UNIT 6 SOURCES OF LONG-TERM FINANCE AND UNDERWRITING

Structure

6.0 Objectives
6.1 Introduction
6.2 Nature and Importance of Long-term Finance
6.3 Sources of Long-term Finance
6.3.1 Capital Market
6.3.2 Special Financial institutions
6.3.3 Leasing Companies
6.3.4 Foreign Sources
6.3.5 Retained Profits
6.4 Underwriting
6.5 Let Us Sum Up
6.6 Key Words
6.7 Some Useful Books
6.8 Answers to Check Your Progress
6.9 Terminal Questions

6.0 OBJECTIVES

After going through this Unit you will be able to':

- explain the nature and significance of long-term finance
- identify the various sources of long-term finance
- define underwriting
- explain the importance and limitations of underwriting
- recognise the legal restrictions on underwriting

6.1 INTRODUCTION

In Unit 5 you have learnt about the nature of financial needs of business and various methods of raising finance. You have also noted the distinction between long-term, medium-term and short-term finance. In this unit we shall examine in detail the nature and importance of long-term finance and the sources through which long-term finance may be raised by companies. We shall further discuss what is meant by underwriting, in what way it helps long-term financing, and the role of different agencies which undertake this function.

6.2 NATURE AND IMPORTANCE OF LONG-TERM FINANCE

You know every business unit requires some amount of money for investment in fixed assets besides the money required for day 'to day operations. The types of fixed assets required for business activities depends mainly upon the nature of business. For example, the fixed assets required by manufacturing companies generally include land and buildings, plant and machinery, furniture, etc. A trading company, on the other hand, may require'a godown, office-building, furniture and fixtures, etc. The proportion of capital to be invested in fixed assets is naturally more in the case of manufacturing companies than trading concerns.

Fixed assets are long-lived assets and, therefore, investment can be made only with long-term finance i.e., funds which will not have to be returned within five years. Actually, the useful life of assets like machinery and equipment, furniture and fixtures, etc. maybe 5 to 10 years. It may be as long as 50 years in-the case of steel plant, and more in the case of buildings. Hence, long-term finance is defined as finance required for a period of five years or more. As a result; profits earned on

long-term investment in fixed assets invariably extend over a long period in the future. In other words, long-term finance is associated with long-term return on the investment. Since the future is always uncertain, long-term finance must be invested with care and estimation of the future prospects of business. Particularly, investment in plant and machinery requires careful consideration of the possibility of changes in production techniques which may necessitate replacement of the existing plant'. Another implication of long-term investment is that decisions once made cannot be reversed at short intervals. For example, if a company has installed plant and machinery with a production capacity of 10 lakh tonnes of cement per year, it cannot reduce the size of the plant just because there is a decline in the demand for cement. Moreover, it may be economical and profitable to instal plant and machinery with large production capacity involving a correspondingly heavy investment. This is true of certain industries like iron and steel, cement, basic chemicals, engineering goods, etc. Even otherwise, large scale production always leads to lower cost of production per unit.

The importance of long-term finance, therefore, lies in its necessity for investment in fixed assets which is essential particularly for manufacturing activities. At the same time, long-term finance involves long-term commitment of funds which cannot be withdrawn at short notice. And larger the business greater is the need for long-term finance.

check Your Progress **A**

1. Fill in the blanks.
   i) Long-term finance is required for investment in ....
   ii) The need for long-term finance is relatively more in case of .... companies than in .... companies.
   iii) Long-term investment decisions cannot be .... at short notice.
   iv) Funds invested in fixed assets cannot be .... within a short period.
2. Which of the following statements are True and which are False?
   i) Long-term finance isgenerally required for a period of 20 years or more.
   ii) Fixed assets are long-lived assets.
   iii) Plant and machinery once installed must be used continuously till the same are completely worn out.
   iv) Long-term finance is required in all types of business activities — manufacturing, trading as well as transport business.
   v) The amount of long-term investment required depends upon the nature and size of the business-unit.

6.3 SOURCES OF LONG-TERM FINANCE

Funds required for investment in fixed assets'are mainly provided by the promoters in the case of proprietory and partnership business. Friends and relatives of the proprietor or partners may also make long-term investment in the business on the personal security of the promoters. However, if large amounts of funds are required for any business venture, the promoters generally set up a company. This is because in the case of a company, there is greater scope of raising finance from different sources. Generally speaking', long-term finance may be raised by companies from , one or more of the following sources:

1 Capital market which consists of individual investors, financial institutions and investment companies
2 Special financial institutions consisting of development banks and institutional investors
3 Leasing companies
4 Foreign sources
5 Retained profits

Let us examine how long-term finance may be procured from these sources.

6.3.1 Capital Market

The meaning of capital market is not the same as or similar to that of a market place where goods are bought and sold. Capital market actually denotes the arrangements whereby transactions of money capital (not capital goods) are facilitated. In other words, transactions involving procurement of funds and supply of funds which take place among individuals and various organisations may be regarded as the capital market. Thus, the capital market is not located in a particular place. Nor there are fixed categories of investors and dealers in the capital market, that is, those who supply funds and those who procure funds for investment.

You may have heard or read about another type of market in connection with business finance, known as the money market. Money market refers to transactions involving borrowing and lending of money for short periods for which again there is not definite place set aside in a town. Thus, we can say that money market is the market for short-term funds.

Sometimes the term 'money market' is used in a broad sense to include the markets for short-term as well as long-term funds. Strictly speaking, money market refers only to the market for short-term funds. This distinction helps us in understanding the nature of money transactions which take place for financing business activities. But there is a close relation between the capital market and the money market. The same institutions often deal in both the markets. Companies borrow money for capital purposes. Many financial institutions lend money for short periods as also long periods. Apart from having common links, the two markets are mutually interdependent. The relative demand and supply of funds in the two markets are determined by changes in the rates of interest on short-term funds compared to the expected yield on long-term funds. Thus, if there is increase in interest rate in the money market, one expects an increase in demand for funds in the capital market. Or, a rise in the expected yield in the capital market may lead to a rise in demand for funds in the money market.

