15	15	-	-	-	-	-	-	-	-	-	-	-
Reserves and Surplus	-	644	644	70	1566	1636	8	11107	11115	5558	2281	9943	3998	6323
Subsidy from Central Govt	-	-	-	108	-	108	298	137	435	1069	1900	2228	1059	980
Debentures/Bonds	-	490	490	-	20	20	-	6380	6380	7309	8991	57550	18407	95039
Deferred payments	171	383	554	414	98	512	23	-	23	1060	853	648	469	2116
Loans from FIs	5060	3361	8421	9661	4974	14635	8487	5526	14013	44493	76850	114970	58484	139002
Total	7958	6813	14771	15726	10015	25741	13563	25803	39366	92451	148395	259110	157064	315348

Notes: + Including private limited companies converted into public limited companies.
 \$ Split up into the categories of new/existing companies has been discontinued.
 The data for all the companies issuing prospectus which are non-financial & non-govt. companies.

Source: Report on Currency and Finance, 1989-90.

in the issue of total capital and debentures was maintained throughout the eighties (see Table 12).

Within debenture issues, the relative role of non-convertible and convertible segments presents an interesting picture. In absolute amounts, non-convertible issues rose sharply during 1981-82 to 1985-86. Thereafter, the rise was arrested, even declining sharply in some years. The non-convertible debentures (NCDs) market has generally been a captive one, with very little response from the average investor. Banks, mutual funds and other institutions have been the major buyers. Recently, the freeing of interest rates on NCDs from the 14 per cent ceiling is expected to lead to a debenture war, resulting in large-scale floatation of junk bonds in the absence of a proper credit rating system.

Interest has also developed in convertible debentures after the various policy relaxations. Under proper circumstances, there are advantages in these instruments both for the investor and the issuer. For the investor, it provides an ideal combination of high yield, low risk and potential capital appreciation. It also ensures safety of principal and an opportunity to share in the growth of the company. It enables the borrower to broaden the equity holding, impart flexibility to capital structure and reduce tax liability (since interest paid on debentures is chargeable to earnings). However, convertible debentures reveal two aspects which are detrimental to the interest of the investors and also to the health of the capital market. First, the conversions invariably result in "odd lots" as a result of which investors are left with illiquid scrips. Second, conversions are done at a premium which does not reflect the company fundamentals. While the investors lose since the number of shares allotted is lower and market price falls after conversion, the issuer benefits since the premium forms a part of its reserves.

The fact that the boom in the stock markets has not resulted in substantial equity financing of the corporate sector appears to be because of the **narrow base of market capitalisation** and trading activities. On the Bombay Stock Exchange, 86 per cent of the turnover was contributed by the Specified group consisting of 80 scrips. The top 5 scrips account for 45 to 50 per cent of the turnover of all Exchanges, indicating that despite the rapid growth of the secondary market, it is still rather thinly spread and, therefore, tends to be volatile. Out of nearly 6000 companies listed in the stock exchanges, there are about 500 scrips (including specified and non-specified shares) which are frequently transacted in the secondary market. A recent study⁶ on the bullish phase in the stock market following the budget, 1990, found that out of 30 companies which constitute the Bombay Stock Exchange Sensitivity Index (BSESI), only 12 shares were active in inflating the index value during the 12 months. During April to September, 1990, six companies were found to be primarily responsible for spurring the BSESI. Studying the prices of 77 chemical and pharmaceutical scrips during 1988-89 and 1989-90, V.A. Avadhani found that these share prices had no relation to the company fundamentals.⁷ Table 15 shows an international

⁶ See S. Chatterjee (November 25), Stock Markets: The Bull Mirage, PTI Corporate Trends.

