

---

## UNIT 3 SOURCES AND METHODS OF RAISING CAPITAL

---

### Objectives:

After studying this Unit you should be able to:

- Identify the various sources of funding/capital;
- Understand the benefits and the drawbacks of the different Sources of Capital raising;
- Explain raising of capital from International sources

### Structure

- 3.1 Introduction
- 3.2 Need for Capital
- 3.3 Primary Markets
- 3.4 Types of Issues in Primary Markets
- 3.5 Characteristics of Primary Markets
- 3.6 Factors affecting Primary Markets
- 3.7 Equity Capital
- 3.8 Debt Capital
- 3.9 Equity Market Vs. Debt Market
- 3.10 Advantages/Disadvantages of Sourcing Capital through Different Means
- 3.11 Raising Equity Capital in International Markets
- 3.12 Recent Trends
- 3.13 Summary
- 3.14 Self Assessment Questions
- 3.15 Further Readings

---

### 3.1 INTRODUCTION

---

Organisations need capital or funds to make them functional and carry out their operations. Without capital no organization can be formed or perform its functions. The capital required by the organizations can be raised mainly from two sources, viz.; **Internal sources** and **External sources**. **Retained earnings** is the main source of internal funds, whereas, **Equity** and **Debt** are the important source of external funds.

The wealth that is invested in a company, whether in the form of money or other assets, is referred to as capital. The generation of additional income is the primary objective of this strategy. It is an essential component of commercial enterprises. It ensures that corporate operations run efficiently and makes a positive contribution to the overall economy of the country. In order to maintain their day-to-day operations, businesses rely on a variety of

financial structures, including Equity Capital, Loan Capital, and Working Capital. In addition, a company's capital and its capital assets are major factors in determining its net value.

The term "capital" most commonly refers to monetary holdings, such as savings accounts and money obtained through specialised financing channels. Further, capital refers to the assets of a firm that are used for the purpose of providing financing for day-to-day operations, expansion, and development. Capital can be maintained in the form of financial assets, obtained through **Equity Financing**, or **Debt Financing**, or **both**.

#### **A. Equity Capital**

The term "equity capital" refers to the financial resources that a business acquires from its current and potential owners as well as other shareholders in exchange for a percentage of the ownership in the business. Once these funds have been invested, they are subject to risk due to the fact that investors will not be repaid in the event that a corporate liquidation occurs until after the claims of all other creditors have first been settled. Shareholders are the owners of a company, which means they provide the company with capital, assume some of the company's risks, and either directly or indirectly controls the company. The amount of capital that a newly created company is allowed to raise from its shareholders is specified in the company's Memorandum of Association during the formation process. This type of capital is known as 'authorized capital'. Equity capital is raised from the Primary Markets in different forms.

#### **B. Debt Capital**

A firm can acquire debt capital by taking loans from financial institutions or investors and agreeing to make interest payments on those loans. Debt capital is a crucial source of finance for organizations, and it may be put to a variety of uses, including growth, acquisition, and for financing working capital needs. Debt capital is distinct from equity or share capital. The subscribers to debt capital do not become part owners of the business; rather, they are merely creditors. The providers of debt capital typically receive a contractually fixed annual percentage return on their loan. This rate of return is referred to as the 'Coupon Rate'.

#### **C. Retained Earnings**

The percentage of net income that is still in the possession of the company after it has been distributed as dividends to its shareholders is referred to as '**Retained Earnings**'. That is the amount of the company's residual net income that does not get paid out as dividends but is instead reinvested or "ploughed back" into the business. Any company's retained earnings serve as an important source of self-financing or internal financing. Earnings that are retained can be used to pay off external debt, fund for additional assets, growth and expansion of firm. Retained earnings is a convenient and cost-effective source of internal financing.

The funds raised from the above sources may be used for either short-term purpose, like working capital needs, or for long-term purposes, like buying of Machinery. Judicious mix of the above sources of financing constitutes the firm's capital structure. The Managements of companies design their capital structures to strike a balance between the risks and costs that are associated with the company.

---

## 3.2 NEED FOR CAPITAL

---

The capital sourced from the primary markets may be used by the issuers for development of existing or new businesses; modernization, expansion or diversification.

**Expansion:** Investment in fixed assets resulting in increase in the installed capacity of its existing products.

**Diversification:** Creation of production capacity of items not being now manufactured by the unit, without reducing the installed capacity of existing items.

**Modernization:** Technological up-gradation of the production process of the firm.

---

## 3.3 PRIMARY MARKETS

---

Primary market is a market for issue of new instruments or financial claims. This is the reason for Primary Markets to also be known as the "New Issues Market". Primary market is the largest source of raising Capital. The market facilitates generation of fresh capital by issuing securities such as equity shares, preference shares, debentures, Government Securities, Corporate Bonds, etc.

Funds are mobilized in the primary markets by the Central and the State Governments, Public Sector Enterprises, Banks, Financial Institutions, and non-Government Public Limited Companies (Private Sector). These entities issue new securities periodically, to raise funds in order to meet their financial requirements. These new issues are floated through Prospectus, Rights, and Private Placement. We shall discuss the meaning and significance of these terminology with specific reference to the sources and methods of raising capital in this Unit.

Primarily, issues made by an Indian company can be classified as Public, Rights, Bonus, and Private Placement.

