BNY MELLON

CAPITAL FORMATION, STRUCTURE AND EQUITIES

Business L1 Training iNautix

COURSE OBJECTIVE

- Business Entity and Types
- Learn About Capital : Meaning, Significance and Types
- Source of capital and Capital Structure
- Capital Markets : Primary & Secondary Market
- About Indices
- Equities, Financial ratios
- Stock Exchange
- IPO, IPO Process & Regulations
- Concept of Underwriting
- Global Capital

BUSINESS ENTITY & TYPES

Business Entity is an enterprise which is formed by an individual or group of individuals for fulfillment of business agenda

TYPES OF ENTITIES:

- Sole Proprietorship
- Partnership
- Corporation

SOLE PROPRIETOR ENTITIES

CHARACTERISTICS

- One owner
- Unlimited liability
- Personal income taxes on the profits

ADVANTAGES

- Profits go directly to the owner
- Simple structure form of doing business

DISADVANTAGES

- Unlimited liability can be risky
- Harder to raise a capital
- When the owner dies, the business ceases to exist

PARTNERSHIP ENTITIES

CHARACTERISTICS

- 2 or more partners
- Liability shared among partners
- Personal income taxes on the profits

ADVANTAGES

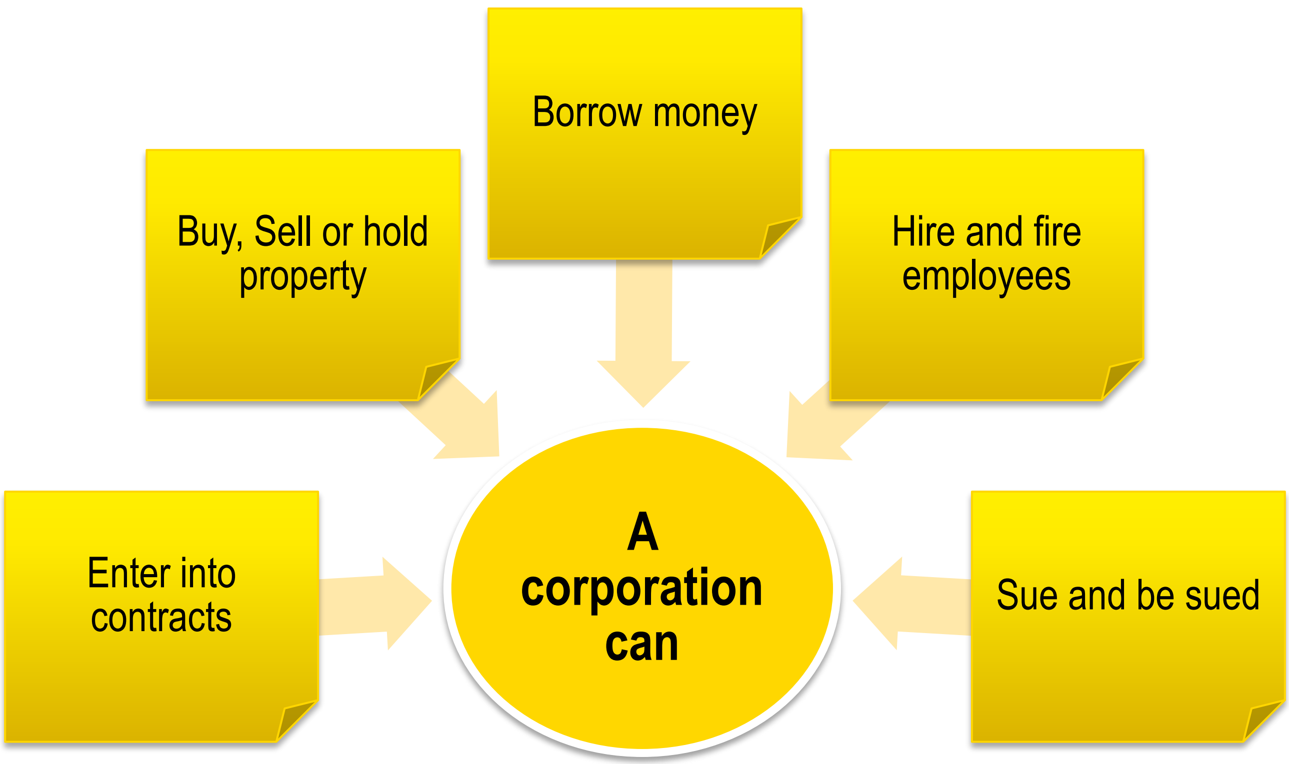
- Profits shared by the owner
- Owners share liability