You have learnt that transactions involving the procurement and supply of long-term funds take place in the capital market. You also know that companies raise funds by issuing shares and debentures of different types. Individuals and institutions which contribute to the share capital of a company become its shareholders. They are also known as members of the company. Share certificates are issued to them by the company bearing the company's seal and indicating the number of shares allotted to the holders of the certificates. Similarly, debentures are issued by companies to raise long-term loans. Debenture bonds are issued to those who subscribe to the loans.

When long-term capital is initially raised by new companies or by existing companies by issuing additional shares or debentures, the transactions are said to have taken place in the market for new capital. Those who deal in newly floated shares or debentures of companies become a part of the capital market known as the market for new capital or **New Issue Market.** 'As you know, shares and debentures issued by public limited companies are freely transferable. Buying and selling of shares and debentures already issued by companies take place in another type of market, known as the **stock exchange,** which is also a part of the capital market. You will learn in detail about stock exchanges in Unit 7.

The New Issue Market for raising capital consists of arrangements which facilitate the procurement of long-term finance by companies issuing shares and debentures. Shares are issued by companies before the commencement of business and, if necessary, subsequently for expansion of business. Before shares are issued, the directors of the company have to decide on the following matters: the amount of capital which is to be raised by issue of shares, the types of shares (preference shares, equity shares, or both) which will be issued, and the time of issuing shares. No company can raise share capital exceeding the amount of authorised capital mentioned in the Memorandum of Association. What part of the authorised capital should'be raised initially or at any other point of time depends upon the purpose for which funds are needed and the alternative sources of raising capital which may be available (like borrowing, for instance). Next, the directors must decide the type or types of shares to be issued. If both equity and preference shares are to be issued,

decisions have to be made as to the proportion in which they will be issued, the number and the face value of shares in each category and the rate of dividend on preference shares. The relative attractiveness of equity shares and preference shares is generally taken into account while deciding the above matters. The time of issue is decided by the directors taking into account the likely demand for shares in the capital market, the investors' mood, government policies with regard to money and credit control and taxation, as well as the prevailing business conditions. If it is desired that the shares to be issued should be listed in the stock exchange for official quotation, the directors must fulfil the conditions for that purpose.

Sometimes, the directors of a company along with their friends and relatives agree to take up a certain proportion of the shares. Similarly, the promoters may privately negotiate with Non-Resident Indians (Indians living abroad) and financial institutions to raise a part of the share capital. The arrangement whereby shares are, thus, decided to be allotted is known as private placement of shares. At the same time, the general public may be invited to subscribe to the share capital through advertisement and issue of prospectus. This is known as public issue of shares.

Where a company decides to issue additional shares at any time after two years of its formation or after one year of the first allotment of shares, whichever is earlier, it is required under law that such shares must be first offered to the existing shareholders of the company. If the offer is declined by the existing shareholders, only then the shares can be issued to the public. Such an issue is called 'rights issue' and these shares are known as 'right shares'.

Besides issuing shares, most companies also raise long-term loans by issuing debentures to the public. A public company can simultaneously issue shares and debentures immediately after its incorporation. The company's indebtedness is acknowledged in the debenture bonds issued to the subscribers. The terms and conditions relating to the issue are also specified in the debenture bond. Debentures are usually repayable after a specified period and carry a fixed rate of interest payable at regular intervals. The company creates a mortgage or charge on its assets to secure the issue of debentures. Although debentures are usually repayable after a fixed period, companies may also issue debentures which are convertible into equity shares after a certain period. Such debentures are known as 'convertible debentures'.

The issue of convertible debentures by a company, which has bright prospects, makes it more attractive for investors. The reason is that, investors as debenture holders enjoy a fixed interest income during the initial stage and, later on, as equity shareholders they become entitled to share in the prosperity of the company through high dividend income as well as increase in share prices. However, approval of the Central Government is required where the holders of debentures are given the option to convert or not to convert the debentures into shares.

Control of **Capital Issues:** To ensure that investment made by companies are in accordance with the national development plans, and not used for wasteful purposes, Government controls the issues of shares and debentures under the Capital Issues (Control) Act, 1947. Let us study the main points in this connection.

1 A company making public offer of shares and debentures must obtain the consent of the Controller of Capital Issues if the amount to be raised during a period of 12 months exceeds Rs. one crore. But public limited companies issuing shares (not debentures) are exempt from seeking consent provided the following conditions are Fulfilled:

a) The amount of debt (borrowings) of the company does not exceed twice that of the owners' investment (in the form of share capital and retained profits) i.e. the debt to equity ratio does not exceed 2:1.
b) The amount of equity (owners' investment) is less than three times that of preference share capital i.e. the equity-preference ratio is less than 3:1.
c) The rate of dividend on preference shares and interest on debentures do not exceed the maximum limit fixed from time to time by the Controller.
d) The shares issued to the public are eligible for being officially quoted on a recognised stock exchange.

2 Companies making fresh issue of shares (not debentures) are to file a statement of proposals for capital issue with the Controller at least 30 days before the date of the proposed offer of shares. The companies must also obtain a letter of acknowledgement from the Controller before making the public offer and make a statement to that effect in the prospectus or statement in lieu of prospectus.

3 Loans raised by companies from financial institutions do not require the Controller's approval.

4 Private limited companies are also subject to control over their capital issues if more than 20% of the amount is subscribed by one or more public limited companies, and the amount of capital issue involved exceeds Rs, one crore during a period of 12 months.

5 Companies must seek the consent of the Controller of Capital Issues for issue of debentures to the public.

6 The amount of debenture issue for working capital purposes is not to cxceed 20% of the gross current assets, loans and advances. For long-term investment projects, the amount will he considered on the basis of approval of the scheme of finance by the financial institutions or Government.

