Liquidity and the Capital Structure: an analysis of selected IT Companies

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ABSTRACT

Today, a crucial tool for critically evaluating a corporation's operation is financial analysis. It aids the business in analysing financial information and providing information that is necessary to make investment decisions and that aids in a better understanding of financial status. The financial analysis shows how financially sound a firm is and assists businesses in increasing their financial resources and managing newly generated funds effectively. India's information and technology sector has expanded dramatically during the past few years. Its impact on the economy has likewise significantly increased. In the Indian environment, investing in the IT sector is regarded as a profitable and less hazardous investment option. The paper aims to make it easier for investors and management to evaluate a company's financial situation.

Keywords: liquidity, capital structure, leverage. IT Cos

JEL classification: G32

INTRODUCTION

The debt-to-equity (D/E) ratio, which measures an organization's long-term liquidity, is used to describe capital structure. The Net Income Approach states that unless a corporation can eliminate debt from its capital structure at a cost that is typically less expensive than the rate of return on the business, it should

continue to do so. Because of this, the company's worth increases along with the value of each project it handles. In such a scenario, the overall cost of capital would be lower the more debt there is in the capital structure.

The strategies used by businesses to finance their assets through a combination of debt and equity are known as capital structure. (Titman & Wessels, 1988). Maximizing a company's value is the overarching goal of capital structure policies (Ross, 1977). Any circumstances that could result in unnecessary expenses (like liquidation) force businesses to diverge from accomplishing their goal (Bradley, Jarrell, & Kim, 1984). High-leveraged businesses that are losing their financial flexibility may find it difficult to acquire fresh sources of funding for their initiatives and run the danger of going bankrupt.

Leverage can increase return on investment if the debt is frequently monitored, kept at a manageable level, and borrowed money is used wisely. Therefore, a company with significant leverage needs to create an effective financial arrangement that would eventually lower its cost (Stulz, 1990). The ability of the company's assets to be easily transformed into cash is known as liquidity. Companies strive to maintain liquidity in their operations, or the capacity fulfills their obligations on schedule (Arlija & Harc, 2012). Therefore, managing liquidity is crucial for every firm to meet its commitments to pay current liabilities, which include financial and operational costs with short-term (ST) debt maturities (Saleem & Rehman, 2011). Debt can lead to a higher return on investment if the amount is kept under control, continuously reviewed throughout time, and handled wisely. A liquid company is one that pays all of its debts on time, making it desirable to funding sources.

One of the most important and difficult managerial decisions is the choice between equity and debt (Khalaj, Farsian, & Karbalae, 2013). More equity increases the external cash flow claims, which subsequently lowers the

company's value. On the other hand, increased debt will result in higher bankruptcy-related fees and financial hardship. According to Morellec (2001), asset liquidity increases debt capacity when bond covenants restrict the assets' ability to be disposed of. On the other hand, the researcher stated above shows that when it comes to unsecured debt, higher liquidity raises credit spreads on corporate debt and lowers optimal leverage.

Myers and Rajan (1998) explore another case for a negative connection, arguing that in the presence of high agency costs of liquidity, external creditors restrict the amount of debt financing that the firm can access. As a result, it is possible to anticipate a negative correlation between liquidity and debt. However, a liquid corporation pays all of its debts immediately. Therefore, for liquid enterprises whose financial characteristics meet the requirements of financial institutions, access to external finance is typically simple. Additionally, according to Trade-off Theory, an ideal mix of capital is found by weighing the net cost of debt against the net cost of equity, with the latter being primarily influenced by the debt tax shield (Lipson & Mortal, 2009).
Whether it is preferable to use external sources and receive compensation in the form of interest rates or to employ internal sources for funding new projects or financial requirements is still up for debate (Arlija & Harc, 2012).

This study was undertaken because there have been few studies on debt structure in the IT Sector and because there has not been enough investigation into the relationship between capital structure and liquidity. The empirical data from this study may shed light on how Indian IT Companies manage their liquidity. The findings demonstrate that the debt-equity (D/E) and current ratio (C/R) of the top five companies in the IT sector have shown 55%. This indicates that only 55% of the variability in the outcome data can be explained by the model.