⁷ See V.A. Avadhani, Share Prices and Performances of the Corporate Sector (Chemical and

comparison of market capitalisation and turnover. India has the largest number of listed companies among the emerging economies. Even as compared to the developing economies, it has more listed companies than many others. However, market capitalisation and turnover are still far less than those in developing countries and rank fourth among the emerging economies. The ratio of market capitalisation to paid-up capital of listed stock increased from 1.3 in 1975 to 2.2 in 1988 although the capitalisation is concentrated in only a few companies. The increasing shareholding by financial institutions, although it leads to stability in the market, has played a part in narrowing the capitalisation base. The Patel Committee (1985) observed that the Life Insurance Corporation (LIC), the General Insurance Corporation (GIC) and the Unit Trust of India (UTI) keep buying the buoyant scrips but, except UTI, none of them are active in selling their shareholding in the market periodically.

The capital market in India is basically dominated by a few inter-connected companies associated to some industrial Houses. Table 16 shows the amount of capital raised by these Houses during January 1984 to December 1989. It is evident that companies affiliated to the two top Houses, Birla and Tata, mobilise most of the resources in the capital market. With the abolition of the asset limit of MRTP companies in the new industrial policy, it is expected that the concentration in the capital market will increase further.

The Bombay Stock Exchange Sensitive Index of Equity Prices consists of 30 scrips from both the Specified and the non-Specified groups, selected on the basis of stock market activity and with due representation from all major industries. Table 17 lists these companies, the industry groups to which they belong and their House associations. Complementary to the earlier finding that most of the capital raised from the stock market goes to the big Houses, this table shows that the same inter-connected companies are dominant in the secondary market also.

The base of market capitalisation has been further narrowed by the phenomenon of **mega issues** since the early eighties. In 1980-81, Tata Engineering (TELCO) made an issue of convertible debentures of Rs 48 crore when the total capitalisation in the Stock Exchanges was Rs 164 crore- the issue thus accounted for 29 per cent of the total amount of issues made in the year. In 1986-87, Indo-Gulf Fertilizers made an issue of Rs 81 crore. UTI issued Master Shares of Rs 50 crore (which ultimately mobilised Rs 150 crore in 1986-87) and Reliance

Table 15
International Comparison
Ten Major Developed Markets and Ten Major Emerging Markets
(As on 31st December, 1988)

(Amount in US \$ Millions)

S.No	Name of the Composite Country	No. of Limited Companies	Market Capitalisation	Turnover	Turnover Ratio Index	
Developed Markets						
1.	Japan	1,571	3,816,908	2,496,227	65.4	18,199.8
2.	United States	6,680	2,793,816	1,719,731	61.6	12,882.8
3.	U.K.	2,054	771,206	579,171	75.1	3,982.8
4.	Germany	609	362,777	350,274	139.1	1,958.6
5.	France	646	244,833	65,505	2.7	781.0
6.	Canada	1,145	241,880	66,654	27.6	779.8
7.	Australia	1,303	183,483	37,412	20.4	537.5
8.	Spain	368	174,689	25,608	14.7	470.9
9.	Italy	211	135,428	31,721	23.4	413.6
10.	South Africa	754	126,094	4,947	3.9	284.6
Emerging Markets						
11.	Taiwan, China	163	1,20,017	2,75,624	229.7	1,151.0
12.	Korea	502	94,238	79,180	84.0	382.9
13.	Brazil	589	32,149	17,979	55.9	140.8
14.	India *	2,238	23,845	12,241	51.3	100.0
15.	Mexico	255	23,630	7,720	32.7	81.0
16.	Malaysia	238	23,318	2,623	11.2	59.6
17.	Thailand	141	8,811	5,598	63.5	41.4
18.	Portugal	171	7,172	666	9.3	18.9
19.	Chile	205	6,849	610	8.9	16.9
20.	Phillipines	141	4,280	875	20.4	12.6

* Only Bombay Stock Exchange.

Source: International Financial Corporation Quarterly Report.