---

## 3.4 TYPES OF ISSUES IN PRIMARY MARKETS

---

When an Issue/Offer of securities is made to new Investors for becoming part of shareholders' family of the Issuer, it is called a **Public Issue**. Public issues can be further classified as Initial Public Offer (IPO) and Further Public Offer (FPO). When an unlisted company makes either a fresh issue of securities or offers its existing securities for sale or both for the first time to the public, it is called an **Initial Public Offering** or an IPO. This enables listing and trading of the issuer's securities in the Stock Exchanges. When an already

listed company makes either a fresh issue of securities to the public or an offer for sale to the public, it is called a **Further Public Offer** (FPO) or Follow on Offer.

When an issue of securities is made by an issuer to its shareholders existing as on a particular date fixed by the issuer (i.e., record date), it is called a **Rights Issue**. The rights are offered in a particular ratio to the number of securities held as on the record date.

When an issuer makes an issue of securities to its existing shareholders as on a record date, without any consideration from them, it is called a **Bonus Issue**. The shares are issued out of the company's free reserve or share premium account in a particular ratio to the number of securities held on a record date.

When an issuer makes an issue of securities to a select group of persons, which is neither a rights issue nor a public issue, it is called a **Private Placement**. Private placement of shares or convertible securities by listed issuer can be of two types, namely, Preferential Allotment and Qualified Institutional Placement (QIP). When a listed issuer issues shares or convertible securities, to a select group of persons, it is called a **Preferential Issue**. The issuer is required to comply with various SEBI guidelines which inter alia include pricing, disclosures in the notice, lock-in, etc. in addition to the requirements specified in the Companies Act. Alternatively, when a listed issuer issues equity shares or securities convertible in to equity shares to Qualified Institutional Buyers, it is called a **Qualified Institutional Placement**.

From the above discussion the types of issues in the primary markets can be summarised as:

- a) Public Issue
  - i) Initial Public Offer (IPO)
  - ii) Follow on Public Offer (FPO)
- b) Rights Issue
- c) Bonus Issue
- d) Private Placement
  - i) Preferential Issue
  - ii) Qualified Institutional Placement

While Right Issues by a listed company and Public Issues involve a detailed procedure, Bonus Issues and Private Placements are relatively simpler.

---

### **3.5 CHARACTERISTICS OF PRIMARY MARKETS**

---

Primary Markets enable efficient allocation of resources between companies seeking funds and investors having surplus funds. The existence of regulatory mechanism ensures that all participants in the primary markets are on a level platform, and to ensure fairness and integrity. This increases confidence in

the entire market. Primary market participants such as Issuing Company, Merchant Bankers, Underwriters, Brokers and Investors need to adhere to regulatory compliance requirements. This also avoids manipulation in the market. The pricing of shares is also transparent, due to the processes such as Book Building Method followed in the markets.

Following is a brief discussion on each of these features of the Primary Markets in India:

**1) Allocation of Resources between Companies and Investors:**

The flow of funds moves from Investors (lenders) to Corporates (borrowers) directly or indirectly (through financial institutions). Thus, Primary markets play a significant role in the allocation of the economy's savings in efficient production of goods and services. Economic development and growth of an economy can be achieved through savings and investment. The pace of economic development depends upon the rate of long term investment and capital formation in a country. Primary market also enables saving of funds (by investors) to transmit into long term investments by deficit units (by corporates).

**2) Existence of Regulatory Mechanism:**

Primary markets should be governed by a strong regulatory mechanism to protect the investors, to stabilize the internal management of financial institutions, and to create/strengthen the structure of the financial markets. Investors should be protected from malpractices and frauds in the primary markets. The regulations also ensure institutions, the freedom of operation to improve the efficiency and provide innovative financial instruments and processes that benefit the investors and other participants. The regulations must aim to ensure the soundness and safety of financial institutions and the market. Thus, existence of regulations enhances credibility and confidence among market participants.

**3) Existence of Price for the Securities issued:**

Companies need to price the shares based on their interactions with the investor community. The existence of competition in the market force companies to price the shares, based on the expected returns of the investors. This is known as '*Price Discovery Process*'. This price discovery mechanism helps allocation of funds to the most productive uses at a lowest cost. While considering investors' expectations, companies consider their future growth prospects as well.

**4) Existence of Investors and Companies:**

This feature is most important for the existence of primary markets. Historically, it has been noticed that the number of companies raising funds increases during bull phases. Bull phases are accompanied by economic development. Hence, a company's fund requirements increase during periods of economic growth development. Another advantage of raising funds during bull phases is availability of liquidity. Liquidity is governed by the surplus funds available with Financial Institutions,

Corporate and the Public at large. Primary Market has tremendous scope and potential in a growing economy. Primary market is also governed by the volume of trading in secondary markets. A liquid secondary market can ensure that investors can sell the shares for meeting capital requirements. Liquidity in the market is a function of the number of buyers and sellers eager to trade the equity shares. During the bear market, reverse is usually observed. There is less liquidity in the secondary markets, less economic development, lower requirement for investments and lack of surplus funds available in the market. Hence, primary market is usually not active in bear phases.

---

### **3.6 FACTORS AFFECTING PRIMARY MARKETS**

---

There are various factors that affect the growth and performance of the Primary markets. Some of these are:

#### **1) Impact of Secondary Markets:**

Historically, it has been observed that the secondary market fuels growth in the primary markets. Growth in primary markets is measured in terms of the number of companies raising funds as well as the quantum of funds raised. As secondary markets developed and attracted new investors from India and abroad (FIIs), the liquidity in the secondary market has improved. As secondary markets provide exit opportunities to primary market investors, a liquid secondary market usually assists the growth and development of primary markets.