LITERATURE REVIEW

Leverage has a major impact on liquidity, although the latter might influence the choice of capital structure in either a positive or negative way. As a result, the net impact is uncertain (Abu Mouamer, 2011). In relation to capital structure, there are several theoretical ideas. According to the conventional wisdom put out by Modigliani and Miller (1958), the company's issued instruments have no bearing on the firm's value or production.

The trade-off theory, in contrast, asserts that the organizations often receive funding from both equity and debt and seeks to identify the ideal level of the capital structure at which firm is value maximized (Chowdhury & Chowdhury, 2010).

At this stage, business performance is maximised and the marginal benefits of debt are equal to the marginal costs of debt (Park & Jang, 2013; Xu, 2012). The business will finance investments in a "pecking order style" (Deesomsak, Paudyal, & Pescetto, 2004). Firms create their capital structure through a hierarchy of financial decisions, according to Myers and Majluf (1984). Initially, businesses use retained earnings to fund projects because there are no fees associated with flotation and no requirements for disclosing financial data (Bevan & Danbolt, 2002). Firms choose debts when their retained earnings are insufficient (DeAngelo & DeAngelo, 2007); if additional funding is needed, the firm's final alternative is to issue equity.

The results of numerous investigations are consistent with the PO hypothesis (Eriotis, Vasiliou, & Ventoura- Neokosmidi, 2007; Rajan & Zingales, 1995; Seifert & Gonenc, 2010; Sheikh & Wang, 2011). Furthermore, when a corporation has an abundance of liquid assets, liquidity has a substantial impact

on a conservative debt strategy; as a result, conservative policies are required to ignore potential hazards. In general, there is no guiding principle for deciding between debt and equity. In other words, conditional theories can be useful. Each of these ideas aids in comprehending the capital structures that businesses select (Akinlo, 2011). As a result, some significant research on the capital structure and liquidity in the various markets is evaluated.

Williamson (1988) demonstrated that asset liquidity limits the company's ideal level of debt in relation to the typical level of debt consumption in a particular industry. The authors of the submission, Submitter and Anderson (2002), showed a strong correlation between the firm's liquid assets and long-term debt. It is clear that the corporation is attempting to lower the likelihood of difficulty caused by the high-leverage LT features of the capital structure by retaining liquid assets as a preventative measure. Additionally, they demonstrated a negative relationship between the firm's ST borrowings and liquid assets, taking the function of replacement financing for them in a cash-flow emergency. Surprisingly, they applied the same test to a sample of Belgian businesses, and their results revealed a favourable link between liquid assets and ST debt.

A study on capital structure and liquidity was done by Anderson and Carverhill in 2007. Findings specifically showed that greater levels of LT debt will lead to more reduction in the best use of ST debt and higher levels of keeping liquid assets. Additionally, the business value is not influenced by the amount of long-term debt. The corporation can meet varied contracting requirements while maintaining roughly the same company value for a variety of LT debt levels by adjusting adequate liquidity, according to the explanation.

Suhaila, Mahmood, and Mansor (2008) studied the changes in debt policies among Malaysian listed companies following the 1997 financial crisis using a

sample of 17 companies throughout the years 2000 to 2005. Their findings demonstrated a negative relationship between liquidity and debt level. Sibilkov (2009) investigated how liquid assets affected capital structure. He discovered that leverage is positively correlated with liquid assets after testing data from a large sample of publicly traded companies in the U.S. Further research revealed a curvilinear relationship between unsecured debt and asset liquidity as opposed to a positive relationship between secured debt and asset liquidity.

The results support the idea that the costs of inefficient liquidation and financial distress are considered from an economic standpoint and have an impact on capital structure decisions. Using the panel regression technique, Chakraborty (2010) investigated the factors affecting the capital structure, including liquidity, among 1169 non-financial listed companies that had been operating for 13 years in India. This study demonstrated that the static trade-off theory and the pecking order theory can both account for the Indian stock market. Using panel data across eight years from 1999 to 2007, Akinlo (2011) explored the factors influencing capital structure among 66 listed companies on the Nigerian Stock Exchange. Leverage and liquidity were found to be positively correlated. The results demonstrated that the Trade-Off Theory is compatible with the positive association between leverage and liquidity.