Table 16

**List of 20 Largest Capital Issues Approved During January 1984-March 1989
(Initial and Further Issues of Share Capital of Rs. 5.00 Crores and Above)**

			(Rs. lakhs)
S.No	Name of the Company	House Association	Capital Consented
1.	Indo-Gulf Fertilizers and Chemicals Ltd.	Birla	84150.00
2.	Chambal Fertilisers and Chemicals Ltd.	Birla	15280.00
3.	Nagarjuna Fertilisers Ltd.	Nagarjuna	13016.34
4.	Tata Fertilisers Ltd.	Tata	12600.00
5.	Aravali Fertilisers Ltd.	Birla	10140.00
6.	Sunflag Iron & Steel Co. Ltd.	Sunflag (NRI)	6340.00
7.	Reliance Petrochemicals Ltd.	Reliance	5750.00
8.	Uptron Colour Picture Tubes Ltd.		5312.50
9.	Shipping Credit & Investment Co. of India		5000.00
10.	Indian Charge Chrome Ltd.	IMFA	4911.00
11.	Gujarat Heavy Chemicals Ltd.	Dalmia	4700.00
12.	Tata Iron and Steel Co. Ltd.	Tata	4216.80
13.	Ispat Profiles India Ltd.	Ispat (Mittal)	4095.00
14.	India Charge Chrome Ltd.	IMFA	4000.00
15.	Tamil Nadu Petroproducts Ltd.	Chidambaram	3900.00
16.	DCL Polyesters Ltd.	Raju M.B.	3775.00
17.	Andhra Petrochemicals Ltd.		3529.00
18.	Jaypee Rewa Cement Ltd.	Jaiprakash	3385.50
19.	Reliance Industries Ltd.	Reliance	3300.00
20.	Metlax Ceramics Ltd.		3287.50

Source: Collected from the quarterly statistics on the working of capital issues control, Corporate Information System, ISID.

Note: House Association Follows Registrations under the Monopolies and Restrictive Trade Practices Act, 1973 and the criteria adopted by the Industrial Licensing Policy Inquiry Committee, 1969. FCC stands for Foreign Controlled Company.

Table 17**List of Shares Selected in the Bombay Stock Exchange Sensitive Index**

S.No.	Name	Industry Group	House Association
1.	ACC	Cement	ACC
2.	Ballapur Industries	Paper	Thapar
3.	Century Spinning	Cotton Textiles	Birla
4.	Bombay Dyeing	Cotton Textiles	Wadia
5.	Reliance Industries	Synthetic Textiles	Reliance
6.	Gwalior Rayon	Synthetic Textiles	
7.	Indian Rayon	Synthetic Textiles	Birla
8.	Great Eastern Shipping	Shipping	Bhiwandiwala
9.	Siemens	Electricals	FCC
10.	Peico Electronics	Electricals	Philips
11.	Tata Powerand Supply	Electricity Generation	Tata
12.	Tata Steel	Iron and Steel	Tata
13.	Hindustan Aluminum	Aluminium	Birla
14.	Tata Engineering	General Engineering	Tata
15.	Larsen and Toubro	General Engineering	Larsen & Toubro
16.	Kirloskar Luminus	General Engineering	Kirloskar
17.	Premier Automobiles	Automobiles	Walchand
18.	Hindustan Motors	Automobiles	Birla
19.	Mahindra & Mahindra	Automobiles	Mahindra
20.	Mukand Iron	Metal Products	Bajaj
21.	Zenith Ltd.	Metal Products	Birla
22.	Gujarat State Fertilisers	Chemicals & Fertilisers	Joint Sector
23.	Indian Organic	Chemicals & Fertilisers	Ghia
24.	Hindustan Lever	Chemicals & Fertilisers	FCC
25.	Glaxo	Pharmaceuticals	FCC
26.	Food Specialities	Food Products	FCC
27.	Ceat Tyres	Rubber Products & Tyres	Goenka
28.	Voltas	Trading	Tata
29.	Indian Hotels	Miscellaneous	Tata
30.	ITC Ltd.	Miscellaneous	ITC

