# PROFITABILITY AND GROWTH OF THE CORPORATE SECTOR IN NEPAL

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## 1. Background

One of the most important features of modern capitalist economy in the present century is the phenomenal growth of corporate sector and rise of corporate economy. With the ascendance of big joint stock companies, most of the activities in a modern capitalist economy today are conducted by a limited number of large corporate bodies owning and controlling a significant portion of the country's economic and financial resources. Corporations today are more than merely a legal device for carrying out business transactions; they are a method of property tenure and a means of organizing economic life. Their significance in the developed economy today is no large that they, with immense economic power, have been a major social institution, giving rise to what is known as a corporate economy - an economy dominated by large corporations which have widely dispersed stock ownership and are effectively controlled by corporate managers. (Herandeen, 1975). The corporate sector in a developed country today makes a substantial contribution to the gross domestic product, total employment, trade and balance of payment of the country and acts as the backbone of its economy.

In Nepal, the corporate sector plays a very limited role and has a very short history. Some large joint stock companies were established during the period of the First World War but being set up mainly to take the benefits of the scarcity of goods and services created then by the war they were not based on long term economic considerations and most of them went into liquidation immediately after the war. The failure of these companies made the general investors skeptical about the corporate form of organization, thus impeding the growth of corporate sector in the subsequent period. The emergence of corporate sector in Nepal occured only from 1956 onward with the adoption of a policy of planned growth by the government. During the First Five Year Plan period, some large-scale enterprises like the Royal Nepal Airlines Corporation, the Nepal Industrial Development Corporation, and

the Timber Corporation of Nepal were established under the public sector. The policy of the government to participate directly, together with the private sector, in the industrial and commercial activities of the nation in the subsequent plans led to a rapid proliferation of enterprises under the public sector in the country. As such, by the end of 1989/90, there were altogether 63 enterprises under the public sector with Rs 4.32 billion equity investment by the government (Ministry of Finance, 1991, p. 4). The investment of the government in the public enterprises at the end of 1992/93 was Rs 7.5 billion in equity and Rs 23.5 billion in loans (Ministry of Finance, 1994, p. 52). The establishment of enterprises under the public sector stimulated the development of the corporate sector to a great extent in Nepal.

The private sector, on the other hand, has played limited role in the development of the corporate sector in Nepal. The share of private sector in total gross investment in Nepal was as high as 75 percent in the 1960's. It declined steadily since then and, by 1984/85, it was merely 47 percent of the total gross investment (Integrated Development System, 1987, p.1). Similarly, the share of private sector in the gross capital formation decreased from 60 percent in 1979/80 to about 44 percent in 1988/89, (Central Bureau of Statistics, 1991). These figures indicate the dormant role played by the private sector in the development of the corporate sector in Nepal. However, in recent years, some large enterprises specially in brewery, soft drink, textile, tobacco, hotels, rubber, cotton yarn, banking and finance have been established under the private sector, providing an impetus to the growth of the corporate sector in the country.

Growth of the corporate sector depends, inter alia, on the availability of finance. In general, a firm can finance its growth internally by ploughing back its profit and externally by borrowing and / or issuing securities to the general investors. While the ability of a firm to finance its growth through internal sources of funds depends on its profitability, the availability of external sources of funds - debt and new issues - depends on the stage of development of capital market. As the capital market in Nepal is still undeveloped and inefficient, a firm can hardly rely on it to finance its growth. A firm in such a situation can grow either by borrowing from bank or by reinvesting its profits. Since the availability of bank loan to a firm depends, to a large extent, on the profitability of the firm itself, growth and profitability of a firm becomes highly related. This implies that if a firm is not profitable, its growth will be highly inhibited. At the macro level, this means that the growth of corporate sector is the function of the profitability of this sector. Thus, higher the profitability, higher the growth rate of the corporate sector. In this paper, attempt is made to examine the profitability-growth relationship in the Nepalese companies and assess the role of profitability in the process of corporate growth in Nepal. For this, in the following section, the theories on profitability-growth relationship are briefly reviewed. Thus, a brief

description of the methods and data used in the study is presented. This is followed by an analysis of the profitability-growth relationship in the Nepalese companies. Finally, the policy implications of the findings are discussed.

