

Impact of Business Groups on Payout Policy in India

A

Ahana Bose

Indian Institute of Management Calcutta, India

INTRODUCTION

The presence of ‘institutional voids’ in the capital, product and labour markets of emerging economies have helped in the evolution of business groups in them. Business groups represent a unique organization structure akin to ‘cliques’ which comprises separate legally independent entities (business houses or conglomerates), working in different industries which may be unrelated in core functions, held together “by persistent formal (e.g., equity) and informal (e.g., family) ties” (Khanna & Yafeh, 2015). “Spawning” new companies by established business groups may potentially be important in emerging markets where it is probably difficult to start *de novo*” (Khanna & Yafeh, 2015). Group-affiliated firms ‘complements firm-level diversification’, reduces risk of loan default, creates internal capital markets to fund projects and aids in value creation (Classens et al., 2000). Agency conflicts in business group occur between majority and minority shareholders. The interests of managers are aligned to the majority shareholders who appoint them. Paying out regular dividends signal good health of firms to investors, but if a majority shareholder wishes to spend the same money in wasteful acquisitions then dividend payments will be irregular. Here the ‘voice’ of a majority shareholder works against the interest of a minority shareholder often forcing the latter to ‘exit’ the firm. To prevent wasteful activities of cash-rich concerns government has advocated for share repurchases through the Companies Act of 2013 in India. Nearly 30 per cent of the firms accounting for 59 per cent of assets in private corporate sector are owned by business groups

in India, one of the leading emerging economies of the world. India is slated to become the third largest economy in the world by 2030, from its 2013 rank of ten according to the estimates of a PricewaterhouseCoopers (PwC) report, which it an important market to study.

Payout policy is closely linked with most of the financial and investment decisions made by firms. It decides how much amount of cash ought to be returned by the firm to its shareholders. Payout in India occurs either through dividends or share buybacks. The challenge faced by financial economists lies in devising suitable payout policies where firms maximize shareholders wealth while investors maximize their utility. Firms in Indian corporate sector have been hoarding cash after the financial crisis of 2008-09¹. Public sector enterprises (PSU) often end up sitting on cash piles as their executives are unable to decide what to do with the excess liquidity in hand. PSUs distributed 33.1 per cent of their net profit as dividends in 2008-09, which jumped to 45.5 per cent in 2013-14. Close to 60 percent of the PSU’s hoarded cash pile is in the hands of a limited number of firms with Coal India leading the pack. Coal India had a dividend yield of 6.95 per cent in 2015.

However, it is not only the PSUs which are hoarding liquidity. The last five years have seen a dramatic rise in cash hoardings in the private sector as well. We observe that “the private sector’s cash and equivalents grew at a compound annual rate of 20 per cent, accounting for 70 per cent India’s cash pile at the end of 2013-14 compared with 52 per cent in 2007-08.”¹ While Reliance Industries have followed a miserly dividend yield of less than 1 per cent for the last five years, Piramal

DOI: 10.4018/978-1-5225-2255-3.ch005

Enterprises have had a dividend yield of 9.6 per cent in FY13. Within the Tata Group, TCS has had a dividend yield of 3.19 per cent last year and had been making regular payouts over the previous five years. On the contrary, Tata Motors, which had followed a policy of making steady payment of dividends for the last fifteen years, missed it in 2015, much to the annoyance of its shareholders.

Cairn India opting for buyback after Companies Act of 2013 belongs to the Vedanta Group while Coal India is a stand-alone company. Further Tatas, Piramal Enterprises and Reliance mentioned above constitute the top business houses in India. Probing further it is observed that Indian corporate sector has been characterized by concentrated ownership and widespread presence of business groups for a long time. The position of family owned independent trading houses strengthened after the East India Company lost its monopoly. The early 1900s, saw ethnic communities such as Tatas & Birlas gaining prominence in the economy. Post-independence, the 1950s witnessed the inception of groups like the Goenkas & Khaitans through the transfer of assets from British trading houses. The 1960s was the era of creation of groups like Reliance due to the policies of the License Raj². Later on, the economic reforms & liberalization which followed brought groups like Wipro & Ranbaxy to the forefront. Through different regimes, ownership by promoters of a business group continued to dominate the Indian corporate environment. Licensing, political connections, regulations as well as financing decisions over time have affected the functioning of business groups.