Based on a sample of 1058 Croatian listed companies, Arlija and Harc (2012) evaluated the impact of asset liquidity on the capital structure. The results demonstrated that the relationships between the leverage ratios and the liquidity ratios were statistically significant. Furthermore, correlations between the composition of current assets and leverage ratios were statistically significant. Furthermore, the ST leverage and liquidity ratios had a greater link than the LT leverage and liquidity ratios. The more liquid the assets, the less leveraged the company.

Companies with LT leverage, however, were more liquid. Rising inventory levels contributed to rising debt, but rising cash levels contributed to falling LT and ST leverage. Results by Rajendran and Achchuthan (2013) showed that from 2005 to 2011, listed businesses in Sri Lanka's telecom sector's capital structure strategies heavily depended on the management of asset liquidity. In order to decide on the capital structure that will maintain the firm's worth in the long term, the company should therefore concentrate on the management of liquidity. Ahmad and Aris (2015) looked at factors influencing capital structure in the service and trading sectors of Bursa Malaysia from 2007 to 2011. Their conclusion suggests that liquidity has a large adverse impact on corporate debt decisions.

RESEARCH METHODOLOGY

The IT companies based on a market capitalization of more than Rs. 100,000 crores as on March 2022 were taken as a part of this study. Out of which, one company was with zero debt, hence the data for the study was taken for only the top five companies. The data was taken from the Capital Line database and to determine the impact of liquidity on leverage, regression was applied to it. The two research objectives are: (1) liquidity ratios impact leverage ratios significantly (2) liquidity ratios do not impact leverage ratios.

The following companies were taken for the purpose of the study:

Companies	**MARKET CAP (Rs in crs)**
TCS	**1368046.13**
Infosys	**802309.19**
Wipro	**324538.56**
HCL Technologies	**315694.22**

Tech Mahindra	**145706.98**

Table 1: IT Companies based on Market Capitalisation

Tata Consultancy Services-It is an IT services, consulting, and business solutions organization that has been partnering with many of the world's largest businesses in their transformation journeys for over 50 years. TCS offers a consulting-led, cognitive-powered, integrated portfolio of business, technology, and engineering services and solutions. This is delivered through its unique Location Independent Agile TM delivery model, recognized as a benchmark of excellence in software development. A part of the Tata group, India's largest multinational business group, TCS has over 592,000 of the world's best-trained consultants in 55 countries. The company generated consolidated revenues of US $25.7 billion in the fiscal year that ended March 31, 2022, and is listed on the BSE (formerly Bombay Stock Exchange) and the NSE (National Stock Exchange) in India.

Infosys Ltd- It is an Indian multinational information technology company that provides business consulting, information technology, and outsourcing services. The company was founded in Pune and is headquartered in Bangalore. Infosys is the second-largest Indian IT company, after Tata Consultancy Services, by 2020 revenue figures, and the 602nd largest public company in the world, according to the Forbes Global 2000 ranking.

Wipro-It is a leading technology services and consulting company focused on building innovative solutions that address clients' most complex digital transformation needs. Leveraging our holistic portfolio of capabilities in consulting, design, engineering, and operations, we help clients realize their boldest ambitions and build future-ready sustainable businesses. With over

240,000 employees and business partners across 66 countries, we deliver on the promise of helping our customers, colleagues, and communities thrive in an ever-changing world.

HCL Technologies- HCL Tech is a leading global IT services company, which is ranked amongst the top five Indian IT services companies in terms of revenues. Since its inception into the global landscape after its IPO in 1999, HCL Tech has focused on transformational outsourcing, and offers an integrated portfolio of services including software-led IT solutions, remote infrastructure management, engineering and R&D services and BPO. The company leverages its extensive global offshore infrastructure and network of offices in 46 countries to provide multi-service delivery in key industry verticals.