7 The debt-equity ratio, including the proposed debenture issue, must not cxceed 2:1. But this requirement may be relaxed in the case of industries like fertilisers, petrochemicals, cement, paper, shipping, etc., which require heavy investments.

8 The debentures shall carry rate of interest not exceeding the rate which may bc prescribed from time to time by the Controller.

Normally debentures shall not be redeemable before the expiry of the period of seven years. A company may have the option of redeeming the debentures from the fifth to the ninth year from the date of issue in such a way that the average period of redemption continues to be seven years. However, investors holding debentures of the face value of Rs. 5,000 or less must be paid in one instalment.

Check Your Progress B

1 Which of the following statements are True and which are False?

i) Companies can raise long-term finance from different sources.

ii) Public limited companies cannot issue shares and debentures simultaneously.

iii) There is no difference between the money market and capital rnarkct.

iv) The new Issue Market is a part of the capital markct.

v) If additional shares are issued by a company within two years of its formation, the shares must be offered only to the existing shareholders.

vi) All companies offering shares or tlebentures to the public must obtain the consent of the Controller of Capital Issues.

vii) The maximum rate of dividend which may be paid on preference shares is notified from time to time by the Controller.

viii) Debentures are permitted to be issued provided the debt-equity ratio does not exceed 2:1.

2 Fill in the blanks.

i) Loans raised by public limited companies from financial institutions do not require the consent of the ....

ii) .... funds are raised from the money market and .... funds from the capital market.

iii) Debentures are not normally redeemable before the expiry of .... years.

iv) Dehentures which can be exchanged for equity shares after a specified period are known as ....

v) When directors or their relatives and financial institutions agree to subscribe to a part of the share issue before they arc offered to the public, the arrangement is known as .... of shares.

vi) A public company can issue shares and debentures after its ....

3 Match the items in column A with those in column B.

Column A	Column B
1) New Issue Market	i) Existing shareholders
2) Issue of debentures	ii) 2:1
3) Right shares	iii) Fresh issue of shares and debentures
4) Capital market	iv) 3:1
5) Debt-equity ratio	v) Long-term funds
6) Equity-preference ratio	vi) Mortgage or charge on assets

6.3.2 Special Financial Institutions

After independence a large number of financial institutions have been established in India with the primary objective of providing long-term financial assistance to industrial enterprises. Some of these institutions have been set up on the initiative of the Central Government, while others have been set up in different states on the initiative of the concerned State Governments. Thus there are all-India institutions like Industrial Finance Corporation of India (IFCI), Industrial Credit and Investment Corporation of India (ICICT), Industrial Development Bank of India (IDBI), and Industrial Reconstruction Corporation of India (IRCI). They mainly provide long-term finance for large companies. On the other hand, at the state level there are State Financial Corporations (SFCs) and Industrial Development Corporations (SIDCs). These state level institutions mainly provide long-term finance to relatively smaller companies. These institutions (both national level and state level) are known as 'Development Banks' because their main objective is to provide financial assistance to industrial enterprises for investment projects, expansion or modernisation of plants in accordance with the priorities laid down in the Five Year Plans.

Besides the development banks, there are several other institutions known as investment companies or investment trusts which subscribe to the shares and debentures offered to the public by companies. For example, the Life Insurance Corporation of India (LIC), General Insurance Corporation of India (GIC), the Unit Trust of India (UTI), etc., come under this category. A brief account of the functions of some of these institutions is given in a subsequent section.

Now let us discuss about the functions of some of the major development banks and investment companies.

Development Banks

1 Industrial Finance Corporation of India (IFCI): This was set up in 1948 under the Industrial Finance Corporation Act, 1948. Its primary objective is to provide long-term and medium-term finance to large-scale industrial concerns particularly when bank loans were not suitable or funds could not be raised from the capital market by issue of shares. The IFCI deals only with industrial enterprises registered as limited companies or cooperative societies. Non-manufacturing concerns, private limited companies, partnership or sole traders cannot get assistance from this institution. It considers loan applications for amounts in excess of Rs. 30 lakh. It provides financial assistance for long-term investment in new industries or expansion or diversification of existing activities, or moderqisation and renovation of plant and equipment. The IFCI can grant loans or subscribe to debentures issued by companies repayable in not more than 25 years. It can also guarantee loans raised from other sources or debentures issued to the public. Further, companies can secure loans in foreign currency from the IFCI or get such loans guaranteed by the Corporation. IFCI takes up the underwriting of the public issue of shares and debentures by companies. You will learn in detail about 'underwriting' of shares and debentures later in this unit.

2 Industrial Credit and **Investment** Corporation of India **(ICICI):** It was incorporated under the Indian Companies Act in 1955. It provides financial assistance to companies in two ways: i) by providing long-term loans for a period upto 15 years, and ii) by subscribing to the shares and debentures issued by companies. However, proprietory and partnership concerns are also entitled to secure loans

from the ICICI. Loans are granted against proper securities. Like the IFCI, the ICICI also guarantees loans raised by companies from other sources, besides underwriting the issue of shares and debentures by companies. Foreign Currency Loans can also be secured by companies from the ICICI.

3 **Industrial Development Bank of India (IDBI):** This was set up by Government of India in 1964 and is a subsidiary of the Reserve Bank of India. It seeks to cover the gaps left by the various institutions in the field of industrial finance. The IDBI can provide financial assistance to all types of industrial enterprises which are registered under the Companies Act or any other law. There is no restriction on the types of finance and the amount of funds that may bc available from this institution. It has the unique role of not only providing financial assistance directly to industrial units, but also to refinance loans granted by other financial institutions. Further, it is required to coordinatc the functions of all development banks, scheduled commercial banks and state cooperative banks as regards industrial financing. Thus, the functions of thc IDBI include the following:

i) It refinances (a) term-loans to industrial concerns granted by IFCI and other financial institutions repayable between 3 and 25 years; (b) loans repayable between 3 and 10 years given by scheduled banks or state cooperative banks; (c) export credit granted by specified financial institutions maturing between 6 months and 10 years.

ii) It subscribes directly to the issue of shares and debentures made by industrial concerns.

iii) It grants loans and advances to companies repayable between 8 to 10 years.

iv) It guarantees loans raised by industrial concerns from the capital market or scheduled banks.

v) It accepts, discounts and rediscounts commercial bills of exchange and promissory notes of industrial enterprises.

vi) It undertakes underwriting of the public issue of shares and debentures made by companies.

vii) To meet the financial requirements of large enterprises, the IDBI also arranges joint financing by two or more financial institutions, particularly when the amount and the risk involved happen to be too heavy for any single institution to bear alone.

