

RESEARCH ARTICLE

Impact of Cash Holding on Foreign Institutional Holding in Large Manufacturing Companies in India: An Empirical Study

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Abstract: Foreign institutions are playing a major role in a number of emerging market economies these days. In India, their investment acts as one of the cornerstones of market movement. In this research paper, it is explored whether cash holding levels have a bearing on the foreign institutional holding in large manufacturing companies in India. Various factors like size, profitability, growth opportunity, lifecycle, prior dividend payout, leverage, and so forth are controlled. Data is analyzed for a period of 16 years starting from the financial year 2000–01. The analysis is done in the form of panel data. The findings of the empirical analysis show that foreign institutions have a higher holding in companies with higher cash holding and lower leverage. Foreign institutions have a higher holding in private sector companies than public sector companies.

Keywords: Foreign Institutions, Manufacturing Companies, Cash Holding

JEL Classification: G11

Existing literature is of the view that foreign portfolio investment (FPI) flows are guided by the diversification consideration of the institutions (Garg & Dua, 2014). The benefits of the diversification are well documented by Grubel (1968), Levy and Sarnat (1970), Solnik (1974), and so forth. Dell Aricia, Igan & Laeven (2008) and Obstfeld (2009) in their work analyzed the benefits accruing to the host countries.

There is a strong growth seen in many of the emerging market economies in the past two decades. An accompanying feature of this development is increasing interest of foreign institutional investors (FIIs) in the emerging markets. In India, 1991 was a watershed year, as the country embarked on a journey

of lesser governmental control across various spheres of economic activity on that year. FIIs were formally allowed in India's equity market on September 1992. The primary reason to allow FIIs were to manage the country's balance of payment more efficiently.

According to the data provided by India's capital market regulator Security Exchange Board of India (SEBI, 2015) as of March 31, 2016, India had 8,717 registered FIIs. The figure was 8,214 as of March 31, 2015 (SEBI, 2015). FIIs registered in the USA lead in terms of the number as well as the asset under custody (AUC). FIIs based in the USA have AUC of INR. 68785.3 billion followed by the FIIs of Mauritius at INR. 43172.9 billion.

Table 1
Calendar year wise FII inflow to India From 1993 to 2014

Year	Total Inflow(in INR billion)
1993	259.51
1994	679.12
1995	385.38
1996	1080.36
1997	620.73
1998	-147.99
1999	669.73
2000	651.09
2001	1249.48
2002	367.79
2003	3515.38
2004	4204.91
2005	4166.35
2006	4058.92
2007	8091.48
2008	-4121.55
2009	8798.76
2010	17967.46
2011	3935.28
2012	16335.00
2013	6228.80
2014	25621.30

Source: SEBI Annual Report, 2015

The table above shows the calendar year wise FII inflow to India over the period of 1993 to 2014. In this 22 years period the inflow had been positive barring only two years(i.e. 1998 and 2008).

Figure 1. Registered number of FIIs in India by countries.

The above figure shows the country of origin of the FIIs present in India. The USA is the home country for the largest chunk of FIIs.

There are a number of research papers on FII inflow to India. Chakrabarti (2001) was of the view that FIIs are not in a disadvantageous position as far as information is concerned. Srikanth & Kishore(2012) reported how FII inflow helped to build the foreign

currency reserve of India. Mukherjee, Bose & Coondoo (2002) discussed how FII in flow acts as the primary driver of the Indian equity market. It should also be noted that greater flow of FII capital exposed Indian capital market to external financial shocks (Singh & Singh, 2016).

Cash holding of companies is showing a definitive upward trend in the course of the last two decades. Dittmar and Mahrt-Smith's (2007) study showed that the firms based in the USA were holding cash equivalent to 10% of the US GDP. Whereas at the beginning of 2000, European firms held around 15% of their assets in the form of cash (Ferreira & Vilela, 2004).

Literature Review

In the last two decades, the removal of restrictions has led to a greater flow of capitals from advanced economies to emerging economies including India (Garg & Dua, 2014). FII inflows to Indian capital markets showed an upward trend post-financial crisis in the western world (Dhingra, Gandhi, & Bulsara, 2016). Existing literature is also of the view that the monitoring by foreign institutions results in better performance of firms (Khanna & Palepu, 2000; Baek, Kang, & Park, 2004). Lins (2003) corroborated these findings. The monitoring of the firm performance becomes even more essential in the context of emerging market economies, as the checks and balances are weak in these markets (Shleifer & Vishny, 1986).

