



# Financing Firms in India

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**CAF-FIC-SIFR Conference, Wharton**  
**April 21, 2007**



# Law, Finance and Growth

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- Conventional Wisdom:
  - Stronger legal protection of investors is associated with more efficient institutions and better financial and economic 'outcomes' (La Porta, Lopez-de-Silanes, Shleifer, and Vishny - LLSV - 1997, 98, 99, 00)
  - The development of financial system (stock market and intermediation sector) contributes to overall economic growth (McKinnon 73, King & Levine 93, Levine 97, Levine & Zervos 98)
- Alternative views:
  - Great reversals (Rajan & Zingales 2003a)
  - Political economy factors (Rajan and Zingales (2003b), Acemoglu and Johnson (2005))
- China as a counter-example (Allen, Qian, and Qian (AQQ, 2005)):
  - One of the largest and fastest growing economies despite its poor legal and financial systems and a corrupt and autocratic government
  - Alternative and informal financing and governance mechanisms have substituted for formal channels and mechanisms
- Why is India important?
  - English common-law legal origin; democracy for over half a century
  - Second most populous country (1.1 billion at the end of 2004) and 2<sup>nd</sup> largest emerging market<sub>2</sub>



# Our approach and methodologies

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- Aggregate evidence:
  - Law, institutions, and business environment;
  - (Formal) financial system: Banking sector and financial markets
  
- Large sample of firms (over 2,700) from *Prowess* database
  - Differentiate Large Enterprises (state-owned or publicly listed) vs. the SME (small- and medium-enterprises) Sector;
  - Specifically, we examine:
    - Ownership, financing channels, dividend policy, and valuation;
    - Comparisons with countries studied in existing literature;
    - Compare growth rates of large firms and SME firms.
  
- Surveys of the SME Sector:
  - 136 firms in New Delhi and 76 firms in Hyderabad;
  - Survey questions:
    - Organization and ownership structure;
    - Financing channels;
    - Governance mechanisms.



# Summary of findings

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- India provides another counterexample to existing literature:
  - Legal protection on paper vs. in practice;
  - Relevance of legal system and political economy factors (e.g., corruption);
  - Relevance of formal financing channels (banks and markets).
  
- Within-country studies vs. cross-country studies:
  - Most cross-country studies examine a few dimensions of sample countries' legal and financial systems:
    - Focus on *formal* channels and mechanisms;
    - Treat each country on an equal-weight basis: Large vs. small countries
  - We provide a more comprehensive study of India's financial system:
    - Importance of informal financing channels and governance mechanisms;
    - Other within-country studies: U.K. (Franks, Mayer & Rossi, 2005); China (AQQ 05)
  
- Survey methodologies:
  - Difference between our surveys vs. those of the World Bank.

## Comparing legal system and institutions (Table 2-B)

	<b>Anti- director Rights</b>	<b>Creditor Rights</b>	<b>Corruption Perception Index</b>	<b>Disclosure Requirement</b>	<b>Earnings Management Score</b>	<b>Legal Formalism Index</b>	<b>Legality Index</b>
<b>India (E)</b>	<b>5</b>	<b>4 (2)</b>	<b>2.9</b>	<b>0.92</b>	<b>19.1</b>	<b>3.42</b>	<b>11.35</b>
English-origin Ave	4.00	3.11	7.50	0.85	4.14	2.72	15.56
French-origin Ave	2.33	1.58	5.54	0.54	18.72	3.99	13.11
German-origin Ave	2.33	2.33	7.51	0.63	21.46	3.42	15.53
Nordic-origin Ave	3.00	2.00	9.28	0.56	9.81	3.11	16.42
LLSV Sample Ave	3.00	2.30	7.08	0.71	11.98	3.23	14.98
China	3	2	3.2	N/a	N/a	3.40	N/a
Pakistan (E)	4	4	2.1	0.58	17.8	3.75	8.27
S. Africa (E)	4	4	4.5	0.83	5.6	2.68	11.95
Argentina (F)	4	1	2.8	0.50	N/a	5.44	10.31
Brazil (F)	3	2	3.7	0.25	N/a	3.44	11.43
Mexico (F)	0	0	3.5	0.58	N/a	4.76	10.79