DISADVANTAGES

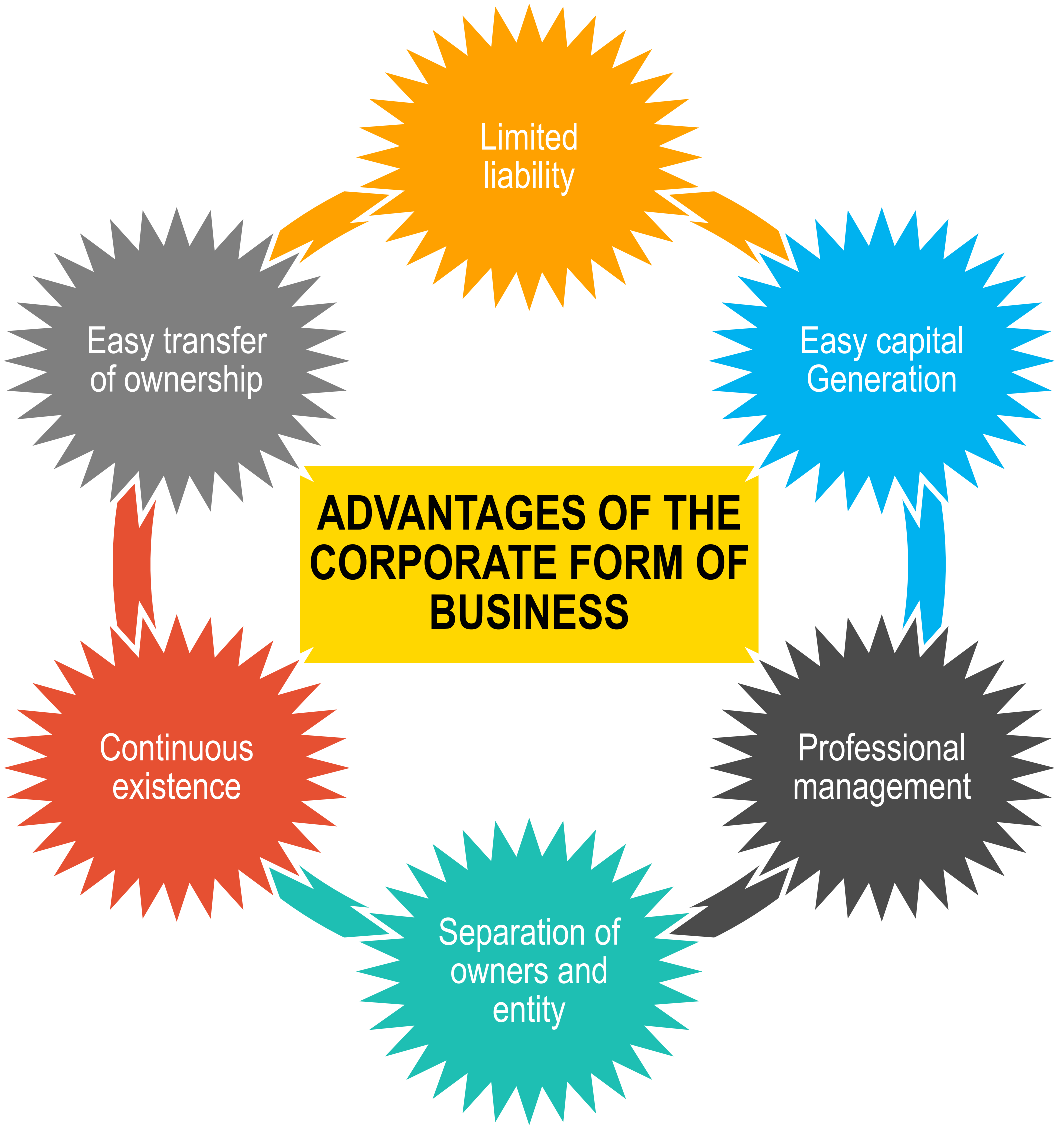
- Decision making is complicated
- Difficult to raise capital
- Many titles causes problem of authority

THE CORPORATION / COMPANY

A business entity recognized by law with existence separate and distinct from its owners.



ADVANTAGES OF THE CORPORATE FORM OF BUSINESS



DISADVANTAGES OF THE CORPORATE FORM OF BUSINESS*

Double
Taxation (Corp tax +Div Tax)

Governmental regulation

Entrenched, inefficient management

Complex Structure

CAPITAL

As for every country capital city is the heart of the country like wise Capital is the heart of every business organization. Thus it is of the highest significance.

<u>DEFINITION IN ECONOMIC TERMS:</u> A factor of production that is not wanted for itself but for its ability to help in producing other goods.

<u>DEFINITION IN BUSINESS TERMS:</u> Cash which can help in putting up manufacturing plants, Retail Stores, buy goods or services which can help business to deliver to its agenda.

TYPES OF CAPITAL & SOURCE OF CAPITAL

Cash Capital and Non Cash Capital are two major categories of capital deployed for business

Cash Capital	Non Cash Capital
Equity	Human Capital
Debt	Intellectual Capital

SOURCE OF CAPITAL

THE TWO MAJOR AND MOST PREFERRED SOURCES OF FUNDS FOR ANY CORPORATION ARE

- ❑ **Debt**
- ❑ **Equity**

❑ **DEBT –** The corporation borrows the required amount of funds and repays it at a later date along with interest. More like a loan taken by the corporation.