Theoretical Framework and Hypothesis Development

Cash generated due to profit of a firm is of immense importance. Managers tend to pile up cash, instead of distributing it as a dividend (Cao, Du & Hansen, 2017). Managers can increase their discretionary power by accumulating cash, thus leading to agency conflict (Jensen, 1986; Chen, 2008). Further, Myers & Rajan (1998) argued that in the firms with higher level of cash, managers maximized their self-interests irrespective of firms meeting their objective. Thus, it can be argued that, in firms with a higher level of cash, there is a higher level of agency cost and conflict.

At the heart of the agency conflict is the separation of ownership and management. The existing literature

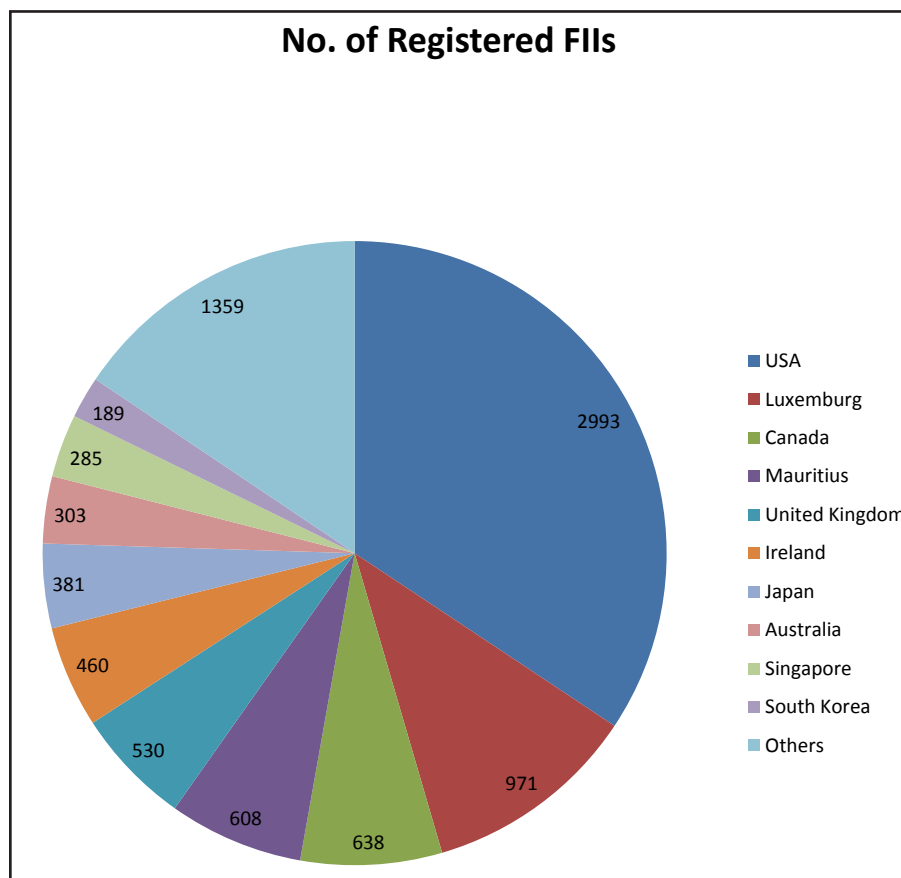


Figure 1. Registered number of FIIs in India by countries.

is of the view that more cash in hand leads to greater conflict. However, this conflict can be mitigated through adherence to corporate governance norms. External controls of corporate governance can be in the form of control exercised by debt holders and auditors. The internal controls of corporate governance consist primarily of internal audit and the role of watchdog played by various stakeholders.

In the developing economies, the concentrated ownership structure of listed firms is often the norm rather than the exception (Chen & Zhao., 2009; Sun & Tong, 2003). Concentrated ownership structure allows the promoter entity to dominate the Board of Directors as well as the top management team (Chen, Firth & Rui.,, 2006). The problem is aggravated by the weak structure of the legal institutions entrusted with the job of enforcement of ownership rights in the developing world (Li & Qian, 2013). The deadly combination of concentrated ownership and weak legal safeguards with regards to corporate governance often

leads to controlling shareholder's expropriation of firm resources at the expense of non-promoter shareholders, especially the minority shareholders (Berkman et al., 2009; Faccio et al., 2001).

