UNIT 11 FINANCING THROUGH CAPITAL MARKETS (DOMESTIC SOURCES)

Objectives

The objectives of this unit are to:

- provide an understanding of money market and capital market,
- highlight redeeming features of capital market,
- explain different methods of raising funds by corporates through capital market.

Structure

11.1 INTRODUCTION

Economic growth implies a long-term rise in per capita national output. The basic conditions determining the rate of growth are effort, capital and knowledge. Among these, capital formation has been recognized as the most crucial factor in the economic growth of the developing countries. Capital formation implies the diversion of the productive capacity of the economy to the making of capital goods which increase future productivity capacity. The process of capital formation, thus, involves transfer of savings from those who have them in the hands of those who invest the same for productive purpose. Saving & investment activities are linked by finance. Finance provides mechanism through which savings of myriads of savers are pooled together and are put into the hands of those able and willing to invest. The mechanism includes a wide variety of institutions which cater, on the other hand, to the safety, liquidity and profitability notions of the savers; and on the other to the different types of requirements for working and fixed capital of the investors. These insittutions are generally grouped into Money Market and Capital Market.

11.1.1 Money Market

Money market comprises those financial institutions which cater to the notions of savers of high liquidity and safety along with profitability and which provide working capital to trade and industries mainly in the form of loans and advances. Thus, money market is reservoir of short-term funds. Money market provides a mechanism by which short-term funds are lent out and borrowed; it is through this market that a large part of the financial transactions of a country are cleared. It is a place where a bid is made for short-term investible funds at the disposal of financial and other institutions, individuals and the Government itself.

11.1.2 Capital Market

Capital market is the place where the medium-term and long-term financial needs of business and other sectors of the economy are met by financial institutions which supply medium and long-term funds to borrowers. The capital market is composed of primary market and secondary market (also known as stock market).

While the primary market provides a mechanism through which the resources of the investing public are mobilized, the secondary market provides mechanism to facilitate an investor to buy and sell securities through dispensation of benefits of easy liquidity, transferability and continuous price formation of securities. Thus, both the primary market and secondary market play an important role in raising maximum resources for capital formation and balanced and diversified industrial growth in the country. However, metamorphic environmental developments in and outside the country following the policy of liberalization, privatization and globalization with the walls cocooning the economy being torn and unprecedented technological advancements have led to geographical and functional integration of international financial markets and intensification of competition among various players both in banking and non-banking sectors, blurring of boundaries between money and capital markets and culminating in the emergence of more diversified multipurpose financial institutions and financial innovations of unprecendented dimensions.

11.2 METHODS OF PROCURING FINANCE

A company can raise funds through capital market by issuing the financial securities. A financial security is a legal document that represents a claim on the issuer. The corporates securities are broadly classified into ownership securities and creditorships securities. There are also securities known as hybrid securities having the mix of the features of ownership securites as well as creditorship securities. Further, company can also raise the funds through public deposits and borrowings from banking sector. Each method of financing has got its distinctive features in terms of risk, return, control, repayment requirements, and security. Depending upon the market conditions and financing strategies, the issuers adopt different methods.

11.2.1 Equity Shares

According to the companies Act 1956, a share is a part of unit by which the share capital of a company is divided. The Act makes a provision for only two classes of shares capital, Viz., equity share capital and preference share capital, Equity share capital refers to the share capital, which is not preference share capital. Equity share capital is also defined as the "amount of the value of property over and above the total liens and charges. In other words, equity share capital is what ever remains in the way of assets after all the debts and other charges have been paid or provided for. Thus equity share capital is also appropriately referred to as residual capital.

Equity shares represent the owner's equity. Its holders are residual owners who have unrestricted claim on income and assets and who enjoy all the voting power in the company and thus can control the affairs of the company. Equity share capital is also known as risk capital as the equity shareholders are exposed to greater amounts of risk, but at the same time they have greater opportunities for getting higher returns. The equity shareholders also enjoy getting higher returns.

Another redeeming feature of equity shares is that its holders have pre-emptive right, right to purchase additional issues of equity shares before the same is placed in the market for public subscription. As a result, equity shareholders have the power their proportionate interest in the assets, earnings and control of the company.