SOURCE: Banks, Govt. Financial Institutions, Financial Institutions (Domestic/Global) etc;

❑ **EQUITY –** The corporation issues shares to the public and raises money. The ownership of the corporation is diluted.

SOURCE: Individuals, Institutions Investors(Domestic/Global), Public, Venture Capitalists etc;

SIGNIFICANCE OF CAPITAL

- Size of business capacity will directly depend on the Quantum of capital invested at Initial stage as well as at various point of business growth phase.

- Capital Intensive: Refineries, Mining, Car Plant, Bank etc;

- Low Capital Intensive Units: Retail Store, Financial Advisory Boutique Etc;

- Low cost of capital is one of the major element which improves cost competitiveness and profitability of the organization

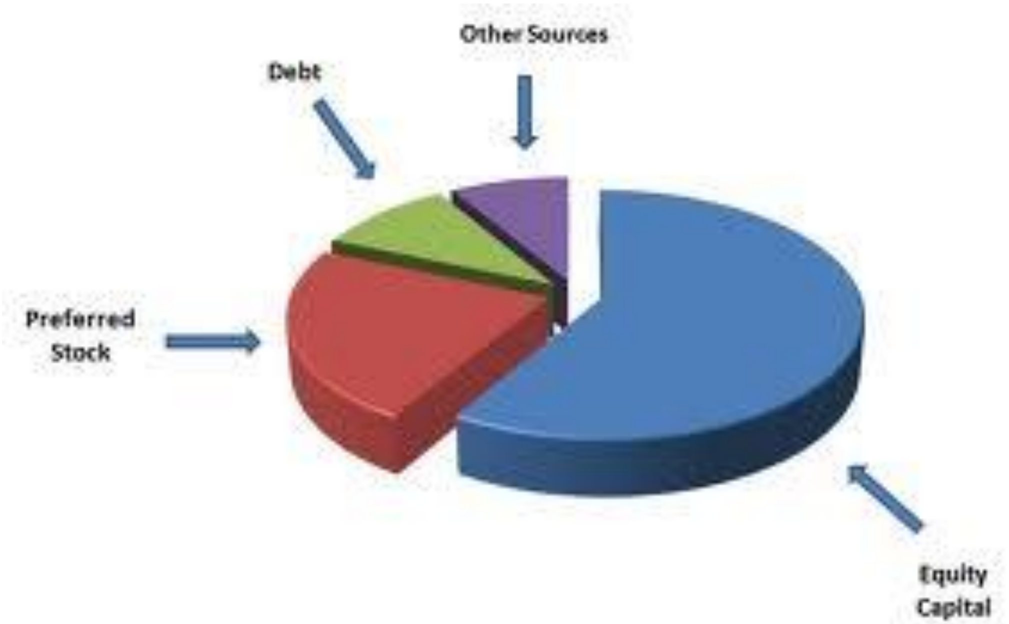
- Thus deciding right capital structure is very important for the business operations and profitability

CAPITAL STRUCTURE - DECISION

A company can obtain long-term financing in form of equity, debt or combination of both

Capital Structure is the proportion of debt and equity shares on a firm's balance sheet

What proportion of debt versus equity maximizes the overall value of the firm ?



RAISING CAPITAL

> **Equity- Share Ownership**

- IPO – Initial public offering
- FPO – Follow-on Public Offering

High return, Liquidity, Capital appreciation, Limited Liability

> **Debt- Take Loan**

- Bond Offerings

Low Risk, Poor Hedge against Inflation, Fixed Yield

CAPITAL STRUCTURE : FEATURES OF CAPITAL

Common Stock	Preferred Stock	Bonds
Represents Ownership in the company	▪ Higher claim on assets and earnings	▪ Debt instruments issued by the company and sold to investors
▪ Voting Rights	▪ No Voting rights	▪ No voting rights
▪ Provide Dividends and/or Capital growth	▪ Specific dividend paid out before common stockholders	▪ Highest claim to the assets during liquidation
▪ Last priority in case of liquidation of assets	▪ Less potential for capital gain.	▪ Provide a fixed yield with low risk

WHY DOES AN INSTITUTION NEED MONEY?

- ✓Establish New Business
- ✓Expand Existing Business
- ✓Pay off Existing Loans
- ✓Buy other institutions

BASICS : CAPITAL MARKET

A market in which individuals and institutions trade financial securities. Organizations/institutions in the public and private sectors also often sell securities on the capital markets in order to raise funds. Thus, this type of market is composed of both the primary and secondary markets.

Both the stock and bond markets are parts of the capital markets.