In this context, the existing literature is of the view that foreign institutional holding enhances the quality of corporate governance in the emerging economies (Desender et al., 2014; Jeon, Cheolwoo, & Moffett, 2011; Kim, Sung & Wei., 2011; Baba, 2009). In a recent study, Huang & Zhu (2015) found that foreign institutions positively influence dividend payment by the firms in the context of China. Thus, it can be hypothesized that everything being equal, a higher amount of accumulated cash by the firms will discourage foreign institutional holding, and they should have an inverse relationship. However, contrarian evidence is also available, for example, Cao et al. (2017) showed that cash holding by firms positively influences FII holding. In view of existing literature, I have the following null hypothesis:

H1: Cash holding of companies does not influence foreign institutional holding in large manufacturing companies in India.

Control Variables

Firm-specific variables which have the capability to influence the FII holding are considered as control variables. First, I controlled the growth opportunities of a firm. Rapidly growing firms will need investment; as a result, they will have less cash holding. There are two proxies for growth opportunity: the first one is market value to book value of equity shares, this is in accordance with Baba (2009) as well as Jeon et al. (2011). The second one is the intangible asset as a proportion to the total asset; this is in accordance to Cao et al., (2017). Larger firms are likely to attract more FII holding (Rubin, 2007), so the size of the firms is controlled. The proxy used for the size of a firm is natural logarithm of market capitalization of the firm. This method is in accordance with Kapoor, Mishra & Anil. (2010).

Also, more profitable firms are likely to attract FII investment; thus, the profitability of firms is controlled. The proxy for profitability is return on asset (ROA) as calculated by earnings before interest and tax (EBIT) divided by total asset. This is in accordance with Chen and Strange (2005).

Mueller (1972) propagated the life-cycle theory of the firms. According to this theory, firms go through different stages in their lifecycle. Mature firms are more likely to have higher cash holding, Lifecycle is computed as the ratio of retained earnings to total equity. This is in accordance with Labhane and Mahakud (2016).

Leverage of a firm is an important control variable, in this respect. Leverage indicates the amount of debt capital the company is using. The higher amount of debt may deter management from paying dividend. Also, large creditors may force management to be prudent with cash (Al-malkawi, 2008; Fama, 1974; Higgins, 1972). Moreover, FIIs may influence the incumbent management of the firms to increase the debt level so that their return is increased due to leverage (Asness, 2004). Leverage is calculated as total debt divided by total asset of the firm. This is in accordance with Shao, Kwok, and Guedhami (2013).

Existing literature is of the view that government owned firms have political objectives to satisfy and may not monitor managers based on shareholder wealth

maximization (Ben-Nasr, 2015; Firth, Fung & Rui, 2006). Moreover, agency theory is of the view that managers of government-owned firms or public sector units, as they are known in India, may have the incentive to keep cash within the firm for their own benefit. This point of view was supported by Ben-Nasr (2015). So government ownership is controlled in accordance to Ben-Nasr (2015) and Firth et al. (2016) using a dummy variable, where 1 is used for government-controlled companies (as per the classification used in Center for Monitoring Indian Economy- CMIE database) and 0 for other companies. Prior dividend payout often acts as the motivation for FIIs to hold their stake (Cao et al., 2017). In this research paper, prior dividend payout ratio (i.e., previous year's dividend as a percentage of net profit) is taken as a proxy for the dividend payout.

Methodology

Data Used

The data for this research paper is sourced from CMIE Prowess database. In India, the financial year starts on April 1st and ends on March 31st. In this paper, the period under consideration starts from April 1, 2000. The starting point is considered based on the existing literature (Mukhopadhyay & Chakraborty, 2017). The last financial year considered is that of the financial year 2015–16 which ended on March 31, 2016. In total, 16 completed financial years data are considered for the study.

Manufacturing firms present in Nifty 500 Index of National Stock Exchange (NSE) as of June 1, 2017, are considered for the study. According to NSE, the Nifty 500 Index represents about 95% of the free float market capitalization of the stocks listed on NSE as of March 31, 2017. NSE is also India's biggest stock exchange in terms of volume. To choose the manufacturing firms, I followed the categorization done by CMIE database. In total, 249 firms are categorized in Nifty 500 as manufacturing firm. Out of these firms, some firms did not have data for all the 16 financial years, so they were removed from the analysis. Finally, 117 firms were analyzed. Data considered is for the stand-alone (not consolidated) firm only.