## 2. The Theory and Evidence

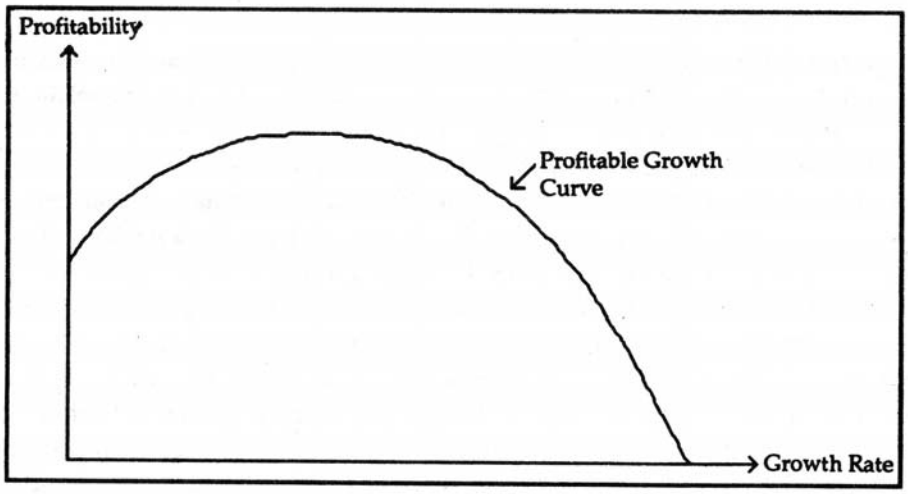
The neo classical economic theories provide little explanation regarding the relationship between profitability and growth in a firm. Under the assumption of perfect competition, a firm grows or shrinks to attain 'optimum size' where it maximizes profits. Once the firm reach an optimum size, it tends to stabilize and does not grow. Thus, in equilibrium, under the framework of perfect competition, there exists no relationship between profitability and growth of a firm. However, a relationship between profitability and growth can be observed in a cross-section of firms when the firms are not for some reasons at equilibrium and, as such, tend to move toward optimum size. But, as Marris (1968) points out, the precise nature of this relationship remains to be indeterminate in general because it depends on the causes of disequilibrium and the speed of adjustment.

A meaningful explanation of the relationship between profitability and growth is found in the managerial theories of the firm. Despite that these theories mark significant departure from the neo- classical economic theories regarding objectives of firms, they accept the importance of profitability of a firm as a major constraint on the firm's behavior when the firm pursues objectives other than profit maximization. Whether a firm attempts to maximize its sales revenue (Baumol, 1959) or utility (Williamson, 1964) or its growth (Marris, 1964) or even appears as a technostructure (Galbraith, 1967) it needs to earn a minimum level of profit to keep its shareholders and creditors satisfied. According to these theories, the relationship between profitability and other objective measures, such as growth, comes into consideration only when the firm earns profit above a required minimum level. The concern for profitability overshadows firms other objectives below this level because at a very low level of profit, security of management is thwarted.

The rate of growth of a firm depends on its ability and willingness to grow (Singh and Whettington, 1968, p. 149). A firm's ability to grow depends on its profitability for two reasons. First, higher profitability means that the firm is in a position to retain more which in turn implies higher growth. Second, there is generally a tendency for profitability to persist overtime. So higher level of current profitability elicits a positive response from potential investors toward new issues of shares of the firm in the market, providing an impetus for the firm to grow. Thus, a firm's ability to grow is closely related to its profitability.

A firm's willingness to grow, on the other hand, is more dependent on factors like the degree of competition, its technological opportunities, the demand of its products, preferences of market etc. Marris (1964, 1971) provides plausible explanation regarding the ability of a firm to grow through retention and its willingness to grow through the concept of 'balanced growth' - a point in growth curve where supply growth curve intersects the demand growth curve. If by some reasons, a firm expands its production capacity without ensuring corresponding increase in its sales, its capacity utilization fall, thereby reducing the average rate of return on assets. This fall in its profitability affects the firm's ability to grow in future, making current growth unsustainable. Similarly, if the firm has inadequate supply of funds, it cannot sustain growth permanently. As Marris (1964, p.7) points out"..... sustainable growth requires a method for persistently increasing sales with at least constant profitability". It is argued that at lower rate of growth, profitability and growth of a firm tend to vary directly partly due to increase in the firm's market share and partly due to reverse penrose effect. At higher growth rates, profitability and growth of the firm tend to vary inversely because of increasing marketing and research and development expenditures, and penrose effect. Thus, the relationship between profitability and growth in the managerial theories takes an inverted U-shape as shown in Figure 1.

