PART FIVE

Financing

CHAPTER 18

Financing of Projects

CHAPTER 19

Venture Capital and Private Equity

Chapter 18 Financing of Projects

LEARNING OBJECTIVES

After studying this chapter you should be able to

- Explain the differences between investment decisions and financing decisions.
- Describe the key factors that have a bearing on the debt-equity ratio for a project.
- Discuss the features of various domestic sources of finance as well as their pros and cons.
- Compare the various methods of raising finance.
- Describe the features of eurocurrency loans and bonds.
- Distinguish between a full recourse structure and a limited recourse structure.
- Specify the kind of information lenders want for appraising term loan requests.
- Discuss how financial institutions appraise a project.

For pedagogic purposes we discuss project financing after project selection. In practice, however, project financing is considered in some way or the other right from the time of project conception. Indeed project financing is intertwined with project planning, analysis, and selection. As the project proposal progresses through the stages of planning, analysis, and selection, the contours of project financing become clearer.

A capital project entails investment in land, plant and machinery, miscellaneous fixed assets, technical know-how, distribution network, and working capital. Hence a capital project may be regarded as a mini-firm - after all when you look at the balance sheet of a firm you find that it has investments in similar assets.

So, the issues to be considered in financing a project are identical to those considered in financing a business firm. What is an appropriate capital structure? Which financing instruments make more sense? What are the pros and cons of public and private sources of capital? How much should the firm depend on domestic capital market and how much on the international capital market?

Note that when financial institutions look at a project, they may consider only the long-term sources of finance. We, however, prefer to look at all the sources of finance, long-term as well as short-term. In line with this perspective, this chapter discusses all the sources of finance required to set up a project.

Financing Decisions are Relatively Easier

The vocabulary of financing is confusing and the number of complex and exotic financing instruments is expanding. Yet, at a fundamental level, financing decisions, compared to investment decisions, are relatively easier to make and have a lesser impact on firm value, thanks to the following differences:

Financing Decisions	*Investment Decisions*
■ Financing decisions take place in capital markets which are approximately perfect.	■ Investment decisions take place in real markets which tend to be imperfect.
■ While making financing decision, decisions, you can observe the value of similar financial assets.	■ While making investment decisions, you have to estimate the value of the capital projects.
■ There are very few opportunities in the realm of financing that have an NPV that is significantly different from zero.	■ There are many opportunities in the realm of capital budgeting that have an NPV that is significantly different from zero.

Given the intense competition in capital market, financial economists argue that securities are fairly priced. Put differently, they believe that the capital market is efficient.

18.1 CAPITAL STRUCTURE

The two broad sources of finance available to a firm are: shareholders' funds and loan funds. Shareholders' funds come mainly in the form of equity capital and retained earnings and secondarily in the form of preference capital. Loan funds come in a variety of ways like debenture capital, term loans, deferred credit, fixed deposit, and working capital advance.

Ignoring preference capital (which is of minor significance), the basic differences between shareholders' funds (referred to as equity) and loan funds (referred to as debt) are as follows:

Equity	*Debt*
■ Equity shareholders have a residual claim on the income and the wealth of the firm.	■ Creditors (suppliers of debt) have a fixed claim in the form of interest and principal payment.
■ Dividend paid to equity shareholders is not a tax deductible payment.	■ Interest paid to creditors is a tax deductible payment.
■ Equity ordinarily has an indefinite life.	■ Debt has a fixed maturity.
■ Equity investors enjoy the prerogative to control the affairs of the firm.	■ Debt investors play a passive role— of course, they impose certain restrictions on the way the firm is run to protect their interest.

Key Factors in Determining the Debt-Equity Ratio

The key factors in determining the debt-equity ratio for a project are:

- Cost
- Nature of assets
- Business risk
- Norms of lenders
- Control considerations
- Market conditions

Cost Lenders require a lower rate of return compared to equity shareholders. This advantage gets magnified when the firm pays taxes, because the interest on debt is a tax-deductible payment whereas the dividend on equity is not. The lower cost of debt, however, is accompanied by a higher degree of risk. Put differently, debt is a cheaper but riskier source of finance, whereas equity is a costlier but safer source of finance.