# Ownership structure (Table 5)

Controlling shareholder	Foreign	Widely-held (%)	State/Govt. (%)	Family/Indiv. (%)	Financial corp. (%)	Non-Financial Corp. (%)
<b>Panel A: LLS (1999) large firms</b>						
High-antidirector average		34.2	15.8	30.4	5.0	5.8
Low-antidirector average		16.0	23.7	38.3	11.0	2.0
Sample average		24.0	20.2	34.8	8.3	3.7
<b>Panel B: LLS (99) medium firms</b>						
High-antidirector average		16.7	10.3	50.9	5.8	1.7
Low-antidirector average		6.0	20.9	53.8	6.7	2.7
Sample average		10.7	16.2	52.5	6.3	2.2
<b>Panel C: Asian firms</b>						
Asia (~Japan, Claessens et al., 00)		3.1	9.4	59.4	9.7	18.6
China (AQQ 2005)		0.4	60.0	13.6	1.8	24.2
<b>Panel D: India</b>						
<b>Full sample</b>	10.7	1.9	0.4	77.6	1.0	8.8
SME - Manufacturing	5.4	0.7	0.0	84.0	0.1	9.7
Large Enterprises - Manufacturing	13.4	1.0	0.3	79.6	0.4	5.6
SME - Service	0.7	2.9	0.0	75.2	0.0	21.3
Large Enterprises - Service	11.5	4.0	0.8	70.4	3.2	10.9
All SMEs	3.5	1.6	0.0	80.4	0.1	14.4
All Large firms	12.8	1.9	0.5	76.7	1.3	7.2

## Sources of funds (Table 6-A)

	Large Enterprises			Small & Medium Enterprises			All
	All Large enterprises	Large-Manufacturing	Large-Service	All SMEs	SME-manufacturing	SME-Service	
Internal Sources	53.85%	66.90%	46.81%	10.13%	24.14%	2.60%	53.42%
Equity (Private + Public)	6.68%	7.25%	6.37%	15.40%	11.89%	17.29%	6.76%
Capital Market-Debt	12.04%	-0.38%	18.73%	1.42%	0.03%	2.16%	11.93%
Debt from Banks & FI's	7.33%	4.32%	8.95%	6.75%	3.83%	8.32%	7.32%
Debt from Group Co's / Promoters	0.75%	1.72%	0.22%	-0.27%	5.44%	-3.34%	0.74%
Trade Credit	9.24%	13.25%	7.07%	58.60%	43.61%	66.66%	9.72%
Others	10.13%	6.93%	11.85%	7.98%	11.07%	6.32%	10.11%
Number of Observations	1761	1374	387	993	655	338	2754