The following are the advantages and disadvantages of raising capital by issuing equity shares.

Advantages:

1) The equity shares are not repayable to the shareholders. So it is a permanent capital for the company, unless the company opts to return it through buying its own shares.
2) The debt capacity of a company depends on it's equity including reserves. Raising capital through equity enhances the company's debt capacity.
3) The company has no legal obligation to service the equity by paying a certain rate of dividend, unlike the debt for which interest is payable. So, the firm can conserve the cash when it faces the shortages, and pay when it's earnings are adequate to do so.

Disadvantages:

1) Among the alternative sources of capital the equity capital's cost is high, because of various reasons like higher risk, flotation costs, non-deductibility of dividend for tax purposes, etc;
2) Investor's perceive the equity shares as highly risky due to last claim on assets, uncertainty of dividend and capital gains. Therefore, the companies should offer higher return to attract equity capital.
3) Addition to equity capital may not raise profits immediately, but will dilute the earnings per shares, adversely affecting the value of the company.
4) Raising of capital by offering equity shares will reduce the controlling power of promoters, unless they contribute proportionately, or opt for non-voting shares which are costlier than ordinary equity shares.

Companies can raise funds by issuing equity shares in five ways, Viz., through public issue, rights issue, private placement, convertible debentures, and warrants, while the first three are discussed here. The other two are explained in the later part.

Public Issue:

To approach the public with a public issue to raise capital, the company should follow various regulations and guidelines of the Companies Act, and Securities and exchanges Board of India (SEBI).

The important activities to public issue are:

1) Prepare a detailed project report, for which funds are intended.
2) Preparation of prospectus, and filing the same with SEBI.
3) Arrangements for listing the equity share in the stock exchanges.

4) Underwriting agreement with merchant bankers, brokers, etc.
5) Bridge loan arrangements to complete the project before equity share capital is raised.
6) Finalization of quotas to promoters, NRI's employees, and firm allotments, and public.
7) If the public issue is not subscribed to the extent of atleast 90 percent of the equity issue, the money so colleted should be returned to the public within 120 days of the last subscription date. In case of over subscription, proportional allotment has to be made as per SEBI guidelines.

11.2.2 Rights Issues

Under section 81 of the Companies Act, exiting shareholders of a company have a right to subscribe for news equity shares. If the company intends to raise additional equity capital in proportion to their share holding, these shares are called rights shares. Instead of acquiring the rights shares the shareholders can transfer the rights to others or can simply forego them. Those shares not subscribed will be allotted to the other shareholders applying for more, proportionately.

If shares are left out even after giving additional allotment to the existing shareholders, those shares can be issued to the public. When rights are offered in proportion to the existing shares of the shareholders, the rights pricing will not influence the value of the company, when adjusted for the capital collected towards rights shares.

The right issue offers three main advantages. First the existing shareholding pattern will remain constant. Therefore, the controlling power of the shareholders including promoter will not be disturbed the promoters may enhance their controlling power, by allotting themselves additional shares to the extent of rights un-utilised by other share holders. Second, raising of capital through rights issue instead of public issue leads to lower flotation, commission, and can reduce the publicity costs.

Even the over subscription will be limited, leading to lower costs of returning the excess capital received. Third, the response to the rights issue is easy to guage, especially when the rights share price is set much below the prevailing price of the share.

The wealth and controlling power of the shareholder will be reduced if he fails to subscrible to the rights issue. In India the financial institutions acquired large number of shares by using the loan conversion clause policy. The loan extended can be converted into equity shares at a pre-determined conversion price at the option of the financial institution. In some profitable companies their share holdings become more than that of the promoters making their controlling power valuable. In such cases the promoters prefer public issue to rights issue.

11.2.3 Private Placement

In this method of raising capital, shares will be issued in bulk to issuing houses through financial intermediaries, investment companies, or other companies. As per SEBI norms a company cannot issue shares to more than 99 persons under private placement. Often these institutions buy the shares through private placement, with an intention to make profit by selling them to the investors in the secondary market through clients. The sale can take place in short-term or long-term. While issuing bankers and brokers normally resell the shares acquired through private placement in the short-term. This method has the advantages of negligible floatation's costs (if any) and better price for the shares.