Nature of Assets The nature of a firm's assets has an important bearing on its capital structure. If the assets are primarily tangible (plant and machinery and buildings) and have a liquid resale/secondary market, debt finance is used more. For example, electric utility companies use more debt because their assets are mainly tangible, physical in nature. On the other hand, if the assets are primarily intangible (brands and technical know how), debt finance is used less. For example, software companies use very little debt as their assets are mainly intangible.

What explains the link between the nature of assets and the use of debt finance? The major explanation is that lenders are more willing to lend against tangible assets and less inclined to lend against intangible assets.

Business Risk Business risk refers to the variability of earning power (defined as profit before interest and taxes/total assets). It is influenced, *inter alia*, by the following factors:

- *Demand Variability* Other things being equal, the higher the variability of demand for the products manufactured by the firm, the higher is its business risk.
- *Price Variability* A project which is exposed to a higher degree of volatility in the prices of its products is, in general, characterised by a higher degree of business risk in comparison with similar firms which are exposed to a lesser degree of volatility for the prices of their products.
- *Variability of Input Prices* When input prices are highly variable, business risk tends to be high.
- *Proportion of Fixed Operating Costs* If fixed costs represent a substantial proportion of total costs, other things being equal, business risk is likely to be high. This is because when fixed costs are high, PBIT is more sensitive to variations in demand.

Generally, the affairs of the firm are, or should be, managed in such a way that the total risk borne by equity shareholders, which consists of business risk plus financial risk, is not unduly high. This implies that if the firm is exposed to a high degree of business risk, its financial risk should be kept low. On the other hand, if the firm has a low business risk profile, it can assume more financial risk.

Norms of Lenders The norms employed by the lenders have a bearing on the capital structure. For example, financial institutions at one time permitted a debt-equity ratio of 2:1. At that time most of the projects had a debt-equity ratio close to 2:1. Now the general debt-equity ratio norm allowed by financial institutions is 1:1. Of course, for highly capital-intensive projects they permit a higher debt-equity ratio. For example, for a power generation project they permit a debt-equity ratio of 2.33:1.

Control Considerations The extent of equity stake that the promoters want to have in a project has an important bearing on its capital structure. Let us say that the cost of a project is 10,000 and the promoters of the project can invest 2,000. If they want to have a minimum stake of 50 percent in the equity of the project, the total equity cannot exceed 4,000. Hence the balance 6,000 has to be in the form of debt, leading to a debt-equity ratio of 1.5:1. On the other hand, if they want a minimum stake of 40 percent in the equity of the project, the total equity cannot exceed 5,000. So, the balance 5,000 has to be in the form of debt, leading to a debt-equity ratio of 1:1.

Market Conditions If the equity market is buoyant and equity shares can be issued at an attractive premium, the project may rely more on equity. On the other hand, if the equity market is depressed, the project may depend more on debt.