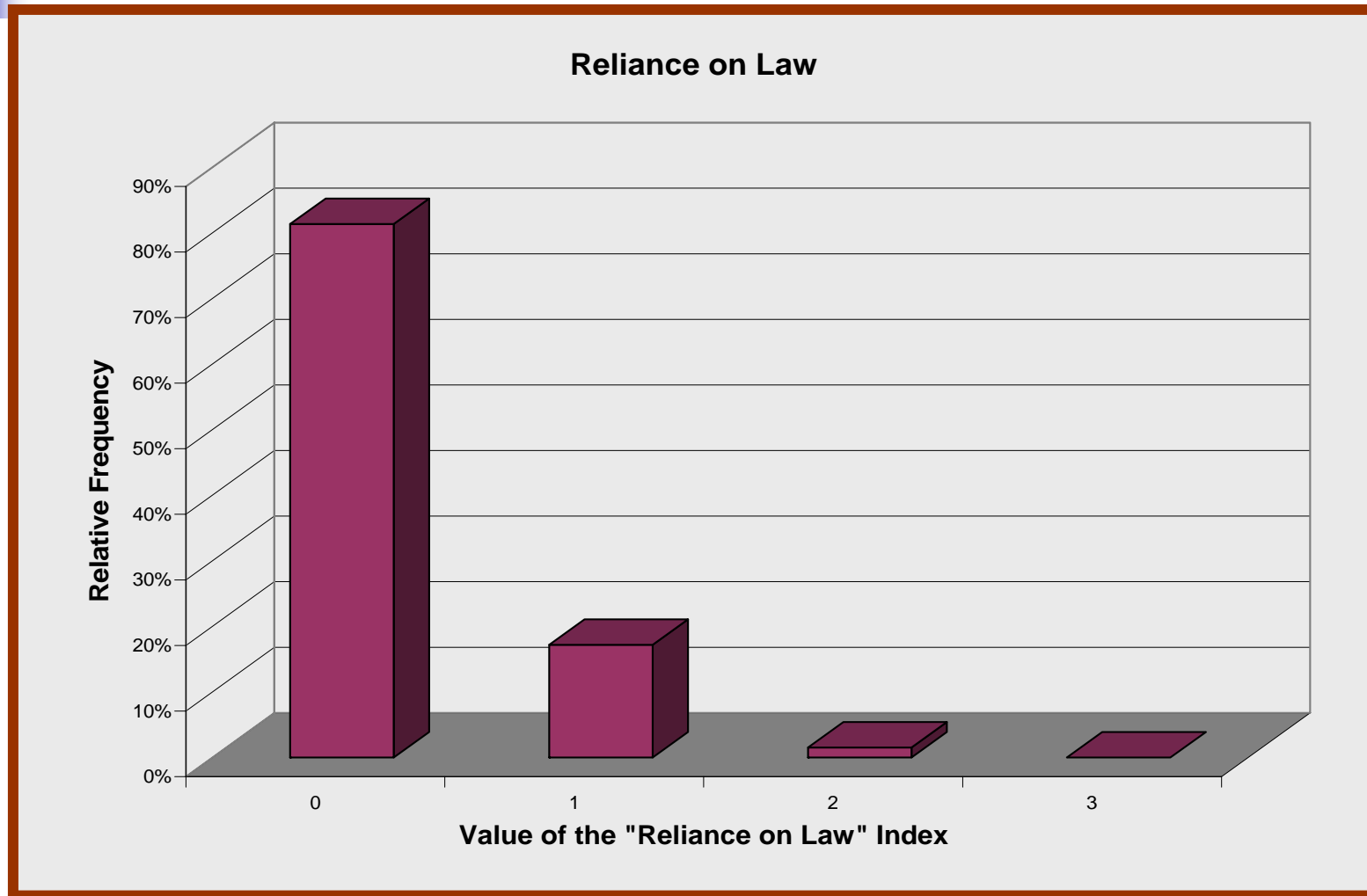


# Evidence from Secondary data

- Indian firms vs. firms from other countries (LLSV, Worldscope; Table 6-C):
  - Indian firms: Concentrated ownership, non-market based financing, low dividend ratio and valuation (Tobin's  $Q$ );
  - Consistent with those of countries with weak legal protection
- Differences between SMEs and large firms:
  - SMEs are more closely held, have lower dividend payout ratios and lower  $Q$ s;
  - Compared to large firms, SMEs operate in environments with weaker investor protection and poorer access to formal financing
- Comparing growth rates (CAGRs; Table 7):
  - Sales: SMEs, 10.55% vs. large firms, 6.74%; ( $p$ -value < .0001)
  - Assets: SMEs, 6.69% vs. large firms, 4.47%; ( $p$ -value < .0001)
  - Fastest growing sector: SME services
  - Inconsistent with predictions of law, finance and growth literature.
- To investigate how SMEs overcome problems of weak investor protection and lack of access to formal financing, we conducted a survey of SME firms.