**Figure 1**
**Relationship Between Profitability and Growth**




In an expanding economy, the relationship between profitability and growth is direct because profitability contributes to firm's ability to grow. A firm's willingness to grow is affected by a wide range of factors but as a firm becomes more diversified, these factors

operate Simultaneously on the firm so that, as Smith, Boyes and Peseau (1979, p. 49) argue, the inter-industry differences become irrelevant in studying profitability-growth relationship.

In the growth theory, the causality between growth and profitability is assumed to flow to one direction, from growth to profitability whereas in most of the research conducted, it is assumed to be the other way. The long-run average growth profitability records of a cross-section of corporations show a simultaneous relationship which, in simpler linear firm, may be formulated as follows (E-at- well, 1971, p.410):

$$G = \partial + \beta P + e \quad \text{(profitability - growth)}$$
$$P = r + \ldots\ldots\ldots \quad \text{(growth - profitability)}$$

In the profitability - growth equation, a positive relationship between profitability and growth is anticipated whereas in the growth- profitability equation, a negative relationship is expected between them. The relationship is simultaneous because while profitability acts as an incentive for a firm to grow, growth also affects the future profitability of the firm. However, in most of the emperical studies, it is the profitability-growth relationship which is identified while regressing long-term growth on long-term profitability. Thus, emperical studies generally focus on profitability-growth relationship, rather than on growth-profitability one.

In many research studies, the profitability growth relationship has been tested using different forms such as log-linear, double-log etc but, in most of the cases, the relationship is found to have been best described in simple linear form. Barna (1962), in his study of firms in food processing and electrical engineering industries for a period between 1949 and mid-1959, used simple linear form to test the relationship between profitability and growth and found a significant positive relationship between them. Similarly, Parket (1964) , Singh and Whettington (1968), Jones (1969), Berry (1975), and Kumar (1984) found significant positive relationship between profitability and growth. Radice (1971), using Marris' model, also observed a positive relationship between profitability and growth but his findings contradicted the managerial theories in that owner-controlled firm's had higher profit rates associated with higher growth rates in comparison to management controlled firms. Whettington (1971) used a simple quadratic equation to test growth-profitability relationship in U.K. quoted companies and found that past growth is not closely associated with future profitability in majority of industries once allowance is made for the influence of past profitability which is correlated with both past growth and future profitability.

## 3. Data

The study is based on a sample of 37 companies of which 26 belong to manufacturing and 11 to non-manufacturing sectors. According to their ownership pattern, 23 companies are under public sector and 14 companies under private sector. The sample was selected from a list of 62 public sector companies obtained from the Corporation Co-ordination Division, Ministry of Finance. Since the study covered a period of 10 years from 1980/81 to 1989/90, divided into two sub-periods of five years each, those companies which were established after 1980/81 were excluded from the sample frame. Unlike in the case of public sector companies, a complete list of private sector companies was not available. However, a list of 142 public limited manufacturing companies was obtained from the Department of Industry and from this list, 12 large companies were selected as sample on judgemental basis. However, of the 12 companies, complete data were available for only six which were included in the sample together with other four private limited manufacturing companies. Similarly, four private sector companies were selected from trading and services sectors. Thus, altogether 14 private sector companies are included as sample in the study.

The data required for the study is collected from the annual general reports of the companies and the Report of the Auditor General's Office. The financial statements of the 37 sample companies were reduced to a standard format to make them consistent and comparable. The growth of a firm in this study its measured as a compounded annual rate of growth of net assets over a period of time. Net assets in this study is calculated as fixed assets plus current assets, less current liabilities and provisions. Profitability of the firm is measured in two different ways:

(i) Pre-tax rate of return on net assets which is defined as earnings before interest and taxes plus (minus) non-normal surplus (loss) divided by aggregate net assets.

(ii) Post-tax rate of return on equity which is measured as the sum of ordinary dividend and total retention divided by aggregate equity assets.

The first measure reflects the total profitability of the firm and helps to assess the effectiveness of the management whereas the second measure is important from the point of view of the growth of the firm.

All these variables were calculated for the whole period (1980/81 - 1989/90, sub-period 1 (1980/81 - 1984/85), and sub-period 2 (1985/86 - 1989/90).

## 4. Test of Profitability - Growth Relationship

The relationship between profitability and growth in the Nepalese companies was tested against the following null hypothesis.

$H_O$ : Profitability and growth of the companies in Nepal are independent of each other, Alternatively,

$H_i$ : Profitability and growth of the companies in Nepal are significantly related.

The relationship between these variables was specified in the following functional form

$$G_{it} = a + b\,P_{it} + e$$

where, $G_{it}$ = growth rate of company i for period t, and

$P_{it}$ = profitability of company i for period t.

a and b are the parameters and e is the error term.

