

A Study of Corporate Investment Practices of Information Technology Industry in India

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Abstract

India's IT Sector is growing rapidly and is expected to enjoy even greater growth opportunities in the future. Corporate Finance has been the subject matter of coherent connotations among the researchers, corporate managers and practitioners ever since the evolution of corporate finance theory. Distinguished scholars, who visited the theory of capital budgeting, capital structure, cost of capital, capitalization, dividend policy and working capital of the firm, have come out with a number of recommendations that are of paramount understanding to budding researchers. In this paper, we have discussed the role of financial services sector in Indian economy and corporate investment practices of IT industry in India.

Keywords

Corporate Investment, Financial Practices, Service Sector, IT

I. Introduction

Over the last century, the researchers from around the Globe have worked upon postulating models and theories facilitating firms to add to their efficiency in terms of competitive corporate financial practices. Information Technology (IT) is both a huge industry in itself and the source of dramatic changes in business practices in all other sectors. The term IT covers a number of related disciplines and areas, from semiconductor design and production (also covered in the profile of the Electronics sector), through hardware manufacture (mainframes, servers, PCs, and mobile devices), to software, data storage, backup and retrieval, networking, and, of course, the internet [1]. Information Technology Services ("ITS") and Business Process Outsourcing ("BPO") are here to stay and are an integral part of today's globalized world. India has rapidly emerged as a preferred destination for global corporations seeking to outsource their business processes. ITS and BPO in a global economy presents unique challenges such as issues relating to permanent establishment, transfer pricing, intellectual property, privacy, data protection, security along with the incorporation of the same into various contracts and agreements. We, at Nishith Desai Associates, have developed an expertise and niche in this area and have advised and assisted several global companies on legal, regulatory, tax and matters in relation to protection of intellectual property [4].

II. Investing Practices in Corporate Finance

One of the most imperative objectives of finance theory is guiding firms on how to make investment decisions. The search for a reliable method of long term project appraisal method dates back to decades. The issue not only continues to be a matter of concern for academics or managers, but is also becoming more and more important to investors and shareholders. Finance theory prescribes the net present value (NPV) rule which states that a firm should take an investment project when the present value of its expected future cash flows, discounted appropriately for the project's riskiness, exceeds the cost of investment. The NPV is computed by forecasting the project's cash flow and discounting it

at a discount rate reflecting the price charged by the capital markets for the cash flow risk. For investors with well diversified portfolios, only the project's systematic risk affects its value: its idiosyncratic risk should not be considered. What capital budgeting tools and techniques are being practiced by the industry? How popular are they? Do firms use methods that help to maximize the value? In practice, the NPV method is used extensively, but it is by no means the only technique used. Alternative methods, such as the Payback method and the use of earnings multiples, are also common. The payback is seen as possibly the most seriously flawed method, since it ignores the time value of money and cash flows beyond an arbitrary cut-off date. Brigham (1975) surveyed 33 large firms and found that 94% use NPV, IRR or profitability index criterion in their capital budgeting decisions. They are not using multiple hurdle rates and 61% use hurdle rate based on weighted Average Cost of Capital (WACC). 39% of the respondents revise hurdle rates less than once a year and they do not have a system for its review. Pandey (1989) studied 14 Indian companies in 1984 and found that payback period method is most widely used followed by IRR as a capital budgeting technique. In Indian corporate, there is a lack of familiarity with the discounted cash flow methodology amongst the corporate executives. The project risk is assessed through sensitivity analysis and conservative forecasts. Surprisingly, Graham and Harvey (2001) report that 57% of the CFOs in their survey of US firms always or almost always use the Payback method in capital budgeting decisions, as compared to the 76% using the NPV method. They find the Payback method to be the most frequently used method among firms in the UK, Germany, and France, and it is also very common in the Netherlands, where it is the second most popular method after the NPV. A number of tools are available to determine the extent of profitability of a project (Akalu, 2001). However, some of these methods are unable to accommodate the current changes in business environment, especially, where increasingly shareholder value is of importance. In addition, their continuous application reveals significant limitations in their capacity to address the basic problems of investment appraisal (Akalu, 2001). And some of these methods requires complex decision making Processes. Thus, the choice of appropriate appraisal method is becoming a difficult task for project managers, which requires critical analysis of various tools.

