17

CHAPTER

Sources of Long Term Finance

Learning Objectives

After studying this chapter you should be able to:

- ✓ Describe the features of various sources of long term finance used by a company.
- ✓ Compare the various sources of long term finance.

To support its investments, a firm must find the means to finance them. Equity and debt represent the two broad sources of finance for a business firm. Equity (referred to as shareholders' funds on balance sheets in India) consists of equity capital, retained earnings, and preference capital[1]. Debt (referred to as loan funds on balance sheets in India) consists of term loans, debentures, and short-term borrowings.

The key differences between equity and debt are as follows: (i) Debt investors are entitled to a contractual set of cash flows (interest and principal), whereas equity investors have a claim on the residual cash flows of the firm, after it has satisfied all other claims and liabilities. (ii) Interest paid to debt investors represents a tax-deductible expense, whereas dividend paid to equity investors has to come out of profit after tax. (iii) Debt has a fixed maturity, whereas equity ordinarily has an infinite life. (iv) Equity investors enjoy the prerogative to control the affairs of the firm, whereas debt investors play a passive role – of course, they often impose certain restrictions on the way the firm is run to protect their interests.

We have already looked at various sources of finance in some context or the other. Our task here is to present a reasonably systematic picture of financing by assembling various pieces in a coherent manner. The concepts of financing are fairly simple and logical, though the language may be somewhat unfamiliar.

In this chapter, we describe the main features of long-term sources of finance[2], while deferring to the next chapter the discussion of mechanics and procedures of raising finance.

17.1 EQUITY CAPITAL

Equity capital represents ownership capital, as equity shareholders collectively own the company. They enjoy the rewards and bear the risks of ownership. However, their liability, unlike the liability of the owner in a proprietary firm and the partners in a partnership concern, is limited to their capital contribution. Thanks to its limited downside and unlimited upside, equity provides enormous incentive for all sorts of innovation.

Some Terms

Authorised, Issued, Subscribed, and Paid-up Capital The amount of capital that a company can potentially issue, as per its memorandum, represents the *authorised capital*. The amount offered by the company to the investors is called the *issued capital*. That part of issued capital which has been subscribed to by the investors represents the *subscribed capital*. The actual amount paid up by the investors is called the *paid-up capital* – typically the issued, subscribed, and paid-up capital are the same.

Par Value, Issue Price, Book Value, and Market Value The *par value* of an equity share is the value stated in the memorandum and written on the share scrip. The par value of equity shares is generally ₹ 1, ₹ 2, ₹ 5, or ₹ 10. Infrequently, one comes across par values like ₹ 50, ₹ 100 and ₹ 1,000.

The *issue price* is the price at which the equity share is issued. Often, the issue price is higher than the par value. When the issue price exceeds the par value, the difference is referred to as the share premium. It may be noted that the issue price cannot be, as per law, lower than the par value.

The *book value* of an equity share is equal to:

$$\frac{\text{Paid-up equity capital + Reserves and surplus}}{\text{Number of outstanding equity shares}}$$

Quite naturally, the book value of an equity share tends to increase as the ratio of reserves and surplus to paid-up equity capital increases.

The *market value* of an equity share is the price at which it is traded in the market. This price can be easily established for a company which is listed on the stock market and actively traded. For a company which is listed on the stock market but traded very infrequently, it is difficult to obtain a reliable market quotation. For a company which is not listed on the stock market, one can merely conjecture as to what its market price would be if it were traded. The market price is determined by a variety of factors like current earnings, growth prospects, risk, and company size.

Rights and Position of Equity Shareholders

Right to Income Equity investors have a residual claim to the income of the firm. The income left after satisfying the claims of all other investors belongs to the equity shareholders. This income is simply equal to profit after tax minus preferred dividend.

The income of equity shareholders may be retained by the firm or paid out as dividends. Equity earnings which are ploughed back in the firm tend to increase the market value of equity shares and equity earnings distributed as dividend provide current income to equity shareholders.

Note that equity shareholders are entitled to approve the dividend that is declared by the board of directors. The dividend decision is the prerogative of the board of directors and equity shareholders cannot challenge this decision in a court of law.

Right to Control Equity shareholders, as owners of the firm, elect the board of directors and enjoy voting rights at the meetings of the company in person or by proxy (except in a poll) or by postal ballot. The board of directors, in turn, selects the management which controls the operations of the firm. Hence, equity shareholders, in theory, exercise an indirect control over the operations of the firm.

In India, most of the firms in the private sector are effectively controlled by business groups or families which often have a shareholding of 25 to 60 percent or even more. While institutional investors that have a sizable stake may exercise some influence, individual investors often have negligible influence as they have small holdings and they are ill-organised.

Companies in India can issue shares with differential voting rights (DVR). For example, in 2008 Tata Motors issued DVR shares carrying one-tenth the voting rights of and 5 percent more dividend than the ordinary shares.

Voting Procedures As per Section 152 (2) of the Companies Act, 2013 directors have to be appointed by the shareholders in a general meeting. While a maximum of 33 percent of the directors can be permanent, the articles of association of a company can provide for all directors to be rotational. At the annual general meeting, one-third of the rotational directors retire and their positions have to be filled by fresh election. Often, however, the rotational directors contest the election again and get re-elected.

Two systems of voting are permitted under the Companies Act 2013: (i) the majority voting system, and (ii) the proportionate representation voting system. Usually, the articles of association of a company provide for electing directors by a majority voting system. Under this system of voting, each share carries one vote and each director position is filled in individually. This means that a group that owns 51 percent of the equity can ensure that all the director positions are filled by its candidates.

As per Section 163 of the Companies Act, 2013, the articles of association of a company can provide for proportionate representation voting system for not less than two-third of its directors. Under the proportional voting system (also called the cumulative voting system), if there are *n* directors to be elected each share carries *n* votes.

The principal difference between the majority rule and proportionate rule voting systems is that under the former a majority is able to elect all members of the board whereas under the latter a significant minority, if it casts it votes intelligently, is assured of some representation on the board.

Pre-emptive Right The pre-emptive right enables existing equity shareholders to maintain their proportional ownership by purchasing the additional equity shares issued by the firm. The law requires companies to give existing equity shareholders the first opportunity to purchase, on a *pro rata* basis, additional issues of equity capital.

What kind of protection is offered by the pre-emptive right? This right ensures that the management cannot issue additional shares to persons or groups who are favourably disposed towards it and thereby strengthen its control over the firm. More important, the pre-emptive right protects the existing shareholders from the dilution of their financial interest, as a result of additional equity issue. This point may be illustrated by a numerical example. Pradhan Enterprises has 1,000,000 outstanding equity shares with a par value of ₹ 10 and a market price of ₹ 20. The firm plans to issue 500,000 additional equity shares at a price of ₹ 12 per share. The market price per share after this issue is expected to drop to ₹ 17.33[3]. Now, if a shareholder has 100 shares in the outstanding equity capital, his financial situation with respect to Pradhan's equity when he enjoys the pre-emptive right and when he does not enjoy the pre-emptive right would be as shown below:

Pre-emptive right		*No Pre-emptive right*	
Value of initial holding (₹ 20 × 100)	= ₹ 2,000	Value of initial holding (₹ 20 × 100)	= ₹ 2,000
Additional subscription (₹ 12 × 50)	= ₹ 600	Additional subscription	= 0
Value of equity holding after the additional issue (₹ 17.33 × 150)	= ₹ 2,600	Value of equity holding after the additional issue (₹ 17.33 × 100)	= ₹ 1,733

From this example, it is clear that the shareholder suffers dilution of financial interest when the pre-emptive right is not enjoyed. Thus the pre-emptive right protects the shareholder.

Right in Liquidation As in the case of income, equity shareholders have a residual claim over the assets of the firm in the event of liquidation. Claims of all others – debenture holders, secured lenders, unsecured lenders, other creditors, and preferred shareholders – are prior to the claim of equity shareholders. More often than not, equity shareholders do not get anything in the event of liquidation because the liquidation value of assets is not adequate to meet fully the claims of others.

Advantages and Disadvantages of Equity Capital

An important source of long-term finance, equity capital offers the following advantages:

- There is no compulsion to pay dividends. If the firm has insufficiency of cash it can skip equity dividends without suffering any legal consequences.
- Equity capital has no maturity date and hence the firm has no obligation to redeem.
- Because equity capital provides a cushion to lenders, it enhances the creditworthiness of the company. In general, other things being equal, the larger the equity base, the greater the ability of the firm to raise debt finance on favourable terms.
- Presently, dividends are tax-exempt in the hands of investors. The company paying equity dividend, however, is required to pay a dividend distribution tax of 15.0 percent plus surcharge and cess.

The disadvantages of raising finances by issuing equity shares are as follows:

- Sale of equity shares to outsiders dilutes the control of existing owners.
- The cost of equity capital is high, usually the highest. The rate of return required by equity shareholders is generally higher than the rate of return required by other investors.
- Equity dividends are paid out of profit after tax, whereas interest payments are tax-deductible expenses. This makes the relative cost of equity more. Partially offsetting this disadvantage is the fact that equity dividends are tax-exempt, whereas interest income is taxable in the hands of investors.
- The cost of issuing equity shares is generally higher than the cost of issuing other types of securities. Underwriting commission, brokerage costs, and other issue expenses are high for equity issues.

17.2 INTERNAL ACCRUALS

The internal accruals of a firm consist of depreciation charges and retained earnings. Depreciation represents a periodic writeoff of a capital cost incurred in the beginning. Put differently, it is a non-cash charge. Hence, it is considered an internal source of finance.