Dependent Variables

In the first and second models, the dependent variable is the proportion of FII holding. In the third and fourth models, the dependent variable is

whether FII holding is substantial in the form of 10% or more holding. In the fifth and sixth models, the dependent variable is whether FII holding is 26% or more. According to the Companies Act(2013) in India, 10% holding is designated as “sufficient holding,” and they can approach Company Law Board against the incumbent management in cases of alleged mismanagement. With 26% holding, shareholders can block any attempt to change the

article of association as well as the memorandum of association of the firm, effectively putting checks and balances on the power of the incumbent management in the areas of entering into a new business, issuance of shares to new investors, and so forth. This is the reason why 10% and 26% shareholding is considered important. In the table below all the variables are defined.

Table 2
Variable Definition

Dependent Variable	
Variable	How it is calculated
FII Holding	The total number of shares held by FIIs divided by the number of shares outstanding. It is calculated in decimal.
FII	In the probit regression model, the dependent variable is whether an FII holding is 10% or more case in the first case scenario (models three and four). FII holding is calculated the same way as the previous one. If it is more than or equal to 10%, coding is 1; otherwise 0. In the second case scenario, FII holding of 26% is considered for models five and six. In this case, 26% or more holding is coded 1, otherwise 0.
Independent Variable	
Cash Holding	Total cash holding of a company is considered in terms of Indian Rupee (INR) millions. To make it normally distributed, natural logarithm of the figure is taken.
Control Variables	
Growth Opportunities	There are two proxies for growth opportunities. The first proxy is the market price to book value (PB) ratio of the equity share. The second proxy is the intangible asset to total asset ratio. Both are measured in decimals.
Size	The proxy for the size of a firm is market capitalization in terms of INR millions. Natural logarithm of market capitalization is considered.
Profitability	EBIT divided by total asset in terms of decimal
Life Cycle	Ratio of retained earnings to total equity capital
Leverage	Total debt divided by total assets in terms of decimal
Public Sector Units/Government-Owned Firms	Dummy variable is used in this case, where 1 is for government-owned firms, and 0 for others.
Prior Dividend Payout	For calculation of year“t,” dividend payout rate (DPR) of the previous year, that is, (t-1) year, is considered. For this variable, the proportion of net profit paid as a dividend is taken in terms of decimal.

Fixed and random effect model is used for the dependent variable in FII holding of companies. The probit model is used when the dependent variable is whether FII holding is less than 10% of the equity share of the firm (assigned a value of 0) or equal or more than 10% (assigned a value of 1).

The panel data is strongly balanced in nature. The data is put through Levin-Lin-Chu unit root test to check whether panels contain unit roots. The result showed that panels are stationary in nature. As only the large companies from the manufacturing sector are considered, the companies are more or less similar in nature. This should add to the robustness of the results of the data analysis.

The underlying model for the analysis:

$$\text{FII Holding} = \beta_0 + \beta_1 \text{ Cash Holding} + \beta_2 \text{ Control Variables} + \varepsilon$$

Empirical Analysis

Figure 2 shows the number of public and private sector companies in the dataset. In total, there are 105 companies from the private sector and 12 companies are from the public sector. This categorization is done as per the CMIE database.

Table 3 shows that the variance inflation factor (VIF) figure is under 2 for all the explanatory variables concerned. This indicates that the model is devoid of any multicollinearity problem. FII holding ranges from 0% to 48% in the companies in the sample set. The mean, as well as the median FII holding, is 17%. The

cash holding ranges from INR 16.5 to 495470 million. Profitability in terms of ROA ranges from negative (-0.05) to 0.54. Leverage of the companies ranges from 0 to 0.62. The mean and median of the leverage are much lower at 0.14 and 0.09 respectively.

Table 4 shows that a cash holding has a significant negative correlation with PB ratio, ROA. It has a significant positive correlation with the total asset, intangible asset, as well as market capitalization.

As Table 5 shows, the R-square (overall) value is much higher in the case of the Random model than the Fixed model. So, in this case, the Random model should be the appropriate model to consider.