Note: FCC denotes foreign controlled company

Industries made an issue of Rs 400 crore of convertible debentures. In 1988, Reliance Petrochemicals made an issue of Rs 516 crore. In 1989, 10 mega issues (including rights) were floated, six of them during September to December. These included the public issue of Rs 360 crore partly convertible debentures and rights issue of Rs 205 crore by Tata Steel; public issue of Rs 406.53 crore fully convertible debentures by Essar Gujarat; public and rights issue of Rs 450 crore 14 per cent fully convertible debentures by Usha Rectifier of which Rs 162 crore was offered to the public; public and rights issue of Rs 500 crore of fully convertible debentures by Bindal Agro Chemical; public and rights issue of Rs 820 crore fully convertible debentures by Larsen and Toubro of which Rs 200 crore was offered on rights basis; rights issue of convertible debentures of Rs 124 crore by Ceat and rights issue of Rs 100 crore convertible debentures by Ispat alloys and Rs 141 crore of convertible debentures by Hindalco. Together these issues accounted for 57.5 per cent of the convertible debentures raised by all non-government public limited companies. Most of these companies floating mega issues are affiliated to large Houses. Indo-Gulf Fertilisers is associated with the Birla House, TELCO and Tata Steel with the Tatas, Reliance Petrochemicals to the Reliance group, Ceat with the Goenkas and Bindal Agro to the Oswal group.

The manner in which these mega issues were floated have aroused widespread criticism. Apprehensions were expressed by investors about insufficient disclosures about the projects, past performance of promoters, extent of premia fixation and deployment of funds before their actual requirement for projects. There have been reports that capital raised by one company are subsequently used for other projects of the group. Besides, the issues were bunched during July to October 1989 and the premia fixed were very high. Thereafter, the regulatory mechanisms were made stricter for the mega issues. A minimum gap of 12 months between two issues, public or right, or six months from the listing of the previous issue, whichever is later, was stipulated. Financial institutions were made responsible for monitoring the end-use of funds raised by companies through capital issues of Rs 50 crore or above. Minimum limit of 90 per cent subscription was also prescribed in case of rights and public issues of securities before allowing allotment by companies. Transactions in security instruments were made more transparent and the listing agreement was amended to improve disclosure requirements in case of acquisition of shares and regulate transactions.

The concentrated capitalisation in the secondary capital market discourages new companies to float shares in the primary market. Widening the activities in the secondary market would lead to more company floatations, greater absorption of household savings by the industrial sector, broadening and diversification of the industrial structure and acceleration in capital formation in the economy.

Speculative activities in the secondary markets have accentuated the narrowness of the capital market. It is argued that some degree of speculation needs to be allowed in the securities market since a market based purely on investment transactions may not be able to clear, without price disturbances, all the purchase and sale orders. However, the

Stock Exchanges in India have experienced speculative activities which are much in excess to the "reasonable" limits required to maintain liquidity and continuity in prices. Excessive speculation has often disrupted trading activities and distorted the price structure. It has also increased the volatility in the market.

The Patel Committee (1985) categorised the following factors responsible for excessive speculation:

- (1) overtrading by stockbrokers on their own account and duality in functioning both as agents and as principals,
- (2) insider trading,
- (3) illegal options and kerb trading, indulged in by the stockbrokers,
- (4) large scale manipulation of markets through rigging up of prices and bearing raids to push down prices by a few outside operators who are not subject to the discipline of the Stock Exchanges,
- (5) the extreme narrowness of the markets and shortage of adequate floating stock of good scrips,
- (6) outside money to finance carry over of transactions,
- (7) lack of effective machinery for reporting , monitoring, inspection and audit of the market operations,
- (8) hesitation of the governing bodies to deal with crisis situations promptly,
- (9) outdated byelaws and regulations,
- (10) other factors like lack of timely disclosure of information by companies, want of co-ordination of common policies of Stock Exchanges, etc.