But if a company's stock price in secondary market decreases below the Issue Price, the investors' confidence in the primary market is affected and demand for new issues decreases.

Issue price is defined as the price at which shares are allotted to investors in the primary markets. Listed Price is the price at which the stock starts trading in the secondary markets.

#### **2) Economic Requirements for Funds:**

Mobilization of funds in the primary market is a reflection of requirement of funds by various companies. Requirement of funds depends upon the business opportunity in terms of modernization, expansion and diversification. Thus, Primary Markets affect the economy of the country and economic development affects the growth of Primary Markets. This is a cyclical effect.

#### **3) Investors Risk-Return Appetite:**

Investors have two options for investments, namely, Primary and Secondary markets. In the Primary markets, the returns generated by investor depend upon the issue price and the listed price. Upon listing on the stock exchange, if the stock commences trading below the issue price, then it generates negative returns. For example, let us consider the case of a company, whose shares were issued in the primary market at Rs. 55 per share. On 15th May 20XX, it was trading at Rs. 20.05. Thus,

if an investor purchased these shares in the primary market at the issue price, and sells the share on 15th May 20XX, he incurs a negative return. If most of the stocks are traded below the issue price, it creates a barrier for new investors to invest in new companies in the primary market.

Let us consider another company, which issued its equity shares in the primary market at Rs. 103 per share. On 15th May 20XX, the shares were trading at Rs 267.10. Thus, if an investor purchases these shares in the primary markets and sells them, s/he generates positive returns.

If most of the stocks are traded below the issue price, it may not attract new investors to invest in new companies in the primary market and at the same time, may not instill confidence among companies which are planning primary market issues, due to the possibility of failure of the new issues and increase in underwriting expenses.

#### 4) Performance of New Issues:

The performance of newly listed companies is also an important factor which effects the growth of primary markets. If most of the new issues are traded above the issue price, investors may be keen in investing in the primary markets, due to possibility of the listing price being above than the issue price.

Let us now discuss the major sources of raising capital in detail.

---

### 3.7 EQUITY CAPITAL

---

A unit of ownership in a company is referred to as equity, and shares can be issued to shareholders in order to obtain equity capital for the company. In some circles, it is also known as share capital. Shareholders are the owners of a company, and as such, they provide the company funds, assume risks, and either directly or indirectly manage the company. The amount of capital that a newly created company is allowed to raise from its shareholders is specified in the company's Memorandum of Association during the formation process. This type of capital is known as "Authorised Capital." When a company needs to raise money from potential shareholders, it will issue a portion of its permitted capital. This type of capital is known as "Issued Capital." It is possible for a business to alter its Authorised Capital, but this requires agreement from the shareholders. It is of immense value to businesses because it allows them to raise substantial funds, which they can then invest in the development of long-term initiatives. The money obtained through equity financing is not required to be repaid by the company to the investor.

Getting clearance for the Prospectus from the Securities and Exchange Board of India (SEBI), appointing Underwriters, Bankers, and Registrars to the issue, and filing the Prospectus with the Registrar of Companies are some of the formalities that need to be accomplished before shares can be issued. Equity financing entails the sale of Common Stock, Share Warrants, Preferred Stock, Convertible Preferred Stock, and other securities. After evaluating its finance requirements, the Corporation must seek equity capital. The Initial Public Offering (IPO) of a company is one method for established

businesses to raise capital via stock investments. Initial public offering permits a company to raise capital by selling shares to the public.

There are two distinct categories of shares. They are *Equity Shares* and *Preference Shares*. Let us discuss these two categories briefly.

### 1. Equity Share

‘Ordinary Share’ is another term that can be used to refer to ‘Equity Share’. These are the most types of shares and therefore, also called Common Shares. Investors are granted ownership rights in the company by means of these documents, which are referred to as Stocks. Equity stockholders are the ones who undertake risk. The opportunity to vote on a variety of company matters is granted to the holders of these shares. Equity shares can be transferred, and the dividend paid represents a percentage of the company's overall earnings. It is important to keep in mind that equity stockholders do not have the right to a fixed dividend. When someone has equity in a company, their liability is capped at the value of their investment in the company. The equity shares can be further classified depending on the bases; On Definition basis, and On Returns basis.

#### *On Definition Basis:*

**Bonus Shares:** The term "Bonus Shares" refers to the additional stocks that are given away to current owners at no cost. These additional stocks are considered as a "Bonus" to the existing shareholders.

**Rights Shares:** Rights shares are offered by a firm to its existing shareholders at a price less than the prevailing market price of the shares of that company. The shareholders are free to subscribe for these shares or not.

**Sweat Equity Shares:** If you are an employee of the firm and have made a substantial contribution, the corporation may choose to award you with sweat equity shares as a form of compensation.

**Voting and Non-Voting Shares:** Even though the vast majority of shares come with voting rights, the corporation reserves the authority to make an exception and grant shareholders differential or zero voting rights.

#### *On Returns Basis:*

**Dividend Shares:** A firm has the option of deciding to pay dividends in the form of issuing new shares on a pro-rata basis. This is referred to as a Dividend Share.

**Growth Shares:** The term "Growth Shares" refers to the many forms of shares that are issued by businesses that have exceptional annual growth rates. Although such businesses do not pay dividends, the value of their stocks typically rises at a quick pace, giving investors with opportunities for capital gains.

**Value Shares:** Value Shares are a form of share that can be bought and sold on stock exchanges at prices that are lower than the intrinsic value of the share. It is reasonable for investors to anticipate that the prices will rise over a period of time, which will result in improved returns for them.

