

CHALLENGES CONFRONTED BY INDIAN ECONOMY IN THE AREA OF FUNDS MOBILIZATION AND MANAGEMENT

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Abstract: The subject of corporate finance has assumed tremendous significance in the light of the ongoing economic uncertainty across the world. Apart from the three most important decisions of fund raising, fund deployment and generation of returns, greater emphasis has been laid down upon creating a long term value through Economic value addition (EVA). The role of assets in generation of cash flows has become even more pronounced in modern day changing dynamics. More than the external factors, India has certain homegrown structural problems which seriously need to be addressed at this juncture; the prominent ones being ensuring a high ICOR and addressing the supply side bottlenecks in the economy. Indian companies will have to address the financial problems in the light of the current macroeconomic turmoil of high inflation and revised growth projection of 5%. This has to be done despite having a sound corporate financial framework. This paper attempts to address these problems and tries to suggest some solution to overcome the period of uncertainty.

Key words: Economic value addition, ICOR, Stagflation, Value creation

INTRODUCTION TO CORPORATE FINANCE

Corporate finance, as a specialized branch of Finance deals mainly with making three crucial decisions by the firm. They are:

- 1) Raising of funds from the various available sources of finance (from domestic and international markets) at the minimum possible cost of capital
- 2) Investment of the raised funds into well performing assets (both long term capital assets , medium term assets and the short term assets)
- 3) Ensuring distribution of returns amongst various providers of capital (In form of interest payments and dividends)

In addition to the abovementioned decisions, corporate finance helps in achieving the ultimate goal of shareholder's wealth maximization in the long term. All the three decisions of the a firm should be focused towards achieving the goal of long term value creation for the shareholders and the stakeholders. Technically speaking, undertaking sound capital budgeting decisions , a proper working capital management and a judicious dividend policy ensures the creation and preservation of long term value , both for the shareholders and the company. In recent times, the concept of Market value addition (MVA) and Economic value addition (EVA) has assumed tremendous significance in the area of corporate finance. Both the metrics gauge the market value of the overall firm over and above the capital employed. (MVA= Market value –Invested capital). Here market value is synonymous with enterprise value. EVA

stands for the economic value added which is (NOPAT – Charges for capital employed). Simply put, EVA studies the excess of Net operating profit accruing to both the debt holders and the equity holders in excess of their respective cost of capital. Higher NOPAT leaves the debt and equity capital providers with better return on their capital (debt & equity) employed. $NOPAT = EBIT(1-t) = PAT + Int(1-t)$. A firm with higher EVA year after year, adds value to both, lenders and shareholders and so it a reliable measure of value creation in the long run. Both MVA and EVA studies the return on capital employed above the cost of capital.

Importance of investments in corporate finance

Investments play a very crucial role in the area of corporate finance. In fact the value of the firm is the market value of its assets which is reflected in the capital markets through the market values of debt and equity. Wealth maximization motive of the firms gets defeated if the choice of the assets (both long term capital expenditures and short term) is not made on the basis of the proper realistic estimation of the future cash flows. The cash flow estimation should also be taken into consideration after duly undertaking the risk analysis concerned with the generation of the future cash flows. Capital raised from various sources of finance do not come for free. The equity capital and retained earnings involve the expectation and opportunity cost of capital which is the costliest source of finance. Debt capital involves interest charges which is comparatively cheaper but exposes the shareholders and the firm to financial risks. In order to strike a balance between cost of capital and riskiness associated with various sources , firms try to combine all the individual sources and finalize an weighted

average cost of capital. Investment in assets are the only way wherefrom returns can be generated and the claims of the suppliers of finance can be satisfied. The cash flows should be the free cash flows which are free for settling the claims of the debt suppliers and the residual amount to be utilized to satisfy the claims of the equity participants.

Free Cash flows = $EBIT(1-t) + Depreciation \pm \text{other non cash items} \pm \text{Change in Net working capital} - \text{Change in Capital expenditure}$.