PRIMARY MARKET : New stock or bond issues are sold to investors by companies.

SECONDARY MARKET : Existing securities are sold and bought among investors or traders

REGULATORY BODIES

Securities and Exchange Commission (SEC) www.sec.gov

- Responsible for administering and enforcing the federal securities laws, and regulating brokerage firms, investment companies and advisers
- Ensures orderly market performance and information availability to investors
- Establish accounting norms for securities transactions

National Association of Securities Dealers (NASD) www.nasd.com

- Works to aid and safeguard investors by regulating markets, formulating guidelines, facilitating dispute resolution and monitoring member activity

Securities and Exchange Board of India (SEBI) www.sebi.gov.in

- The basic functions of the Securities and Exchange Board of India is to protect the interests of investors in securities and to promote the development of, and to regulate the securities market and for matters connected therewith or incidental thereto"

STOCK MARKET PLAYERS

BROKER A person or firm that facilitates trades between customers

- Acts only as an intermediary and does not assume risks for the trade
- Charges commissions

DEALER A person or firm that buys and sells from his or her own inventory of securities as well as for others

- Assumes risk for the transactions
- Marks securities up or down to make a profit on their transactions

REGISTERED REPRESENTATIVES An individual who has passed the NASD's registration process and is t therefore licensed to work in the securities industry

- Follows NASD rules.
- Usually a brokerage firm employee acting as an account executive for clients
- Sell to the public; they do not work on exchange floors

OTHER IMPORTANT PLAYERS: Lead Managers- Merchant Bankers- Underwriters – Regulators – Custodian- Depository Participants- Clearing agents.

WHAT IS EQUITY?

Equity represents ownership in any asset or company after all debts associated with it are paid off.

A share is simply a divided-up unit of the total value or equity of a company.

- **Example:** Suppose that a company ABC Corp issues 100 shares. Out of the 100 shares issued, Mr. X buys 10 shares. Now Mr. X owns 10 percentage of the company ABC Corp.

In accounting terms, the amount of the funds contributed by the owners (the stockholders) plus the retained earnings (or losses). Also referred to as “shareholders’ equity”.

Assets – Liabilities = Shareholders’ Equity

COMMON TERMINOLOGY

- **Authorized Stock** – Maximum number of shares that can be issued
- **Issued Stock** – Shares that have been issued and are held by the stock holders
- **Treasury Stock** – Shares that have been bought back or repurchased by the issuer
- **Outstanding Stock** – Shares that are currently available in the open market

OUTSTANDING STOCK = ISSUED STOCK – TREASURY STOCK

AUTHORIZED STOCK = ISSUED STOCK + STOCK NOT ISSUED

Authorized Shares

The maximum number of shares the corporation may issue as designated in its charter is the authorized number of shares.

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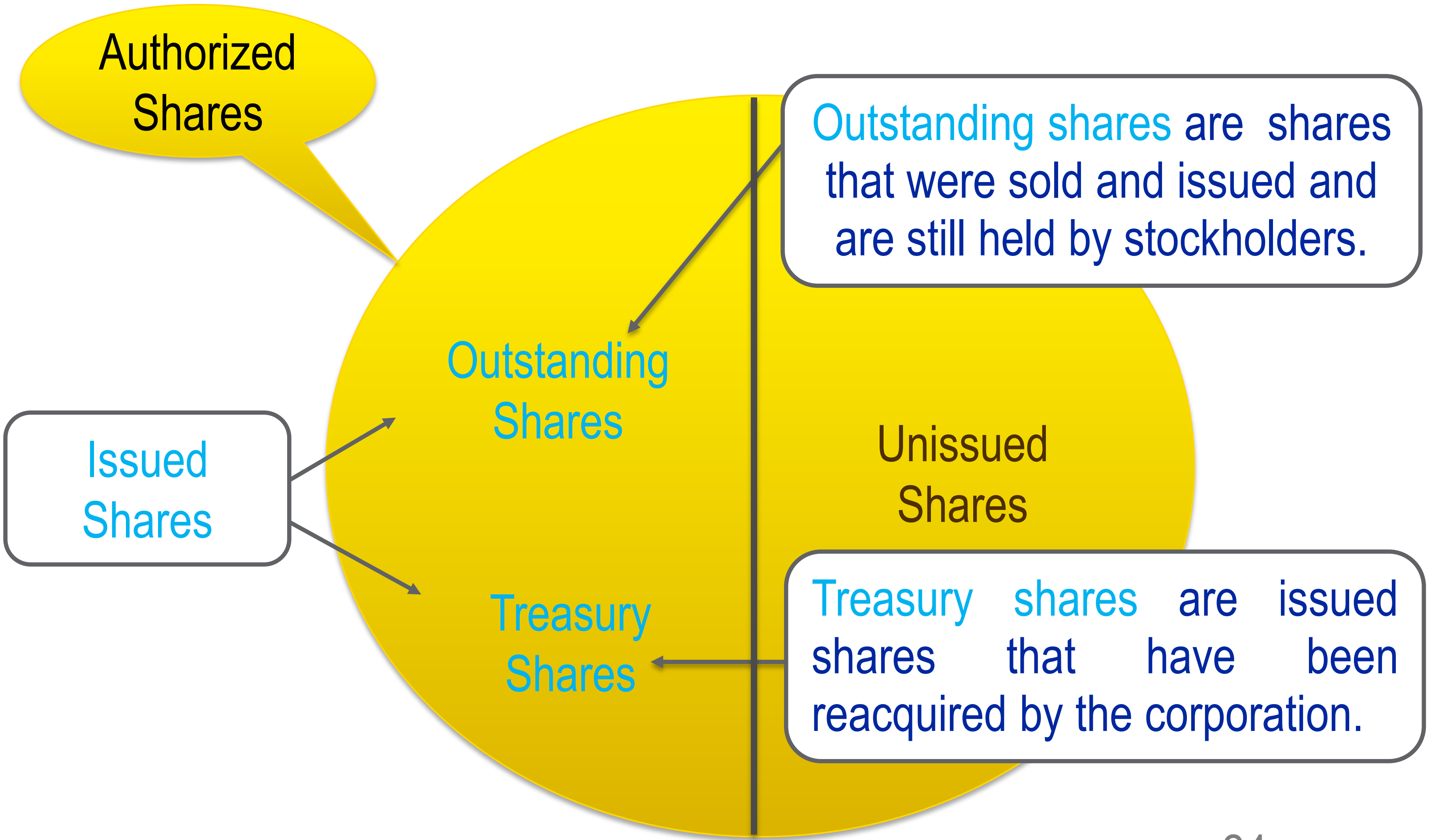
Authorized Shares