11.2.4 Non-Voting Shares

The government came out with the proposal of non-voting shares to safeguard the promoters from hostile takeovers. As per the Government proposal the non-voting share is similar to ordinary equity shares in all respects except in case of voting rights and dividend payment. The owners of non voting shares do not possess voting right, and as a compensation for loosing the voting rights, they will be paid a few percentage points of higher dividend than that was paid to ordinary equity holders. If a company fails to pay dividend for more than a stipulated period, the non-voting shares will automatically stand converted into ordinary equity shares with voting rights.

11.2.5 Preference Share

Preference shares are those which carry certain preferential rights as compared to other securities. The preference shareholders have the right to get dividend at a fixed rate prior to any other class of shareholders. Similarly, the preference shareholders get repayment of capital before any other class of shareholders get it when the company is liquidated. In other words, preference shares have prior claims over equity shares on earnings and assets in the event of liquidation, but rank below creditors. But unlike interest on bonds, dividend declaration by the company is not obligatory and may not be paid in a year when profits are not enough. In other words, the preference shareholders cannot take legal action against the company for not declaring dividends. However, the preference shareholders have got the protection that no dividend can be declared on the ordinary shares, unless dividend on preference shares is declared and paid. Further, if the preference shares are cumulative type, dividends not paid in any year will accumulate and must be paid at a later date, before paying dividend on ordinarily shares.

Preference shares are also of different kinds like redeemable preference shares, cumulative preference shares and convertible preference shares. Redeemable preference shares are those which will be redeemed in course of time as per the terms and conditions as stated in the offer document. Cumulative preference shares carry accumulated unpaid dividends year to year till the company is in a position to pay all the dividends including the arrears at a stated rate. While the convertible preference shares get converted into equity shares as per the terms and conditions as stated into offer document, the investors who seek security and assured returns than in found in equity shares generally subscribe preference shares. Companies generally issue preference shares in order to maintain the status quo in the control of the equity stock and also to reduce the cost of capital as the preferred stock carries lower rates of dividends as compared to other debt securities like debentures which usually carry higher rates of interest. At time, the preference shareholders may have a right to share the surplus profits by way of additional dividend and the right to share in the surplus assets in the event of winding up after all kinds of capital have been repaid.

11.2.6 Cumulative Convertible Preference Shares (CCP)

Cumulative Convertible Preference (CCP) shares were introduced by the government in 1985.

The features of CCP are:

1) The CCP’s can be issued by any public limited company to raise funds for new projects, expansion and diversification etc.
2) The amount of funds raised can be to the extent of the equity shares to the public for subscription.
3) The dividend payable is 10 per cent.

4) The entire amount of CCP would be convertible into equity shares between three and five years.

This instrument is yet to become popular. Companies did not prefer it because the dividend on CCP's is not tax deductible as in case of interest on debt. At the same time dividend of 10 percent is also not attractive to the invester. However dividends become tax free in the hands of shareholders from the fiscal 1998-99 and therefore CCP's may become popular.

11.2.7 Warrants

Warrants is similar to call options. It is a right to buy a share of a company which issues them at a certain price during a specified period of time. When a warrant is exercised, the number of shares of the company increases, at the same time resulting in cash flow for the company. Warrants may be issued in the following circumstances.

i) Warrants may be attached to the sale of new equity shares as sweetener.

ii) Through exchange as a result of reorganisation.

iii) Through separate sale, as issued to promoters of some Indian companies to strengthen their controlling power. This is not a common practice.

Price of Shares Issued Through Warrants

The company will receive the consideration for shares issued through warrants in three parts of (a) Cash received on sale of the warrants, (b) Cash received on exercise of warrants, and sale of the warrants, and (c) the consideration for the earlier financing supplied to the company. The fair value of shares issued on the exercise of warrants is the most reasonably determinable measure of the total consideration for the shares issued through warrants. The difference betwen the total consideration for the cash received represents the cost of corporate financing. The following are the benefits to the company and investor, when warrants are issued.