4 **State Financial Corporations (SFCs):** These institutions are set up in different states by the respective state governments under the provisions of the State Financial Corporation Act, 1951. All types of enterprises — proprietory and partnership concerns as well as limited companies — can seek financial assistance from the SFCs. The primary objective of these corporations is to accelerate the pace of industrial development in their respective states.

SFCs provide finances in the form of long-term loans or advances or through subscription of debenture issues repayable within 20 years. But the maximum amount of loan or advance granted to any single enterprise is not to exceed 10% of the paid up capital of the SFC or Rs. 10 lakhs, whichever is less. Loans raised by industrial concerns from other sources and repayable within 20 years can be guaranteed by the SFCs. SFCs also take up underwriting public issue of shares and debentures made by companies. They cannot directly subscribe to the shares issued by companies. If shares are required to be taken up as a result of the underwriting obligation, the same must be disposed of in the market within 7 years.

Investment Institutions

We have mentioned earlier about another category of institutions known as 'investment corporations' or 'investment trusts' or 'investment companies' which provide long-term finance. These institutions promote the savings habit among individuals and households with an assurance that the amount of savings entrusted to them would be invested in profitable channels and help in earning adequate return for the savers.

Investment Corporations: The most important investment corporations in India are: i) Life Insurance Corporation of India, and ii) General Insurance Corporation of

India. The Life Insurance Corporation of India (LIC) which undertakes life insurance business, guarantees payment of the amount of policy on the death of the insured person or on the expiry of a certain period. The amount of premium received from the policy-holders are invested by the LIC in different types of securities, e.g. Government bonds, shares and debentures of public limited companies, etc. Similarly, the General Insurance Corporation of India (GIC) invests its funds in Government securities, and shares and debentures of companies. As you know, the GIC undertakes general insurance business including fire, marine, accident, burglary and so on. Thus, the LIC and GIC may be regarded as sources of long-term finance for industrial enterprises.

Investment Companies: A number of investment companies registered under the Companies Act have been engaged in financing industrial concerns by subscribing to the shares and debentures of other companies. These investment companies issue their own shares and debentures to individuals, and borrow money from other institutions. The funds so raised are invested in the shares and debentures of other companies. Besides providing long term finance to industrial concerns, the investment companies also underwrite the issue of shares and debentures of other companies. However, financing of industrial companies by the investment companies is regulated by law (the Companies Act). They can invest in the shares of another company upto 10% of the subscribed capital of that other company, and the aggregate of investments made in all other companies should not exceed 30% of the subscribed capital of the investing company. Some of the well-known investment companies in India are: Investment Corporation of India Ltd., Sri Ram Investment Co. Ltd., Eastern Investment Ltd.. Shree Sun Investment and Trading Co. Ltd., Shree Rishav Investment Co. Ltd., etc.

Investment Trusts: Another category of investment institutions which provide long-term finance to companies is investment trusts. Investment trusts specifically refer to those investment companies which are established for the investment of funds obtained from individuals and institutions. The investors receive shares (or units) issued by the investment trusts. These investment trusts are also known as Unit Trusts. The Unit Trust of India (UTI) is the largest organisation of this type in our country. The UTI was set up under the Unit Trust Act of 1962, and started its operation in 1964. Its initial capital was subscribed by the Reserve Bank of India, LIC, State Bank of India and other financial institutions. Let us try to understand the working of the UTI in some more detail.

Briefly speaking, the UTI invests its funds in shares and debentures of different companies. The securities (shares and debentures) are held in trust by the management. Based on the value of the securities, the management offers 'units' to the public. Each unit having a specified face value is a kind of certificate of participation in the 'unit scheme'. Individuals can buy and sell units at any time. The management receives interest and dividend on the debentures and shares held by them. The income so realised is distributed among the unit-holders in proportion to the value of their holdings. Thus, small savers find it convenient to buy units with an assurance that the UTI will invest the savings in profitable companies, and give them a reasonable return by way of dividend on value of units. On the other hand, the investible funds of the UTI are available to industrial enterprises. You will study the working of financial institutions in detail in another course.

6.3.3 Leasing Companies

Manufacturing companies can secure long-term funds from leasing companies. For this purpose a lease agreement is made whereby plant and machinery and fixed assets may be purchased by the leasing company and allowed to be used by the manufacturing concern for a specified period on payment of an annual rental. At the end of the period the manufacturing company (lessee) may have the option of purchasing the asset at a reduced price. The ownership of the asset remains with the leasing company (lessor) during the lease period. To meet its financial requirements, a manufacturing company may also sell its existing fixed assets to a leasing company at the current market price on the condition that the leasing company would lease the assets back to the seller for a specified period. Such an arrangement is known as 'sale and lease back'. The manufacturing company in this case gets the fund

immediately without having to part with the physical possession of the assets. It continues to use the assets on payment of periodical rent for the lease. In any type of lease agreement, the lease rent includes an element of interest besides expenses and profits of the leasing company. Actually, the leasing company makes an investment of its own funds and must earn an income as a return on its investment through the lease rents.

6.3.4 Foreign Sources

Funds can also be collected from foreign sources which usually consist of:i) foreign collaborator, ii) international financial institutions, and iii) non-resident Indians (NRIs)

Foreign Collaborators: If approved by the Government of India, large companies may be able to secure long term finance on the basis of collaboration agreements with companies abroad. Foreign collaboration may, thus, enable Indian companies to secure equity capital from abroad through the subscription of foreign collaborator to their share capital, or by way of supply of technical knowledge, patents, drawings and designs of plants or supply of machinery.