Tech Mahindra - Tech Mahindra Ltd provides comprehensive range of IT services, including IT enabled service, application development and maintenance, consulting and enterprise business solutions, etc. to a diversified base of corporate customers in a wide range of industries.

VARIABLES USED IN THE STUDY

Variables	Measures	Symbols
Current Ratio	Current Assets/ Current Liability	CR
Debt equity Ratio	Total debt/ Equity	DEBT/ EQUITY

The data used in the study is depicted in the following table:

Companies	Equity	Debt	Current Assets	Current Liabilities
TCS	366	5855	64930	36925

Infosys	2103	3786	46970	24418
Wipro	1096.4	8804.1	27698.5	15069.2
HCLTechnologies	543	880	20848	8818
Tech Mahindra	485.9	517.5	13708.7	6463

Table 2: Data of the companies as on 31.03.22 (Rs. in crs)

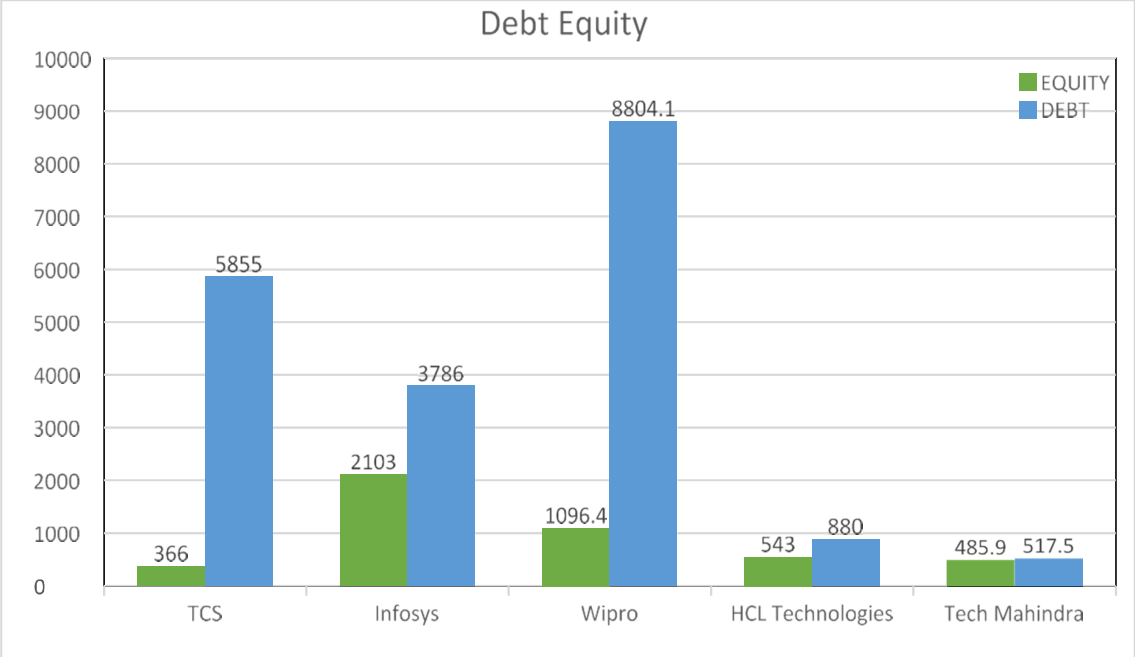

Figure 1: Debt and Equity of The Cos

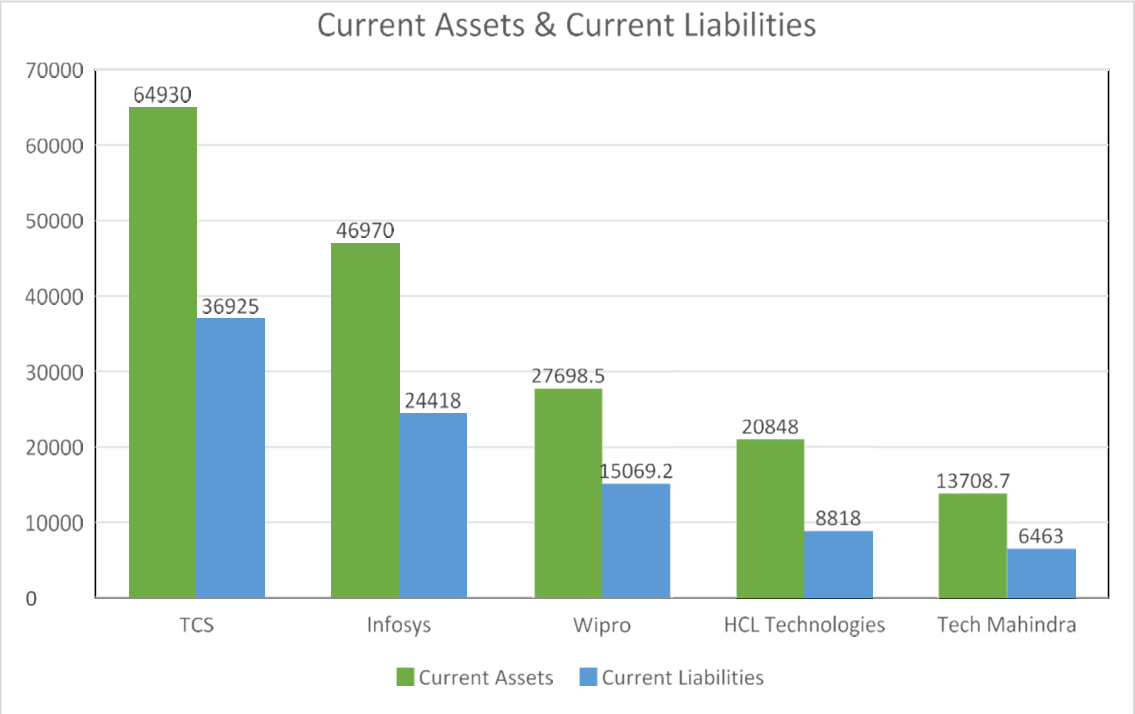

Figure 2: Current Assets and Current Liabilities of The Cos

Companies	CR	Debt Equity
TCS	1.758429	15.99727
Infosys	1.923581	1.800285
Wipro	1.838087	8.030007
HCL Technologies	2.364255	1.620626
Tech Mahindra	2.121105	1.065034

Table: 3 Current ratios and Debt Equity ratios of the companies; Author's calculations

REGRESSION STATISTICS:

Multiple R	0.737130911
R Square	0.543361979

Adjusted R Square	0.391149306
Standard Error	0.190234595
Observations	5

ANOVA:

	df	*SS*	*MS*	*F*	*Significance F*