Issued shares are authorized shares of stock that have been sold.

Unissued shares are authorized shares of stock that have never been sold.


Authorized Shares
Outstanding shares are shares that were sold and issued and are still held by stockholders.
Outstanding Shares
Issued Shares
Unissued Shares
Treasury Shares
Treasury shares are issued shares that have been reacquired by the corporation.

COMMON TERMINOLOGY CONTD..

FACE VALUE OR PAR VALUE

- The nominal value of a share as stated by the issuer
- No relation to the Market value of the share.

BOOK VALUE

- The value of an asset as carried on a balance sheet.
- In general, book value of an asset equals its acquisition cost minus the depreciation

MARKET VALUE OR MARKET PRICE

- The price at which a share is currently sold or bought in the market

MARKET CAPITALIZATION

- The total value of the tradable shares of a corporation
- Equals market price times the number of shares outstanding

COMMON TERMINOLOGY CONTD..

DIVIDENDS

- Portion of the company's earnings shared with the stockholders
- Decided by the board of directors of the company
- Dividends can be both cash or stock.
- Important dates
  - **Declaration Date –** Board of directors announce dividend
  - **Record Date –** Determines who receives the Dividend based on records
  - **Payment Date –** Dividend is paid
  - **In-Dividend Date –** cum Dividend; Ex-Dividend Date **–** without Dividend

RETAINED EARNINGS

- Earnings not paid out as dividends but re-invested / used to pay off debts
  - **Retained Earnings (RE) = Net Income (NI) – Dividends**

RETURNS FROM EQUITY

Equity Returns = Capital Appreciation + Dividends

- Capital Appreciation: Growth in value of the stock; depends entirely on the market conditions and expectations
  - **Example:** Suppose an investor buys 100 shares of Reliance for Rs 70,000 at a market price of Rs 700/share. After a few days the market price of Reliance goes up to Rs 720/share. Also the board of directors at Reliance declare a dividend of Rs 10/share.
- Now the returns for the investor would be a capital appreciation of Rs 20/share in addition to the dividend of Rs 10/share. In total the investor would enjoy a return of Rs 30/share or Rs 3000 on his investments.

CORPORATE ACTIONS

REPURCHASE / BUY BACK

- Corporations sometimes buy back their own stock
- Stock is either retired or kept as treasury stock
- Available for re-issuance.
- Reasons for buy back
  - Increase Earnings/share (EPS) & Return on Equity
  - Tax efficient distributions of excess cash to shareholders

BONUS ISSUE

- Additional free shares issued to the shareholders
- Is not a dividend pay out in the form of shares
- Paid out of company's free reserves
- No change in the Face value of the share

CORPORATE ACTIONS CONTD..

STOCK SPLITS

- Existing share is divided in to multiple shares
- Increases the number of outstanding shares by that multiple
- Face value of the stock is reduced by that multiple
- A good sign; but actually no change in real value to the shareholders
- Initiated when the share price grows so high that they are too expensive to buy for small investors

REVERSE STOCK SPLIT OR STOCK MERGE

- Existing shares are merged reducing the number of outstanding shares
- Bad sign; Done to increase the share's market price
- Reduces the number of shareholders; rest are paid money

CORPORATE ACTIONS CONTD..