## 2. Preference Share:

These shares have the preferential right to profit from the company's earnings before the Ordinary Shareholders. During the liquidation of a company, preference is given to the distribution of funds to shareholders holding preference shares prior to the equity shareholders. Some of the categories of preference shares are:

**Cumulative and Non-Cumulative Preference Shares:** Both Cumulative and Non-Cumulative Preference Shares Exist. With cumulative preference shares, the advantage is carried forward to the following fiscal year if the issuing business does not pay an annual dividend. With non-cumulative preference shares, the benefit is not carried forward. Non-cumulative preference shares do not entitle their holders to receive benefits accruing from outstanding dividends.

**Participating and Non-Participating Preference Shares:** Participating Preference Shares enable shareholders to obtain surplus profits after the company has paid dividends. Non-Participating Preference shares do not allow shareholders to receive surplus profits. This is in addition to the regular dividend received.

**Convertible and Non-Convertible Preference Shares:** Convertible Preference Shares have the ability to be converted into equity shares of the firm after satisfying the necessary requirements outlined in the company's Article of Association (AoA), but Non-convertible Preference shares have no such benefits attached to them.

**Redeemable and Irredeemable Preference Shares:** Redeemable Preference Shares are those that a firm has the option to redeem at a pre-determined price and time. On the other hand, these conditions are not applicable to irredeemable preference shares.

### The Pros and Cons of Equity Capital:

Following are some of the advantages, disadvantages, and the challenges of raising capital through the Equity Shares.

#### *Advantages:*

**No Repayment Requirement:** It is said that equity capital is for free. When you use equity capital, you are not responsible for making interest payments or returning investors' initial investment. In contrast, debt capital requires regular interest payments in addition to the redemption of the borrowed principal amount.

**Lower Risk:** In general, companies with a larger proportion of equity to debt are less likely to declare bankruptcy. If a company experiences a setback and is unable to make its interest payments, its creditors can force the company into insolvency. Equity investors have no access to these privileges.

**Investor Recruitment as Equity Partners:** The most apparent advantage of new equity is a rise in available financial resources. However, the partners you will be working with have a financial interest in the success of your business. It is conceivable that the presence of these partners, each of whom possesses substantial knowledge, connections, and influence, will determine the firm's success. Additionally, having dependable equity companions can increase the likelihood of acquiring more desirable loans in the future, should they be required.

***Disadvantages:***

**The Diluting of Ownership:** When we issue equity stocks to the new investors, there is the risk of losing control over affairs of the firm, as the equity investors often have the right to vote on significant matters affecting the organisation. As a result your ownership position will be diluted or reduced proportionately for each and every share of stock that you sell to the Investors.

**Greater expense:** Although equity does not require investors to make interest payments, the overall cost of equity investments is often higher than that of borrowed capital. When compared to creditors, stockholders take on a greater proportion of the company's risk because they are the last to be paid in the event of insolvency of the company. As a direct result of this, equity investors expect a better rate of return on their equity investments.

**Spending Both Time and Effort:** The procedure to get funds through equity capital is more time-consuming, expensive, and difficult.

***Challenges of Equality Financing:***

**Market Scenario:** During bearish scenario, the market risk increases. So raising funds becomes challenging.

**Investor Sentiments:** Investor sentiments are affected due to market crash. So investor may not commit funds to new issues.

**Regulatory constraints in terms of Eligibility:** As there are specific eligibility criteria, some companies become ineligible to raise funds through IPOs.

**Company's Past History and Future Projections:** Financial Risk increases based on negative future projections.

**Exit Options in case of Private Placement:** Operational risk increases in case of private placements.

---

### **3.8 DEBT CAPITAL**

---

A company can acquire capital through debt by borrowing from financial institutions or investors and agreeing to repay the loans with interest. Debt capital is an important source of financing for businesses, and it can be utilised for a variety of purposes, including expansion, acquisition, and working capital. The expression "Debt Capital" refers to the amount of money a company or other organisation obtains through loans or investments

from third parties. When it comes to capital formation, businesses frequently utilise debt financing options such as loans, bonds, or other debt securities. Debt financing typically incorporates a repayment schedule. This type of funding offers financial leverage and tax benefits. The debt-to-capital ratio is widely used by investors and analysts to measure the level of financial risk and leverage associated with a company. The debt in capital structure of a corporation usually includes both short-term and long-term debt.

The following are some forms of Debt-based financing:

**Loans:** Borrowing money from financial institutions or banks in the form of loan is often done for the purpose of acquiring assets or providing working capital.

**Bonds:** Bonds are financial instruments that are offered to investors and can have either a fixed or variable interest rate attached to them. These Bonds are re-paid at the end of the specified period. The interest on these Bonds be paid periodically or at the end of the tenure of the Bond.

**Line of Credit:** This type of credit facilities enable a company to borrow money as and when needed upto a certain maximum that has been specified.

**Equipment Financing:** Equipment Financing is a form of debt financing in which an organisation borrows money to purchase equipment, with the intention of using the equipment as collateral for the loan.

**Commercial Paper:** The issuance of commercial paper, also known as a commercial promissory note, is a rapid way for businesses to raise capital in a risk-free and short-term manner.

**Debenture:** Debentures are another method of financing that can be utilized by the companies. Debentures are a form of debt instrument that allow corporate houses to borrow money from investors. Debentures are sold in units, and each debenture has a face value that corresponds to its market price. For instance, if the face value of a debenture is Rs. 100 and if you invest Rs.1,000, you will receive ten Debenture Units. The investor in the debenture receives interest payments at a fixed rate. The debenture may be redeemed by the firm either at a discount or a premium, or at its face value, depending on the company's preference. A firm has the ability to issue a variety of debentures, including convertible and non-convertible debentures, depending on the needs of the business.