Retained earnings are that portion of equity earnings (profit after tax less preference dividends) which are ploughed back in the firm. Because retained earnings are the sacrifice made by equity shareholders, they are referred to as internal equity. Companies normally retain 30 percent to 80 percent of profit after tax for financing growth. If you look at a sample of corporate balance sheets you will find that reserves and surplus (other than share premium reserve and revaluation reserve), which essentially represent accumulated retained earnings, are often the dominant source of long-term finance. Even this is an understatement of the contribution of retained earnings to long-term finance because a portion of reserves and surplus would have been capitalised by the firm if it had issued bonus shares.

Advantages and Disadvantages of Internal Accruals

Internal accruals are viewed very favourably by most corporate managements for the following reasons:

- Retained earnings are readily available internally. They do not require talking to outsiders (shareholders or lenders).
- Retained earnings effectively represent infusion of additional equity in the firm. Use of retained earnings, in contrast to external equity, eliminates issue costs and losses on account of underpricing.
- There is no dilution of control when a firm relies on retained earnings.
- The stock market generally views an equity issue with skepticism. Retained earnings, however, do not carry any negative connotation.

The disadvantages of retained earnings include the following:

- The amount that can be raised by way of retained earnings may be limited. Further, the quantum of retained earnings tends to be highly variable because companies typically pursue a stable dividend policy. As a result, the variability of profit after tax is substantially transmitted to retained earnings.
- The opportunity cost of retained earnings is quite high for the firm. Remember that retained earnings, in essence, represents dividends foregone by equity shareholders.
- Many firms do not fully appreciate the opportunity cost of retained earnings. They impute a low cost to it. As a result, they may, comforted by the easy availability of retained earnings, invest in sub-marginal projects that have a negative NPV. Obviously, such a sub-optimal investment policy hurts the shareholders.

17.3 ▌ PREFERENCE CAPITAL

Preference capital represents a hybrid form of financing – it partakes some characteristics of equity and some attributes of debentures. It resembles equity in the following ways: (i) preference dividend is payable only out of distributable profits; (ii) preference dividend is not an obligatory payment (the payment of preference dividend is entirely within the discretion of directors); and (iii) preference dividend is not a tax-deductible payment.

Preference capital is similar to debentures in several ways: (i) the dividend rate of preference capital is fixed – since preference shares in India usually carry a cumulative feature with respect to dividends, unpaid dividends are carried forward and payable when the dividend is restored; (ii) the claim of preference shareholders is prior to the claim of equity shareholders; (iii) preference shareholders do not normally enjoy the right to vote; and (iv) preference capital is typically repayable.

Advantages and Disadvantages of Preference Capital

Preference capital offers the following advantages.

- There is no legal obligation to pay preference dividend. A company does not face bankruptcy or legal action if it skips preference dividend.
- Financial distress on account of redemption obligation is not high because preference shares are redeemable only out of profits or proceeds of a fresh issue of share (equity or preference).
- Preference capital is generally regarded as part of net worth. Hence, it enhances the creditworthiness of the firm.
- Preference shares do not, under normal circumstances, carry voting right. Hence, there is no dilution of control.
- No assets are pledged in favour of preference shareholders. Hence, the mortgageable assets of the firm are conserved.

Preference capital, however, suffers from some serious shortcomings:

- Compared to debt capital, it is a very expensive source of financing because the dividend paid to preference shareholders is not, unlike debt interest, a tax-deductible expense. Further, there is a dividend distribution tax.
- Though there is no legal obligation to pay preference dividends, preference dividends are typically payable with arrears.
- Compared to equity shareholders, preference shareholders have a prior claim on the assets and earnings of the firm.
- Preference shareholders acquire voting rights if the company skips preference dividend for a certain period.

17.4 TERM LOANS

So far we looked at the sources of finance which fall under the broad category of equity finance (or shareholders' funds). Now we turn our attention to long-term debt. Firms obtain long term debt mainly by raising term loans or issuing debentures. Historically, term loans given by financial institutions and banks have been the primary source of long-term debt for private firms and most public firms. Term loans, also referred to as term finance, represent a source of debt finance which is generally repayable in less than 10 years. They are mainly employed to finance acquisition of fixed assets and working capital margin. Term loans differ from short-term bank loans which are employed to finance short-term working capital need and tend to be self-liquidating over a period of time, usually less than one year[4].

Features of Term Loans

Currency Financial institutions (and banks) give rupee loans as well as foreign currency term loans. The most significant form of assistance provided by financial institutions, rupee term loans are given directly to business concerns for setting up new projects as well as for expansion, modernisation, and renovation projects. These funds are provided for incurring expenditure for land, building, plant and machinery, technical know-how, miscellaneous fixed assets, preliminary expenses, preoperative expenses, and margin money for working capital. Financial institutions (and banks) give rupee loans as well as foreign currency term loans.

Financial institutions provide foreign currency term loans for meeting the foreign currency expenditure towards import of plant, machinery and equipment, and payment of foreign technical know-how fees. The periodical liability for interest and principal remains in the currency/currencies of the loan and is translated into rupees at the prevailing rate of exchange for making payments to the financial institutions.

Security Term loans typically represent secured borrowing. Usually assets which are financed with the proceeds of the term loan provide the *prime* security. Other assets of the firm may serve as *collateral* security.

All loans provided by financial institutions, along with interest, liquidated damages, commitment charges, expenses, etc., are secured by way of:

- First equitable mortgage of all immovable properties of the borrower, both present and future.
- Hypothecation of all movable properties of the borrower, both present and future, subject to prior charges in favour of commercial banks for obtaining working capital advance in the normal course of business.

Interest Payment and Principal Repayment The interest and principal repayment on term loans are definite obligations that are payable irrespective of the financial situation of the firm. To the general category of borrowers, financial institutions charge an interest rate that is related to the credit risk of the proposal, subject usually to a certain floor rate. Financial institutions impose a penalty for defaults. If there is a default in payment of installments of principal and/or interest, the borrower is liable to pay by way of liquidated damages additional interest calculated for the period of default on the amount of principal and/or interest in default. In addition to interest, lending institutions may levy a commitment fee on the unutilised loan amount.

The principal amount of a term loan is generally repayable over a period of 5 to 10 years after an initial grace period of 1 to 2 years. Typically, term loans provided by financial institutions are repayable in equal semi-annual installments or equal quarterly installments.

Note that the interest burden declines overtime, whereas the principal repayment remains constant. This means that the total debt servicing burden (consisting of interest payment and principal repayment) declines over time. This pattern of debt servicing burden, typical in India, differs from the pattern obtaining in western economies where debt is typically amortised in equal periodic installments.

Restrictive Covenants In order to protect their interest, financial institutions generally impose restrictive conditions on the borrowers. While the specific set of restrictive covenants depends on the nature of the project and the financial situation of the borrower, loan contracts often require that the borrowing firm:

- Broad-base its board of directors and finalise its management set-up in consultation with and to the satisfaction of the financial institutions.
- Make arrangements to bring additional funds in the form of unsecured loans/deposits for meeting overruns/shortfalls.
- Refrain from undertaking any new project and/or expansion or make any investment without the prior approval of the financial institutions.
- Obtain clearances and licences from various government agencies.
- Repay existing loans with the concurrence of financial institutions.
- Refrain from additional borrowings or seek the consent of financial institutions for additional borrowings.
- Reduce the proportion of debt in its capital structure by issuing additional equity and preference capital.
- Limit its dividend payment to a certain rate or seek the consent of financial institutions to declare dividend at a higher rate.
- Refrain from creating further charges on its assets.
- Provide periodic information about its operations.
- Limit the freedom of the promoters to dispose of their shareholding.
- Effect organisational changes and appoint suitable professional staff.
- Give financial institutions the right to appoint nominee directors.

Advantages and Disadvantages of Debt Financing

Term loans and debentures are two important ways of raising long-term debt. The advantages of debt financing are as follows:

- Interest on debt is a tax-deductible expense, whereas equity and preference dividend are paid out of profit after tax.
- Debt financing does not result in dilution of control because debt holders (term lending institutions and debenture holders) are not entitled to vote.
- Debt holders do not partake in the value created by the company as payments to them are limited to interest and principal.
- The maturity of a debt instrument can be tailored to synchronise with the period for which the firm needs funds.
- If there is a precipitous decline in the value of the firm, shareholders have the option of defaulting on debt obligations and turning over the firm to debt holders.
- Issue costs of debt are significantly lower than those on equity and preference capital.
- The burden of servicing debt is generally fixed in nominal terms. Hence, debt provides protection against high unanticipated inflation.
- Debt has a disciplining effect on the management of the firm.
- It is generally easier for management to communicate their proprietary information about the firm’s prospects to private lenders than to public capital markets.

Debt financing is not an unmixed blessing. It has several disadvantages associated with it:

- Debt financing entails fixed interest and principal repayment obligation. Failure to meet these commitments can cause a great deal of financial embarrassment and even lead to bankruptcy.
- Debt financing increases financial leverage which, according to CAPM, raises the cost of equity to the firm.
- Debt contracts impose restrictions that limit the borrowing firm’s financial and operating flexibility. These restrictions may impair the borrowing firm’s ability to resort to value-maximising behaviour.
- If the rate of inflation turns out to be unexpectedly low, the real cost of debt will be greater than expected.