Benefits to the Company

By issuing warrants the company will receive funds for its investment needs. However, it has no obligation to service those funds raised, in terms of paying interest, and principal amount. The price of this privilege is the obligation to deliver the share wherever the warrant holder desires so during the prespecified time period. Normally, the exercise price will be more than the current price of the share.

Benefits to the Investor

The investors seeking warrants advance funds to a company bearing the risk of expecting return based on future share price of that company. The investors do not get any interest, or dividends on their investment unless the warrants are converted into shares. The possible gains to the investor are :

i) Instead of investing in the equity shares of a company at current price, the investor can opt for warrants with a right to buy the same number of shares at a specified price in future paying a small amount for the warrants. The funds, thus, saved can be used for other investment avenues.

ii) The warrants are usually traded on the stock exchanges offering liquidity. The Investor can book profits,or can en-cash the warrants, if necessary.

11.2.8 Debentures

Debentures are one of the principal sources of funds to meet long-term financial needs of companies. Though there is no specific definition of debenture, according to the Companies Act 1956, the word debenture includes debenture stock, bonds and any other securities of a company. Thus, a debenture is widely understood as a document issued by a company as evidence of debt to the holder, usually arising out of loan and mostly secured by charge. The major differences between shares and debentures are as follows;

i) The equity shareholders have proprietary interest in the company whereas the debenture holders are only creditors of the company.

ii) The equity shareholders have voting rights whereas debenture holders do not enjoy such a right.

iii) Debenture holders are entitled to interest at a fixed rate whereas the equity Shareholders are entitled to dividends at varying rates.

iv) Debenture are usually redeemable and therefore have maturity period whereas the equity shares are not redeemable.

v) Debenture holders have priority over shareholders in the distribution of assets on liquidation of the company.

Debenture holders can initiate legal proceedings against a company, if it defaults on its interest payment or principal repayment when these become due. The company using debentures usually offers some sort of a security which is called charge. The charge may be fixed charge or floating charge.

Debenture are of various forms like: (i) secured and unsecured debentures,
(ii) Fully convertible, partly convertible and non-convetible debentures,
(iii) Redeemable and irredeemable debentures.

Of all the various kinds of debentures, convertible debentures, of late, have become more appealing to the investors. The investors may also have the option of retaining the debentures without exercising the conversion option. The partly convertible debentures with buy back facility are also issued, wherein one part of the debenture is converted into equity and non convertible part may have the facility of buy back either by the company or its associates. The convertible debentures can be exchanged for equity shares of the same company on the terms and conditions stipulated at the time of issue of the debentures. Till conversion, these debentures are treated as debt instruments and enjoy the same priority in claims as those of ordinary debenture holders, on the assets of the company. For the company, there is scope for reducing the cost of capital, since investors would be content with a lower return than that on ordinary debentures, if there is a high likelihood of capital appreciation of the company's shares in later years.

There are many advantages of debenture issues for the company. More particularly, the debenture holders cannot interfere with the operation of the company as they do not have voting rights. The cost of debentures is usually low, as the interest payments on debentures are tax deductible expenses.

11.2.9 Bonds

A bond is a creditorship security whereby a company obtains money from the lenders for a promise to pay the stipulated rate of interest at specified intervals and to repay the principal on maturity, and they get the principal sum on maturity, which is also mentioned in the agreement. Bond holders have a prior claim on the receipt of the interest and repayment of the principal over other creditors of the company.

Bonds are of different types like secured and unsecured bonds, bearer bonds, perpetual bonds, sinking funds bonds, zero coupon bonds, convertible bonds, floating rate bonds, etc.

Zero coupon bonds have become very popular in recent years with the investing public. The zero coupon bondholders are not entitled to any interest and they get the principal sum on maturity. The zero coupon bonds are usually sold at a hefty discount and the difference between the face value of the certificate and the acquisition cost is the gain to the investors. There are certain advantages to both the investors and issuers. As far as investors are concerned, they need not bother about reinvestment of interest as there is no periodical interest payment. Further, the difference between the acquisition cost and maturity value of the bond is considered as capital gain and therefore, it attracts lower rate of tax as compared to the tax rates applicable to interest incomes. For the issuer, since there is no periodical payment of interest, the company may not have the cash flow problem in the initial years of the projects whereafter the payment to the bondholders can be synchronized with cash flow pattern of the project.