### **The Pros and Cons of Debt Capital:**

Following are some of the advantages, disadvantages, and challenges of raising capital through the Debt.

#### ***Advantages:***

**Predictable Cash flows:** Cash flows from the debt are predictable because interest and principal payments on debt are often fixed. This provides the company to plan its cash flows more efficiently.

**Tax benefits:** Since interest payments on debt are deductible from taxable income of the company, effective cost of funds for the company would be less.

**Unrestricted funds:** This type of funding can be used to fund a variety of activities, including research and development, expansion, and acquisitions.

**Leverage:** Businesses are able to leverage their existing assets through the use of debt financing, which may result in an increased return to the equity shareholders.

***Disadvantages:***

**Default Risk:** If a borrower is unable to make the interest or principle payments on its debt, the borrower is at risk of defaulting on the loan, which would result in a financial loss for the Lender.

**Interest Payments:** Despite the fact that interest payments are eligible for a tax deduction, they nonetheless constitute a significant expense for the company. Therefore, the cost of debt financing will increase in direct proportion to the level of interest paid on the debt.

**Debt Servicing:** In order to repay their debts, borrowers must allocate a percentage of their cashflow. This can restrict their ability to make investments in their business's expansion or to cover unanticipated costs.

**Negative impact on Credit Rating:** A company that carries an excessive amount of debt may find that it suffers a negative impact on its credit rating, making it more difficult for the company to secure future funding at reasonable terms.

***Constraints in Debt Financing***

- Firm-specific factors such as leverage, growth opportunities, and cash holdings are related with the convertibility, maturity, and security structure of issued bonds.
- Economy-wide factors, in particular the state of the macro economy, affect the quality distribution of securities offered. In particular, during recessions, firms issue fewer poor quality bonds than in good times but similar numbers of high-quality bonds.
- Controlling for firm characteristics and economy-wide factors, project specific factors appear to influence the types of securities that are issued.

---

### **3.9 EQUITY MARKET Vs. DEBT MARKET**

---

Some of the differences between Equity markets and Debt Markets are discussed below:

**Fund Raising:** In equity markets, the securities issuers are typically Corporations that are seeking to raise capital from members of the General Public or from the Institutional Buyers. In the debt market, debt securities such as bonds, debentures, and other similar instruments are issued by Corporations and Governments at the national, state, and local levels when they require funds for a pre-determined amount of time.

**Investor Status:** Shareholders become partial owners of the company in which they have invested by purchasing equity shares issued by that

company. Equity shareholders not only receive financial benefits but also have the power to vote on important company issues. Debenture holders and bondholders are considered to be creditors of the corporation because they provide funds temporarily for a particular period. At the end of that time period, the company is obligated to repay the principal amount that was borrowed.

**Risk:** When compared to the risk associated with the debt market securities, the risk associated with the equity market securities is significantly higher. In the event that the firm that issued equity shares declares bankruptcy, the shareholders run the risk of losing the entire money they invested in the equity shares of the company. This is due to the fact that shareholders are placed at the bottom of the line for repayment and only receive their money after debt holders and preferred shareholders have been compensated. However, creditors get paid back before anyone else when a situation like this arises.

**Returns on Investments:** Dividends and appreciation of the investments are the two ways in which shareholders earn returns on their equity holdings. Capital appreciation is the difference between the price at which equity shares are sold and the price at which they were originally purchased. Dividends are a portion of the profit that the company has decided to deliver to its shareholders. Debt holders get periodic interest and the principle at the end of the specified period. Sometimes, certain bonds can also be traded on stock exchanges. When this occurs, investors have a chance to benefit from the appreciation of their investments.

**The make up of the Returns:** Returns on stock investments are typically variable because they are tied to the share price at the time of selling and are not thus pre-determined. On the other hand, debt securities frequently make fixed interest payments at pre-determined times. Due to the fact that the risks associated with the equity market are greater than those associated with the debt market, the equity market has the potential to give bigger returns than the debt market.

**Volatility:** When compared to the value of debt instruments, the prices of equity shares are subject to more frequent changes. As a result, the stock market is subject to a greater degree of volatility than the debt market.

**Regulators:** The Securities and Exchange Board of India, is the primary regulatory organisation that oversees the Indian equity market. Both the Securities and Exchange Board of India (SEBI) and the Reserve Bank of India (RBI) work together to oversee the debt market in India.

---

### **3.10 ADVANTAGES/DISADVANTAGES OF SOURCING CAPITAL THROUGH DIFFERENT MEANS**

---

This section of the Unit presents a picture of the advantages and disadvantages of sourcing Capital through different means to Issuers/Borrowers and for Shareholders/Lenders.