International Financial **Institutions:** There are a number of international financial institutions which provide long-term funds for industrial development all over the world. The most important among them are: i) The World Bank, and ii) International Finance Corporation.

The World Bank grants loans for specific industrial projects of high priority included in the national development plan. The loans have to be guaranteed by the Government of India, and may be given directly to an industrial concern, or through a Government agency, or may be given to the IOBI for refinancing to companies.

The International Finance Corporation (IFC) was established in 1956. It is an affiliate of the World Bank. As you know the World Bank grants loans only to governments of member-countries or private enterprises with guarantee of the concerned government and it does not provide risk capital to enterprises in member-countries. IFC was set up to assist the private undertakings without the guarantee of the member-countries. It also provides them risk capital. IFC grants loans to industrial firms for a period of 8 to 10 years. Such loans do not require Government guarantee. Industrial concerns with investment plans drawn in accordance with the priority laid down under the national development plans can secure long-term loans from the IFC. But the corporation considers loan applications involving large amounts of about $100,000 or more from organisations having total assets of the value of at least $500,000.

Non-resident Indians: Persons of Indian origin and nationality living abroad (Non-resident Indians) are also permitted to subscribe to the shares and debentures issued by companies in India. A non-resident or a company controlled by a non-resident can invest upto a maximum of 5% of the paid up equity capital of an Indian company. New issues of shares or debentures by an industrial company can be subscribed by non-resident Indians to the extent of 40% of the new issue subject to a quantity ceiling of Rs. 40 lakh if the non-resident wants to have the option of repatriating the investment i.e. sell the shares and debentures and get the amount remitted abroad. However, exceptions are allowed in the case of priority industries like industrial machinery, scientific instruments, fertilisers, chemicals, drugs, export industry, hotels, etc.

6.3.5 Retained Profits

An important source of long-term finance for ongoing profitable companies is the amount of profit which is accumulated as general reserve from year to year. To the extent profits are not distributed as dividend to the shareholders, the retained amount can be reinvested for expansion or diversification of business activities. It can also be used for renovation of assets or modernisation of plant and equipment. It may be interpreted that the existing shareholders provide the finance. Hence, the company must decide to reinvest profits only when the rate of return is comparable with that of other similar companies. Moreover, a part of the profits must be

distributed as dividend keeping in mind shareholders' expectation and the effect of dividend rate on the market price of shares. Retained profit is an internal source of finance. Hence it does not involve any cost of floatation which has to be incurred to raise finance from external sources. Further, the company does not have to face the uncertainties of external financing. The only drawback of this source of long-term finance is that it depends on the availability of adequate profits for retention.

Look at Figure 6.1. It shows various sources through which companies raise long-term finance.

Check Your Progress **C**

1 Fill in the blanks with appropriate words.

i) IFCI is a .... bank.

ii) Companies can seek loans from the IFCI which are repayable in not more than .... years.

iii) Long-term loans are granted by ICICI for a period upto .... years.

iv) IDBI .... long-term loans granted to companies by other development banks.

v) The maximum amount of loan which a company can obtain from any SFC is Rs. .... lakhs or .... % of the paid up capital of .... whichever is less.

2 Which of the following statements are True and which are False?

i) LIC is an investment trust.

ii) UTI can invest its funds in shares and debentures of companies.

iii) An industrial concern can raise long-term finance from an investment company upto 20% of its subscribed capital.

iv) A partnership firm can get loans sanctioned by the IFCI.

v) SFCs grant loans to companies as well as proprietory and partnership concerns.

vi) Units issued by UTI can be purchased any time by the public at face value.

vii) Development banks are just like commercial banks.

viii) Companies can raise funds by issuing shares to investment companies.

3 Which of the following statements are True or False?

i) 'Sale and lease back' is based on an agreement between leasing company and a manufacturing concern.

ii) Assets which are used for sometime on lease must be invariably returned to the leasing company at the end of the lease period.

iii) Foreign companies can never subscribe to the issue of shares in India.

iv) The World Bank can give Ioans directly to an industrial firm without Government guarantee of its repayment.

v) The International Finance Corporation grants loans for a period of twenty years.