17.5 DEBENTURES

For large publicly traded firms, debentures are a viable alternative to term loans. Akin to promissory notes, debentures are instruments for raising long term debt. Debenture holders are the creditors of company. The obligation of a company toward its debenture holders is similar to that of a borrower who promises to pay interest and principal at specified times. Debentures often provide more flexibility than term loans as they offer greater variety of choices with respect to maturity, interest rate, security, repayment, and special features.

Features of Debentures

Trustee When a debenture issue is sold to the investing public, a trustee is appointed through a trust deed. The trustee is usually a bank or a financial institution or an insurance company. Entrusted with the role of protecting the interest of debenture holders, the trustee is supposed to ensure that the borrowing firm fulfills its contractual obligations.

Security Most debenture issues in India are secured by mortgages/charges on the immovable properties of the company and a floating charge on its other assets (subject to prior charges created in favour of the company's bankers over the current assets). However, the order of priority of mortgages/charges may vary across different debenture issues. Occasionally, companies issue unsecured debentures. These are regarded as deposits under the Companies Act.

Interest Rate Debentures may carry a fixed interest rate or a floating interest rate or a zero interest rate. The fixed interest rate debenture issue has been the most popular debenture instrument in India. Typically, the interest rate is payable in two equal semi-annual instalments.

Maturity and Redemption Corporate debt may be short-term, medium term, or long term. Short-term corporate debt of less than one year is called commercial paper. Since this is an instrument of working capital financing, it is discussed in Chapter 27. Medium term debentures may have a maturity of 1 year to 5 years[5]. Long-term debentures typically have a maturity period of 5-15 years. While financial markets are generally not receptive to debentures that mature beyond 15 to 20 years, some firms like Disney, Boeing, and Reliance have issued debentures with maturities of even 50 to 100 years in recent times. Medium term debentures are often redeemed by way of a bullet payment, whereas long term debentures are generally redeemed in installments of 2-3 years.

For all debenture issues with a maturity period of more than 18 months, a Debenture Redemption Reserve (DRR) has to be created. The company should create a DRR equivalent to at least 25 percent of the amount of issue before redemption commences.

Call and Put Feature Debentures may carry a 'call' feature which provides the issuing company the option to redeem the debentures at a certain price before the maturity date. Sometimes the debentures may have a ‘put’ feature which gives the holder the right to seek redemption at specified times at predetermined prices.

Convertibility A company may issue debentures which are convertible into equity shares at the option of the debenture holders. The ratio of conversion and the period during which conversion can be effected are specified at the time of debenture issue.

Advantages and Disadvantages of Debentures

The advantages and disadvantages of debt financing, discussed in the previous section which focused on term loans, are more or less applicable to debenture financing as well. One important difference between debentures and term loans may be noted here. Before the issue, a firm enjoys greater flexibility in designing the debenture issue. After the issue, however, the firm hardly has any freedom in re-negotiating the terms of the issue.

By comparison, a firm has lesser flexibility in hammering out the features of a term loan. After taking the term loan, however, the firm enjoys greater real freedom in re-negotiating the terms of the loan contract.

The reason for this difference is fairly straightforward. In the case of a debenture issue a firm deals with numerous investors whereas in the case of a term loan a firm deals with one or a few institutional investors.

QUESTIONS

1. What are the key differences between debt and equity?
2. Define the following terms in relation to an equity share: par value, issue price, book value, and market value.
3. What is the equity shareholders' right to income and control?
4. Discuss the pre-emptive right of equity shareholders.
5. What kind of protection is provided by the pre-emptive right?
6. What are the advantages and disadvantages of equity capital?
7. What are the advantages and disadvantages of retained earnings?
8. Why is preference capital considered as a hybrid form of financing?
9. What are the advantages and disadvantages of preference capital?
10. Discuss the important features of term loans in India.
11. What are the advantages and disadvantages of debt financing?
12. Discuss the salient features of debentures.
13. How do various instruments of long-term financing compare?
14. What has been the pattern of corporate financing in India?

PRACTICAL ASSIGNMENT

For the company chosen by you, analyse the pattern of financing for the past three years.

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[1] Strictly speaking, preference capital is a hybrid source of financing. Sacrificing some rigour, we have included it under equity here.

[2] Short-term sources of finance will be discussed in Chapter 27.

[3] The expected price is calculated as follows

(1,000,000 × ₹ 20 + 500,000 × ₹ 12)/1,500,000 = ₹ 17.33

[4] In practice, of course, due to the phenomenon of "roll over", their effective maturity is longer.

[5] Many companies issue debentures that have a maturity of slightly less than 18 months to circumvent a SEBI regulation that calls for compulsory credit rating of all debenture issues that have a maturity of 18 months or more.

18

CHAPTER

Raising Long Term Finance

Learning Objectives

After studying this chapter you should be able to:

- ✓ Describe the features of venture capital and private equity.
- ✓ Understand the pros and cons of a public offering.
- ✓ Appreciate the characteristics of a rights issue.
- ✓ Know the procedure associated with a term loan.
- ✓ Explain the services provided by an investment banker.

When a company is formed, it first issues equity shares to the promoters (founders) and also, in most cases, raises loans from banks, financial institutions, and other sources. As the need for financing increases, the company may issue shares and debentures privately to promoters' relatives, friends, business partners, employees, financial institutions, banks, mutual funds, venture capital funds, and private equity funds – the last two are likely to be an important source of finance for a nascent venture. Such investors are specific and small in number.

As the company grows further, it may have to raise capital from the public. The first issue of equity shares to the public by an unlisted company is called the initial public offering (IPO). Subsequent offerings are called seasoned offerings.

In Chapter 17 we looked at the features of various securities and term loans used by business firms for raising long term finance. This chapter discusses the procedures involved in issuing securities and raising term loans. While the procedures described in this chapter apply to both debt and equity, our emphasis will be more on equity. The focus will be on when, how, and to whom securities are issued.

18.1 VENTURE CAPITAL AND PRIVATE EQUITY

A young private company that is not yet ready or willing to tap the public financial market may seek venture capital (VC). Such capital is provided by venture capital funds which are prepared to finance an untried concept that appears to have promising prospects. Venture capital funds seek to support growing firms during their initial stages, before they are ready to make a public offering of securities. Venture capital is provided mainly in the form of equity capital.

Venture capital represents financial investment in a highly risky proposition made in the hope of earning a high rate of return. While the concept of venture capital is perhaps as old as the human race, the practice of venture capitalism has remained somewhat fragmented and individualised throughout its long history. Only in the last five decades or so, the field of venture capital has acquired a certain degree of coalescence, maturity, and sophistication, particularly in the U S. Venture capital, a relatively new phenomenon on the Indian scene, is expected to assume greater significance in the years to come.

A related term in industry circles is private equity (PE). While there are some differences between the two, there is considerable overlap between the two. Most of the discussion here would apply equally to VC and PE.

Evolution of Indian VC Industry[1] The Indian VC industry is of relatively recent origin. Prior to the formation of these VC institutions, Indian development financial institutions provided risk capital to industry in the form of subscription to equity, seed capital to first generation entrepreneurs, and other similar forms of risk capital. They were playing the role of VCs in a way, although they did not follow the rigorous processes that a modern day VC would follow. ICICI Ventures (formerly TDICI Ltd.) was the first VC institution and was promoted as a joint venture of ICICI Ltd. and Unit Trust of India (UTI) in 1988. Several other commercial banks and development financial institutions followed with their own VC subsidiaries. With the liberalisation of foreign investment into Indian companies, international investors emerged as more significant players in the Indian VC industry from the mid 1990s.

Foreign investors brought with them the lessons they had learned in various other developed as well as emerging markets. They have introduced the western investment philosophy and processes into their transactions with Indian companies. Rigorous due diligence, tight contracting, active post financing involvement, and a sharp focus on timely and profitable exit are among their more important contribution. Since their investible funds are part of a global pool of capital, investment sentiments of foreign VC investors in India became closely tied into international investment sentiments.

Features of Venture Capital Although the terms and conditions on which venture capital is provided are not standardised, the following appear to be the salient features of venture capital arrangements:

- The venture capitalist (VC, hereafter) is inclined to assume a high degree of risk in the expectation of earning a high rate of return.
- The VC typically subscribes to equity or quasi-equity financing instruments, which enable it to share the risks and rewards of the investee firm.
- The VC, in addition to providing funds, takes an active interest in guiding the assisted firm.
- The financial burden for the assisted firm tends to be negligible in the first few years.
- The VC normally plans to liquidate its investment in the assisted firm after 3 to 7 years. Typically, the promoter of the assisted firm is given the first option to acquire the equity investment held by the VC.

Private Equity and Venture Capital Private equity (PE) and venture capital (VC) have some common features:

- They invest in companies that are not able or ready to raise capital from the public.
- They are set up as independent pools of capital contributed by institutions or high net worth individuals and run by managers with strong financial incentives linked to the performance of the funds.
- Armed with tightly written investment agreements, they actively oversee the investee companies.
- Their activities are subject to few regulations.

There are, however, some differences between the operations of PE and VC:

- In contrast to VC, PE investors invest mostly in later stage operations with a substantial operating history.

- PE investment may be used for financial or operational restructuring of the investee company.
- PE investment package may include debt, which is rare in a VC investment package.
- The PE investor puts more emphasis on corporate governance, whereas the VC investor focuses more on management capability.