**Table 3.1: For Shareholders/Lender**

<b>Capital</b>	<b>Advantages</b>	<b>Disadvantages</b>
Equity Capital	<ul style="list-style-type: none"> <li>• Shares are easily transferable (via trading on Exchanges).</li> <li>• Limited liability to the extent of the face value of the share.</li> <li>• Share in the profits of the company (Dividends).</li> </ul>	<ul style="list-style-type: none"> <li>• Ownership equity is the last or residual claim against assets, paid only after all other creditors are paid.</li> <li>• Dividends are paid depending on the profits available/discretion of directors. Hence a company may decide to retain the earnings.</li> <li>• Sale of equity to outsiders dilutes the existing shareholder control.</li> </ul>
Preference shares	<ul style="list-style-type: none"> <li>• Prior claim on the assets and earning of the company as compared to the equity holders.</li> </ul>	<ul style="list-style-type: none"> <li>• No legal obligation on the company to preferential dividend</li> <li>• No voting rights</li> </ul>
Debentures	<ul style="list-style-type: none"> <li>• The company is liable to pay interest even if there are no profits.</li> </ul>	<ul style="list-style-type: none"> <li>• No voting rights</li> </ul>
Loans from Financial Institutions	<ul style="list-style-type: none"> <li>• The company is liable to pay interest/principal amount.</li> </ul>	<ul style="list-style-type: none"> <li>• No voting rights</li> </ul>
Loans from commercial Banks	<ul style="list-style-type: none"> <li>• The company is liable to pay interest/principal amount</li> </ul>	<ul style="list-style-type: none"> <li>• No voting rights</li> </ul>
Public Deposits	<ul style="list-style-type: none"> <li>• The company is liable to pay interest/principal amount</li> </ul>	<ul style="list-style-type: none"> <li>• No voting rights</li> </ul>
Reinvestment of Profits	Not Applicable	Not Applicable

**Table 3.2: For Issuers/Borrowers**

<b>Capital</b>	<b>Advantages</b>	<b>Disadvantages</b>
Equity Capital	<ul style="list-style-type: none"> <li>• Equity Capital has no maturity date, hence the firm has no obligation to redeem.</li> <li>• Larger the equity base, greater the creditworthiness of the company.</li> </ul>	<ul style="list-style-type: none"> <li>• Cost of issuing equity shares is generally higher than the cost of issuing other securities. Cost involves underwriting commission, issue expenses, brokerage cost.</li> </ul>

Preference shares	<ul style="list-style-type: none"> <li>• It is regarded as part of networth hence enhances the creditworthiness of the firm.</li> <li>• No voting rights, hence no dilution of control.</li> </ul>	<ul style="list-style-type: none"> <li>• Though there is no legal obligation to pay preference dividends, skipping them effect the image of the company.</li> </ul>
Debentures	<ul style="list-style-type: none"> <li>• More flexible as compared to loans in term of maturity, interest rate, repayment.</li> </ul>	<ul style="list-style-type: none"> <li>• Need to follow strict regulations like appointment of debenture trustee, creating a reverse for redemption (Debenture Redemption Reverse).</li> </ul>
Loans from Financial Institutions	<ul style="list-style-type: none"> <li>• Loans can be customized in terms of repayments and maturity.</li> </ul>	<ul style="list-style-type: none"> <li>• Financial institutions impose restrictive conditions on the borrowers.</li> </ul>
Loans from commercial Banks	<ul style="list-style-type: none"> <li>• Loans can be customized in terms of repayments and maturity.</li> </ul>	<ul style="list-style-type: none"> <li>• Banks impose restrictive conditions on the borrowers.</li> </ul>
Public Deposits	<ul style="list-style-type: none"> <li>• These are an easier method of mobilizing funds than banks, especially during periods of credit squeeze.</li> </ul>	<ul style="list-style-type: none"> <li>• Restrictive conditions on the borrowers in terms of max amount and period of borrowing.</li> </ul>
Reinvestment of Profits	<ul style="list-style-type: none"> <li>• It reduces the dependence on external sources of finance.</li> <li>• It increases the credit worthiness of the company.</li> <li>• It enables the company to withstand difficult situations.</li> <li>• It enables the company to adopt a stable dividend policy.</li> </ul>	<ul style="list-style-type: none"> <li>• Shareholders may demand dividends. Hence Board of Director need to justify the rationale behind investing the Profits into the company.</li> </ul>

### 3.11 RAISING EQUITY CAPITAL IN INTERNATIONAL MARKETS

In 1991, when the country (India) accepted LPG (Liberalisation, Privatisation, and Globalisation), the Globalisation aspect widened the channels through which businesses can acquire funds. Prior to this policy, businesses were restricted to the borders of the nation. With the advent of globalization, however, the scope for raising funds expanded significantly. Prior to this, firms in our country were not permitted to seek external funding

to meet their financial requirements. Now, they are no longer limited by national borders; rather, their reach has expanded, and the local market is now exposed to the global capital market. International financing promotes financial transactions between two or more nations. With the opening of the Indian economy, the corporate sector is now able to raise funds on the international market for two specific purposes;

1. To meet foreign currency needs for import, expansion, and other purposes, and
2. To reduce the overall cost of capital, as international resources are likely to be less expensive than those in India.

The International Capital Market increases productivity and scale. The majority of funding comes from it. Following are the different avenues for resource mobilization from international markets:

- Global Depository Receipts (GDRs)
- American Depository Receipts (ADRs)
- Indian Depository Receipts (IDRs)
- Foreign Currency Convertible Bonds (FCCBs)
- External Commercial Borrowings (ECBs)

In this section, we shall discuss about the GDRs, ADRs, and IDRs. There is also one more method of raising capital. This is External Commercial Borrowings which is debt capital. Also, Foreign Currency Convertible Bonds are also an important method of raising capital, whereby, on a later date, the debt issued may be converted into equity capital. Let us understand these sources of raising capital through GDRs, ADRs, IDRs, FCCBs and FCCBs.

