

Evaluation of liquidity measures: Study of Indian Construction Industry



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Abstract

Implications of firm capital structure, capital budgeting and working capital management decisions for stake holder wealth maximization have got impressive mention in finance literature. Firm value maximizes by optimizing working capital level, which is always a vital part of managerial decision (Khan & Jain, 2007). However, attaining optimal levels continues to be a puzzle. Repetitive revenue generating activity of an organization requires funds and working capital management deals with such requirement (Bhatia & Srivastava, 2016). It is said that for efficient operations of an organization, it is necessary to have both profitability and liquidity (Bolek & Wilinski, 2012). Working capital management of a firm is very complicated and strategic due to the presence of an inverse relationship between the two crucial goals of liquidity and profitability. Majority of recent studies are confined to empirical testing of the relationship between liquidity and profitability in different economies. However, existing liquidity measures appear to be inadequate in the light of several recent defaults of Indian Construction Companies. They failed in managing liquidity, and banks, rating agencies etc. failed in assessing the actual liquidity condition of Indian construction companies.

For a very long period, “Unused Bank Limit” was argued to be a good liquidity indicator (Keynes, 1930; Richards & Laughlin, 1983). However, studies have expressed difficulty in getting data related to unused borrowing limit of any firm since companies keep this data confidential. This paper strives to solve the long pending “unused borrowing limit” puzzle by introducing a new measure “Debt Capacity Utilisation (DCU) and Debt Capacity Utilisation for working capital (DCUWC)”, which will indicate both overall used and unused borrowing capacity, and against working capital respectively.

Another way to capture liquidity has been the working capital operating cycle. From this perspective, several measures such as, Cash Conversion Cycle (CCC) (Richards & Laughlin, 1983), Net Trade Cycle (Shin & Soenen, 1998), modified Cash Conversion Cycle (mCCC) (Talonpoika, Monto, Pirttila, & karri, 2014), to name a few, have been developed. In Cash Conversion Cycle (CCC), working capital operating components such as, Inventory,

Receivables and Payables, were considered. This was improved by including advances received from customers and the modified Cash Conversion Cycle (mCCC) was developed. It was argued by Talonpoika *et al.*, (2014) that other important components significantly impacting the working capital operating cycle should be included and they had named advances given to vendors as a component. For Indian construction companies, advances to various sub-contractors and vendors is an important component and needs to be included in the operating working capital cycle. Therefore, through this paper, I have introduced another new measure “modified Net Trade Cycle (mNTC)” by including advances given to vendors in the working capital operating cycle.

This research paper did comparative empirical testing (existing liquidity indicator CCC, mCCC vs. new measures developed DCU, DCUWC, and mNTC) on ten-year data (2006-2015) of 55 Indian Construction Companies listed on BSE / NSE. The empirical tests compared the usefulness of existing measures such as, CCC, mCCC *vis a vis* the new measures developed through this paper i.e., DCU, DCUWC and mNTC. Empirical test results show significant negative relationship between DCU and firm performance measures. “Debt Capacity Utilization (DCU)” has emerged as a robust liquidity indicator of construction companies as compared to all other measures. DCUWC has shown an inverted U-shaped relationship with both Gross Operating Profit (GOP) and Tobin’s Q (TQ). By using DCU and DCUWC, banks/investors and even corporate managers can take guidance on company’s borrowing plans. Another measure, mNTC, is a more comprehensive measure of Indian Construction Company’s working capital operating cycle. Introduction of these significant liquidity measures and testing their empirical relationship with the profitability and market measure of Indian construction companies is a novel aspect of this research.

