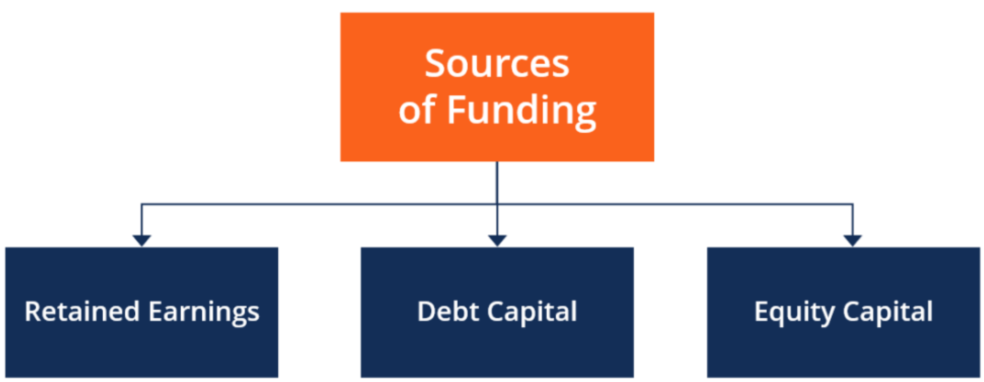
UNIT 4:

Raising Funds

What are Sources of Funding?

Companies always seek sources of funding to grow their business. Funding, also called financing, represents an act of contributing resources to finance a program, project, or need. Funding can be initiated for either short-term or long-term purposes. The different sources of funding include:

- Retained earnings
- Debt capital
- Equity capital



Retained Earnings

Businesses aim to maximize profits by selling a product or rendering service for a price higher than what it costs them to produce the goods. It is the most primitive source of funding for any company.

After generating profits, a company decides what to do with the earned capital and how to allocate it efficiently. The retained earnings can be distributed to shareholders as dividends, or the company can reduce the number of shares outstanding by initiating a stock repurchase campaign.

Alternatively, the company can invest the money into a new project, say, building a new factory, or partnering with other companies to create a joint venture.

Debt Capital

Companies obtain debt financing privately through bank loans. They can also source new funds by issuing debt to the public.

In debt financing, the issuer (borrower) issues debt securities, such as corporate bonds or promissory notes. Debt issues also include debentures, leases, and mortgages.

Companies that initiate debt issues are borrowers because they exchange securities for cash needed to perform certain activities. The companies will be then repaying the debt (principal and interest) according to the specified debt repayment schedule and contracts underlying the issued debt securities.

The drawback of borrowing money through debt is that borrowers need to make interest payments, as well as principal repayments, on time. Failure to do so may lead the borrower to default or bankruptcy.

Equity Capital

Companies can raise funds from the public in exchange for a proportionate ownership stake in the company in the form of shares issued to investors who become shareholders after purchasing the shares.

Alternatively, private equity financing can be an option, provided there are entities or individuals in the company’s or directors’ network ready to invest in a project or wherever the money is needed for.

Compared to debt capital funding, equity funding does not require making interest payments to a borrower.

However, one disadvantage of equity capital funding is sharing profits among all shareholders in the long term. More importantly, shareholders dilute a company's ownership control as long as it sells more shares.

Other Funding Sources

Funding sources also include private equity, venture capital, donations, grants, and subsidies that do not have a direct requirement for return on investment (ROI), except for private equity and venture capital. They are also called "crowdfunding" or "soft funding."

Crowdfunding represents a process of raising funds to fulfill a certain project or undertake a venture by obtaining small amounts of money from a large number of individuals. The crowdfunding process usually takes place online.

Define Issue of Shares

Issue of Shares is the process by which companies pass on new shares to shareholders, who can be either individuals or corporates. While acquiring the shares, companies follow the rules prescribed by the Companies Act 2013.

There are 3 basic steps of the procedure of issuing the shares.

1. Issue of Prospectus

2. Receiving Applications

3. Allotment of Shares

A share is a unit of ownership in a company or an organization. It is also considered as an asset because in case a company makes a profit, an amount in proportion to the share held by you will be provided to you in the form of a dividend. Anyone who holds a share is called a shareholder for that specific financial asset or organization.

It should be noted that an organization is allowed to offer shares to be purchased by others through the Companies Act 2013 and has to follow the rules predefined under the act.

Generally, the Issue of Shares is of two kinds - common shares and preference shares. While the former allows for voting rights to the shareholders, the latter does not permit the holders of any rights.

However, the dividend is passed on to both in case of a profit. In another instance, when there is a bankruptcy, the preferred shareholders are given preference in matters of dividend sharing. So, they receive the dividend even before the common shareholders and have an upper hand.

What is the Issue of Shares?