# SME Survey Evidence:

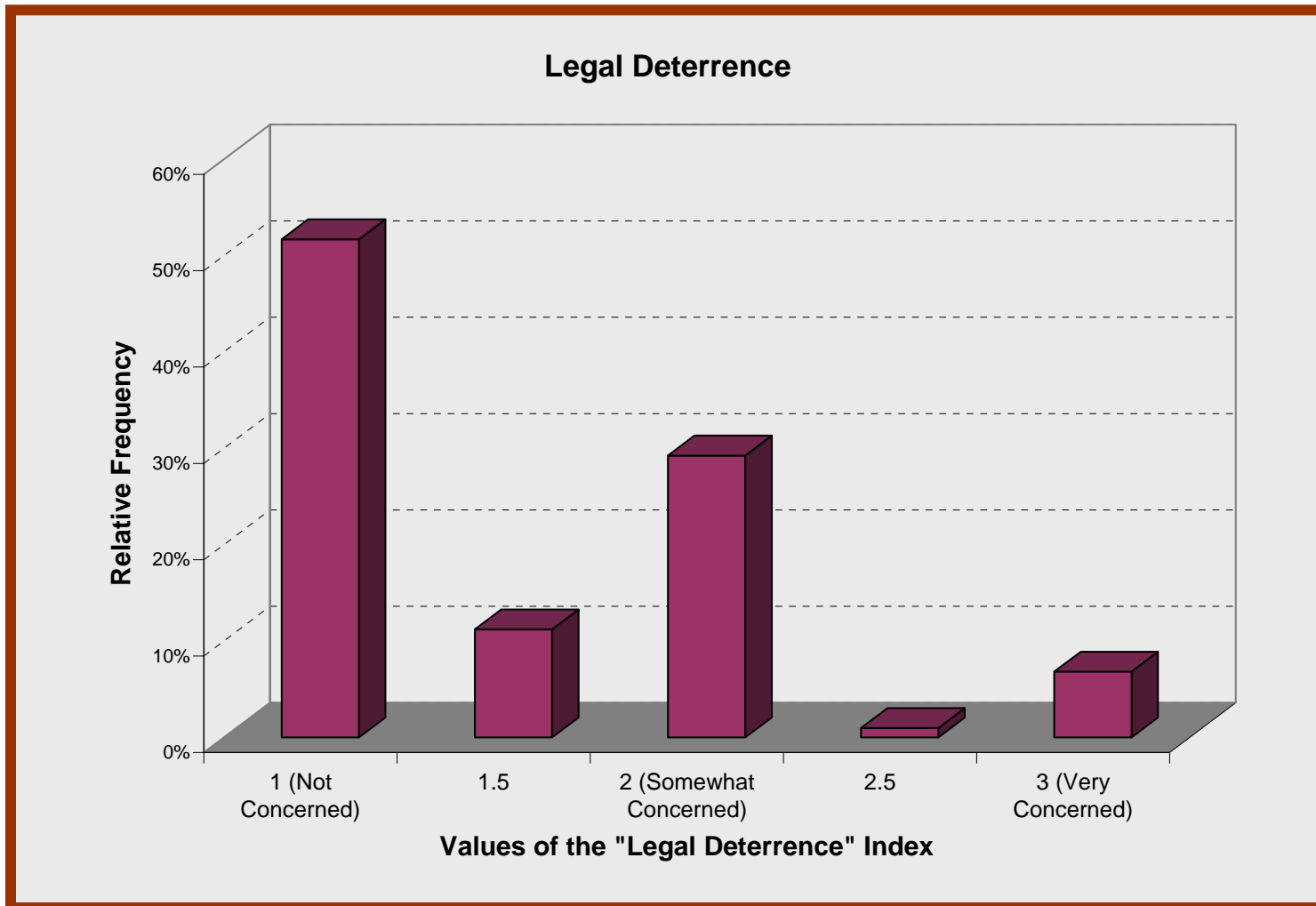
## Reliance on the legal system (Panel A, Fig. 3)



(Index construction: Answers to how to deal with defaults, contract breach, and disputes)