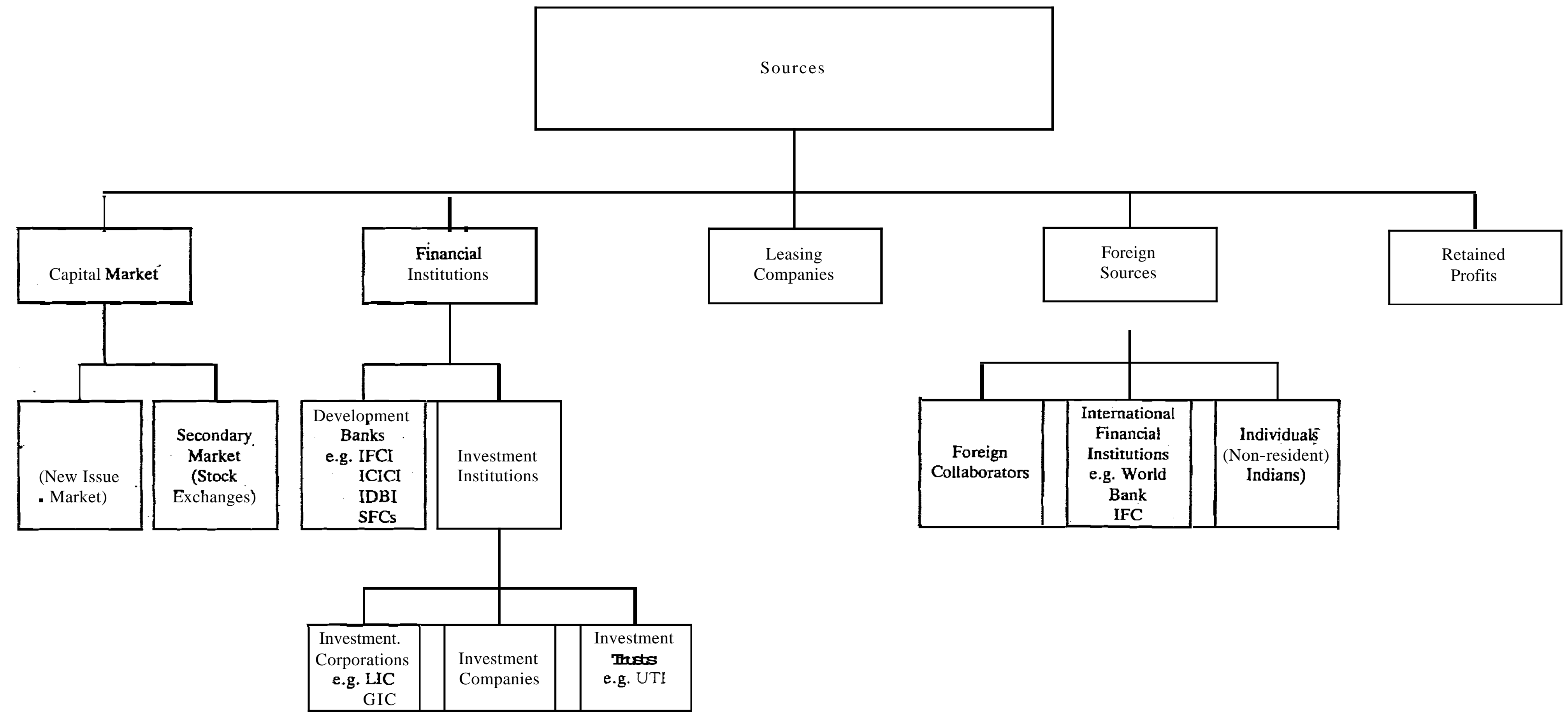
vi) Non-resident Indians can subscribe to the new issue of shares upto a maximum of 10% of the paid up equity capital of a company,

vii) A company need not pay dividend out of profits if the whole amount of profit can be reinvested for the expansion of business to earn higher level of profits.

6.4 UNDERWRITING

We have already mentioned that development banks and financial institutions **underwrite** the issue of shares and debentures of public limited companies. Besides, investment trusts, stock-brokers. issue houses and other similar organisations also underwrite the public issue of shares and debentures. Those who underwrite security issues are known as **Underwriters.** Let us study in detail about underwriting.

Figure 6.1 : Sources of Long-term Finance



What is Underwriting?

Before issuing the prospectus inviting public subscription for shares and debentures, the promoters of a company generally make arrangements whereby public response to the issue may be encouraging. Otherwise, the promoters cannot be sure that the shares or debentures would be fully or substantially subscribed by the public and necessary finance would be available. Similarly, when any existing company decides to raise additional finance by issuing shares or debentures, it has to be reasonably sure that there is adequate response to the issue.

Underwriting refers to an agreement between the promoters or directors of a company on the one hand, and an individual, firm or institution (known as underwriter) on the other, whereby the latter agrees to take up the whole or part of the shares or debentures issued which may not be subscribed by the public. In consideration of the undertaking given by the underwriter, the company agrees to pay a commission which is known as 'underwriting commission'. The commission agreed upon is generally a percentage of the issue price of the shares or debentures underwritten.

Terms and Conditions of Underwriting

There is a written agreement between the company and the underwriter known as the 'Underwriting Agreement' (or Contract). Usually the following aspects are specified in this agreement.

i) The number of shares or debentures which are agreed to be underwritten.
ii) An undertaking by the underwriters to take up such of the shares or debentures as are not subscribed by the public.
iii) An undertaking by the company that the terms of issue given in the prospectus will not be changed without the consent of underwriters.
iv) Authority of the underwriters to the company to allot them the balance of shares or debentures not taken up by the public.
v) The rate of commission to be paid to the underwriters and the mode of payment.

The commission is payable as a percentage of the issue price of all the shares or debentures even if the issue is fully subscribed by the public.

Sometimes the underwriters want to subscribe to a block of shares or debentures even if the total issue is fully subscribed by the public. This is known as 'firm offer'. A clause to that effect is then included in the underwriting agreement. Thereby the underwriters are assured of allotment of the block of shares or debentures specified for which they have made a firm offer.

Legal Regulations

Regarding payment of underwriting commission, certain legal requirements, as prescribed under the Companies Act, must be fulfilled by the company. First, the payment of the commission must have been authorised by the Articles of Association of the company. Secondly, the commission agreed to be paid must not exceed 5% of the issue price of shares, and in the case of debentures it must not exceed 2.5% of the issue price. The amount or rate of commission agreed to be paid must be disclosed in the prospectus or statement in lieu of prospectus. The commission may be paid out of capital or out of profits.

Advantages and Limitations of Underwriting

To the promoters of a company the most important advantage of underwriting is that the funds required for the enterprise become available whether or not there is adequate public response to the issue of shares and debentures. The underwriters ensure the availability of finance. A new company has to invariably enter into various contracts with different parties for purchase of fixed assets and other arrangements, before the commencement of business. The promoters can confidently proceed with the preliminary steps after the underwriting agreement. They do not have to wait for the public response and actual subscription to the issue of shares and debentures. Thus, precious time may be saved and business activities started on a sound basis as a result of underwriting.

Another advantage of underwriting is that the company gets the benefit of expert advice from the underwriters. Every underwriter, before entering into an

agreement, carefully examines the scheme of financing the business ventures prepared by the company. The underwriter signs the contract only when the scheme is sound. While examining the scheme, the underwriter may suggest improvements in the scheme and thus enable the company to avoid future setbacks. If a reputed firm has underwritten the issue of shares or debentures, it creates confidence in the public and helps the company to raise the necessary amount of finance from the public.

