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Internal Financing Constraints and Corporate Investment: Evidence from Indian Manufacturing Firms

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Abstract : This study focuses on the significance of internal financing constraints on the determination of corporate fixed investments in the case of Indian manufacturing companies. Financing constraints companies which have less internal fund or retained earnings face more transaction and borrowing costs due to imperfections in the capital market. The period of study is 1999-2000 to 2013-2014 and we consider 618 manufacturing companies for which the continuous data is available throughout the study period. The data is collected from PROWESS data base maintained by Centre for Monitoring Indian Economy Pvt. Ltd. Panel data methods like fixed effect and random effect methods are used for the analysis. The Likelihood Ratio test, Lagrange Multiplier test, and Hausman test results conclude the suitability of the fixed effect model for the estimation. The cash flow and liquidity of the company have been used as the proxies for the internal financial constraints. In accordance with various theories of corporate investments, we consider other firm specific variable like firm age, firm size, profitability, sales and leverage as the control variables in the model. From the econometric analysis, we find internal cash flow and liquidity have the significant and positive impact on the corporate investments. The variables like cost of capital, sales growth and growth opportunities are found to be significantly determining the corporate investments in India, which is consistent with the neoclassical, accelerator and Tobin’s q theory of corporate investment. To check the robustness of results, we divided the sample on the basis of cash flow and liquidity. Firms having cash flow greater than zero are put under one group, and firms with cash flow less than zero are put under another group. Also, the firms are divided on the basis of liquidity following the same approach. We find that the results are robust to both types of companies having positive and negative cash flow and liquidity. The results for other variables are also in the same line as we find for the whole sample. These findings confirm that internal financing constraints play a significant role for determination of corporate investment in India. The findings of this study have the implications for the corporate managers to focus on the projects having higher expected cash inflows to avoid the financing constraints. Apart from that, they should also maintain adequate liquidity to minimize the external financing costs.

Keywords : cash flow, corporate investment, financing constraints, panel data method
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