Growing Prominence of PE In its formative years, the Indian industry was characterised more by VC style investing in small, early stage companies. More recently, in the past decade years or so, PE type investments have become more common. One possible explanation for the shift away from small and early stage investments might be the difficulty in disposing of such investments. Another reason could possibly be that larger investments enable fund managers to manage larger pools of capital without increasing the number of companies in the portfolio. This in turn allows the fund management companies to realise economies of scale by earning higher fee income without expanding the staff complement. It is also equally likely that the absence of high quality early stage opportunities that one finds in the U.S. and the lack of experience among investment managers to deal with the risks in those investments are some of the other reasons for the shift to larger investments, as has been the experience in Europe.

Preparing a Business Plan If you are approaching a venture capitalist or a private equity fund to finance your project, how should you prepare your business plan? Here are some guidelines:

- Use simple and clear language. Avoid bombastic presentation and technical language.
- Focus on four basic elements, viz., people, product, market, and competition.
- Give projections for about two years with emphasis on cash flows.
- Identify risks and develop a strategy to cope with the same.
- Convince that the management team is talented, committed, and determined.

Relevance of Private Equity

Globally, private equity has become an integral part of the financial services industry in the last two decades. There has been a paradigm shift in the investment model. Partnership and mutual dependence have become the basis of the relationship between private equity investors and investee companies.

In India, too, private equity has become quite important in the last decade or so. It seems to be an attractive funding option. David Rubenstein, co-founder of The Carlyle Group, argues: “Large private equity firms have the experience, organisation, processes, and risk appetite to move rapidly to evaluate and close investments. It is the only class of investors who have the ability, track record and willingness to add value without any ultimate control desires.”

18.2 INITIAL PUBLIC OFFER

The first public offering of equity shares of a company, which is followed by a listing of its shares on the stock market, is called the initial public offer (IPO).An IPO is often considered as an important milestone in a company's lifecycle marking its transition from a small closely-held company to a listed entity.

An IPO can be done either through a fresh issue of shares by the company or through an offer for sale of existing shares to investors. In the former case, fresh capital is injected into the company and its equity base expands. In the latter case, there is no infusion of capital in the company because the proceeds of the issue go to shareholders who offer their shares for sale.

In 2010, SEBI prescribed a minimum threshold level of public holding to be 25 percent for all listed companies. If the post issue capital of a company, calculated at the offer price, is more than ₹ 4,000 crore, the company is allowed to go public with 10 percent public shareholding and comply with the mandatory 25 percent public shareholding requirement by increasing its public shareholding by at least 5 percent per annum. Likewise, existing listed companies having less than 25 percent public shareholding have to comply with 25 percent public shareholding norm by an annual increase of not less than 5 percent to public shareholding.

Decision to Go Public

The decision to go public (or more precisely the decision to make an IPO so that the securities of the company are listed on the stock market and publicly traded) is a very important, but not well studied, question in finance. It is a complex decision which calls for carefully weighing the benefits against costs.

Benefits of Going Public The potential advantages that seem to prod companies to go public are as follows:

Access to Capital The principal motivation for going public is to have access to larger capital. A company that does not tap the public financial market may find it difficult to grow beyond a certain point for want of capital.

Respectability Many entrepreneurs believe that they have “arrived” in some sense if their company goes public because a public company may command greater respectability. Competent and ambitious executives would like to work for growth. Other things being equal, public companies offer greater growth potential compared to non-public companies. Hence, they can attract superior talent.

Investor Recognition In his capital asset pricing model with incomplete information, Robert Merton shows that, other things being equal, stock prices are higher, the larger the number of investors who are aware of the securities of the firm.

Window of Opportunity As suggested by Jay Ritter and others, there are periods in which stocks are overpriced. Hence, when a non-public company recognises that other companies in its industry are overpriced, it has an incentive to go public and exploit that opportunity.

Liquidity Promoters of a company would eventually like their investment to become liquid. This becomes easier when they take their company public.

Benefit of Diversification When a firm goes public those who have investment in it – original owners, investors, managers, and others – can cash out of the firm and build a diversified portfolio.

Signals from the Market Stock prices represent useful information to the managers. Everyday, investors render judgment about the prospects of the firm. Although the market may not be perfect, it provides a useful reality check.

Costs of Going Public A public company, of course, is not an unmixed blessing. There are several disadvantages of going public.

Adverse Selection Investors, in general, know less than the issuers about the value of companies that go public. Put differently, they are potential victims of adverse selection. Aware of this trap, they are reluctant to participate in public issues unless they are significantly underpriced. Hence, a company making an IPO, typically has to underprice its securities in order to stimulate investor interest and participation.

Dilution When a company issues shares to public, existing shareholders suffer dilution of their proportionate ownership in the firm.

Loss of Flexibility The affairs of a public company are subject to fairly comprehensive regulations. Hence, when a non-public company is transformed into a public company there is some loss of flexibility.

Disclosures A public company is required to disclose a lot of information to investors and others. Hence, it cannot maintain a strict veil of secrecy over its expansion plans and product market strategies as its non-public counterpart can do.

Accountability Understandably, the degree of accountability of a public company is higher. It has to explain a lot to its investors.

Public Pressure Because of its greater visibility, a public company may be pressurised to do things that it may not otherwise do.

Costs Apart from the cost of issuing securities, a public company has to incur recurring costs for providing investors with periodical reports, holding shareholder meetings, communicating with institutional investors and financial analysts, and fulfilling various statutory obligations.

Eligibility for an IPO[2]

To be eligible to make an IPO a company has to satisfy all the following conditions.

Track Record The company should have net tangible assets of at least ₹ 3 crore, net worth of at least ₹ 1 crore, and minimum average pre-tax profit of ₹ 15 crore in 3 out of preceding five years on a consolidated basis. The issue size should not exceed five times the pre-issue net worth.

If a company does not fulfil the above eligibility criteria, it has to necessarily make an IPO through the book-building route.

QIB Participation The issue is made through the book-building process, with at least 75 percent of the issue size being allotted to Qualified Institutional Buyers[3]. The post-issue capital has to be at least ₹ 10 crore, failing which the company may choose to list on the SME platform with compulsory market making for three years.

Issue Pricing

As per the present SEBI Issue of Capital and Disclosure Requirements (ICDR) Regulation, every company, whether unlisted or listed, which is eligible to make a public issue can freely price its shares. However, the issuing company has to disclose the basis for the issue price in terms of the following:

- Adjusted EPS (for past three years)
- P/E ratio in relation to issue price
- Return on net worth
- Minimum return on the total net worth after the issue needed to maintain EPS
- Net asset value

IPOs are priced by companies in conjunction with merchant bankers. There are three ways of pricing an IPO: fixed price mechanism, book building, and French auction. In the **fixed price mechanism**, the price at which the shares are to be issued to the public is fixed before the issue opens for subscription.

In the **book-building mechanism**, the company announces a price band within which potential investors are required to bid for the shares. During the bidding process, investors can change their bids. After the bidding is over, the cut-off price is determined based on the demand for the share. Retail investors can opt for the cut-off price.

Under the **French auction**, retail investors are free to bid at the floor price but institutional investors have to bid at a higher price: Investors cannot change their bids during the bidding process. In a French auction, successful institutional bidders pay the actual price they bid for, while retail and non-institutional investors pay the floor price. For their follow on public offers in 2010, NTPC and REC used the French auction.

Principal Steps in an IPO

The issue of securities to members of the public through a prospectus involves a fairly elaborate process, the principal steps of which are as follows.

1. The board of directors approves the proposal to raise capital from the public and authorises the managing director (or a board committee) to proceed with it.
2. The company convenes a meeting to seek the approval of shareholders and the shareholders pass a special resolution under the Companies Act authorising the company to make the public issue.
3. The company appoints a merchant banker as the lead manager (LM) to the issue.
4. The LM carries out due diligence to check all relevant information, documents, and certificates for the issue.
5. The company, advised by the LM, appoints various intermediaries such as the registrar to the issue, the bankers to the issue, the printers, and advertiser.
6. The LM draws up the issue budget, keeping in mind the guidelines issued by the Ministry of Finance on issue expenses, and the company approves the same (The main components of the issue expenses are fees for LM, underwriters, registrar and bankers, brokerage, postage, stationery, issue marketing expenses, etc.)
7. The LM prepares the draft prospectus in consultation with management and seeks the approval of the board.
8. The LM files the draft prospectus, approved by the board, with SEBI for its observation along with a soft copy on the CD. SEBI places the same on its website for comments from the public.
9. The company makes listing application to all the stock exchanges where the shares are proposed to be listed along with copies of the draft prospectus. The draft prospectus is also hosted on the websites of the LM and the underwriters.
10. The company enters into a tripartite agreement with the registrar and all the depositories for providing the facility of offering the shares in a dematerialised mode.
11. If the issue is proposed to be underwritten (it is optional in a retail issue and mandatory in a book built issue to the extent of the net

public offer), the LM makes underwriting arrangements.