The absence of institutions in emerging markets creates difficulties in efficient resource allocation to firms. Diversified groups step in to fill the gap, aiding innovation and entrepreneurship. The goodwill of the group brand name provides a guarantee on behalf of the borrower trying to secure funding for his venture. The guarantee provided by a group's brand name (Maurer & Sharma, 2001) greatly increases its acceptability in the corporate sector due to lack of adequate screening mechanisms in emerging economies to

signal whether a borrower is a 'lemon or a plum' (Akerlof, 1995). Further reallocation of in-house talent within a business group can be done easily benefitting the new units of the group. Jones (2000) notes the similarity of BG firms to private equity ones, relating it to British trading houses in the early twentieth century. He says that one of the primary functions of these early groups was "identifying opportunities and placing potential British investors in touch with them". However not all business groups are alike. For e.g. Birla, another Indian group, "helped found and finance new firms, which were later spun-off using the entrepreneurial talent of its employees".

In the light of the above discussion the focus of the article will be to investigate the impact of a firm's ownership structure on its payout policy.

BACKGROUND

Literature reveals that one of the common ownership patterns prevalent in economies characterized with ambiguous distinction between cash and control rights is business groups. Business groups in different countries have different structures such as pyramids and clusters. *Keiretsu* groups in Japan can be horizontally or vertically integrated. *Keiretsus* can either be conglomerates constituting different industries horizontally linked through cross-shareholdings and intra-group financing or a hierarchical system of suppliers vertically integrated to the core manufacturer. *Chaebol* firms in South Korea are characterized by pyramids and cross shareholdings ownership structure. A few large, older firms present in a *chaebol* control the other firms in the group. *Pyramidal structures* finance new investments of the new firms through the existing equity holdings of the controlling group members while *direct ownership structure* deals with funding requirements through a family owner's personal wealth. Firms controlled through pyramids have lower profitability than their directly controlled counterparts and often their profits are *tunneled* away to firms where

8 more pages are available in the full version of this document, which may be purchased using the "Add to Cart" button on the publisher's webpage:

www.igi-global.com/chapter/impact-of-business-groups-on-payout-policy-in-india/183720

Related Content

E-Textbooks as a Classroom Tool

Jackie HeeYoung Kim (2015). *Encyclopedia of Information Science and Technology, Third Edition* (pp. 2288-2297).

www.irma-international.org/chapter/e-textbooks-as-a-classroom-tool/112641

Application of Methodology Evaluation System on Current IS Development Methodologies

Alena Buchalcevova (2018). *International Journal of Information Technologies and Systems Approach* (pp. 71-87).

www.irma-international.org/article/application-of-methodology-evaluation-system-on-current-is-development-methodologies/204604

Digital Literacy

Anirban Ray (2018). *Encyclopedia of Information Science and Technology, Fourth Edition* (pp. 2225-2234).

www.irma-international.org/chapter/digital-literacy/183935

Reversible Data Hiding Scheme for ECG Signal

Naghma Tabassumand Muhammed Izharuddin (2018). *International Journal of Rough Sets and Data Analysis* (pp. 42-54).

www.irma-international.org/article/reversible-data-hiding-scheme-for-ecg-signal/206876

The Changing Nature of Information Behaviour

Jennifer Rowley (2015). *Encyclopedia of Information Science and Technology, Third Edition* (pp. 3955-3961).

www.irma-international.org/chapter/the-changing-nature-of-information-behaviour/112836