EXAMPLE:

BONUS ISSUE: Suppose a company announces a 2 for 1 bonus issue, then every investor who owns a share will receive 2 additional shares. If Mr. X owns 100 shares of Rs 10 face value, then he will now own an additional 200 shares of Rs 10 face value. In total, Mr. X would now own 300 shares of the company of Rs 10 face value.

STOCK SPLIT: Suppose a company announces a 2 for 1 stock split, then every investor who owns a share will receive one additional share. If Mr. X owns 100 shares of Rs 10 face value, then he will now get an additional 100 shares of the company and the face value of each share would come down to Rs 5. Mr. X would now own 200 shares of the company of Rs. 5 face value.

Theoretically, market price of the share in both a bonus issue as well as a Stock Split will decrease in proportion to the number of new shares. But in reality this does not happen.

STOCK SPLIT – BREAK A SHARE INTO MULTIPLE SHARES

Shares Before Split	Type of Split	Shares After Split
100	2 for 1	200
100	4 for 1	400
100	3 for 2	150
100	1 for 2	50

Objective is to increase liquidity and shareholder value

FINANCIAL RATIOS

PRICE TO BOOK (P/B)

Compare a stock's market value to its book value

Calculated by dividing the current closing price of the stock by the latest book value per share.

P/B Ratio = Total Market Value / (Total Assets – Liabilities)

A lower P/B ratio could mean that the stock is undervalued

Gives an idea whether you're paying more for what would be left if the company went bankrupt immediately.

FINANCIAL RATIOS CONTD..

EARNINGS PER SHARE (EPS)

Portion of the Net Income (profit) allocated to each outstanding share annually.

EPS = Net Earnings / Outstanding Shares

PRICE-EARNINGS (P/E) RATIO (Price multiple / Earnings Multiple / Multiple)

Company's current share price compared to its per-share earnings

P/E Ratio = Market Value of one share / EPS

Higher the P/E lower is the value in comparison to other stocks

Trailing P/E – EPS calculated from last 12 months

Forward P/E or Projected P/E – EPS calculated from projected earnings for next 12 months

FINANCIAL RATIOS CONTD..

RETURN ON EQUITY (ROE)

Indicates the returns generated from the money invested by the shareholders

Does not include debt burden or preferred shares; Useful in comparing firms within an industry

Return on Equity = Net Income / Shareholder's Equity

RETURN ON ASSETS (ROA)

Indicates the returns generated from the total assets owned by a company

Shows the efficiency of the management in generating profits relative to its investments / assets

Return on Assets = Net Income / Total Assets

FINANCIAL RATIOS CONTD..

EXAMPLE:

ABC Corp recently showed an annual income of Rs 2,000 against its total assets worth Rs 1,00,000. The corporation owes Rs 55,000 to its lenders. The market capitalization of ABC Corp is Rs 50,000 with 1000 outstanding shares.

- What is the market value and book value of its share?
- Also calculate P/B, EPS, P/E, RoE and RoA.
  - Market Value of each share = 50000/1000 = 50
  - Book Value of each share = 45000 / 1000 = 45
  - P/B ratio for the stock = 50,000 / 45,000 = 1.11
  - EPS = 2000 / 1000 = 2
  - P/E ratio for the stock = 50 / 2 = 25
  - RoE = 2000 * 100 / 45000 = 4.44 %
  - RoA = 2000 * 100 / 100000 = 2%

INDEX

- **WHAT IS AN INDEX AND HOW IS IT CREATED?**
- A stock market index is a measure of the relative value of a group of stocks in numerical terms. As the stocks within an index change value, the index value changes.
- A stock market index is created by selecting a group of stocks that are representative of the whole market or a specified sector or segment of the market.
- An Index is calculated with reference to a base period and a base index value.

- **USAGE OF AN INDEX**
- An Index is used to give information about the price movements of products in the financial, commodities or any other markets.
- Index is used as a benchmark for Asset Management Funds to compare the fund performance.
- Financial indexes are constructed to measure price movements of Stocks, Bonds, T-bills and other forms of investments.
- Stock market indexes are meant to capture the overall behavior of equity markets
- An index is a mathematical construct, so you cannot invest in it directly. However, there are index funds that attempt to resemble the development of indices.

