

# Debt Strategy Trends of Emerging Market Firms: Evidence from India

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## ABSTRACT

Different industry sectors have high degree of variation with respect to financial leverage. The excessive use of financial leverage by firms had played a paramount role in the 2008 financial crisis. This study examines the average debt intensity of different industrial sectors during different time period. The study was based on a sample of approximately 20,000 companies representing 19 different industry sectors. The study explores whether there exist persistent differences in leverage ratios across different industry sectors in India. The study examines whether the leverage measures of the Indian firms have changed during different period of analysis. The study also examines the determinants of an optimal capital structure. Electricity sector is the most debt intensive sector among the different industry sectors. Communication, construction and real estate sectors were the next debt intensive sectors among the Indian industrial sectors. The average debt equity ratio of all the industry sectors was 16.57 reflecting the high debt intensity characteristics of Indian Industry. The mean debt equity ratio ranged from 1.45 (Machinery & Transport) to 85.64(Electricity) during the period 2005-2016. The average return on capital employed was negative for all the sectors during the period 2000-2016 except for electricity sector. The average leverage of 10 industry sectors increased in the period 2010-2016 compared to the period 2000-2009. The study document statistically significant variation in mean leverage ratio for industry sectors like communication, construction and real estate, electricity and miscellaneous manufacturing. The most leverage intensive sector construction and real estate sector was the only sector with positive average return on capital and had highest cash flow intensity during the period 2010-2016. Regression results finds statistically significant negative relationship between profitability and leverage. Less profitable firms tend to use more financial leverage. Firms that have more profits tend to have lower leverage. This result is in line with pecking order theory. Some evidence suggest that debt ratio is inversely related to the costs of financial distress. Firms with higher discretionary expenditures tend to have higher cash flows and hence lower costs of bankruptcy. Textile, metal, financial services, electricity and consumer goods are highly debt intensive industries.

## KEYWORDS

Cash Flow Intensity, Debt Equity Ratio, Debt to Capital Ratio, R&D Intensity, Trends in Leverage

DOI: 10.4018/IJSDS.2017100104

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## 1. INTRODUCTION

High degree of leverage in companies often pose a risk to a country's economic stability. The failure of Lehman Brothers and host of highly leveraged financial institutions signify the negative ramifications associated with the use of highly levered capital structures. According to IMF study<sup>1</sup>, a third of the corporate debt in India has a debt to equity ratio of more than three which is considered to be the highest degree of leverage in the Asia Pacific region. A high debt equity ratio indicates that firms have been borrowing to fund expansion instead of raising money from the market. This trend would affect the health of the firm if interest rates rises and economic growth falters. According to the IMF, the important mitigating factor is that debt owed by the highly leveraged firms in Asia Pacific region is small relative to overall size of the economies. The corporate sector would be under strain if the global liquidity recedes and interest rates rise. High corporate debt poses a systemic risk since it is widespread among sectors like infrastructure, power and real estate. According to IMF Global Financial Stability Report 2014, half of the corporate debt owned by firms in India and China have return on assets below 5 per cent. Over leveraged companies put significant stress on banks. According to rating agency India Ratings and Research, a third of India's 500 largest listed non-financial companies failed to earn enough cash flows to make interest payments in the financial year 2015.<sup>2</sup> According to Ministry of Finance estimates, the total amount of gross non-performing assets (NPAs) for public and private sector banks in India amounted to 6 lakh crore by June 2016. The basic metal and metal products sector is the worst performing sector in terms of NPA ratio. Stressed assets account for an estimated 14 per cent of the total assets of Indian banking system. Indian public sector state-owned banks provide a bleak picture as the stressed accounts account for 17 per cent of their total lending with 6.2 per cent of total loans classified as non-performing.

Stressed assets accounted for an estimated 14 per cent of India's total banking system as of September 2016, according to the RBI. The picture is particularly bleak at state-owned banks. The stressed assets account for 17 per cent of their total lending, with 6.2 per cent of total loans classified as non-performing. The rest of the loans have been restructured with extended repayment schedules and in some cases additional funds have been provided to keep alive projects which has suffered from delays in clearances and rising costs. Under a strategic debt restructuring scheme revealed by Reserve Bank of India in 2016, companies that revise loans must now sign binding contracts which enable the lenders to take over the company if it fails to comply with the new repayment term.<sup>3</sup>

One of the most debated contentious issues in the theory of finance has been the theory of capital structure. It had been a challenge for financial scholars to develop a definitive theory of capital structure. Capital structure theories have often led to different and in some ways diametrically opposed decisions and outcomes. Some scholars suggest that capital structure is largely irrelevant in the sense that they have no predictable material effects on corporate market value. Another viewpoint is that capital structure decisions signifies an attempt by corporate managers to balance the tax shields of higher debt against the potentially large costs of financial distress. Excessive debt can lead to destruction of value through financial distress and under investment, while too little debt particularly in large mature companies can lead to over investments and low returns on capital. Financing decisions by managers are also analyzed along "signaling" effects of such decisions.

## 2. OBJECTIVE

The study examines whether average leverage ratios are strongly related to industry classifications. The study explores whether there exist persistent differences in leverage ratios across different

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