12. Within 21 days, SEBI makes its observations on the draft prospectus. The stock exchanges also suggest changes, if any. The company carries out the modifications to the satisfaction of these authorities.
13. The company files the prospectus with the Registrar of Companies (ROC).
14. The LM and the company market the issue using a combination of press meetings, brokers' meetings, investors' meetings, and so on.
15. The company releases a mandatory advertisement, called the 'announcement advertisement' 10 days prior to the opening of the issue. This has to conform to Form 2A, also called the abridged prospectus.
16. The LM and the printer dispatch the application forms to all stock exchanges, SEBI, collection centres brokers, underwriters, and investor associations. Every application form is accompanied by the abridged prospectus.
17. The issue is kept open for a minimum of 3 days and a maximum of 10 days, in the case of a book built offer.
18. After the issue is closed, the basis of allotment is finalised by the stock exchange, LM, and the registrar, in conformity with certain SEBI- prescribed rules.
19. The LM ensures that the demat credit or dispatch of share certificates and refund orders to the allottees is completed within two working days after the basis of allotment is finalised and the shares are listed within 7 days of the finalisation of the basis of allotment.
20. If there is a devolvement on the underwriters, the LM ensures that the underwriters honour their commitments within 60 days from the date of closure of the issue.
21. If the issuing company avails of the Green Shoe option(under which the company retains a portion of the over-subscription), the company appoints one of the issue managers as the stabilisation agent (SA), who will be responsible for the price stabilisation process.

Role of the Lead Manager of the Issue

The lead manager of a public issue may be likened to the ‘conductor’ of an opera who has to ensure the overall success of the issue. His principal tasks are to:

- Structure the issue, taking into account the funds requirements of the company, the expectations of the investors, and other relevant factors.
- Submit the draft prospectus to SEBI.
- Arrange underwriting by financial institutions, commercial banks, and brokers.
- Finalise the prospectus in consultation with solicitors, stock exchange authorities, and others.
- Coordinate the efforts of brokers, bankers, registrars, advertising agencies, printers, and others.
- Develop the strategy for marketing the issue by using a judicious mix of conferences (press, broker, and investor), advertisements, mailings, etc.
- Monitor the issue during the subscription period.
- Help in finalising the basis of allotment.
- Assist in securing stock exchange listing.

Cost of Public Issue

The cost of public issue is normally between 6 and 12 percent, depending on the size of the issue and the level of marketing effort. The important expenses incurred for a public issue are as follows:

Underwriting Expenses The underwriting commission may be upto 2.5 percent of the nominal value (including premium, if any) of the equity capital being issued to public.

Brokerage Brokerage applicable to all types of public issues of industrial securities is fixed at not more than 1.5 percent, whether the issue is underwritten or not. The managing brokers (if any) can be paid a maximum remuneration of 0.5 percent of the nominal value of the capital being issued to the public.

Fees to the Managers to the Issue Previously the aggregate amount payable as fees to the managers to the issue was subject to certain limits. Presently there are no such restrictions. The fees is fixed on the basis of negotiation.

Fees for Registrars to the Issue The compensation to the registrars, typically based on a piece rate system, depends on the number of applications received, number of allottees, and the number of unsuccessful applicants.

Printing Expenses These relate to the printing of prospectus, application forms, brochures, share certificates, allotment/refund letters, envelopes, etc.

Postage Expenses These pertain to the mailing of application forms, brochures, and prospectus to investors by ordinary post and the mailing of allotment/ refund letters and share certificates by registered post.

Advertising and Publicity Expenses These are incurred primarily toward statutory announcements, other advertisements, press conferences, and investor conferences.

Listing Fees This is the fees payable to concerned stock exchanges where the securities are listed. It consists of two components: initial listing fees and annual listing fees.

Stamp Duty This is the duty payable on share certificates issued by the company. As this is a state subject, it tends to vary from state to state.

In order to control the costs of public issues, the following overall ceiling limits were fixed sometime back under the Companies Act. Though redundant now, they serve as guidelines.

Particulars of Issue	*Limit of the Cost*
(a) Equity and convertible debentures	
—Up to ₹ 5 crore	Mandatory costs + 5 percent
—In excess of ₹ 5 crore	Mandatory costs + 2 percent
(b) Non-convertible debentures	
—Up to ₹ 5 crore	Mandatory costs + 2 percent
—In excess of ₹ 5 crore	Mandatory costs + 1 percent

Mandatory costs include underwriting commission, brokerage, fees of managers to the issue, expenses on statutory announcements, listing fees, and stamp duty. SEBI guidelines, however, have not prescribed any cost ceiling.

Underpricing of Initial Public Offerings (IPOs)[4]

Underpricing of IPOs appears to be a universal phenomenon, though the degree of underpricing varies widely across countries. Why does such underpricing happen? Financial economists offer the following explanations.

- *Winner's Curse* Investors may be divided into two categories, viz., 'informed' and 'uninformed'. In general, financial institutions are likely to be informed and individual investors uninformed. Individual investors, uninformed as they are, tend to be victims of the winner's curse. When they receive allotment of shares they have applied for in an IPO, it may be because the shares are overpriced and informed investors have, in general, stayed away from the issue. Hence, the uninformed investors will need an incentive in the form of substantial underpricing of the IPO to remain in the market.
- *Bait for Future Offerings* A company making an IPO would like the investors to have a rewarding experience. Satisfied investors develop a loyalty toward the company. This helps the company in raising more capital at a higher price in future.
- *Informational Asymmetry* In general, merchant bankers (also referred to as investment bankers) know the market better than the issuing company. They may exploit this superior knowledge to underprice issues. This makes their job easier and helps them earn the goodwill of investors.
- *Regulatory Constraints* Sometimes regulatory guidelines lead to underpricing. During the days of the Controller of Capital Issues, the issue price in India was governed by a very conservative formula.
- *Political goals* Companies may deliberately underprice their issues and allot them to people in power. In Japan, for example, the Recruitment Company sold the shares of its subsidiary Cosmos through a severely underpriced IPO to several politicians including the then Prime Minister Takeshita (when the scandal was exposed Takeshita had to resign). In U.K., Margaret Thatcher privatised firms like British Airways and British Steel through underpriced IPOs to garner acceptance for her privatisation initiatives and promote popular capitalism.

IPO Puzzles

Financial economists are puzzled by four characteristics of IPOs.

- One, on average, IPOs appear to be underpriced. The closing price on the day of issue is often significantly higher than the issue price.
- Two, the number of issues is highly cyclical. During good times, the market is flooded with new issues; during bad times, the number of issues falls substantially.
- Three, issue costs of IPOs are quite high.
- Four, the long-run performance (three to five years from the date of issue) of IPOs is poor.

18.3 FOLLOW ON PUBLIC OFFER

For most companies, their IPO is seldom their last public issue. As companies grow, they are likely to make further trips to the capital market with issues of debt and equity. These issues may be public issues offered to investors at large (called follow on public offers or FPOs) or rights issues offered to existing shareholders. This section looks at a follow on public issue and the following section at a rights issue.

The procedure for an FPO of equity is similar to that of an IPO. Hence, most of the steps involved in an IPO, discussed in the previous section, are applicable to a secondary public offer as well. However, an FPO is subject to fewer regulations, when compared to an IPO.

The key provisions applicable to a FPO are as follows:

- A listed company is eligible to a public offer of equity shares or a convertible instrument provided that the aggregate size of the proposed issue and all previous issues made in the same financial year by the company do not exceed five times its pre-issue net worth as per the audited balance sheet of the last financial year. For this purpose, the aggregate size of the issue should be reckoned at the net public offer through the offer document + firm allotments + promoters' contribution through the offer document.
- The promoters shall either participate to the extent of 20 percent of the proposed issue or ensure that their holding in the post-issue equity capital is at least 20 percent.
- If the promoters wish to subscribe in the FPO beyond the required minimum of 20 percent, such excess contribution shall be subject to preferential allotment guidelines. Participation by the promoters in the secondary offer in excess of the required minimum percentage of 20 percent shall be locked in for a period one year.
- The requirement of minimum promoters' contribution and lock-in of excess contribution shall not be applicable in case of a secondary offer by a company that has been listed on a stock exchange for a minimum of 3 years and has a track record of dividend payment for the immediately preceding 3 years. The requirement for promoter's contribution also does not apply for companies where no identifiable promoter or promoter group exists.

Public Offer of Debt At the outset it may be noted that as far as debt issues are concerned, no distinction is made between an IPO and FPO. The most important distinction in the case of debt is between a public offer and a private placement. Public offers of debt securities are governed by a separate set of regulations issued by SEBI.

The mechanics of a public offer of a debt security are much the same as that of a public offer at equity. However, there are some differences:

- Pure debt securities are typically offered through the 100 percent retail route because the book-building route is not appropriate for them.
- Debt securities are generally secured against the assets of the issuing company and the security should be created within six months of the close of the issue of debentures.
- The prospectus for a debt offering typically emphasises a company's stable cash flows, whereas the prospectus for an equity offering highlights the company's growth prospects.

As per SEBI (Issue and Listing of Debt Securities) Regulations, 2008, for making a public issue of debt securities the following conditions have to be satisfied as on the date of filing of draft offer document and final offer document with the designated stock exchange through the lead merchant banker.

- An application has been made to one or more recognised stock exchanges for listing of such securities and an in-principle approval for the listing has been obtained.
- Credit rating has been obtained from at least one credit rating agency registered with SEBI and the same is disclosed in the offer document.
- An arrangement for dematerialisation of the debt securities with a SEBI-registered depository has been made in accordance with the Depositories Act, 1996.
- One or more SEBI-registered merchant bankers have been appointed with at least one of them serving as the lead merchant banker.
- One or more debenture trustees have been appointed in accordance with the provisions of the Companies Act and SEBI (Debenture Trustees) Regulations.
- Where the issuer desires to roll-over the debt securities issued by it, it shall do so only upon passing of a special resolution of holders of

such securities and give twenty one days' notice of the proposed roll out to them.