The meaning of the Issue of Shares is that the shares of an enterprise or any financial asset are distributed among shareholders who wish to purchase them. These shareholders can be either individuals or corporates who take part in buying the shares at a specific price.

Let us understand the concept of share allocation with the help of an example.

A company called XYZ has a total capital of Rs. 6 lakhs. It has divided the capital into 6000 units of shares each amounting to Rs. 100. Therefore, you can see that each unit or share of the company costs Rs. 100. Individuals or corporations can purchase the share at this price.

Hence, holding a share in an organization is often regarded as partial ownership as well. It is for the same reason that anyone holding a share is termed as a shareholder.

What are the Steps involved in Issue of Shares?

The process of issues of shares is primarily divided into three significant steps, which are:

1. **Prospectus Issue**

   This is the first step of the Issue of Shares wherein an enterprise releases a prospectus to the public. It contains the details that a new enterprise has come into being and that it would require funds from the public to operate, for which the public can purchase shares of that particular enterprise.

   The prospectus has all the necessary details of that share issuing authority along with details pertaining to how they will collect money from investors.

2. **Application Receipt**

The second step in share issuing is the receipt of application as and when an investor wishes to purchase a share of that asset or enterprise. However, they have to follow the necessary rules and regulations as cited in the prospectus issued earlier.

They also have to deposit the amount against shares they are willing to purchase. The money has to be deposited to any scheduled bank along with the application.

3. Share Allocation

This is the last step in issues of shares wherein after completing the formalities from the investor's side, the enterprise will issue the shares to the investors. As there is a minimum subscription limit, one has to wait till that quota is fulfilled.

Once that limit is fulfilled, the shares will be allocated to those investors who have subscribed for the capital shares. A letter of allotment is also sent out to those who have been allocated with shares.

Therefore, this process makes up for an authentic way of trading shares between investors and enterprises.

The main reason for issuing new shares by the company is to raise money to finance the business. The following are some of the examples where an Allotment of Shares may be considered.

- A number of shares will usually be issued when the company is established. With the help of a share issue, the company will be able to trade, along with any money that the company may borrow.
- Allotment of Shares is considered when the company requires new funds to grow the business organically. There are various factors that influence how many shares to issue.
- In order to repay all or some of the company's borrowing, shares can be issued.
- Shares can be issued to fund the purchase of another company, which means raising cash from a share issue and using that cash to acquire the new business.
- Shares can also be issued to continue trading after a particularly difficult period, to repair a damaged balance sheet or in case of problems across an industry or part of a wider downturn in the whole economy.

- The company can make a capitalization Issue of Shares to existing shareholders. Rather than the shareholders needing to pay for the shares themselves, the company uses its own money to fund the allotment. This generally has the effect of reducing the value of the shares in issue, which may, in turn, make them more merchantable to investors.
- If shareholders prefer not to receive a cash dividend, the company may offer them a 'scrip' dividend instead by allotting shares of the same value as the cash dividend. This is often popular among companies because issuing shares as a dividend does not impact cash flow in the way a cash dividend does.
- In case a director or employee of the company takes on a share option after being permitted by the company, the company may acquire shares.
- The company may consider allotting the shares in case a new director or senior employee joins the business or an existing employee becomes a director. This can demonstrate the commitment of an employee or a new director to the business, and they will have a clear interest in the company's success. The shares would either be passed to the employee or new director through a transfer from existing shareholders or by a new Allotment of Shares.

What are the Different Classes of Shares?

The types of issues of shares are usually set by a company or enterprise that is issuing its share to the public. This division is generally set to keep a limitation to all rights being conferred to those shareholders.

For instance, the right to vote and the amount of dividend they will receive when there is a profit incurred by an enterprise whose share is out for sale is decided on the basis of such divisions.

The division is made in the following two types -

1. **Ordinary Share**

   This is the most common type of share issued by an enterprise that grants voting rights to the shareholders.

2. **Deferred Share**

   These shares grant fewer rights than common shares, wherein dividends are paid only after a certain period of time and various other constraints.

3. **Redeemable Share**

As the name suggests, these shares might be bought back by an enterprise that sold them for the first time from the shareholders.

4. **Non-voting Share**

   These shares do not permit any voting rights to their shareholders. Meaning that the shareholders are not able to partake in any executive decision regarding that organization. However, they are part owners of the enterprise.

5. **Preference Share**

   These shares grant a prefixed amount of dividend to its shareholders. They do not enjoy voting rights, though they receive a dividend before any other shareholder.

6. **Management Share**

   The shareholders are granted special voting rights when they hold management shares. Herein, for every share that a shareholder holds, they are permitted to exercise two votes.

7. **Alphabet Share**

   These types of shares are a subcategory of common shares, wherein management divides the shareholders into multiple classes, all these classes are granted different voting rights.

What are Equity Shares?