The above equation hypothesizes that growth is a linear function of profitability, with the parameter b measuring absolute change in growth rate in response to the change in profitability, both expressed in terms of percentage. With the view to list the relationship between the variables as specified in the above equation, growth rates were regressed on both the measures of profitability separately for all 37 sample companies and 26 manufacturing companies for the whole and each of the sub-periods. The regression results are presented in Table Nos. 1 and 2 below.

Table 1

REGRESSION RESULTS OF GROWTH ON PRE-TAX RATE OF RETURN FOR THE SAMPLE COMPANIES

| | | |
|---|---|---|
| **Whole period (1980/81 – 1989/90)** | | |
| All Companies (n = 37) | G = 9.278 + 0.03 P | $\bar{R}^2$ = –0.02 |
| | (0.075) | |
| Manufacturing Companies (n = 26) | G = 8.375 + 0.023 P | $\bar{R}^2$ = –0.04 |
| | (0.10) | |
| **Sub-period 1 (1980/81 – 1984/85)** | | |
| All Companies (n = 37) | G = 12.767 – 0.815 P | $\bar{R}^2$ = –0.01 |
| | (0.105) | |
| Manufacturing Companies (n = 26) | G = 11.996 – 0.017 P | $\bar{R}^2$ = – 0.04 |
| | (0.13) | |
| **Sub-period 2 (1985/86 – 1989/90)** | | |
| All Companies (n = 37) | G = 5.473 + 0.121 P | $\bar{R}^2$ = 0.03 |
| | (0.087) | |
| Manufacturing Companies (n = 26) | G = 4.892 + 0.045 P | $\bar{R}^2$ = 0.01 |
| | (0.052) | |

Note: Figures in parentheses are standard errors.

Table 2

REGRESSION RESULTS OF GROWTH ON POST-TAX RATE OF RETURN FOR THE SAMPLE COMPANIES

| | | |
|---|---|---|
| **Whole Period (1980/81 – 1989/90)** | | |
| All Companies (n = 37) | G = 9.789 + 0.029 P | $\bar{R}^2$ = –0.01 |
| | (0.036) | |
| Manufacturing Companies (n = 26) | G = 8.818 + 0.026 P | $\bar{R}^2$ = –0.02 |
| | (0.038) | |
| **Sub-period 1 (1980/81 – 1984/85)** | | |
| All Companies (n = 37) | G = 11.214 – 0.089 P* | $\bar{R}^2$ = 0.05 |
| | (0.51) | |
| Manufacturing Companies (n=26) | G= 11.202 - 0.066 P | $\bar{R}^2$ = 0.01 |
| | (0.058) | |
| **Sub-period 2 (1985/86 – 1989/90)** | | |
| All Companies (n = 37) | G = 7.301 + 0.041 P | $\bar{R}^2$ = –0.01 |
| | (0.05) | |
| Manufacturing Companies (n = 26) | G = 5.629 + 0.019 P | $\bar{R}^2$ = –0.01 |
| | (0.022) | |

Note: Figures in parentheses are standard errors

* Significant at 0.1 level.

The regression results in the above tables indicate a positive relationship between profitability and growth during the ten-year period for both the pre-tax rate of return on net assets and post-tax rate of return on equity. When this relationship was estimated for two sub-periods separately, it was found negative during sub-period 1 and positive during sub-period 2 for both the pre-tax and post-tax rates of return. While the positive relationship between these variables during the whole period and sub-period 2 was theoretically plausible, it was rather disturbing to note the negative relationship between them during sub-period 1. On further examination, it was revealed that the companies having very low

or even negative rates of return had high growth rates during sub-period 1. This relationship did not change when only the manufacturing companies were considered as sample for both of these profitability measures.

It is noteworthy that the 'b' coefficients in the above tables are insignificant in all the cases (except in all companies sample during sub-period) in case of post tax rate of return which was significant only at 0.1 level. This implies that the relationship between growth and profitability measures was weak. This is further supported by low or negative $R^2$ which indicates that profitability of the companies was not an important explanatory factor of their growth in Nepal.