- An issuer may list its debt securities issued on private placement basis on a recognised stock exchange provided it is credit-rated and dematerialised and the issuer makes required disclosures.

18.4 RIGHTS ISSUE

A rights issue is an issue of capital to the existing shareholders of the company through a 'Letter of Offer' made in the first instance to the existing shareholders on a *pro rata* basis. This is required under the Companies Act. The shareholders, however, may by a special resolution forfeit this right, partially or fully, to enable the company to issue additional capital to public. As an alternative, after shareholders pass a general resolution, the Board of Directors can seek the approval of the Central Government to issue additional shares to outsiders. The Indian law regarding rights issue is similar to that of European countries. In the U.S., however, rights issues are made mostly by closed-end investment companies.

Characteristics of Rights The important characteristics of rights are:

- The issuing firm decides on the number of rights shares to be issued. For example, a firm that currently has 100 million outstanding shares may decide to issue 20 million right shares.
- Based on the number of rights shares proposed to be issued, the rights entitlement of the existing shareholders is determined. Thus, in the above case 5 existing shares are required to subscribe to 1 rights share.
- The price per share for additional equity, called the subscription price, is left to the discretion of the company.
- Rights are negotiable. The holder of rights can sell them.
- Rights can be exercised only during a fixed period which is usually about 30 days.

Procedure for a Rights Issue A company making a rights issue sends a 'letter of offer', along with a composite application form consisting of four forms (A, B, C, and D) to the shareholders. Form A is meant for acceptance of the rights and application for additional shares. This form shows the number of rights shares the shareholder is entitled to. It also has a column through which a request for additional shares may be made. Form B is to be used for renouncing the rights in favour of someone. Form C is meant for application by the renouncee in whose favour the rights have been renounced, by the original allottee, through Form B. Form D is to be used to make a request for split forms. The composite application form must be mailed to the company within a stipulated period, which is usually about 10 days.

Conditions The conditions that have to be satisfied for obtaining the approval for rights issues are as follows:

- Existing shareholders, who exercise their rights in full, are given an opportunity to apply for additional shares.
- Existing shareholders who renounce their rights, wholly or partially, are not entitled to apply for additional shares.
- Shares which become available, due to non-exercise of rights by some shareholders, are allotted to shareholders who have applied for additional shares in proportion to their shareholding.
- Any balance shares, left after meeting requests for additional shares by the existing shareholders, are disposed of at the ruling market price or the issue price, whichever is higher.

Consequences of a Rights Issue What are the likely consequences of a rights issue on the market value per share, value of a right, earnings per share, and the wealth of shareholders? To answer this question, let us look at the illustrative data of the Right and Left Company given in Exhibit 18.1.

Exhibit 18.1 **Illustrative Data of the Right and Left Company**

Paid-up equity capital (1,000,000 shares of ₹ 10 each)	₹ 10,000,000
Retained earnings	20,000,000
Earnings before interests and taxes	12,000,000
Interest	2,000,000
Profit before tax	10,000,000
Taxes (50 percent)	5,000,000
Profit after taxes	5,000,000
Earnings per share	₹ 5
Market price per share (Price-earnings ratio of 8 is assumed)	₹ 40
Number of additional equity shares proposed to be issued as rights shares	200,000
Proposed subscription price	₹ 20
Number of existing shares required for a rights share (1,000,000/200,000)	5

Value of a Share The value of a share, after the rights issue, is expected to be:

$$\frac{NP_0 + S}{N + 1} \tag{18.1}$$

where N is the number of existing shares required for a rights share, P_0 is the cum-rights market price per share, and S is the subscription price at which the rights share are issued.

The rationale behind this formula is as follows: For every N shares before the rights issue, there would be $N + 1$ shares after the rights issue. The market value of these $N + 1$ shares is expected to be the market value of N cum-rights shares plus S, the subscription price.

Applying this formula to the data given in Exhibit 18.1 we find that the value per share after the rights issue is expected to be:

$$\frac{5 \times 40 + 20}{5 + 1} = ₹\ 36.67$$

Value of a Right The theoretical value of a right is:

$$\frac{N(P_0 - S)}{N + 1} \tag{18.2}$$

The value is determined as follows. The difference between the market price of a share after the rights issue and the subscription price is the benefit derived from a right, which is required along with the subscription price to obtain one rights share. This means that the value of a right is:

$$\frac{NP_0 + S}{N + 1} - S = \frac{N(P_0 - S)}{N + 1} \tag{18.3}$$

Applying the above formula to the data given in the Exhibit 18.1, we find that the value of one right of the Left and Right Company is:

$$\frac{5(40 - 20)}{5 + 1} = ₹\ 16.67$$

Wealth of Shareholders The wealth of existing shareholders, *per se*, is not affected by the rights offering, provided, of course, the existing shareholders exercise their rights in full or sell their rights. To illustrate this point, consider what happens to a shareholder who owns 100 equity shares of the Left and Right Company that has a market value of ₹ 40 each before the rights issue. The impact on his wealth when he exercises his rights, when he sells his rights, and when he allows his rights to expire is shown below.

He exercises his rights

Market value of original shareholding at the rate of ₹ 40 per share	= ₹ 4,000
Additional subscription price paid for 20 rights shares at the rate of ₹ 20 per share	= ₹ 400

Total investment	= ₹ 4,400
Market value of 120 shares at the rate of ₹ 36.67 per share after the rights subscription	= ₹ 4,400
Change in wealth (₹ 4,400 − ₹ 4,400)	= ₹ 0

He sells his rights

Market value of original shareholding at the rate of ₹ 40 per share	= ₹ 4,000
Value realised from the sale of 20 rights at ₹ 16.67 per right	= ₹ 333
Market value of 100 shares held after the rights issue at the rate of ₹ 36.67 per share	= ₹ 3,667
Change in wealth (₹ 3,667 + ₹ 333 − ₹ 4,000)	= ₹ 0

He allows his rights to expire

Market value of original shareholding at the rate of ₹ 40 per share	= ₹ 4,000
Market value of 100 shares held after the rights issue at the rate of ₹ 36.67 per share	= ₹ 3,667
Change in wealth (₹ 3,667 – ₹ 4,000)	= ₹ (333)

Setting the Subscription Price Theoretically, the subscription price is irrelevant because the wealth of a shareholder who subscribes to the rights shares or sells the rights remains unchanged, irrespective of what the subscription price is. To illustrate this point, consider a shareholder who has *N* shares valued at P_0 and who enjoys the right to subscribe to an additional share for *S*. His total investment would be:

$$NP_0 + S \tag{18.4}$$

The value of his shareholding after subscription would be:

Number of shares × Market value per share after rights issue

This is equal to:

$$(N+1) \times \frac{NP_0 + S}{(N+1)} = NP_0 + S \tag{18.5}$$

Thus the value of his shareholding after subscription is equal to the value of his investment, irrespective of the subscription price *S*.

In practice, however, the subscription price is important. Existing shareholders do not like the idea of S being higher than P_0 because when S is higher than P_0, the market value after issue would be lower than S. Non-shareholders, who have an opportunity to subscribe to shares not taken by existing shareholders, will have no interest in the shares if S is higher than P_0 because they would then suffer a loss when the market value falls below S after the issue.

Hence, S has to be set equal to or lower than P_0. A value of S equal to P_0 is not advisable because it has no appeal to existing shareholders and other investors as they do not see any opportunity of gain in such a case. So, S has to be set lower than P_0, may be 10% lower.

Comparison between Rights Issue and Public Issue Here is a comparison between a rights issue and a public issue: (i) A rights issue is likely to be more successful than a public issue because it is made to investors who are familiar with the operations of the company. (ii) Since the rights issue is not underwritten, the floatation costs of a rights issue are significantly lower than those of a public issue. (iii) A rights issue generally has to be made at a lower price than a public issue because existing shareholders expect rights issue to be made at a lower price. Due to this, a rights issue tends to result in a dilution of earnings per share.

18.5 PRIVATE PLACEMENT

A private placement is an issue of securities to a select group of persons not exceeding 200. Private placement of shares and convertible debentures by a listed company can be of two types: preferential allotment and qualified institutional placement.

Preferential Allotment

When a listed company issues shares or debentures to a select group of persons (such as promoters, foreign partners, and private equity funds) in terms of the provisions of Chapter VII of SEBI (ICDR) Regulations, it is referred to as a preferential allotment. Since preferential allotment is amenable to potential abuse, it is subject to the following regulations:

Special Resolution The shareholders of the company must pass a special resolution or the central government must grant a special approval before a company makes a preferential allotment.

Pricing The price at which a preferential allotment of shares is made should not be lower than the higher of the volume weighted average of the weekly high and low of the closing prices of the shares quoted on the stock exchange during the six months period before the relevant date or during the two-week period before the relevant date.

Open Offer A preferential allotment of more than 25 percent of the equity necessitates an open offer to the existing shareholders under the SEBI takeover code. However, this can be done away with, if the special resolution passing the preferential allotment also ratifies the change in control.

Lock-in Period Securities issued to the promoter group by way of a preferential issue are subject to a lock-in period of three years—this means that they are not transferable for that period. However, securities issued to other categories of investors by way of a preferential allotment are subject to a lock-in period of one year.

Qualified Institutional Placement (QIP)

A QIP is an issue of equity shares or convertible securities to Qualified Institutional Buyers (QIBs) in terms of the provisions of Chapter VIII of the SEBI (ICDR) Regulations 2009. It represents a private placement with QIBs.