Equity shares are issues of shares that are purely meant for ownership. It is entirely opposite to preference shares and does not provide any preference rights to shareholders during the distribution of dividends. However, these shareholders have voting rights.

The Process for Issue and Allotment of Shares

The following steps are involved in the process for the issue and Allotment of Shares.

Step 1: Board resolution

Step 2: Passing of special or ordinary resolution

Step 3: Filing of necessary forms

Step 4: Approval of the ROC

What are Forfeited Shares?

The forfeited shares definition refers to company shares that have been surrendered or given up by a shareholder due to non-payment of the required amount. When a shareholder fails to make the necessary payments for the subscribed shares, the company has the right to forfeit or cancel them. The company can sell or reissue them to a new shareholder.

Forfeited shares are often seen as a last resort for companies to enforce the payment of the required amount from defaulting shareholders. These shares help companies maintain their financial stability.

How Forfeited Shares Work?

Now that you know the forfeited shares meaning, let’s understand how it works.

Suppose Lalita decides to purchase 5,000 shares, but the company requires an initial upfront payment of 20%, followed by four annual instalments of 20% each, according to a schedule set by the company. If Lalita fails to make one of these instalment payments, the company may decide to take away all her purchased shares. In this case, Lalita would lose the money she had already paid for the shares.

Employee Share Forfeiture

Employee share forfeiture is one of the types of forfeiture of shares when an employee loses the rights to their stock in a company because they fail to meet specific requirements, typically outlined in the company's share plan or agreement.

Example of Forfeited Shares

Forfeiture of shares examples are as follows.

Let's say a company grants 1,000 shares to an employee as part of their compensation package, with a condition that requires the employee to work for the company for three years to fully vest in the shares. The vest is in equal instalments over three years, each ending after a year of employment.

If the employee leaves the company before the end of this period, they may forfeit some or all of their shares. For example, if the employee leaves the company after two years, they may only have vested in 2/3 of their shares, and the remaining 1/3 shares can be forfeited.

Alternatively, if the employee is terminated (e.g. for violating company policy), they may forfeit all of their shares, regardless of their employment years.

In either case, the forfeited shares would be returned to the treasury stock, which the company could choose to reissue or retire permanently.

Reissue of Forfeited Shares

When forfeited shares are returned to a company's treasury stock, they may choose to execute a reissue of forfeited shares. This means the company will sell the shares to new shareholders through a new stock offering or private placement.

The reissue of forfeited shares can have several benefits for the company. It can increase the company's cash reserves, which can be used for business operations or to fund new projects. Reissuing shares can also help the company raise capital without incurring debt or diluting the ownership of existing shareholders.

There are some downsides to reissuing forfeited shares. For example, if the shares were originally forfeited due to a lack of demand for the company's stock, reissuing could dilute the value of existing shares. Additionally, if the company reissues shares at a lower price than the original offering price, it could result in a loss for the company and its shareholders.

Effects of Share Forfeiture

Share forfeiture can have several effects on the employee and the company.

1. **Loss of ownership:** The employee loses share ownership when shares are forfeited. This means they will no longer have the right to vote on company matters or receive dividends.
2. **Loss of potential gains:** If the forfeited shares were expected to increase in value over time, the employee might lose out on potential gains. This could be a significant loss if the shares were granted as part of their compensation package.
3. **Impact on financial ratios:** Such shares can impact the company's financial ratios. For example, if the company has a high number of forfeited shares, it may have a lower earnings per share (EPS) or return on equity (ROE), which could impact investor confidence.
4. **Impact on treasury stock:** Forfeited shares can increase the number of outstanding shares and dilute the value of existing shares. However, if the company chooses to retire the shares instead of reissuing them, it can reduce the number of outstanding shares and increase the value of existing shares.
5. **Legal and tax implications:** Share forfeiture can have legal and tax implications for both the employee and the company.

Benefits of Forfeited Shares

Forfeited shares can provide benefits to a company in many ways.

1. When the money paid for forfeited shares is returned to the company, it can be used for various purposes, such as funding future development projects or paying off liabilities and improving the company's financial position.
2. If the company decides to reissue the forfeited shares, it can sell them at a higher price than their face value. The additional amount received, known as the premium, can be added to the company's reserves and surplus. This can increase its ability to invest in growth opportunities.
3. Overall, forfeited shares can provide a source of funds for a company and increase its financial flexibility and strength.

Factors to consider before you invest

When shares are forfeited, the shareholder loses ownership of them, and they become the property of the issuing company. If an employee leaves before the mandatory vesting period in an Employee Stock Option Plan (ESOP), their options are forfeited. Investors lose the subscription money they have already paid, and there are no capital gains in such cases.

The company can reissue forfeited shares to another shareholder at a different price, usually at a discount, because the company would have relinquished a portion of the initial payment on the shares. This process applies to listed and unlisted companies.