A Checklist

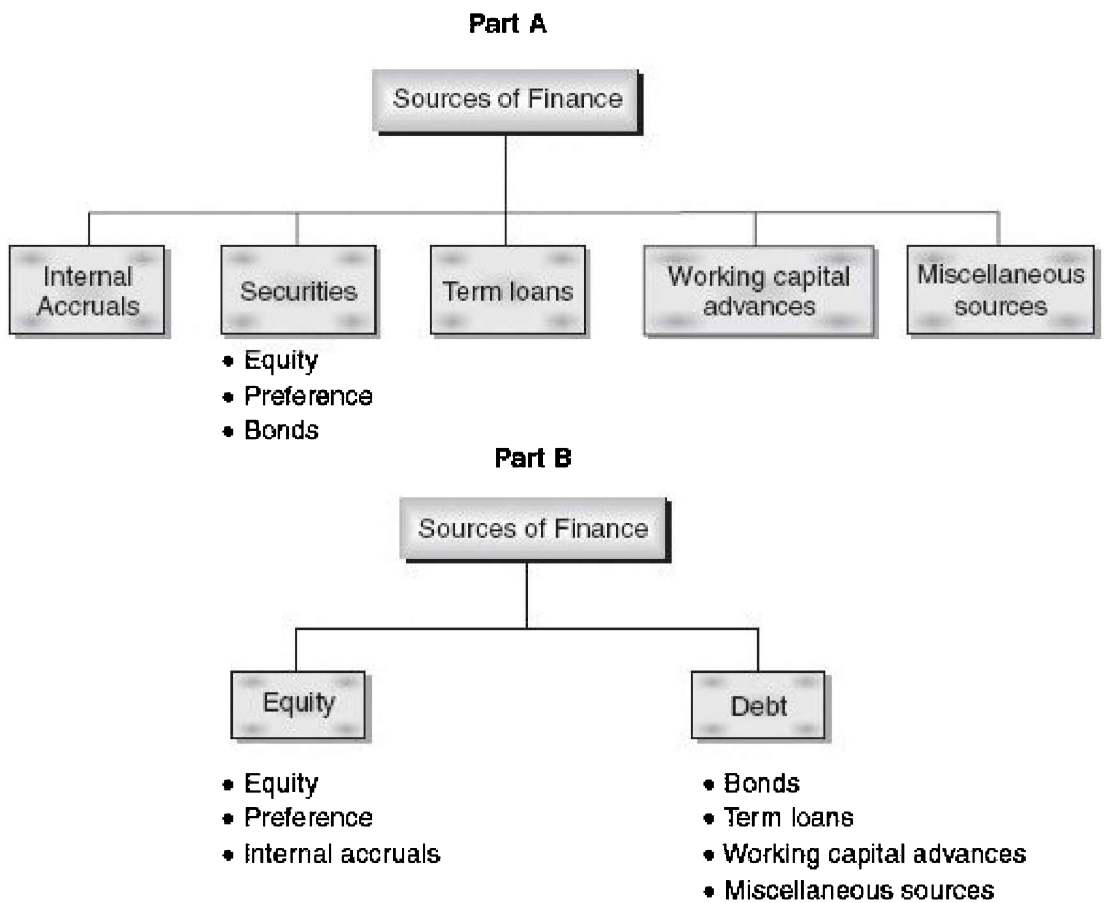
When should a project use more equity and when should a project use more debt. Here is a checklist:

Use more equity when	*Use more debt when*
■ The tax rate applicable is negligible.	■ The tax rate applicable is high.
■ Business risk exposure is high.	■ Business risk exposure is low.
■ Dilution of control is not an important issue.	■ Dilution of control is an issue.
■ The assets of the project are mostly intangible.	■ The assets of the project are mostly tangible.
■ The project has many valuable growth options.	■ The project has few growth options.

18.2 MENU OF FINANCING

Finance can be raised from a variety of sources that may be classified in different ways as shown in Exhibit 18.1. The various forms of financing are discussed in the following sections.

Exhibit 18.1 *Sources of Finance*



Public and Private Sources of Capital

A firm can raise equity and debt capital from both public and private sources. Capital raised from public sources is in the form of securities offered to public through an offer document filed with the Securities Exchange Board of India[1]. These securities can be traded on public secondary markets like the National Stock Exchange or the Bombay Stock Exchange, which are recognised stock exchanges that facilitate the trading of public securities.

Private capital comes either in the form of loans given by banks and financial institutions or in the form of issue of securities like equity shares, preference shares, and debentures which are privately placed with a small group of sophisticated investors like private equity funds, venture capital firms, financial institutions, insurance companies, mutual funds, and wealthy individuals.