QIPs are a very popular form for raising equity capital. They offer the following advantages:

1. QIPs are placed with institutional investors who are well informed. So they can be issued at a price close to the current market price. Indeed, according to the above regulations, the issue price of a QIP cannot be less than the volume-weighted average of the weekly high and low of the closing prices during the two preceding weeks.
2. Compared to a public issue, a QIP requires less preparatory work and limited marketing effort. Hence, the issue cost of a QIP is considerably less than that of a public issue.
3. QIPs can be timed opportunistically. Typically, the company planning a QIP has the statutory approvals and offer documents in place. It times its issue after its stock has enjoyed a rising trend for two weeks or more.
4. A QIP is normally completed in a few hours.

To sum up, QIPs fetch a good price, entail minimal effort and cost, and can be completed in few hours.

In July 2009, SEBI introduced the concept of “anchor investor.” An anchor investor is a qualified institutional buyer (QIB) making an application for a value of ₹ 10 crore or more through the book-building process. An anchor investor(s) gives a guideline for issue pricing and infuses confidence in the market, thereby attracting QIBs and retail investors. SEBI has stipulated several conditions for anchor investors.

Private Placement of Bonds

Corporate bonds in India are largely privately placed. Private placement of corporate bonds is mostly done through a book built issue to institutional investors. Details of the issuer and the bond are provided in the placement document (information memorandum). When the book building mechanism is used, the issue manager collates investor interest in the issue. Potential investors indicate how much they are willing to buy and at what yield; or they may indicate how much they are willing to buy at the cut-off yield. Based on the letters of commitment received the lead manager (book runner) to the issue decides on the cut-off yield and the same will be applicable to all investors in the issue. If the issue is over-subscribed, the allocation will be determined by the company and the book runners.

Earlier, the information and disclosures to be included in the Private Placement Memorandum were not defined, credit rating was not mandatory, listing was not compulsory, and banks and financial institutions could subscribe to these issues without too many constraints. The regulatory framework changed significantly in late 2003 when SEBI and RBI tightened their regulations over the issuance of privately placed debentures and the subscription of the same by banks and financial institutions. The key features of the new regulatory dispensation are:

- The disclosure requirements for privately placed debentures are similar to those of publicly offered debentures under SEBI regulations.
- Debt securities shall carry a credit rating of not less than investment grade from a credit rating agency registered with SEBI.
- Debt securities shall be issued and traded in demat form.
- The trading in privately placed debt shall take place between QIBs and HNIs (High Networth Individuals) in standard denomination of ₹ 10 lakh.
- Banks should not invest in non-SLR securities of original maturity of less than one year other than commercial paper and certificates of deposits which are covered under RBI guidelines.
- Banks should not invest in unrated non-SLR securities.

How Do the Various Methods of Offering Compare

How do the three methods compare broadly in terms of the amount that can be raised, the cost of issue, dilution of control, degree of underpricing, and market perception? The following table presents a summary comparison for an equity issue. As far as a debt issue is concerned, dilution of control is a non-issue and the market perception is neutral to positive under all the methods.

	Public issue	*Rights issue*	*Private placement*
■ Amount that can be raised	Large	Moderate	Moderate
■ Cost of issue	High	Negligible	Negligible
■ Dilution of control	Yes	No	Yes
■ Degree of underpricing	Large	Irrelevant	Small
■ Market perception	Negative	Neutral	Neutral

18.6 OBTAINING A TERM LOAN

Term Loan Procedure

The procedure associated with a term loan involves the following principal steps:

Submission of Loan Application The borrower submits an application form which seeks comprehensive information about the project. The application form covers the following aspects:

- Promoters' background
- Particulars of the industrial concern
- Particulars of the project (capacity, process, technical arrangements, management, location, land and buildings, plant and machinery, raw materials, effluents, labour, housing, and schedule of implementation)
- Cost of project
- Means of financing
- Marketing and selling arrangements
- Profitability and cash flow
- Economic considerations
- Government consents

Initial Processing of Loan Application When the application is received, an officer of the financial institution reviews it to ascertain whether it is complete for processing. If it is incomplete the borrower is asked to provide the required additional information. When the application is considered complete, the financial institution prepares a 'Flash Report' which is essentially a summarisation of the loan application. On the basis of the 'Flash Report', it is decided whether the project justifies a detailed appraisal or not.

Appraisal of the Proposed Project The detailed appraisal of the project covers the marketing, technical, financial, managerial, and economic aspects. The appraisal memorandum is normally prepared within two months after site inspection. Based on that a decision is taken whether the project will be accepted or not.

Issue of the Letter of Sanction If the project is accepted, a financial letter of sanction is issued to the borrower. This communicates to the borrower the assistance sanctioned and the terms and conditions relating thereto.

Acceptance of the Terms and Conditions by the Borrowing Unit On receiving the letter of sanction from the financial institution, the borrowing unit convenes its board meeting at which the terms and conditions associated with the letter of sanction are accepted and an appropriate resolution is passed to that effect. The acceptance of the terms and conditions has to be conveyed to the financial institution within a stipulated period.

Execution of Loan Agreement The financial institution, after receiving the letter of acceptance from the borrower, sends the draft of the agreement to the borrower to be executed by authorised persons and properly stamped as per the Indian Stamp Act, 1899. The agreement, properly executed and stamped, along with other documents as required by the financial institution must be returned to it. Once the financial institution also signs the agreement, it becomes effective.

Disbursement of Loans Periodically, the borrower is required to submit information on the physical progress of the projects, financial status of the project, arrangements made for financing the project, contribution made by the promoters, projected funds flow statement, compliance with various statutory requirements, and fulfillment of the pre-disbursement conditions. Based on the information provided by the borrower, the financial institution will determine the amount of term loan to be disbursed from time to time. Before the entire term loan is disbursed, the borrower must fully comply with all pre-disbursement terms and conditions of the loan agreement.

Creation of Security The term loans (both rupee and foreign currency) and the deferred payment guarantee assistance provided by the financial institutions are secured through the first mortgage, by way of deposit of title deeds, of immovable properties and hypothecation of movable properties. As the creation of mortgage, particularly in the case of land, tends to be a time consuming process, the institution generally permits interim disbursements against alternate security (in the form of guarantees by the promoters). The mortgage, however, has to be created within a year from the date of the first disbursement. Otherwise the borrower has to pay an additional charge of 1 percent interest.

Monitoring Monitoring of the project is done at the implementation stage as well as at the operational stage. During the implementation stage, the project is monitored through: (i) regular reports, furnished by the promoters, which provide information about placement of orders, construction of buildings, procurement of plant, installation of plant and machinery, trial production, etc., (ii) periodic site visits, (iii) discussion with promoters, bankers, suppliers, creditors, and others connected with the project, (iv) progress reports submitted by the nominee directors, and (v) audited accounts of the company.

During the operational stage, the project is monitored with the help of (i) quarterly progress report on the project, (ii) site inspection, (iii) reports of nominee directors, and (iv) comparison of performance with promise.

The most important aspect of monitoring, of course, is the recovery of dues represented by interest and principal repayment.

Project Appraisal

Financial institutions appraise a project from the marketing, technical, financial, economic, and managerial angles. The principal issues considered and the criteria employed in such appraisal are discussed below.

Market Appraisal The importance of the potential market and the need to develop a suitable marketing strategy cannot be over-emphasised. Hence efforts are made to:

- Examine the reasonableness of the demand projections by utilising the findings of available surveys, industry association projections, and independent market surveys (which may sometimes be commissioned).
- Assess the adequacy of the marketing infrastructure in terms of promotional effort, distribution network, transport facilities, stock levels, etc.
- Judge the knowledge, experience, and competence of the key marketing personnel.

Technical Appraisal The technical review done by the financial institutions focuses mainly on the following aspects: product mix, capacity, process of manufacture, engineering know-how and technical collaboration, raw materials and consumables, location and site, buildings, plant and equipments, manpower requirements, and break-even point.

The technical review is done by qualified and experienced personnel available in the Institutions and/or outside experts (particularly where large and technologically sophisticated projects are involved).

Financial Appraisal The financial appraisal seeks to assess the following:

Reasonableness of the Estimate of Capital Cost While assessing the capital cost estimates, efforts are made to ensure that (a) padding or under-estimation of costs is avoided, (b) specification of machinery is proper, (c) proper quotations are obtained from potential suppliers, (d) contingencies are provided, and (e) inflation factors are considered.

Reasonableness of the Estimate of Working Results The estimate of working results is sought to be based on (a) a realistic market demand forecast, (b) price computations for inputs and outputs that are based on current quotations and inflationary factors, (c) an approximate time schedule for capacity utilisation, and (d) cost projections that distinguish between fixed and variable costs.

Adequacy of Rate of Return The general norms for financial desirability are as follows:

■ Internal rate of return	:	15% or 3 – 5% more than WACC
■ Return on investment	:	20-25 percent after tax
■ Debt-service coverage ratio	:	1.50 and above
■ Loan life coverage ratio	:	This is a DCF version of the DSCR
■ Break-even point	:	The break-even point in the optimal year (the year when the project is expected to achieve the Highest capacity utilisation) must result in a margin of safety over installed capacity.

In applying these norms, however, a certain degree of flexibility is shown on the basis of the nature of the project, the risks inherent in the project, and the status of the promoter.