Regression	1	0.129186588	0.129186588	3.569755176	0.15524957
Residual	3	0.108567603	0.036189201		
Total	4	0.237754191			

	Coefficients	*Standard Error*	*t Stat*	*P-value*	*Lower 95%*	*Upper 95%*	*Lower 95.0%*	*Upper 95.0%*
Intercept	2.160757757	0.119913826	18.01925453	0.000372791	1.779138444	2.542377071	1.779138444	2.542377071
X Variable 1	-0.027998659	0.01481897	-1.889379574	0.15524957	-0.075159234	0.019161917	-0.075159234	0.019161917

DISCUSSION AND CONCLUSION

Earlier studies pertaining to the impact of liquidity on the capital structure of the firm show that the capital structure is impacted by the current ratio. On the other hand, in other studies, it was observed that more liquid firms are also financed through their own capital. The aim of this paper was to investigate the impact of liquidity on the capital structure of IT firms. The results of this research show liquidity and capital structure of these firms are showing an R-square of approximately 55%. Long-term leveraged firms are more liquid, assuming that

managers or business owners are not inclined to risky projects. The study revealed that the liquidity ratios have less impact on debt-equity ratios of top five cos of IT sector. A detailed analysis of the complete sector might give a different conclusion. Further, research can be done on the complete sector.

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