* The Typical Pattern of Financing

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 others - venture capital funds 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.

Apart from equity shares, a firm may issue preference shares[2] and debentures to the general investing public through a public issue.

18.3 INTERNAL ACCRUALS

The internal accruals of a firm consist of depreciation charges and retained earnings. Depreciation represents the allocation of capital expenditure to various periods over which the capital expenditure is expected to benefit the firm. Suppose a machine costs ₹100,000 and has an economic life of five years at the end of which its expected salvage value is 0. If the machine is depreciated using the straight line method the annual depreciation charge will be ₹20,000. Each year a depreciation cost of ₹20,000 is shown in the profit and loss account. This cost merely 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 an important source of long-term financing. Even this is an understatement of the contribution of retained earnings to long-term financing 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:

- Internal accruals are readily available. Management does not have to talk to outsiders (shareholders or lenders).
- Use of internal accruals, 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 internal accruals.
- The stock market generally views an equity issue with skepticism. Internal accruals, however, do not carry such negative connotation.

The disadvantages of internal accruals include the following:

- The amount that may be available by way of internal accruals may be limited.
- The opportunity cost of retained earnings is quite high as it is equal to the cost of equity—remember that retained earnings, in essence, represent dividends foregone by equity shareholders.
- The opportunity cost of depreciation-generated funds is equal to the weighted average cost of capital of the firm.
- Many firms do not fully appreciate the opportunity costs of retained earnings and depreciation-generated funds. They tend to impute a low cost to internal accruals. Comforted by the easy availability of internal accruals and the notion that they have a low cost, managements may invest in sub-marginal projects that destroy shareholder value.

18.4 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 contributions.

Some Terms

Let us look at some of the terms relating to equity capital.

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 ₹10 (the most popular denomination) or ₹100. Infrequently, one comes across par values like ₹1, ₹2, ₹5, ₹50, and ₹1,000.

The *issue price* is the price at which the equity share is issued. Generally the issue price and par value are one and the same for new companies. An existing company may sometimes set its issue price higher than the par value. Sonata Software (India) Limited, for example, set its issue price at ₹80 per share as against the par value of ₹10 per share. 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.[3]

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

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

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 such a company, the market quotation may reflect the sale of a few shares in a past period and hence may not reflect the current market value of the firm. 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 of Equity Shareholders

The rights of equity shareholders are as follows:

Right to Income The 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. The dividend decision is the prerogative of the board of directors.

Right to Control Equity shareholders elect the board of directors and have the right to vote on every resolution placed before the company. The board of directors, in turn, selects the management which controls the operations of the firm. Hence, equity shareholders exercise an indirect control over the operations of the firm. How effective is such indirect control? Often such indirect control is weak and ineffective because of the apathy and indifference of most of the shareholders who rarely bother to cast their votes, by post or through a proxy, let alone attend the annual general meetings. Scattered and ill-organised, equity shareholders fail to exercise their collective power effectively. Usually, the management of the firm, with the support of a well organised but not necessarily a very substantial group of shareholders, is able to hold the reins of control.

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 pro rata basis, additional issues of equity capital. For example, if the company has 1,000,000 outstanding shares of equity stock and proposes to issue 200,000 additional equity shares, an equity shareholder owning 100 shares has the right to purchase 20 of the 200,000 new shares before those are offered to anyone else. The equity shareholders may, however, forfeit this right, partially or totally.

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 share-holders—are settled 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 fully meet the claims of others.

Advantages and Disadvantages of Equity Capital

An important source of long-term financing, 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.
- Presently, equity dividends are tax-exempt in the hands of investors.

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. 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.

18.5 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 usually fixed; (ii) the claim of preference shareholders is prior to the claim of equity shareholders; and (iii) preference shareholders do not normally enjoy the right to vote.

Types of Preference Shares

There are various types of preference shares, depending on the rights associated with them.