The concept of Working capital management is substantial, particularly from research point of view, because of its effects on the firm's profitability and risk, and consequently its value. Its major areas include inventory, receivables and payables. All these variables have immense impact on the risk and return of the firm. A firm is required to maintain liquidity in its day-to-day operations to ensure smooth running of the operations and to meet its short-term obligations. However, this is not a simple and straightforward task, as it has to operate its business both efficiently and profitably. To start with, on the one hand, maintaining high inventory levels reduces the cost of possible interruptions in the production process or of loss of business due to the scarcity of products, reduces supply costs, and protects

against price fluctuations. On the other, granting trade credit favors the firm's sales in various ways; for instance, influence customers to acquire merchandise at times of low demand (Emery, 1987), to attract new customers. However, firms that invest heavily in inventory and trade credit can suffer reduced profitability. Thus, the greater the investment in current assets, the lower the risk, but also the lower the profitability obtained. Decisions about how much to invest in the customer and inventory accounts, and how much credit to accept from suppliers, are reflected in the firm's Cash Conversion Cycle (CCC), which represents the average number of days between the date when the firm must start paying its suppliers and the date when it begins to collect payments from its customers. Cash Conversion Cycle is an outcome of working capital financing decision of a firm - whether the inventory and receivables are financed through suppliers' credit or through some other source. Some previous studies have used this measure to analyze whether shortening the cash conversion cycle has positive or negative effects on the firm's profitability. In particular, Shin and Soenen (1998) analyzed the relation between the cash conversion cycle and profitability for a sample of firms listed on the US stock exchange during the period 1974-1994. The results show that reducing the cash conversion cycle to a reasonable extent increases firms' profitability. More recently, Deloof (2003) studied a sample of large Belgian firms during the period 1992-1996. His results confirm that Belgian firms can improve their profitability by reducing the number of days accounts receivable are outstanding and reducing inventories. Moreover, he finds that less profitable firms wait longer to pay their bills. In case of financial firms as well, management of liquidity for day to day operations is of great importance. Providing liquidity to customers is one of the intermediation functions of financial concerns.

III. Industry Growth

The birth of the software industry in India began in 1970 with the entry of Tata Consulting Services (TCS) into the domain of outsourced application migration work. In the late 1960s, the Tatas (name of a large conglomerate of companies) created TCS as a central service center for Tata Group companies. With IBM having been thrown out of India, the concept of outsourcing application development work had become a necessity for Indian companies. Within a few years TCS began sending young Indian engineers to a joint venture partner in the United States, Burroughs, for training [3]. Fig. 1, shows Revenue Growth in Dollar Terms.

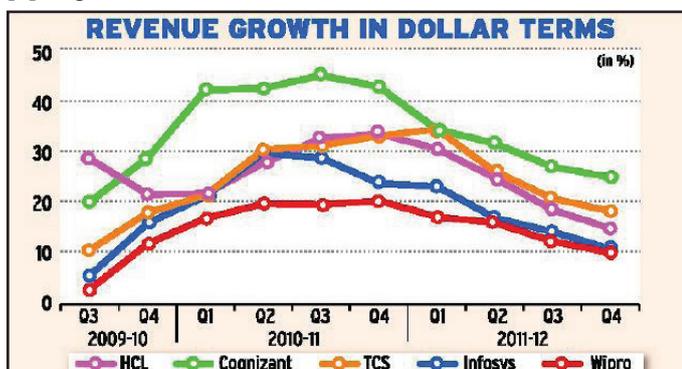


Fig. 1: Revenue Growth in Dollar Terms [6]

IV. Conclusion

India is now home to a number of IT giants. The operations of IT firms like Wipro, Infosys, Accenture, Capgemini, Tata Consultancy Services and many more in different locations of India have changed the entire scenario of the Indian job market. The ITES

sector has also come up to complement the growth of Indian IT sector [5]. India's IT Sector is growing rapidly and is expected to enjoy even greater growth opportunities in the future. Corporate Finance has been the subject matter of coherent connotations among the researchers, corporate managers and practitioners ever since the evolution of corporate finance theory.

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