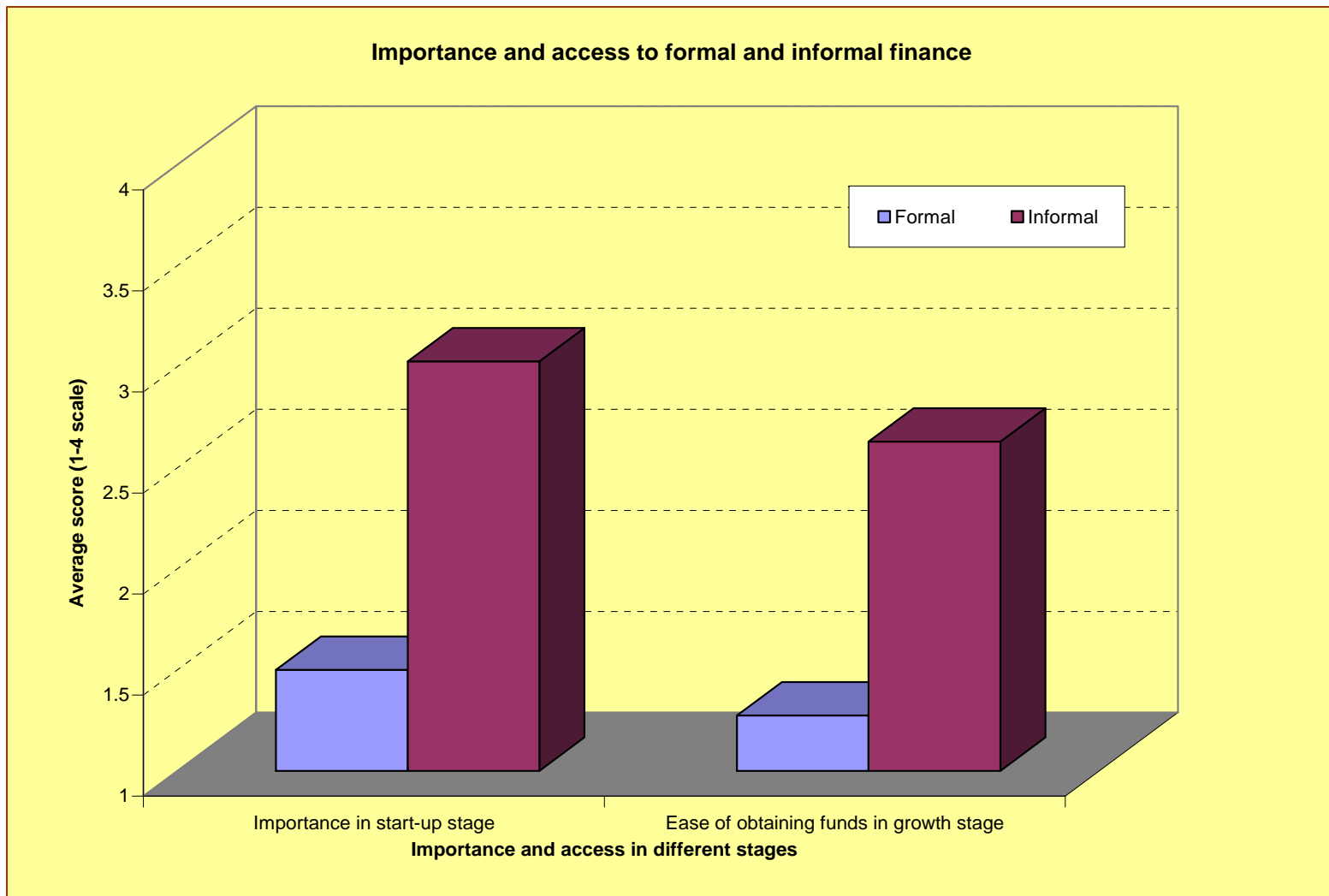
# SME Survey Evidence:

## Significance of legal deterrence (Panel B, Fig. 3)



(Index construction: Legal concerns for default or breaching contract)

# SME Survey Evidence: Financing: Formal vs. informal channels (Fig. 4)



(Informal financing: Financing not backed by legally binding contract)

# SME Survey Evidence: Importance of informal financing

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- Ordered probit regressions of importance of informal financing on firm characteristics (Table 10)
- Greater reliance on informal financing is associated with:
  - Smaller firms;
  - Firms that face greater requirements from banks, and for firms that find formal financing more difficult to obtain;
  - Hence informal finance seems to pick up the slack of formal finance
- Reliance of informal finance does not necessarily go down as firm becomes more mature:
  - Stickiness in the difficulty of accessing formal finance?
  - Or, SMEs firms choose to stay with informal financing once relationship is forged with investors