As the result shows, the proportion of FII holding is positively influenced by the cash holding of the companies. Whether FIIs hold a substantial proportion (i.e., 10% as well as 26% or more) is also positively influenced by cash holding. This is a significant finding in the context of large listed manufacturing firms in India. As the numbers in models 3, 4, 5, and 6 suggest, larger firms in terms of market capitalization seem to have lesser interest from FIIs. FIIs do not like firms with higher leverage in terms of debt to equity ratio. This is understandable as higher leverage increases the risk for the firm. Similarly, public sector ownership also has a negative impact on ownership. FIIs like high growth companies as both the measures of growth, namely, ratio of intangible asset to total asset and PB ratio, positively influence FII holding. As expected, FII holding is higher in the case of more profitable companies.

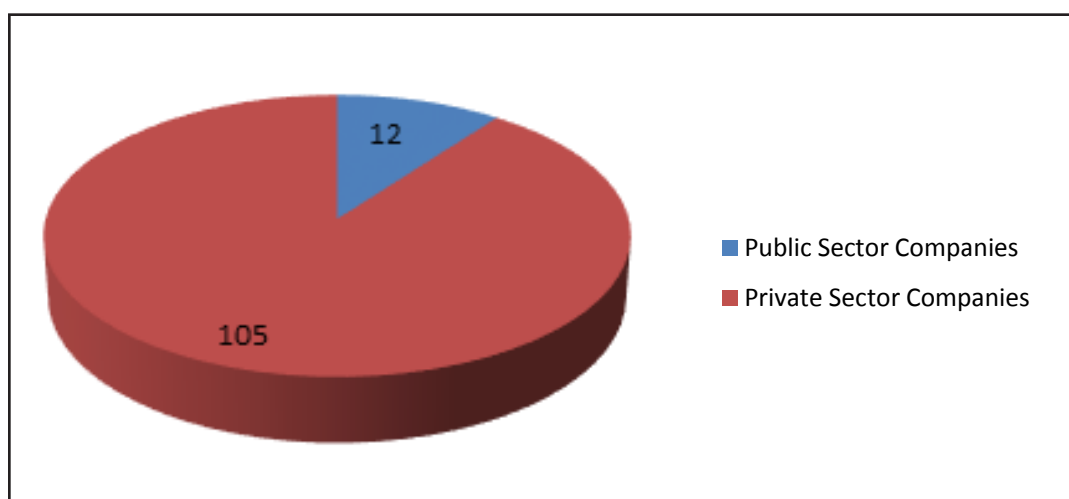


Figure 2. Number of companies in the private and public sectors.

Table 3
Descriptive Statistics

Variable	Minimum	Maximum	Mean	Median	VIF
FII Holding	0	0.48	0.17	0.17	
Cash Balance (in INR Million)	16.5	495470	10150.28	1422.35	1.09
PB	0.44	39.6	6.76	4.5	1.53
Intangible Asset/Asset	0	0.6893	0.0272	0.0070	1.06
Market Capitalization (in INR Million)	5364.83	3386841	291061.8	164890	1.62
DPR(t-1)	0	1.09	0.28	0.26	1.64
Profitability (ROA)	-0.05	0.54	0.17	0.15	1.57
Life Cycle	0.07	0.99	0.96	0.98	1.16
Leverage	0	0.62	0.14	0.09	1.08

Table 4
Pearson Correlations Among Various Independent Variables

	1	2	3	4	5	6	7	8	9
1. Cash Holding	1								
2. PB Ratio	-0.148	1							
3. Asset	0.586	-0.277	1						
4. IntangibleAsset	0.714	-0.102	0.778	1					
5. DPR	-0.100	0.299	-0.134	-0.088	1				
6. LifeCycle	0.041	-0.478	0.062	0.043	-0.186	1			
7. ROA	-0.167	0.550	-0.293	-0.089	0.198	-0.252	1		
8. DE	0.026	-0.238	0.237	0.081	-0.331	-0.017	-0.378	1	
9. Market Capitalization	0.501	-0.023	0.674	0.683	0.035	0.081	0.039	-0.080	1

