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Investment–cash flow sensitivity and financing constraints: New evidence from Indian business group firms☆

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ABSTRACT

A controversy exists on the use of the investment–cash flow sensitivity as a measure of financing constraints of firms. We re-examine this controversy by analyzing firms affiliated to Indian business groups. We find a strong investment–cash flow sensitivity for both group-affiliated and independent firms, but no significant difference in the sensitivity between them. Additional tests consistently demonstrate that investment–cash flow sensitivity of Indian group affiliated firms is not significantly lower relative to unaffiliated firms.

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1. Introduction

A large body of literature investigates how the investment–cash flow sensitivity changes with the financing constraints of firms (see Hubbard, 1998; Lensink et al., 2001 for excellent surveys of the

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literature). Analyzing a sample of U.S. firms, Fazzari et al. (1988, 2000) document that investments undertaken by more financially constrained firms are more sensitive to the availability of internal funds. International studies also provide evidence of a firm's investments being highly related to its cash flows. Most of these studies focus primarily on developed industrialized economies like Canada, France, Germany, Japan, Netherlands, and the U.K. (see for example, Kadapakkam et al., 1998; Goergen and Renneboog, 2001; Degryse and De Jong, 2006; Aggarwal and Zong, 2006; Cleary et al., 2007). A few studies also analyze data from some emerging economies like China, Chile, India, Indonesia, Mexico, Taiwan, etc. (Laeven, 2003; Bhaduri, 2005; Shen and Wang, 2005; Ghosh, 2006).

A controversy arises when Kaplan and Zingales (1997, 2000) and Cleary (1999) show that least financially constrained U.S. firms also exhibit greater investment–cash flow sensitivity. This opposite finding came as a blow to those who were firm believers of the traditional view. Later studies indicate that the source of this mixed result lies, among others, in the disagreement among researchers in identifying appropriate factors to segregate more financially constrained firms from less constrained ones (Moyen, 2004; Cleary et al., 2007). The criteria used to classify firms into more and less constrained categories – dividend payout ratio, debt financing, financial distress, debt rating, firm size and firm age – are not without drawbacks. For example, the criteria are endogenous in the sense that these are not independently determined. The financial constraint feature itself may already influence these firm-specific variables. Moreover, these classifying factors are time-variant: a company identified as financially constrained now may not remain constrained in the future.

The potential to resolve the controversy lies in the analysis of cross-country/international data whereby researcher can use exogenous criteria. For example, multinational data can be used to categorize firms into bank-based and capital market-based financial systems. These two types of financial systems are expected to generate a differential impact on the cost/availability of internal and external financing, and thus easing of financial constraints (Bond et al., 2003; Aggarwal and Zong, 2006). Another exogenous characteristic to explore is network-based organizations present in many countries. The most popular and well-documented form of networks related to the multinational arena is that of business groups. Business groups are a set of independent firms connected together by means of formal and informal relationships. These exist in most emerging markets as well as in many developed economies (Ghemawat and Khanna, 1998). Firms belonging to business groups can use internal capital market benefits and receive better access to financial resources relative to stand-alone firms (Deloof, 1998; Lensink et al., 2003). This feature makes it quite appealing to examine business group firms and compare their investment–cash flow sensitivity with those of non-group firms.

Empirical tests are performed by Hoshi et al. (1991) and Kato et al. (2002) who examine Japanese business groups, and Shin and Park (1999) who examine Korean business groups. Interestingly, these studies find a mixed result: Japanese business group firms exhibit a lower investment–cash flow sensitivity while there is no relationship between cash flow and investment among group-affiliated firms in Korea. This conflicting finding is due to unique characteristics of business groups of Japan and Korea (see for example Ferris et al. (1995) and Shin and Park (1999) for a description of salient features of Japanese and Korean business groups). Another reason could be the lack of plenty robustness checks with alternative empirical specifications.

The purpose of the paper is to extend prior international studies examining the investment–cash flow relationship among group firms by focusing on one of the largest emerging markets—India. An analysis of Indian business groups can be useful because of several distinct features. First, it is possible to identify business group affiliation in India with a high level of accuracy. This information is publicly disclosed in annual reports and/or filings with regulatory authorities.[1] Moreover, firms are usually members of only one business group as there are very few mergers between firms across different groups. Second, Indian business groups are not centered on a financial intermediary and therefore do not have close banking ties, as is the case for business groups in Japan. A strong influence of a bank usually can result in firms holding less free cash flows for future investment purposes. Third, the group-affiliated firms of India we analyze are free of any selection bias. There are basically hundreds of business groups in India. Several are extremely big with dozens of affiliated companies. On the other

[1] Hoshi et al. (1991) discuss the problems one faces in accurately determining group membership of Japanese firms.

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