Another important finding of the regression result is that for both measures of profitability, the 'b' coefficients varied during the two sub-periods, indicating lack of stability in the relationship between profitability and growth. The change in signs of 'b' coefficients between sub-period 1 and sub-period 2 have different implication for the process of corporate growth in Nepal. The negative 'b' coefficients in sub-period 1 denotes that profitability was not an incentive for growth of the corporate sector in Nepal but on the contrary, higher profitability led to lower growth. Although uncommon, such a relationship is not theoretically unacceptable. According to Mueller's life cycle hypothesis, a mature firm prefers distribution of large portion of its earnings by way of dividends to retention and as such does not grow despite high level of profit (Mueller, 1972). Similarly, Marris (1964) also assumed a negative relationship between profitability and growth at higher growth rates. In such cases, growth of firm is explained more by other factors such as firms maturity, and ownership pattern than simply by profits.

The positive relationship between profitability and growth in the Nepalese companies during sub-period 2 implies that profitability was an incentive for growth during the period. This change in profitability-growth relationship of the Nepalese companies contradicts the assumption of state growth which implies consistency in the relationship overtime.

## Growth and Post Profitability

Since on further analysis of data it was found that companies with lower or negative profitability grew at a much higher rate than the companies with positive profitability, it was suspected that growth rate of the Nepalese companies is more a function of post profitability than current one. In a developing economy like Nepal where capital markets are undeveloped and technological progress is slow, growth may respond to profitability only with a lag. Such lag exists due to procedural delays and red tapism in the government

offices for obtaining necessary approval for expansion of existing capacities or for undertaking new projects. This is particularly so with large firms in general and with public enterprises in particular.

To examine the impact of past profitability on growth of Nepalese companies, a simple linear regression was run with the growth during the sub-period 2 as the dependent variable and the post tax rate of return on equity assets during the sub-period 1 as the independent variable. Thus, the following regression equation was run both for the manufacturing and all company samples.

$$G_{it+1} = a + b P_{it} + e$$

Where $G_{it+1}$ = growth rate of company e at time t + 1

$P_{it}$ = Post tax rate of return of company e at time t

t = Sub-period 1 i.e. 1980/81 – 1984/85

t + 1 = Sub-period 2 i.e. 1985/86 – 1989/90

a and b are the parameters and e is the error term.

The results of the regression are given in Table No. 3

**Table 3**

**REGRESSION RESULT OF GROWTH ON PAST POST-TAX RATE OF RETURN ON EQUITY ASSETS**

| | | | |
|---|---|---|---|
| All Companies (n = 37) | $G_{it+1}$ | = 7.597 + 0.064 P | $\bar{R}^2$ = 0.05 |
| | | (0.04) | |
| Manufacturing Companies (n = 26) | $G_{i+1}$ | = 5.7817 + 0.034 P* | $\bar{R}^2$ = 0.04 |
| | | (0.02) | |

Figures in parentheses are standard-errors

* Significant at 0.1 level.

The regression results show that growth of the Nepalese companies is positively related with post profitability and this relationship was found to be significant at 0.1 level in the case of the manufacturing companies. The positive $\bar{R}^2$ indicates that the post-tax rate of return on equity assets in the Nepalese companies explains to some extent the variation in the growth rate of these companies. A comparison of these results with those of Table 2 indicates that past post-tax rate of return offers much better explanation of current growth

rate than the current post-tax rate of return. This means that the role of profitability in the process of corporate growth in Nepal need not be undermined. Since with a lag, growth does respond to profitability to some extent in the Nepalese companies.

## Growth and Positive Profitability

It is argued that if growth is a function of profitability, then in the long-run companies with positive profitability should be growing. A company with continuous loss cannot finance its growth either by borrowing and/or issuing shares to the general investors. Thus, it is pointed out that a positive relationship between profitability and growth can be expected only in the case of the companies which have records of positive profitability in the past. With a view to test the relationship between profitability and growth in those Nepalese companies which had positive profitability in the past, simple linear regression was run on a restricted sample that includes only such companies, while running the regression. Companies having positive profitability but negative growth rates were also included in the sample. The regression on the restricted sample was run for the whole as well as each of the sub-periods separately. The relationship was tested only between post tax rate of return and growth. The results of the regression are given in Table No. 4.