Conclusion

In section I of this paper, we discussed the trends in resource mobilisation in the private corporate sector in India. We found that corporate savings have fallen far short of the investment needs of firms, both small and large and in all industries. External sources of funds have become more important in recent years, but this has been more in the form of debt than equity. The boom in the stock markets have not developed the equity base in the economy. This has serious implications for the cost of capital to firms. In section II, we discussed the imperfections in the capital market which has led to a situation in which only a few big companies can tap the capital market for their investment needs. While, the majority of the smaller firms remain dependant on banks and financial institutions.

APPENDIX

Limitations of RBI Data on Finances of Private Sector Companies

Estimates of resource mobilisation in the non-Government non-financial corporate enterprises are usually made from the RBI sample surveys of medium and large public and private limited companies. Though the private corporate sector is one of the organised segments of the economy, the accuracy of the above estimates can be questioned.

The RBI samples of medium and large public limited companies consist of companies which account for 80 to 90 per cent of the paid-up capital of all companies. But they exclude non-operating companies and companies under construction.⁸ The problem with the sampling procedures for the smaller private limited companies have been found to more serious.

Resource mobilisation and utilisation for the private corporate sector can be estimated from the combined sources-and-uses-of-funds accounts presented in the RBI surveys. The internal sources of funds include the paid-up capital, reserves and surplus and the provisions for depreciation, taxation, etc. External sources include net issues and share premium, capital receipts, borrowings, trade dues and other miscellaneous liabilities. Funds are assumed to be utilised for gross fixed asset formation, inventory accumulation, loans, investments and other asset formation.

The sources-and-uses-of-funds accounts are derived from the combined balance sheets. There are several problems in such computations. Firstly, intra-sector transactions are eliminated by grouping together those asset and liability items which seem inter-related as contra items, that is, those items which appear on both sides of the accounting statement.⁹ Ideally, these items should be netted out so that intra-sector indebtedness is eliminated and it also shows to what extent trade credit represents a source or a use of funds for the sector as a whole. Similarly, a part of the share and debenture issues may be directly subscribed within the sector. Deducting the increase in security holdings within the sector from the total securities issue would give the net funds to the corporate sector.

Secondly, the sources-and-uses-of-funds accounts do not reconcile the changes in reserves and accumulated depreciation as per the balance sheet with the retained income and depreciation provisions as per the income statement. The balance sheets are affected by numerous purely book-keeping transfers from one account to another, like capitalisation of reserves on issue of bonus shares, revaluation of assets, adjustments to reserves, etc. In

⁸. A study by RBI, "Finances of Companies Under Construction and Time Lags in Commencement of Production, 1971-72 to 1975-76, RBI Bulletin, February 1981, found that a significant quantum of fixed asset formation take place through the companies under construction.

⁹. See L.C.Gupta (1969).

particular, balance sheet changes understate substantially the funds accruing to enterprises through depreciation provisions. The correct procedure would be to derive the figures of depreciation provisions and retained income from the income statement.

Thirdly, the RBI includes provisions for taxation and for other current and non-current liabilities under internal sources. However, since these are in the nature of liabilities, they should have been treated as external sources.

Fourthly, the RBI surveys present the data at the aggregate level and for disaggregate industry groups. The industries are classified as (i) agriculture and allied activities, (ii) mining and quarrying, (iii) manufacture of foodstuffs, textiles, tobacco, leather and their products and (iv) manufactures of metal and chemical products. Data at a more disaggregate level is needed to make any analysis of the structure of industries and their financing. Such broad groupings of industries come also in the way of investigating the link between industrial, trade and financial liberalisation.

Fifthly, The RBI covers different companies in each of the surveys and the sample size varies. It is not possible, then, to construct a time-series for the private sector resource mobilisation.

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