SOME IMPORTANT STOCK MARKET INDICES:

Index	Follows	Calculation Methodology
Dow Jones Industrial Index	30 Major US companies	Price-Weighted Average
S&P 500	500 Major US companies	Capitalization-Weighted Index
Nikkei 225	Most important Japanese index	Price-Weighted Average
Sensex	Index of BSE - India	Capitalization-Weighted Index
Nifty 50	Index of NSE - India	Free Float Market Capitalization Index

Index

Types of Indices

1. Broad Market Indices
2. Sectorial Indices
3. Thematic Indices
4. Fixed Income Indices
5. Strategy Indices
6. Customized Indices

STOCK IPO

SALE OF STOCK TO PUBLIC FOR THE FIRST TIME INVOLVES…

- Registration statement filed with Regulator (SEC in US and SEBI in India)
- Underwriting - The investment banker functions as an intermediary (Underwriter) between the issuing corporation and the investors
- Underwriter offers stocks to the general public and institutions for sale through selling group members
- Prospectus Issue - Legal documents explaining the financial facts important to an offering; must precede or accompany sale of primary offering
- Issue subscribed to by investors

STOCK IPO PROCESS

PREPARATORY STEPS

- Annual Report / Financial Planning
- Business Plan
- Banking Memorandum
- IPO/ Capital Market Concept
- Valuation Indicators
- Presentation of Banks
- Selection of group of underwritters

DUE DILIGENCE

- Legal
- Tax
- Management
- Financial

PROSPECTUS CREATION

- Prospectus Creation
- Registration Statement
- Review of Drafts

EQUITY STORY / RESEARCH

- Stock Market Strategy
- Creation/Distribution of IPO
- Announcement of Stock Issue

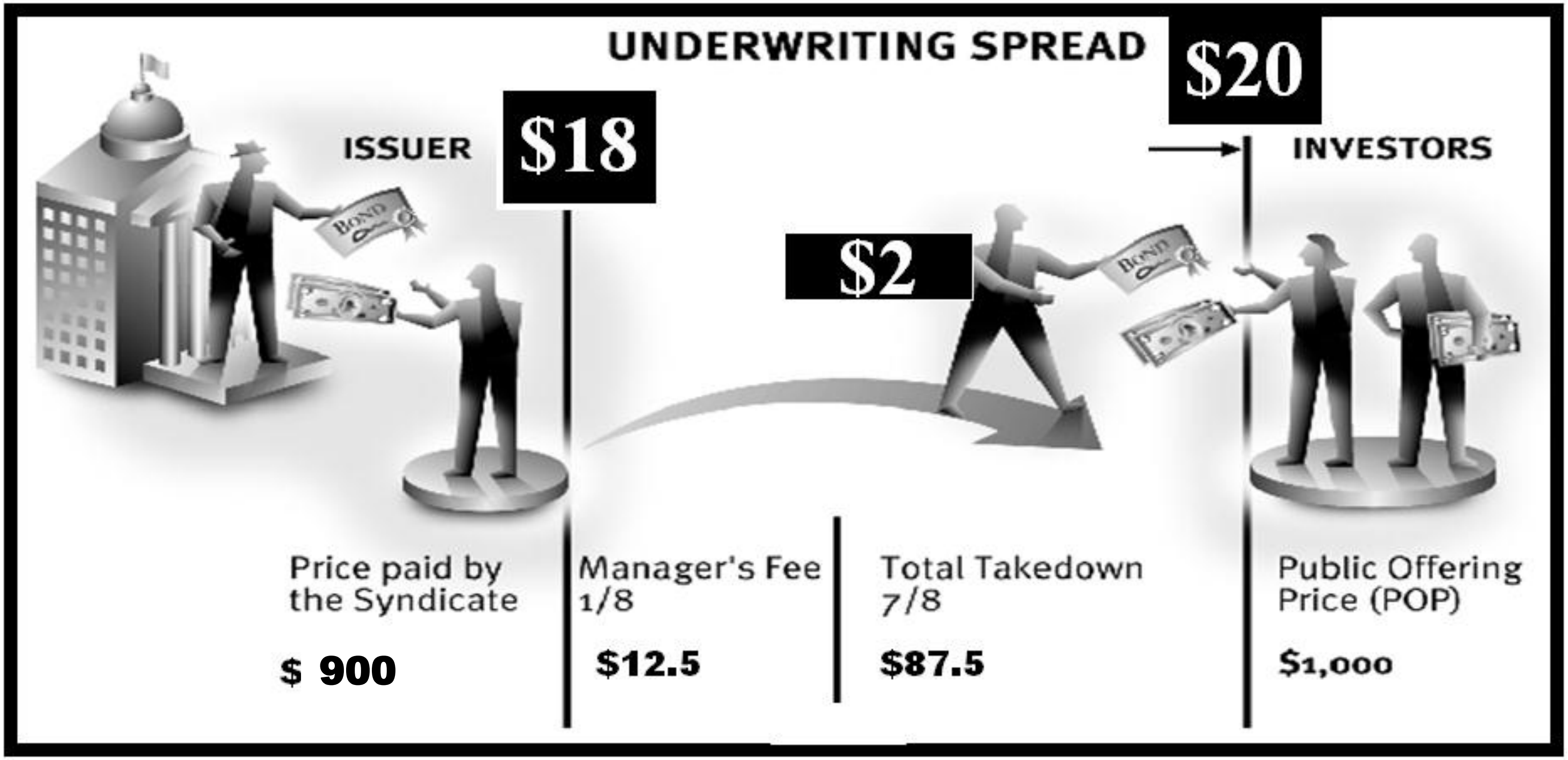
MARKETING/BOOK BUILDING

- Dry Run - Road show
- Approach of Key Investors/ Pre Marketing
- IOP Presentation
- Fixing Price Range