In order to undertake various projects, it is imperative to rank them on the basis of discounted and non discounted cash flows methods. Discounted methods discount the future cash flows with the help of a discounting rate which is the cost of capital. They include NPV, IRR and the PI index methods while the non discounted methods make use of Pay back period, discounted payback period and accounting rate of return. Projects yielding a return above their cost of capital are given preference in acceptability. In fact it is the efficiency of the capital expenditures that help in the creation of a positive EVA, of course after getting support from the cost management part as well. This goes all the way in creating value for the shareholders and the debenture holders. In addition to the capital expenditures, it becomes extremely important that the firms manage their current assets especially inventory and receivables. Firms should decide upon a balanced credit policy while dealing with the receivables. A proper tradeoff between liquidity and profitability should be ensured at all points of time. Due diligence should be exercised in inventory management which shall ensure the minimum wastage through loss or theft. Surplus cash should be deployed into marketable and highly liquid securities with easy liquidity being the paramount consideration. Investment in current assets should not be taken lightly because the daily operating efficiency of a firm depends upon them and if due diligence is not exercised, it may have serious repercussions in the future in terms of precarious liquidity crisis and the overall return on capital employed being adversely affected. In brief now a days considerable amount of effort is being channelized in working capital management as it is one of the key areas of modern day corporate finance.

As per the Financial Managers in India, there are four corporate finance goals which are of utmost importance. They are as follows:

1. Ensuring a smooth fund raising process at a minimal cost of capital
2. Maximization of growth and ensuring value creation for the shareholders

3. Maximization of Earnings before Interest and taxes (EBIT)

4. Enhancement of the return on investment (ROI)

In the light of the current macroeconomic scenario prevailing in the country, achievement of the aforementioned corporate finance goals seems to be a daunting task. Besides her own share of problems in the form of high fiscal & current account deficits, persistent inflation, overall stagflationary conditions, weak sentiments in the financial markets, weak rupee etc. the Indian economy is also battling slowdown from within and international markets. Still on the back of reforms initiated by the GOI, a slow but steady turnaround is expected. At present, the Indian corporate sector is grappled with the following issues which are threatening the value and long term wealth creation goal. The issues are:

Problem in raising funds

Due to domestic and global economic slowdown triggered by the sub prime and the Euro zone debt default crisis, obtaining capital from home and abroad has become very costly as the financial meltdown has made the investors risk averse. Indian capital markets have gone into hibernation in terms of IPOs/ FPOs and the banking system is battling one of the worst NPA and debt recast problems in recent times. This fiscal , CDR request is Rupees 218000 crore (approx) as on March 2012 which grew @ 58% since 2009. This has forced them to be very strict in terms of providing funds to the Indian corporate sector. Rather their lending to the Government securities has gone up via the SLR route. Foreign investors have become skeptical about lending to Indian companies in light of the political and economic uncertainty

Investment of funds

Fund raising difficulties and a slowdown across domestic and international economies have forced the Indian companies to withhold their CAPEX investment plans. Slowdown has reduced the marginal efficiency of capital. Exorbitantly high short term and long term financing costs has made the capital raising exercise very painful. Companies prefer to conserve valuable cash resources for future than undertake CAPEX through costly financing. In 2011-12, banks sanctioned 668 projects worth 212000 crores (appx) against 710 projects worth 392800 crores (appx) in 2010-11. In 2012-13, CAPEX can be lower at 207000 crores.

Possibility of a “crowding out effect”

Another risk looming large on the horizon of the Indian corporate sector is the possibility of a crowding out effect

in case the GOI embarks on a ruthless investment expeditation drive by raising funds from banks and FIs aggressively (which has already begun) by offering attractive return on the borrowings and invest the same in infrastructural and other sectors thereby increasing the aggregate demand in the economy . This will negatively impact the private firms in two ways. Firstly, input costs shall go up due to inflation and secondly cost of funds shall flare up as well finally forcing them to crowd out.