Floating Rate Bonds (FRB) have also become popular in recent years. The first floating rate bond in the Indian capital market was issued by the State Bank of India adopting a reference rate of one-year bank deposit rate plus 300 basic points (BP). The bank also had the call option after 5 years to redeem the bonds earlier than the maturity period of 10 years at certain premium. Later many corporate and development finance institutions came out with floating rate bonds of different maturity periods. But most of them used 364-days Treasury bill rate as the bench mark plus certain basis Points, which again varied from issue to issue. For example, ICICI issued floating rate Bonds adopting 364-days T-bill rate : 180 BP but Anvind Mills launched floating rate Bonds adopting 364 days T Bill rate : 325 BP. Thus, the floating rate bonds provide varying rates of return with a minimum assured return to the investors. The issuers may also have the benefits of making interest payments according to the current market.

11.2.10 Secured Premium Notes (SPN)

The Tata Iron and Steel company was the first corporate to issue SPN on rights basis. The main features of SPN, as issued by TISCO are as follows:

The face value of a SPN was Rs 300 and no interest will become due or accrue during the first three years after allotment. Therefore, each SPN will be repaid in four equal annual instalments of Rs. 75 from the end of the fourth year together with an equal amount of Rs. 75 with each installment, which will consist of a mix of interest and premium on redemption. Further, each SPN will have a warrant attached to it which will give the holder the right to apply for or seek allotment of one equity share for cash payment of Rs. 80 per share. Such rights are exercisable between first year and one and a half year after allotment.

Thus, SPN can serve as long-term securities and given more flexibility to the companies as well as investors.

11.2.11 Public Deposits

According to the companies Act, 1956, all types of money received by a company except the contribution to capital would fall in the category of deposits. Fixed deposits which are also known as public deposits have become attractive for companies as well as investors. For the companies, public deposits are easy form of fund mobilization without mortgaging assets. For the investors, public deposits provide a simple avenue for investment in good and popular companies at a better rate of interest without many formalities as involved in the case of shares and debentures. However, the public deposits being unsecured, the repayment of deposits and regular payment of interest are subject to a lot of uncertainty. That is, by presenting false information some companies manage to collect large deposits from the gullible public and fail to honour commitments on payments, inspite of many regulatory provisions, as contained in the Companies Act and Companies (Acceptance of Deposits) Rules, 1975.

11.2.12 Bank Credit

Banks including the development finance institutions have become chief source of funds to the corporate sector. In other words, the industrial credit is a major revenue earner to the banking sector as other types of credit like agricultural credit are subject to many restrictive conditions and regulations of RBI and therefore, the margins on such credits are very thin. Banks extend credit to industries and commercial establishments at varying rates of interest depending upon the credit worthiness of the borrower as well as period of loan. The proportion of bank credit in the total funds of the companies is very high in many a case. The major advantage for the companies in that the bank credit is a flexible source of financing and it is relatively easy to mobilize funds through this source.

11.2.13 Venture Capital

Governments around the world have been actively encouraging small and medium business, especially feasible projects. The usual sources of capital generally do not suit those promoters who are not in a position to put in enough contribution to satisfy the other investors and lending institutions. Even if other investors are willing to chip in despite negligible promoter contributions, the promoter cannot retain the control of the business after establishing and stabilizing in a profitable path, if the other investors chose to vote them out. The objective of the venture capital is to encourage those desiring entrepreneurs by providing long-term capital without the risk of losing control. By 1980’s, the U.S.A. had a well developed venture capital market. In India venture capital market is emerging as a new source of funds.