Note: Bold type denotes significance at the 0.1% level

Table 5
Model Summary

Dependent Variable	FII Holding		FII(Whether holding is 10 % or more)		FII(Whether holding is 26 % or more)	
	Model 1 (Fixed)	Model 2 (Random)	Model 3 (Population Averaged)	Model 4 (Random)	Model 5 (Population Averaged)	Model 6 (Random)
P Value	0.0000	0.0000	0.0000	0.1493	0.0369	0.0385
R square (overall)	0.0183	0.1340				
	F = 15.20	Wald chi = 125.77	Wald chi = 37.32	Wald chi = 13.30	Wald chi = 17.86	Wald chi = 17.73
Number of observations	1872	1872	1872	1872	1872	1872
Number of groups	117	117	117	117	117	117
Ln_Cash Holding	0.0039** (.0022)	0.0022 (.0021)	2.7229* (.4736)	4.6388* (1.4700)	3.954667* (1.0268)	4.2445* (1.1714)
PB Ratio	-0.0020* (.0008)	0.0013** (.0007)	0.1125* (.0397)	0.1991* (.0855)	.2299* (.0827)	0.2297* (.0907)
Intangible Asset/Asset	0.0096 (.0601)	0.0318 (.0560)	4.5486 (3.4236)	6.4163 (6.0300)	6.2775** (3.4043)	7.8255 (3.3214)
Ln_Market Capitalization	0.0390* (.0055)	.0340* (.0048)	-2.3464* (0.4514)	-3.8485* (1.1481)	-3.7593* (.9919)	-4.0039* (1.1035)
Dividend Payout Ratio	-0.0246 (.0211)	-.0300 (.0199)	-.1571 (1.0676)	.2953 (1.7157)	.8441536 (1.7785)	0.8618 (1.8921)
Life Cycle	-0.0472 (.0577)	.0034 (.0538)	-3.5474 (2.9076)	-5.0876 (4.9134)	10.3361** (5.7595)	-12.82079* (6.1571)
PSU	Omitted	-.1238* (.0364)	-2.8244* (0.9880)	-4.9432* (2.2286)	-4.106611* (1.4244)	-4.553903* (1.5353)
Return on Asset	0.0001 (.0465)	.0224 (.0443)	8.4967* (2.5368)	13.4937* (5.1483)	10.73725* (5.1419)	12.11531* (5.8974)
Debt to Equity Ratio	-0.0828* (.0403)	-.0762 (.0354)	-9.2925* (2.6223)	-14.3425* (5.3957)	-19.64169* (7.4159)	-22.72374* (7.9371)
Constant	-0.2508* (.0783)	-.2236 (.0701)	6.4468** (3.6310)	8.1359 (6.2052)	14.97059* (6.1375)	17.48003* (6.5117)

Coefficient figures(within parenthesis the corresponding standard error value is written)

*significant at 5% level; **significant at 10% level

Conclusions

FII's like firms with higher cash holding. The explanation of this phenomenon can be that firms with higher cash holding can pursue profitable growth without accessing outside capital in the days to come. From the FII's perspective, earnings of the firm will not be diluted.

Another notable point is that FII's do not like firms with higher leverage, as that may restrict the firm's maneuvering capability, and creditors may put pressure on the management to restrict dividend payment and curtail future capital expenditure, especially in a gloomy economic scenario.

A point to note is that FII's do not like public sector companies, as is the case in the most emerging market economies. One probable reason can be because the governance of public sector companies, on the basis of business considerations and the firm's resources, may use to fulfill non-value adding activity from the shareholder's perspective.

As India does not have a well-developed corporate debt market, the primary source of debt capital is the banking system. India's banking system is dominated by public sector banks (PSBs). As per the data compiled by Dun and Bradstreet (year), as of 2017, more than 69.7% of the banking transaction in India are done through PSBs. India's banking system, especially the PSBs, are in the midst of a major non-performing asset (NPA) problem. As an aftershock of the doldrums in the banking sector, borrowing cost for the corporates is rising in India. In this situation, companies with good cash reserve should be in a position to chart their future growth path with ease. This is particularly true in the case of manufacturing companies in which requirement of capital is of relatively higher proportion in order to grow their business. In recent months, Indian currency has depreciated to a great extent with respect to the US dollar. As a result, borrowing through external commercial borrowing route is more or less closed for the Indian companies. As FII's act as the pivot of equity market sentiment in India, the companies with higher cash reserve should be able to raise equity capital also at a higher valuation due to the favorable view of the FII's.

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