Fall in growth, operating margins and shareholder's value creation

Stubbornly high inflation has resulted in increased inventory costs, labor charges and other operating costs & expenses (especially the transportation costs). Further, stagflationary conditions prevailing in the economy has drastically reduced the top line of the companies. The slowdowns in the international markets are also to be blamed for dismal sales growth of the Indian companies. Ultimately the operating margins (EBIT) falls and this exerts pressure on the profitability of the companies and eventually the shareholders value erosion starts.

Risks of default

Persistently depressed EBIT can also create problems in terms of debt default and interest payment charges in case the financial leverage is high. Low EBIT gives lesser interest coverage ratio and this drags the companies into a potential debt trap. Recently Indian companies are coming under margins pressure and after the default of Suzlon on her FCCBs, the debt default probability is looking pressing. The recent increased debt recast requests by corporates to the banks highlight this unpleasant fact and is seriously jeopardizing the bottom lines of the banks as well.

SUGGESTIONS

The conditions do look challenging but certainly not unmanageable. If the issues are addressed in the following manner with full resolve, then the corporate finance issues can be resolved:

1. The GOI should NOT try to reduce the interest rates forcibly in order to stimulate the economy. Inflation risks are high coupled with sluggish growth. The govt. should act with patience and first ensure a low ICOR on the fiscal expenditures. Augmentation of revenues is not only sufficient but the expenditures should be fruitfully productive. E.g. rural wages have gone up without an increase in productivity. This creates supply side bottlenecks because increased demands do not get matched by supply. Before undertaking Greenfield CAPEX plans across various sectors, Govt. should simultaneously

expedite the existing Brownfield projects which are long pending. This will have a few long term benefits. First, the expenditure locked in such pending projects will start generating revenues once they are commissioned. This will drastically reduce the ICOR and capital efficiency shall be achieved. Secondly, India is infrastructure hungry. Quick completion of the projects shall improve the logistics and the supply chain . This will help in faster meeting of supply with demand. India mainly suffers from supply side constraints and the recent stagflationary trend can be countered if instead of creating further demand, supply and employment is ensured beforehand. Undertaking of the new projects with completion of the existing ones shall create more employment opportunities and this will augment the productive incomes. The Govt. should also stop the wasteful expenditures in the form of unproductive rural wages. It will take some time before the benefits are fully reaped but this will automatically bridge the gap between demand and supply, reduce inflation and soften real interest rates. Above all , the fiscal deficits will come down once the efficiency of capital is achieved and the revenue augmentation takes place on a sustained basis.

2. The RBI recently took a pragmatic approach in handling issues of inflation control and reduction of NPA problems of the banks by reducing the CRR by a meager 0.25% to 4.25%. and increasing the provision against recasted loans to 2.75% This will infuse liquidity to the tune of 17500 crores in the system. In the light of recent growth forecast being pegged around 5%, the RBI shall be under pressure to lower the interest rate further, but inflation risks are still looming large due to the supply side mismanagement. This calls for a very balanced approach by the central bank. This move should be welcomed because a steep cut in CRR would have reduced lending rates and there would have been a growth in loan demands from the corporate sector. This would lead the banks into higher NPAs because loan repayments are stressed due to anemic growth. Companies will have to exhibit superlative performance in terms of growth in revenues, reduction of costs, improvement in operating margins and a high sustained Return on investment which will create faith in the eyes of the banks because by increasing the provisioning norm on advances, the RBI has made its intention clear regarding her resolve in fighting the problems of deteriorating asset quality of the PSU banks in particular. RBI should take a call in reducing the interest rates further only when she feels that by doing so inflation does not get out of hand and companies can actually generate a healthy ROI from the assets once when the economy catches pace. The Govt. should gradually reduce her dependence over the banks' funds in the form of SLRs and rely more on her income

enhancement by achieving capital efficiency through non-slippages of revenue and stopping capital wastages. This will leave the banks with more loanable funds which can be lent to promising companies once when the economy recovers.