Features:

It is defined as (similar to) equity investment in growth oriented small or medium business to enable the investors to accomplish corporate objectives, in return for minority shareholding in the business or the irrevocable right to acquire it. Further, venture capital organization provides value addition in the form of management advice and contribution of overall strategy. The relatively high risk will normally be compensated by the possibility of high return in the form of capital gains in the medium term. Venture capital is also called as private equity. The following are main features that distinguish the venture capital from other sources of capital market.

i) Venture capital is a form of equity capital for relatively new companies, which find it too premature to approach the capital market to raise funds. It can also be in the form of loan or convertible debt. However, the basic objective of a venture capital fund is to earn capital gain, which usually will be higher than interest at the time of exit.

ii) It is long-term investment. The transfer of existing shares from other shareholders cannot be considered as venture capital investment. The funding should be for new project or for rapid growth of the business, with cash transferring from the fund to the company.

iii) The venture capital organization will actively participate with the top management of the firm.

iv) All the projects financed by the venture capitalists will not be successful. However, some of the ventures yield very high return to more than compensate for heavy losses on others.

Selection for Investment

The appraisal procedure for investment is similar to feasibility studies of the development finance institutions for grant of term loans and other financial assistance. In addition, the venture capital organization may persue track record of enterpreneurs, threats from technological obsolescence and preliminary views on preferred exits. The stages of financing and the mode of financing will also be finalized at this stage.

Stage of Financing: Generally, the stages of financing are (a) early stage and (b) later stage.

Early stage Financing: This stage is essentially an applied research phase where the concepts and ideas of the promoters are discussed and tested leading to a prototype. If the prototype is satisfactory, this stage moves towards the development phase leading to product testing and commercialization. Normally promoters complete this phase with their own resources, because very few venture capital funds finance this stage.

Start-up : This refers to the stage when commercial production is ready to begin. At this stage product will be commercialized in association with the venture capital organization. In this stage some indication of the potential market for the new product will be available. The risk perception is still high. The involvement of the venture capital organization at this stage also is relatively less. Due to the unwillingness of the promoters to dilute their controlling stake, or too small amounts involved, or even unclear risk perceptions.

Later stage Financing : At this stage the investor firms require funds but cannot approach markets. This stage includes development capital, expansion, buy-outs and turn around.

Development Capital : It is for financing of established firms which have overcome the high risk stage with a profit record for a few years, but can not raise funds in the capital market. The reasons for venture capital funds at this stage are for purchase of new equipment/plant, expansion, improving marketing facilities, refinancing of existing debt etc. In this stage the risk perception is medium and venture capital funds involve actively.

Expansion and Buy-outs : In this stage the firms try to expand their productive assets and marketing facilities considerably either by procuring assets or by acquiring controlling power of other similar firms through controlling stakes or other options.

Turn Around : This is an important segment of venture capitalists business. They require not only money but also management skills. Once the venture capitalists identify the firms with good management skill, they come forward to provide money. As the risk perception is high, skill is a focus area for many venture capital funds.

Thus, the venture capital firms fund both early and later stage of requirements of investor firms, balancing between risk and prifitability. This is an ideal source of capital for promotes having very good technical and management skills, with limited financial resources.

11.3 SUMMARY

Capital market plays a very important role in the mobilization of funds for Investment. Capital market can be classified as primary market and secondary market which are complimentary to each other. The capital market has experienced metamorphic changes over the last few years. The competition in the market has become so intense necessitating the introduction of several kinds of securities. The corporates in India mostly raise their funds through capital market by issuing equity shares, preference shares, debentures, bonds and secured premium notes. They also raise their funds through public deposits and borrowings from banks. Technocrats and entrepreneurs with feasible project but having limited financial resources can approach venture capital organization. Each method has got its own distinctive features and depending upon the market conditions and financing strategies the issuers adopt different methods.

11.4 SELF ASSESSMENT QUESTIONS

1. What are the characteristics of capital market? How is it different from money market.
2. Explain the relationship between primary market and secondary market?
3. Assess utility of equity shares as source of corporate financing.
4. “Preference shares are known as ‘hybrid’ securities”. Comment.
5. What is creditorship security? How is it different from ownership security?
6. Examine potentiality bonds as source of corporate financing.

11.5 FURTHER READINGS

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