Underwriters usually have working arrangement with brokers and agents who secure public subscription on behalf of the company and earn commission for their services. Thus, public response to the issue of shares and debentures is not restricted to any particular area but secured from different areas. Members of the public who intend to invest their savings are also benefited as a result of underwriting of shares and debentures offered by a company. It is expected that the underwriters must have fully satisfied themselves about the soundness of the issue before underwriting the same. Hence, an investor runs much less risk when he subscribes to the issue which has been underwritten than otherwise.

The only disadvantage of underwriting is that it adds to the cost of raising finance. Thus, the rate of return on investment proposed to be made with the funds raised must be sufficiently high so as to absorb the additional cost of floating shares and debentures. But the significance of underwriting arrangement is such that even well-established profitable companies cannot avoid it while issuing additional shares or deberitures to the public. Smaller companies often find the cost involved quite heavy.

Underwriting Agencies and Institutions

We have stated before that any individual, partnership firm, company or financial institution may become an underwriter. They may be regarded as underwriting agencies or institutions. In India, the development banks, commercial banks, investment companies, investment trusts and stock brokers (share brokers) engage in underwriting business. Some of the well-known underwriting agencies in India are given below.

1	Development banks	IFCI, IDBI, ICICI, SFCs
2	Investment Institutions	LIC, GIC, UTI and Investment Companies
3	Commercial Banks	State Bank of India, Central Bank, Bank of India, Bank of Baroda, etc.
4	Others	Stock brokers and financiers like the Firm of Place, Siddens and Gough, etc.

Check Your Progress D

Put a tick mark against the appropriate answer.

a) Underwriting means

   i) promise to buy shares.
   ii) promise to buy debentures.
   iii) assuring public subscription to the issue of shares.
   iv) undertaking to subscribe to shares or debentures if public subscription is not adequate.

b) Underwriting commission is payable as a percentage of

   i) the face value of shares.
   ii) the market price of shares.
   iii) value of shares subscribed by the public.
   iv) issue price of all the shares offered to the public.

c) A company can pay underwriting commission upto a maximum rate of

   i) 2% on shares underwritten,
   ii) 4% on shares underwritten.
   iii) 5% on shares underwritten,

iv) 7.5% on shares underwritten.

d) Payment of underwriting commission must be authorised by

i) Board of Directors.
ii) Articles of Association.
iiif Memorandum of Association.
iv) Managing Director of the Company.

6.5 LET US SUM UP

Investment in fixed assets can be made only with long-term finance. The need for long-term finance is more in the case of manufacturing concerns. Public limited companies can raise long-term funds on a much larger scale than other forms of organisation. Companies can procure long-term finance from capital market, special financial institutions, leasing companies, foreign sources as also through retention of profits.

Capital market denotes transactions involving procurement and supply of long-term funds which take place among individuals and institutions.

Long-term capital which is raised by companies by issue of shares and debentures also involves transactions. Dealings in such newly floated shares and debentures of companies form a section of the capital market known as 'new issue market'. The arrangement whereby shares or debentures are decided to be allotted to friends and relatives of directors or promoters, or through private negotiation with investors is known as 'private placement'.

A company making public offer of shares and debentures must obtain prior consent of the Controller of Capital Issues if the amount to be raised during one year exceeds Rs. one crore. But public limited companies issuing shares are exempt from seeking consent provided certain conditions are satisfied. But companies must seek the consent of the Controller for issue of debentures to the public. Loans raised from financial institutions do not require the Controller's approval.

There are a number of special financial institutions at national level and state level — IFCI, ICICI, IDBI, IRCI — which provide long-term financial assistance to business enterprises. These institutions are known as development banks. Several other types of institutions known as 'investment companies' or 'investment trusts' also subscribe to the shares and debentures issued by companies. These development banks and investment institutions, besides giving loans to industrial enterprises, also guarantee loans and underwrite shares and debentures issued by such companies.

Assets may be acquired by companies for use under 'lease agreement' with any leasing company. Leasing companies invest funds in assets and charges rental from the user companies. Long-term finance is sometimes available to large industrial concerns through collaboration with foreign companies or from the World Bank or International Finance Corporation, subject to the approval of the Government of India. Non-resident Indians can also subscribe to the shares and debentures issued by companies in India subject to certain restrictions. To the extent profits are not distributed as dividends, the retained amount becomes a source of long-term finance for companies.

Underwriting of securities refers to an agreement between the promoters or directors of a company and another party (the underwriter) whereby the latter agree to take up the whole or part of the shares or debentures issued which may not be subscribed by the public. The company agrees to pay commission at an agreed rate to the underwriter subject to the maximum rate laid down in the Companies Act.

Companies are assured of the availability of finance by virtue of the underwriting agreement. Companies sometimes get the benefit of expert advice from the underwriters. Since the underwriters fully satisfy themselves about the soundness of the company which'is raising the capital, investors run less risk when they subscribe

to the issues which have been underwritten. The disadvantage of underwriting is that it adds to the cost of raising finance. In India, the development banks, commercial banks, investment companies as well as stock-brokers (share brokers) engage in underwriting business.

6.6 KEY WORDS

Capital Market: The transactions through which long-term funds are procured by companies and supplied by investors. This is the market for long-term capital.

Convertible Debentures: Debentures issued initially to raise loans but subsequently convertible into equity shares.

Development Banks: Financial institutions which provide long and medium-term finance to entrepreneurs and organisations so that funds are invested in industrial ventures which are in conformity with national development plans,

Investment Institutions: Financial institutions which promote the saving habits of people with an assurance that the savings entrusted to them would be invested in profitable channels and help in earning adequate return for the saving public.

Investment Trust: Investment company which raises funds from the public for investment in profitable securities against which its own shares (or units) are issued to the public which can be encashed at any time at their underlying asset value.

Money Market: Market for short-term capital involving borrowing and lending of money for short periods.

New Issue Market: Arrangements which facilitate issue of shares and debentures by companies.

Private Placement: Shares and debentures decided to be allotted through private negotiation before offering them for public subscription.