Appropriateness of the Financing Pattern The institutions consider the following in assessing the financial pattern:

- A general debt-equity ratio norm of 1: 1. For capital-intensive projects a higher debt- equity ratio is permitted.
- A requirement that promoters should contribute a certain percentage of the project cost (30-50 percent)
- Stock exchange listing requirements
- The means of the promoter and his capacity to contribute a reasonable share of the project finance

Economic Appraisal The economic appraisal looks at the project from the larger social point of view. The methodology adopted by the financial institutions for the purpose of economic appraisal is labeled as 'Partial Little Mirrlees' approach. In addition to the calculation of the economic rate of return as per this approach, they also look at two other economic indicators: (i) effective rate of protection, and (ii) domestic resource cost. Admittedly, the economic appraisal done by financial institutions is not very rigorous and sophisticated. Also, the emphasis placed on this appraisal is rather limited.

Managerial Appraisal In order to judge the managerial capability of the promoters, the financial institutions examine the following:

Resourcefulness This is judged in terms of the prior experience of the promoters, the progress achieved in organising various aspects of the project, and the skill with which the project is presented.

Understanding This is assessed in terms of the credibility of the project plan (including, *inter alia*, the organisation structure, the staffing plan, the estimated costs, the financing pattern, the assessment of various inputs, and the marketing programme) and the details furnished to the financial institutions.

Commitment This is gauged by the resources (financial, managerial, material, and other) applied to the project and the zeal with which the objectives of the project, short-term as well as long-term, are pursued.

Managerial appraisal also involves an assessment of the calibre of the key technical and managerial personnel working on the projects, the schedule for training them, and the remuneration structure for rewarding and motivating them.

18.7 INVESTMENT BANKING

The term investment banking may suggest that it has something to do with investment or banking. In reality, it is neither. Investment banking, also referred to as merchant banking, primarily refers to the business of raising capital for companies and advising them on mergers, acquisitions, and restructuring. Investment banks also have businesses like asset management (mutual funds, hedge funds, private equity, and venture capital), stock broking and investment advisory, risk advisory and management, and custodial services. While a commercial bank has an inventory of cash deposits that it lends, an investment bank is just an intermediary that matches sellers of securities and businesses with the buyers of securities and businesses. Of course, in recent years investment banks with deep pockets have also supported their clients with financing arrangements.

Global and Indian Investment Banks[5]

Globally, the investment banking industry is dominated by a handful players called the 'Global Bulge Group' comprising of Goldman Sachs, Merrill Lynch, Credit Swisse First Boston, Salomon Smith Barney (Citigroup), Morgan Stanley Dean Witter, J.P. Morgan, UBS Warburg, and Deutsche Bank. In addition, there are a number of 'boutique' firms specialising in niche areas. These banks handle significant fund-based business along with non-fund services.

Depending on the regulatory requirements in the operating environment of each country these activities are handled either on the same balance sheet or through subsidiaries and affiliates. As far as the U.S. investment banks are concerned, proprietary trading and investment contribute significantly to their revenues.

The major investment banks in India are Kotak Capital, Axis Capital, SBI Capital Markets, Citigroup, and JP Morgan. The core services provided by Indian investment banks are: (a) merchant banking, underwriting, and book running, (b) mergers and acquisitions advisory, and (c) corporate advisory relating to project financing, corporate restructuring, capital restructuring through repurchases, private equity, and so on. The allied services provided by Indian investment banks are (a) securities business, (b) asset management business, and (c) investment advisory and wealth management.

The Indian regulatory framework does not allow all investment banking functions to be performed within one legal entity. So, Indian investment banks follow a conglomerate structure in which different business segments are handled by different corporate entities to meet regulatory norms. For example, merchant banking business has to be in a separate company with a merchant banking license from SEBI. Asset management business has to be done by a mutual fund that requires a 3-tier structure under SEBI regulation. Securities business has to be done in a different company which requires stock exchange membership apart from SEBI registration.

Role of Investment Bankers

Investment Bankers are Not	*But Investment Bankers Do*
Consultants who are asked to analyse market share, generate new product ideas, and so on.	Analyse a company's strategic position vis-à-vis its competitors and evaluate its viability.
Accountants who audit a company's financial statements and certify their validity.	Provide a 'sanity check' on a company's financials and use the same for valuation purposes.
Lawyers who understand every minor technicality in a merger agreement or covenant package.	Understand all the significant items in a legal agreement that affect their clients.
Operations specialists who do a detailed evaluation of internal processes and suggest measures for improvements.	Conduct a comparative evaluation of the operations of the client and its peers and highlight the key differences.

SUMMARY

- Business firms raise money from promoters, banks, financial institutions, private investors, and general public.
- **Venture capital and private equity funds** support promising firms during their initial stages before they are ready to make a public offering of securities.
- The decision to **go public** is a complex one which calls for carefully weighing the benefits against costs. A company has to satisfy certain conditions before making an **initial public offering (IPO)**.
- A series of steps are involved in a public issue, whether it is an **IPO** or a **secondary offer**.
- The manager of a public issue may be likened to the 'conductor' of an opera who has to ensure the overall success of the issue.
- The **cost of a public issue** is between 6 and 12 percent. Underpricing of public issues appears to be a universal phenomenon.
- A **rights issue** involves selling securities in the primary market to the existing shareholders. In theory, the value of a share after the rights issue is expected to be $(NP_0 + S)/(N + 1)$ and the value of a right is expected to be $(P_0 - S)/(N+1)$. The **subscription price** of a rights issue is irrelevant from the point of view of shareholder wealth.
- **Private placement** and **preferential allotment** involve sale of securities to a limited number of sophisticated investors such as financial institutions, mutual

funds, venture capital funds, private equity funds, banks, and so on.

- When a firm plans to sell securities, **dilution** is an issue that often comes up.
- The procedure associated with a **term loan** involves several steps.
- Financial institutions appraise a project from the marketing, technical, financial, economic, and managerial angles.

QUESTIONS

1. What are the features of venture capital and private equity?
2. Discuss the state of the venture capital industry in India.
3. How should you prepare your business plan when you approach a venture capitalist/private equity fund?
4. What are the benefits and costs of going public?
5. List the conditions that an Indian company should satisfy for making an IPO.
6. Discuss the steps involved in a public issue.
7. What are the tasks of the manager of a public issue?
8. What costs are incurred in a public issue?
9. Why are IPOs generally underpriced?
10. What are the characteristics of rights?
11. Discuss the procedure for a rights issue.
12. What conditions have to be satisfied for obtaining the approval for a rights issue?
13. What is the theoretical value of a share after the rights issue?
14. What is the theoretical value of a right?
15. Discuss the impact of a rights issue on the wealth of shareholders with the help of a suitable example.
16. Compare a rights issue with a public issue.
17. What is the difference between private placement and preferential allotment?
18. What are the key features of the regulatory framework for the private placement of debt?
19. What regulations apply to preferential allotment?
20. Discuss the key steps involved in obtaining a term loan.
21. What are the types of appraisal done by financial institutions?
22. What is the role of investment bankers – what they are and what they are not?

SOLVED PROBLEMS

18.1 The equity stock of Karnataka Beverages is selling for ₹ 120 per share. The company is planning to issue rights shares at ₹ 80 each in the ratio of 1:2 – this means that for every two shares held one rights share will be issued.

Calculate:

(a) the theoretical value per share of the ex-rights stock

(b) the theoretical value of a right

Solution

(a) The theoretical value per share of the ex-rights stock is:

$$\frac{NP_0 + S}{N+1} = \frac{2 \times 120 + 80}{2+1} = ₹\ 106.7$$

The theoretical value of a right is:

$$\frac{NP_0 + S}{N+1} - S = \frac{2 \times 120 + 80}{2+1} - 80 = ₹\ 26.7$$

PROBLEM

18.1 Value of a Right The equity stock of Narmada Foods is selling for ₹ 180 per share. The firm is planning to issue rights shares in the ratio of one right share for every existing five shares:

(a) What is the theoretical value of a right if the subscription price is ₹ 150?

(b) What is the ex-rights value per share if the subscription price is ₹ 160?

(c) What is the theoretical value per share when the stock goes ex-rights, if the subscription price is ₹ 180? ₹ 100?

MINICASE

PTR is a venerable restaurant of Bangalore set up decades ago by Prakash Naik. Despite its phenomenal success, Prakash Naik was unwilling to set up branches because he was concerned about the dilution of quality. In the last decade, however, alluring business opportunities and competitive compulsions persuaded Prakash Naik to set up a few branches of PTR at select locations in Bangalore and Chennai. This initiative, financed mainly through internal accruals, turned out to be quite profitable. Buoyed by this success, the Naik family, which owns 100 percent equity of PTR Limited, has chalked up an ambitious plan to set up a nation-wide chain of PTR restaurants and to support this initiative it wants to raise ₹ 100 crore through an initial public offering.

Prakash Naik has asked you to brief the family members on various issues associated with the move, by answering the following questions

(a) What are the pros of going public?

(b) What are the cons of going public?

(c) What conditions should a company satisfy to make an IPO?

(d) What is book building?

(e) What are the principal steps in an IPO?

(f) What role is played by the lead manager?

(g) What are the costs of a public issue?
(h) Can a company making a public issue freely price its shares?
(i) Why is under-pricing of IPOs a universal phenomenon?
(j) What is a rights issue?
(k) What are the different kinds of dilution?

PRACTICAL ASSIGNMENT

For the company chosen by you, identify the ways in which different forms of long-term finance was raised in the past ten years. Discuss the rationale for the same.