### **Global Depository Receipts (GDRs)**

Global Depository Receipts (GDR) are equity instruments issued by authorized Overseas Corporate Bodies (OCB) against Shares/Bonds of Indian Companies that are deposited with designated Domestic Custodian Banks. The issue of GDR is in lieu of the shares deposited. The GDR can be listed in international stock exchanges and are tradable.

A GDR may represent one or more shares of the company, based on a fixed ratio. A holder of the GDR can convert the receipt into equity shares it represents, at any time. A GDR by itself does not carry voting rights. But after conversion, the shares allotted have all characteristics of common/ordinary equity shares issued by the company and are tradable on the domestic (Indian) exchange. Most of the listings of the GDR issued by Indian companies are in Luxembourg Stock Exchange and London Stock Exchange. Indian GDRs are primarily sold to institutional investors. GDRs are tradable on the over-the-counter markets also, where market makers provide liquidity for the instrument. The primary purpose of issuing GDRs is to attract global investors. GDR issuance provides a low-cost mechanism for investors to participate. In addition to their local capital market, foreign investors have the opportunity to participate in or gain access to global capital markets. GDRs are utilized by Indian corporations such as ICICI, Wipro, Reliance, and

Infosys to raise foreign currency. Several international banks, including Citigroup and JPMorgan Chase, issue GDR in lieu of shares.

In May 1992, Reliance became the first Indian company to raise equity in international capital markets through the mechanism of Global Depository Receipts (GDR).

### **American Depository Receipts (ADRs)**

American Depository Receipt (ADR) is a negotiable instrument that is denominated in US Dollars (USD). When a non-US based company - that seeks to list in USA - deposits its shares with a designated bank, the company receives a receipt, which enables it to issue American Depository Shares (ADS). These ADS are share certificates and are used interchangeably with ADR, which represent ownership of the deposited shares. American Depository Receipts cannot be offered for sale-purchase to any foreign country, unlike Global Depository Receipts; they can only be issued to residents of the United States. There are two different kinds of ADRs; sponsored, and unsponsored. ADRs are identical to any other common stock for Americans trading on the United States capital market.

ADR represents a fraction of a share; a single share, or multiple shares of company's deposited stock. These receipts pay dividends in USD (through a trustee) and is traded on a US-based stock exchange - such as New York Stock Exchange (NYSE) or the NASDAQ. The price of an ADR is based on the price of the issuing company's stock in its home market.

Thus, Investors attempting to enter the emerging markets or other foreign stock exchanges have to go through expensive commissions and currency exchange before successfully investing in a foreign market. With ADR, investors can take advantage of foreign markets while trading in US stock markets.

### ***Difference between ADR and GDR***

Following are the major differences between ADR and GDR:

- ADR issues offer access to not only the institutional investors, but also retail investors based in USA. On the other hand, GDR offers access only to the US-based institutional investors.
- If the Depository Receipt is traded in a country other than USA, it is called a Global Depository Receipt. GDR can be converted into ADR. This is based on Securities Exchange Commission (SEC) guidelines. SEC is the regulator in US.
- The investors in Europe are not actively participating in the GDR issuance process. This is due to the lack of confidence among investors, in the Indian company's performance. Thus, more companies are converting their existing GDR into ADR, as well as issue ADS to enable greater market reach, liquidity and participation by US-based investors.

### **Indian Depository Receipts (IDRs)**

Similar to the mechanism by which Indian companies can issue GDR and ADR in the international markets, the Foreign Companies can source capital

by issuing Indian Depository Receipts (IDR) in the Indian markets. IDR enables Indian investors to diversify their portfolio risk. It also serves to integrate the Indian capital markets with international markets.

A foreign company can access Indian securities market for raising funds through issue of Indian Depository Receipts (IDRs). An IDR is an instrument denominated in Indian Rupees in the form of a Depository Receipt created by a Domestic Depository (custodian of securities registered with the Securities and Exchange Board of India) against the underlying equity of issuing company to enable foreign companies to raise funds from the Indian securities Markets. Central Government notified the Companies (Issue of Indian Depository Receipts) Rules, 2004 (IDR Rules) pursuant to the section 605 A of the companies Act. SEBI issued guidelines for disclosure with respect to IDRs and notified the model listing agreement to be entered between exchange and the foreign issuer specifying continuous listing requirements. The company is not required to comply with the listing and regulatory requirements of each country in which it wishes to sell shares. Investing in IDRs is a profitable alternative to purchasing Foreign Exchange Stocks. Standard Chartered Bank was the first international institution to issue an IDR.

#### **Foreign Currency Convertible Bonds (FCCBs)**

Foreign Currency Convertible Bonds are debt and equity instruments combined. Like all other convertible securities, these bonds are convertible, meaning that they can be exchanged for Depository Receipts or Equity Shares at a future date after specified period of time has passed. The Bond's Bearer may exchange FCCBs for equity shares for which the price has already been determined or for any exchange rate. The bearer may also choose to keep their FCCBs with them. FCCBs are always traded on international financial markets. The fixed interest rate on foreign currency convertible bonds is typically lower than that of other debt instruments that are non-convertible. At maturity, the Bond is redeemed for its full face value. In addition, the redemption period for Foreign Currency Convertible Bonds is typically around five years. Its operation closely resembles that of Indian convertible financial instruments. The issuance of Foreign Currency Convertible Bonds dilutes ownership, resulting in a decline in earnings per share for existing shareholders. In this case, holders lack control over the conversion rate.