3. Indian companies will have to show some patience. They should try to increase the sales volume by lowering the prices. Companies will do well if they can target the emerging rural markets, wherein the disposable income has gone up due to various schemes like MNREGA undertaken by the GOI. Operating leverage should be kept within manageable limits. Unnecessary costs should be cut. Margins will be temporarily low but this will help in maintaining a steady EBIT figure. They should not withhold expansion plans although it might seem to be a better option in times of rising cost of inputs, cost of capital and falling revenues. In such testing times, the marginal efficiency of capital and labor falls but shutting down operations completely is going to aggravate the problem further because it will cause mass layoffs of people from employment which will worsen the stagflationary situation prevailing currently. So to stay afloat, they should continue making investment but on a decreased scale and upon being convinced with the cash flow generation of the projects after taking into consideration all the future risks & uncertainties. In order to achieve this goal, the companies should try to be cash rich by employing more debt (medium to long term) and reduce the dividend pay out ratio. This will create retained earnings and this can be used in future for CAPEX expansion. Steady EBIT will insulate the companies against interest payments defaults but shareholders will have to be contented with low dividends for some times ahead. This will help in conservation of cash. This shall be a temporary phase because overcapitalization in times of uncertainty is not an option and this will result in a low ROI, high cost of capital which will eventually destroy wealth. This strategy will at least ensure low combined leverage and a steady EBIT. Another vital aspect that calls for attention is the management of the working capital. During times of faltering economic growth, credit sales become vigorous and unavoidable but an equally sharp strategy should be laid in place to ensure that timely recovery is being made and loss of bad debts is minimized. Credit payments should be deferred tactfully without denting the credibility of the firm. In short the operating cycle should be achieved at the shortest possible time. Investors may not feel comfortable initially with the idea of a dividend cut but gradually they shall understand that the essence of corporate finance does not lie only in creating value by maximizing the market price of the shares during good times but also in preventing the value from

eroding into wealth destruction during testing times. Even the dividend policy vouches for the same logic. As per the Walter's model of dividend distribution, a declining firm opts for a 100% payout ratio because it is no more able to create long term value for the shareholders. Technically speaking where ($K_e > ROI$). In the case of growth firms, (where $K_e < ROI$), the dividend policy to be adopted should be 0% or 100% of retention. Where $K_e = ROI$, payments of dividends or not, do not make any impression on the market price of shares. The current uncertain times tests the corporate finance and investment decision making skills of the companies. It is better to raise funds from internal accruals and long term debts (by opting for low payout) than raise funds at a high cost of capital and undertake investments which will fail to generate returns amidst a struggling macroeconomic outlook. This will ultimately lead to the cost of capital superseding the return on investments and threaten the very existence of the firm by dragging it into a vortex of debt default and irrecoverable losses to shareholders.

CONCLUSION

In the end, the onus lies on GOI to reduce fiscal deficits, contain inflation and ensure low real interest rates which will show the road to sustained economic recovery. Once the fiscal discipline is ensured and real interest rates come down, firms will find making corporate financial decisions easier and the overall operating environment will become more congenial as well. The main issue which is plaguing the Indian economy is the lack of capital formation despite a huge population base. When capital formation rate is low, investment cycle can never achieve its goal. In order to achieve capital formation growth, it is imperative that savings is generated in the economy. This can be achieved only when the general price level is under moderation and there is income generation in the hands of masses. With prices low, interest rates (both short & long term) becomes benign. When savings rate grows in the economy, half of the job is done and to achieve the remaining half, the Government will have to show commitment in the development of a full fledged financial system in form of better profit generating banks replete with adequate capital and more sophisticated capital markets with world class risk surveillance system which will give length and breath to our economy and firms will feel more confident about raising funds, applying them and generating returns to the fund providers. Besides, India shall also be a favored destination for foreign long term investments which can prove to be excellent growth partners in the economic liberation dream. More investments will create more internationally competitive goods whose demand in the international markets will strengthen our currency and

improve our forex reserves as well. At the moment everything sounds a bit overoptimistic but it can be said that with a resolute Govt. and sound corporate financial decision making blending, this dream is very much achievable. All that is needed is the unleashing of long term investments which creates , preserves and distributes value.

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