Keywords–Liquidity, working capital management, profitability, Indian construction company

TABLE OF CONTENTS

Sr. No.	Description	Page No
	Abstract	i
	Acknowledgements	iii
	Table of Contents	v
	List of Tables	vi
	List of Figures, Flow-charts and Graphs	vii
1.0	Introduction	1
1.1	Motivation of the Study	10
1.2	Indian Construction Industry	12
1.3	Backdrop of studying liquidity measures in the Construction Industry	19
1.4	Survey	21
1.5	Research Question	27
2.0	Literature Review	29
2.1	Liquidity Measures: Theoretical and Conceptual Development	29
2.2	Empirical Findings on Liquidity & Profitability	31
2.3	Research Gap	35
3.0	Research Design	36
3.1	Hypothesis	36
3.2	Model	41
3.3	Methodology	43
3.4	Variables	44
3.4.1	Gross Operating Profit (GOP)	44
3.4.2	Tobin's Q (TQ)	44
3.4.3	Cash Conversion Cycle (CCC)	45
3.4.4	Modified Cash Conversion Cycle (mCCC)	48
3.4.5	Modified Net Trade Cycle (mNTC)	48
3.4.6	Debt Capacity Utilisation (DCU)	51
3.4.7	Debt Capacity Utilisation for Working Capital (DCUWC)	56
3.4.8	Other Control Variables	57
3.5	Data	62
4.0	Data Analysis and Empirical Result	65
4.1	Descriptive Statistics	65
4.2	Correlation	66
4.3	Pooled Ordinary Least Square Regression	70
4.4	Panel Data Analysis with Fixed and Random Effect	75
4.5	GMM System Estimation	80
4.6	Result in scenarios when DCU & DCUWC increase exponentially	84
4.7	Result Summary	88
4.8	Robustness Check	89
5.1	Discussion	95
5.2	Conclusion	104
5.3	Contribution	107
5.4	Limitations and future directions for research	110
Annexure	1. List of Prominent Companies defaulted or credit rating susp.	112
	2. Survey Question	113
	3. Margin query to Banks	115
	4. Major policy initiatives impacting lending to corporates	117
	5. Bibliography	118

List of Tables

Sr. No.	Title	Page No.
1	Liquidity Measures: Theoretical and conceptual development	8
2	Empirical Evidence on Relationship of WC with Firm Performance	9
3	Size Distribution of registered Indian Contractors	13
4	Indian Economy Statistics on GDP, Loan and NPA	20
5	Summary of Respondents Profile	22
6	Survey Response Table 6 (A) to 6 (E)	24-26
7	mNTC Calculations	50
8	Debt Capacity Calculation	53
9	Margin Stipulation of Banks	55
10	Variables	59
11	Sample Finalization	63
12	Descriptive Statistics	66
13	Correlation Statistics	69
14 A	Pooled OLS Regression (GOP)	73
14 B	Pooled OLS Regression (TQ)	74
15 A	Panel Data Regression (GOP)	77
15 B	Panel Data Regression (TQ)	79
16 A	GMM Regression (GOP)	81
16 B	GMM Regression (TQ)	82
17	Scenario result in OLS, Panel & GMM when DCU increases exponentially	86
18	Scenario result in OLS, Panel & GMM when DCUWC increases exponentially	87
19 A	Panel Data Regression on NIFTY Companies (GOP)	91
19 B	Panel Data Regression on NIFTY Companies (TQ)	92
20	Panel result when DCU & DCUWC increases exponentially for NIFTY Co.	94
21	Comparative Table	96
22	List of Companies defaulted/delayed bank obligation/rating suspend	102
23	List of Companies attaining 100% DCU but managed liquidity	103

List of Figures, Flow-Chart and Graph

Sr. No.	Title	Page No.
Flow-Chart		
1	Explaining Key Points – Understanding problems of Construction Industry	18
Figures		
1	mNTC Model	50
Graphs		
1	CCC days data point of defaulting/delayed / rating suspended companies	98
2	mCCC days data point of defaulting/delayed / rating suspended companies	98
3	mNTC days data point of defaulting/delayed / rating suspended companies	98
4	DCU percentage data point of defaulting/delayed / rating suspended companies	99
5	DCUWC percentage data point of defaulting/delayed / rating suspended companies	99