Cumulative and Non-cumulative Preference Shares Cumulative preference shares entitle the shareholders to receive dividends for previous year/s in which dividend was not paid. A company cannot declare equity dividends unless dividends on cumulative preference shares are paid with arrears.

Participating and Non-participating Preference Shares The holders of participating preference shares get a share in the profits of the company after a certain rate of dividend is paid to the equity shareholders of the company. This is in addition to the fixed rate of dividend declared on preference shares before any equity dividend is paid. The holders of non-participating preference shares can get only a fixed dividend and do not get any share in the surplus left after paying equity dividend.

Redeemable and Non-redeemable Preference Shares Redeemable preference shares are repayable at par or at premium after a specified period. Non-redeemable preference shares are not repayable, except when the company goes into liquidation. At present, companies in India can issue only redeemable preference shares where the redemption period does not exceed twenty years.

Convertible and Non-convertible Preference Shares Convertible preference shares can be converted into equity shares at the option of the preference shareholders in accordance with certain predetermined terms. Non-convertible shares do not carry such an option.

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.
- There is no redemption liability in the case of perpetual preference shares. Even in the case of redeemable preference shares, financial distress may not be much because (i) periodic sinking fund payments are not required and (ii) redemption can be delayed without significant penalties.
- Preference capital is regarded as part of net worth, if its redemption is subordinated to repayment of debt.
- Preference shares do not, under normal circumstances, carry voting right. Hence, there is no dilution of control.
- No security of assets is provided to 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 more expensive source of financing because the preference dividend is not, unlike debt interest, a tax-deductible expense. Further, there is a dividend distribution tax.
- Skipping preference dividend can adversely affect the image of the firm in the capital market.
- Compared to equity shareholders, preference shareholders have a prior claim on the assets and earnings of the firm.
- If a firm skips preference dividends for three years, it has to grant voting right to preference shareholders, on matters affecting them.

18.6 DEBENTURES (OR BONDS)

For large publicly traded firms, debentures are a viable alternative to term loans. Akin to promissory notes, debentures are instruments for raising debt finance. Debenture holders are the creditors of the 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 choice with respect to maturity, interest rate, security, repayment, and special features.

Features

The important features of debentures are as follows:

- When a debenture issue is sold to the investing public, a trustee is appointed through a trust deed. The trustee, usually a bank or financial institution or insurance company, is supposed to ensure that the borrowing firm fulfills its contractual obligations.
- Debenture issues in India are typically 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 debentures that are not backed by specific assets of the firm, but by its general credit.
- Corporate debt may be short-term, medium-term or long-term. Short-

term corporate debt of less than one year is called commercial paper. Medium-term debentures may have a maturity of 1 year to 5 years. Long-term debentures typically have a maturity period of 5 to 12 years.

- Publicly issued debentures that have a maturity period of 18 months or more have to be compulsorily credit rated.
- Debentures are typically redeemable in nature. 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.
- Debentures may carry a fixed rate of interest or floating rate of interest or zero rate of interest.
- Debentures may carry a 'call' feature, which provides the issuing company the option to redeem the debentures at a certain price before the maturity period. Sometimes debentures may have a 'put' feature which gives the holder the right to seek redemption at specified times at predetermined prices.

Innovations in Debentures

Thanks to the latitude enjoyed by companies from early 1990s, a variety of debt instruments have been employed. Here is a sampling:

Deep Discount Bonds A deep discount bond does not carry any coupon rate but is issued at a steep discount over its face value. It is also referred to as a 'zero interest (coupon) bond' or just a zero. For example, in 1992 the Industrial Development Bank of India (IDBI) issued deep discount bonds. Each bond having a face value of ₹100,000 was issued at a deeply discounted price of ₹2500 with a maturity period of 25 years from the date of allotment (i.e. February 1, 1993). The investor as well as IDBI have the option to withdraw or redeem the bond respectively at the end of 5, 9, 12, 15, or 20 years from the date of allotment at the deemed value of ₹5300, ₹9600, ₹15,300, ₹25,000 and ₹50,000 respectively.