Retained Profits: Amount of profits which is not distributed as dividend to shareholders.

Special Financial Institutions: Financial institutions set up for long-term financial assistance to industrial enterprises.

Underwriting: Agreement whereby the underwriter agrees to take up the shares or debentures issued by a company to the extent they are not subscribed by the public on payment of a commission known as 'underwriting commission'.

6.7 SOME USEFUL BOOKS

Bhushan Y.K. 1987. ***Fundamentals of Business Organisation & Management,*** Sultan Chand & Sons: New Delhi. (Part Eight, chapters 2 & 3)

Musselman, Vernon A., and John H. Jackson, 1985. ***Introduction to Modern Business,*** Prentice-Hall of India: New Delhi. (chapter 14)

Ramesh M.S., 1985. ***Principles and Practice of Business Organisation, Administration & Management,*** Kalyani Publishers: New Delhi. (Volume III chapters 15–17)

Singh, B.P., and T.N. Chhabra, 1988. ***Business Organisation and Management,*** Kitab Mahal: Allahabad. (Section Five, chapters 17–19).

6.8 ANSWERS TO CHECK YOUR PROGRESS

A 1 i) fixed assets ii) public, private
iii) reversed iv) withdrawn

2 i) False ii) True iii) False iv) True v) True

B 1 i) True ii) False iii) False iv) True v) False
vi) False vii) True viii) True

2 i) Controller of Capital Issues
ii) Short-term, long-term
iii) seven
iv) convertible debentures
v) private placement
vi) incorporation

3 i) iii ii) vi iii) i iv) v
v) ii vi) iv

C 1 i) development ii) 25 iii) 15 iv) refinances v) 10, 10, SFC

2 i) False ii) True iii) False iv) False
v) True vi) True vii) False viii) True

3 i) True ii) False iii) False iv) False
v) False vi) False vii) False

D a) iv b) iv c) iii d) ii

6.9 TERMINAL QUESTIONS

1 Briefly explain the meaning of: (a) Money Market, (b) Capital Market. and (c) New Issue Market.

2 Mention the sources from which companies may raise long-term finance. Distinguish between investment companies and investment trusts as sources of long-term finance.

3 What is meant by private placement of shares? Is private placement possible for debentures also?

4 Is it compulsory to seek the consent of the Controller of Capital Issues before offering shares and debentures to the public? What are the conditions to be fulfilled if a company wants to issue debentures to the public?

5 What do you understand by the term development bank? State the functions of two all-India development banks.

6 State briefly the functions of the Unit Trust of India.

7 What is a leasing company? How can a company secure long-term finance through a leasing company? What do you undetstand by 'sale and lease back'?

8 Write explanatory notes on the following;
a) Retained profits as a source of long-term finance.
b) Foreign sources of long-term finance.
c) Restrictions on investment in shares by non-resident Indians,

9 What is meant by 'Underwriting' of shares and debentures? How does it help companies in raising Iong-term finance? Discuss briefly the terms and conditions relating to underwriting of shares and debentures.

10 A public company issuing debentures and shares has entered into an underwriting agreement with IFCI. The agreement covers the issue of 1,00,000 equity shares of Rs. 10 each and 50,000 debentures of Rs. 100 each. Underwriting commission is payable at the maximum rate allowed under the ,Companies Act, Public Subscription has been secured for 70,000 shares and 40,000 debentures. The balance of shares and debentures are taken up by the underwriters. Calculate the amount of underwriting commission to be paid.

Note: These questions will help you to understand the unit better. Try to write answers for them. But do not send your answers to the university. These are for your practice.

UNIT 7 STOCK EXCHANGES

Structure

7.0 Objectives
7.1 Introduction
7.2 What is a Stock Exchange?
7.3 Functions of Stock Exchanges
7.4 Method of Trading on a Stock Exchange
7.5 Types of Dealings in a Stock Exchange
7.6 Some Important Terms
7.7 Listing of Securities on a Stock Exchange
7.8 Speculation and Stock Exchange
7.9 Factors Affecting Prices in a Stock Exchange
7.10 Advantages and Shortcomings
7.10.1 Advantages
7.10.2 Shortcomings
7.11 Regulation and Control of Stock Exchanges
7.12 Let Us Sum Up
7.13 Key Words
7.14 Some Useful Books
7.15 Answers to Check Your Progress
7.16 Terminal Questions

7.0 OBJECTIVES

After studying this unit, you should be able to:

- explain the meaning and importance of stock exchange
- state the economic functions of stock exchanges
- explain the method of trading on a stock exchange
- describe the terms used and types of dealings conducted at the stock exchanges
- describe the importance of listing
- explain the meaning of speculation
- identify the factors responsible for fluctuations in the prices of securities at the stock exchanges
- enumerate the advantages and shortcomings of stock exchanges
- appreciate the need to regulate and control stock exchanges
- explain the provisions of the Securities Contracts (Regulation) Act, 1956.

7.1 INTRODUCTION

In Units 5 and 6 you have learnt about the need for capital and the sources of short-term and long-term finance. You also know that companies raise capital by issuing shares or debentures known as corporate securities. Like companies, the central and state governments alsp issue bonds or instruments known as government securities to raise funds from the public. So do various other authorities like Port Trusts, Municipalities and public undertakings. Most investors hold securities to earn income by way of interest or dividend. But many of them might decide to sell them either to meet their urgent financial needs or to reinvest those funds in some other securities with a promise of better income. Similarly, people with accumulated savings or the institutions having surplus funds may also like to invest their funds in various securites.

If some investor wants to sell securities, he has to find another person who is interested to buy. But it is not easy to find ready buyers. Even if he finds one, the buyer may take advantage of the seller's urgency to sell and offer a lower price. A similar problem may be faced by a buyer also. Buyer may not be able to find a ready seller. Even if he finds, the seller may quote a high price knowing the buyer's eagerness to invest. Thus, both buyers and sellers have problems of identifying each