**Table 4**

**REGRESSION RESULTS OF GROWTH ON POST-TAX RATE OF RETURN ON RESTRICTED SAMPLE**

| | | |
|---|---|---|
| **Whole period (1980/81 – 1989/90)** | | |
| All Companies (n = 19) | $G_{it} = 5.939 + 0.257\ P$ | $\bar{R}^2 = 0.002$ |
| | (0.22) | |
| Manufacturing Companies (n = 14) | $G_{it} = 3.463 + 0.353\ P^*$ | $\bar{R}^2 = 0.22$ |
| | (0.171) | |
| **Sub-period 1 (1980/81 – 1984/85)** | | |
| All Companies )n = 21) | $G_{it} = 8.847 + 0.085\ P$ | $\bar{R}^2 = -0.03$ |
| | (0.115) | |
| Manufacturing Companies (n = 13) | $G_{it} = 8.12 + 0.132\ P$ | $\bar{R}^2 = -0.1$ |
| | (0.087) | |
| **Sub-period 2 (1985/86 – 1989/90)** | | |
| All Companies (n = 18) | $G_{it} = 5.913 + 0.144\ P$ | $\bar{R}^2 = 0.03$ |
| | (0.201) | |
| Manufacturing Companies (n = 12) | $G_{it} = 5.425 + 0.026\ P$ | $\bar{R}^2 = -0.09$ |
| | (0.193) | |

Figures in the parentheses are standard errors

* Significant at 0.05 level.

The regression results in the above table reveal a positive relationship between profitability and growth in the Nepalese companies but this relationship, except in the case of manufacturing company sample during the 1980/81 – 1989/90 period, was rather insignificant despite the fact that these companies had positive post-tax rate of returns. The small $\bar{R}^2$ indicate that even in the companies having positive post-tax rate of return, profitability was not an important determinant of growth. A comparison of these results with those of Table 2 reveal no significant difference, except that the relationship was positive in both sample groups even in sub-period 1. This suggests that for Nepalese companies, whether profitable or not, growth is not a functions of profitability. Thus the null hypothesis that profitability and growth in the Nepalese companies are independent of each other is not rejected.

## Implications

As pointed out earlier, a close relationship between profitability and growth is expected because profits provide funds for a firm to grow either in form of retention and easier access to outside funds. In developing countries, profits are the main source of non-loan capital that allow expansion of firm without incurring increased owner's risk. So a close relationship between profitability and growth means that financial constraint on growth is predominant. On the contrary, if a firm's growth is dependent on market factors which are outside its own control, growth and profitability need not be closely related. The weak relationship between profitability and growth in the Nepalese companies indicates that growth of the Nepalese corporate sector is more constrained by market factors rather than by financial ones. This implies that policy makers in Nepal need to pay more attention to make market factors more conducive for the growth of the Nepalese corporate sector. This implication is important in the present context of rapid growth of financial sector in Nepal. It is necessary to realise that if the present growth of financial sector is not accompanied by adequate efforts to improve market factors, not only the financial sector will suffer but also the growth of the corporate sector will be impaired.

The weak relationship between profitability and growth also means that the business houses themselves tend to impose a limit on the amount of expansion undertaken because of the possible effects of business failure on the entrepreneurs total wealth, if a large amount of fund is invested in the firm. This is the Kaleckian concept of 'the principle of increasing risk". (Kalecki, 1937). Thus, a company in Nepal may not retain a large part of its profit in business, limiting thereby the firms growth. Thus, it is necessary that the policy makers consider this seriously and frame suitable policies that encourage the firms to re-invest its profits in business. In this context, the present policy relating to tax deduction on amount

reinvested, the methods of depreciation followed by firms, the treatment of capital gains and ordinary income should be reviewed.

The positive relationship between profitability and growth, albiet weak, does suggest that industrial concentration is likely to be increased as a result of large firms growing at a faster average rate than small firms. Although this tendency was not noticed markedly in the period between 1980/81 and 1989/90, policy makers need to have a surveillance on this tendency because growth with increased profitability often leads to increase in firms size which means more business concentration. This has become a matter of serious concern specially after the adoption the policy of economic liberalization and privatization by the government.

Higher growth of some firms despite their lower profitability reflects the flaws in the Nepalese financial system which is more bank-dominated than market - oriented. In Nepal the availability of bank loan to a firm is believed to depend more on personal relation between the owner/manager and the bank than on proper appraisal of the project for which loan is sought. In such a situation, it is not surprising that a firm despite being in red is able to obtain funds in the form of loan from banks. Most of the public sector companies in Nepal recorded high growth despite continuous loss because they were able to get subsidy from the government or obtain loan from banks under government guarantee.

## Conclusion

Although profitability in general is a major determinant of growth of firm, it was not found so in the process of corporate growth in Nepal. The corporate sector in Nepal has a very short history. One of the reasons for its tardy growth is that the Nepalese corporate sector in the past had never been able to generate internal funds adequate to finance its growth. It is, thus, necessary that serious attention be paid on creating a market environment which is conducive to corporate profitability and growth.

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