#### **External Commercial Borrowings (ECBs)**

External Commercial Borrowings (ECBs) include, Commercial Bank Loans; Buyer's Credit; Supplier's Credit; Securitized Instruments (floating rates notes and fixed rate bonds); Credit from official export credit agencies; and Borrowings from Multilateral financial institutions such as international finance corporation, ADB, etc. ECB can be accessed under two routes, viz., (i) Automatic Route and (ii) Approval Route.

(A) **Automatic Route:** Under the extant policy, ECBs for investment in real sector -industrial sector and, especially, infrastructure sector-in India, are under Automatic Route, i.e. do not require RBI/Government approval. In

case of doubt as regards eligibility to access Automatic Route, applicants may take recourse to the Approval Route.

(B) **Approval Route:** Financial institutions dealing exclusively with infrastructure or export finance such as IDFC, IL&FS, Power Finance Corporation, Power Trading Corporation, IRCON, and EXIM Bank are considered on a case-by-case basis. Banks and financial institutions which had participated in the textile or steel sector restructuring package as approved by the government are also permitted to the extent of their investment in the package and assessment by RBI based on prudential norms. Any ECB availed for this purpose so far are deducted from their entitlement.

---

## 3.12 RECENT TRENDS

---

Because of the growing demand for spending on infrastructure and the excessive reliance placed on the banking sector to fulfill funding requirements, the capital market plays an important role in both the mobilization of capital for productive investment and the closing of the funding gap. A capital market that is both well-developed and deep is beneficial to the expansion of the economy. In addition to encouraging a more disciplined approach to performance among businesses, meeting long-term investment needs in a timely manner contributes to the expansion of the economy. This can be achieved by encouraging the development of innovative and cost-effective financial instruments, which in turn helps to lower the cost of capital and diversify credit risk.

With respect to market capitalization, turnover, and the number of listed companies, the Indian stock market has grown rapidly over time and is currently among the biggest in the world. The equity market has held up well despite the pandemic problems of the previous two years and the geopolitical unrest that appeared at the end of the previous fiscal year. A record number of Initial Public Offerings (IPOs) were listed on stock exchanges in fiscal year 2022 (FY22), and corporations raised the most money through IPOs ever. Despite a decline in equity FPI flows, this was accompanied by strong domestic fund flows in the form of increased retail participation. The stock market's exceptional performance was primarily caused by three factors:

- 1) Investing in stocks has become a tempting option for those seeking greater returns due to the prevalence of easy monetary policy and low interest rates
- 2) Technological developments that made it easier to access markets
- 3) Simple internet and data access.

India's market capitalization (m-cap) percentage has grown over time. In terms of market capitalization, India is currently ranked fifth in the world, just after the United States, China, Japan, and Hong Kong. India's market value at the moment is roughly USD 3.5 trillion, which is almost equal to India's GDP. In contrast, the United States' market capitalization (USD 42 trillion) is almost two times its GDP. India needs to increase its market capitalization to USD 80 trillion in order to match the US's 2:1 market

capitalization to GDP ratio in order for its GDP to reach USD 40 trillion in 2047. This suggests that over the next 24 years, the market capitalization CAGR will be around 14%.

The Bombay Stock Exchange has the most listed companies worldwide and is the oldest stock exchange in Asia. As of November 2022, there were 2,155 listed companies on the NSE, compared to 5,414 on the BSE. The number of listed companies on the BSE has increased by 5.5% over the past 12 years, while the number on the NSE has increased by an astounding 31%.

---

### 3.13 SUMMARY

---

In order to function properly and carry out their missions, organizations require financial backing in the form of capital or funds. No organization can be formed or carry out its functions if it does not have access to capital. Internal sources and external sources are the two primary avenues through which organizations can obtain the funding necessary to meet their financial obligations. Internally generated funds are primarily derived from retained earnings, while externally generated funds are primarily derived from equity and debt investments. It is possible to keep capital in the form of financial assets, acquire it through Equity Financing, Debt Financing, or both of these methods.

The term "equity capital" refers to the financial resources that a company acquires from its current owners and potential owners as well as other shareholders in exchange for a percentage of the ownership in the company. Equity capital can also refer to the financial resources that a company receives from outside investors. A company can acquire debt capital by entering into loan agreements with investors or financial institutions in order to obtain loans, and by doing so, the company commits to making interest payments on the loans. Both issuers and borrowers, who are also known as borrowers, and shareholders and lenders, have specific interests to consider when deciding how best to source capital. Additionally, capital can be raised from international markets by utilizing *ADR*, *GDR*, *IDR*, *FCCBs* and *ECBs*, and other similar instruments.

---

### 3.14 SELF ASSESSMENT QUESTIONS

---

1. What does the term "Primary Markets" mean? What are its distinguishing features?
2. Who are the Primary Market Participants?
3. Make a difference between Debt and Equity capital.
4. Explain preference and equity shares.
5. What do you mean by ADR, GDR, IDR, FCCBs and ECBs?

---

### 3.15 FURTHER READINGS

---

- Pathak, Bharati V. (2010) *The Indian Financial System, Markets Institutions and Services*, Pearson Education.
- Machiraju H.R, (2019) *Indian Financial System*, Vikas publishing House
- Khan M.Y (2019) *Indian Financial System*, McGraw Hill
- Singh, Preeti (2018) *Dynamics of Indian Financial System: Markets, Institutions and Services*, ANE Books
- Surendra S. Yadav, P.K. Jain, and Max Peyraid, (2001). *Foreign Exchange Markets: Understanding Derivatives and Other Instruments*, Macmillan-India.



ignou  
THE PEOPLE'S  
UNIVERSITY