Deep discount bonds appeal to issuers interested in conserving their cash flows during the life of the bonds. On the other side of the market, they appear attractive to investors who want to protect themselves against the reinvestment rate risk. Remember that the imputed interest on a deep discount bond is automatically reinvested at a rate equal to its yield to maturity.

Convertible Debentures A convertible debenture, as the name suggests, is a debenture that is convertible, partially or wholly, into equity shares. As per

SEBI guidelines, the provisions applicable to fully convertible debentures (FCDs) and partially convertible debentures (PCDs) are as follows:

- The conversion premium and the conversion timing shall be predetermined and stated in the prospectus. If the convertible portion exceeds ₹50 lakh and the issuer has not determined the conversion price at the time of issue, the holders of such convertible debt instruments shall be given the option of not converting the convertible portion into equity shares. However, where the upper limit on the conversion price is disclosed to the investors at the time of issue, such option need not be given, as long as the conversion price is within the said upper limit.
- Compulsory credit rating will be required for partly convertible debentures.

Convertible debentures are commonly used all over the world and are gaining currency in India as well. Why are they popular? The conventional explanations for their popularity are: (a) convertible debentures are a cheaper source of finance because interest rate on them is typically lower than that on straight debentures; (b) convertible debentures enable a company to effectively issue equity shares at a premium because the conversion price associated with a convertible debenture is typically higher than the price at which equity shares can be issued currently.

The conventional explanations have a "free lunch" flavour. So you should be suspicious of them.

Modern finance theory offers better explanations: (a) Convertible debentures improve cash flow matching. Firms prefer financing instruments that can be comfortably serviced. A growing but risky firm may find convertible debentures appealing because of a lower initial burden, though they may entail expensive dilution later. (b) Convertible debentures generate financial synergy. They make sense when it is very costly or difficult to assess the risk characteristics of the issuing firm. Remember that these instruments have two components, the straight debenture component and the call option component. If thecompany turns out to be risky, the debenture instrument will have a low value but the call option component will have a high value. On the other hand, if the company turns out to be relatively risk-free the debenture component will have a high value but the call option component a low value. Given this compensating behaviour of the two components, the required yield on the convertible debenture will not be very sensitive to default risk.

Floating Rate Bonds Conventional bonds carry a fixed rate of interest. Floating rate bonds, on the other hand, earn an interest rate that is linked to a benchmark rate such as the Treasury bill interest rate. For example, in 1993 the State Bank of India came out with the first ever issue of floating interest rate bonds in India. It issued 5 million (₹1000 face value) unsecured, redeemable, subordinated, floating interest rate bonds in the nature of promissory notes carrying interest at 3 percent per annum over the bank's maximum term deposit rate.

Floating rate bonds have been essentially a response to inflation risk. They make sense to a borrower whose assets earn returns that fluctuate with interest rates. Financial institutions and banks which give variable rate interest loans find such bonds appealing. Who is interested in buying floating rate bonds? Investors concerned about the stability of their principal find floating rate bonds attractive. The prices of these bonds tend to be fairly stable and close to par value compared to fixed interest bonds.

Indexed Bonds The payoff of a typical indexed bond consists of two parts. The first part represents a fixed amount and the second part represents a variable component whose value is dependent on some index. For example, ICICI issued Indexed Bonds in 1997 for ₹6000 each. It was a composite instrument comprising of two parts: a discount bond and a detachable index warrant. The face value of the discount bond was ₹22,000 and its redemption date was May 27, 2009. The detachable warrant had a payoff that was linked to BSE Sensex as follows: 2000 × BSE Sensex 2009/BSE Sensex 1997.

An indexed bond appeals to investors who are looking for an assured return along with capital appreciation that is linked to some index.