SECONDARY MARKET PHASE

- Greenshoe
- Ongoing Investor Relations
- Ongoing Research

UNDERWRITING SPREAD



Underwriting spread can be a variable factor, ranging from 1% for Federal, State Firms with a Brand name to 10% for private firms which are financially sick.

UNDERWRITERS AND SYNDICATES

A GROUP OF UNDERWRITERS FORM A SYNDICATE TO:

- Reduce risk
- Distribute the issue quickly

THERE IS NO LIMIT ON THE NUMBER OF UNDERWRITERS FOR A SYNDICATE

- More they are, less is the risk.

Syndicate

- Underwriter A
- Underwriter B
- Underwriter C

FIRM COMMITMENT UNDERWRITING

- Syndicate purchases entire issue and attempts to resell to the public
- Underwriter acts on a principal basis (assumes risk)
- If equity sold are less than 90%, Underwriter/Syndicate has the option to cancel the Issue.

US REGULATION: SECURITIES ACT OF 1933

- Regulates the sale of new issues to the public
- Disclosure philosophy
- All new issues must be registered with the SEC unless an exemption applies.
- Prospectus

THE REGISTRATION PROCESS

Filing Date

Effective Date

PHASE #1
Pre-Registration Period

PHASE #2
Cooling-Off Period

PHASE #3
Post-Registration Period

THE REGISTRATION PROCESS (CONT'D)

Pre-Registration Period

Issuer and underwriter prepare a registration statement that will be sent to SEC

Cooling-Off Period

SEC reviews registration statement (Length of period is 20 days)

Preliminary prospectus (red herring) is sent to investors

State securities registration (Blue-Sky Laws)

- Blue-Sky Law- Was first enacted in Kansas in 1910 after the Public fraud by quick gold/oil firms, to protect investors from such frauds.

Post- Registration Period

Confirm sales to public

Final prospectus is issued

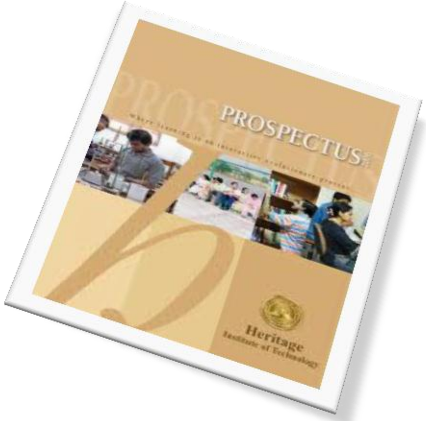
REGISTRATION STATEMENT

BACKGROUND ON THE ISSUER

- Issuer is the Firm or Company, which plans to raise Capital

BACKGROUND ON THE OFFICERS

- Officers are the Board members of the Firm's Management
  - **Amount of money to be raised**
  - **Use of the proceeds and Risks**
  - **Preliminary Prospectus**
- Contains price range only
- Indications accepted
- Money cannot be accepted during cooling-off period with preliminary prospectus



EXEMPT SECURITIES

WHY EXEMPT

- Cost Issues
- Speed Issues
- Legal limits to Federal power

EXEMPT SECURITIES (EXAMPLES)

- U.S. Government Securities
- Agency Securities
- Municipal Securities
- Commercial Paper

REGULATIONS

RULE 147

- Single state offering
- Conditions that must be met:
- Minimum 80% revenues, assets, and proceeds in state
- 100% sold to state residents

REGULATION A

- May raise up to $5,000,000 in 12-month period

REGULATION D

- Private Placement
- No general solicitation or advertising
- No more than 35 non-accredited investors

THE GLOBALIZATION OF CAPITAL MARKETS

- Capital Limitation Issuers cannot find enough capital domestically (e.g. Nokia, Ericsson)
- Cost of Capital- Interest rate differentials-issuer/investor
- Investors looking to diversify- Correlation of markets
- Currency Issues- Instability, relative valuation, scarcity, repatriation
- Government Policy -Tax and/or other incentives/disincentives

ACCESSING INTERNATIONAL CAPITAL

Benefits	Costs
Lower Cost of Funds	Listing Fees
Expanded Shareholder Base	Accounting Issues
Greater Liquidity	Legal Considerations
Political Considerations- Japan in U.S. Auto Industry, Bilateral Trade Agreement	Regulatory Costs
	Taxation
	Back Office Difficulties

Questions

Thank You