Strips GE Capital Services India issued India's first STRIP debentures (separately tradeable interest and principal debentures) in 1998. Each STRIP debenture consisted of seven detachable strips, one for the principal and six for interest coupons. Each strip was to be listed and traded separately on the National Stock Exchange.

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 dividends 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.
- 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.
- The maturity of a debt instrument can be tailored to the needs of the borrowing firm.

Debt financing is not an unmixed blessing. It has certain 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.

Dominance of Straight Debt and Equity

Apart from straight debt and equity, firms can issue a variety of other securities. Theoretically, firms can issue an endless range of securities. However, the actual number of alternative securities used by firms in not very large and the proportion of financing raised through them is fairly small. Why? A plausible explanation why firms primarily use straight debt and equity is offered by Fama and Jensen*. According to them it makes sense to segregate the financial claims of the firm into only two parts: a relatively lowrisk claim represented by debt and a relatively high-risk claim represented by equity. They argue that specialised risk bearing by residual claimants reduces contracting costs – the costs incurred to monitor contract fulfillment. Thanks to specialised risk bearing, shareholders and bondholders do not have to monitor each other. It is enough if debtholders monitor shareholders. This kind of one-way monitoring lessens the total cost of contracting than what it would otherwise be. Hence it makes sense for most firms to use only straight debt and equity.

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* Fama, E.F., and M.C. Jenson, "Agency Problems and Residual Claims," *Journal of Law and*

Economics, June 1983.

18.7 METHODS OF OFFERING

There are different ways in which a company may raise finances in the primary market: public offering, rights issue, and private placement.

Public Offering

A public offering or public issue involves sale of securities to the members of the public. The three types of public offering are: the initial public offering (IPO), the seasoned equity offering, and the bond offering.

Initial Public Offering 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 offering (IPO).

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 are publicly traded) is a very important issue. It is a complex decision, which calls for carefully weighing the benefits against costs.

Benefits	*Costs*
■ Access to a larger pool of capital	■ Dilution
■ Respectability	■ Loss of flexibility
■ Lower cost of capital compared to private placement	■ Disclosures and accountability
■ Liquidity	■ Periodic costs

Eligibility for IPOs An Indian company, excluding certain banks and infrastructure companies, can make an IPO if it satisfies the following conditions.[4]

- The company has a certain track record of profitability and a certain minimum networth.
- The securities are compulsorily listed on a recognised stock exchange, which means that a certain minimum percent of each class of securities is offered to the public.

- The promoter group (promoters, friends, relatives, associates, etc.) is required to make a certain minimum contribution to the post-issue capital.
- The promoters' contribution to the equity is subject to a certain lock-in period.

The IPO Process From the perspective of merchant banking, the IPO process consists of four major phases: (a) hiring the merchant bankers, (b) due diligence and prospectus preparation, (c) marketing, and (d) subscription and allotment.

The company wishing to go public has to hire the merchant bankers to manage its offering. The selection of a merchant banker is usually referred to as a 'beauty contest'. Typically, it involves meeting different merchant bankers, discussing the plans for going public, and getting a valuation estimate. Understandably, the choice of the merchant banker is guided mainly by the valuation estimate offered. Often, a company going for an IPO selects two or more merchant bankers to manage the issue. The primary manager is called the "lead manager" and the other managers are called "co-managers".

Once the managers are selected, *due diligence and prospectus preparation* begin. The merchant bankers understand the company's business and plans, examine various documents and records, prepare the draft prospectus, file the same with the regulatory authorities, and arrange for its printing. Merchant bankers, lawyers, accountants, and company managers have to toil for countless hours to complete the legal formalities that finally culminate in the printing of the prospectus. Since book building is commonly used, the issue price is not fixed in advance, but a price band is given.

The next phase of an IPO is the *marketing phase*. After all the regulatory approvals are in place, the company embarks on a *road show* to promote the issue. A road show involves presentation by the management of the company to potential investors (mostly institutional) in different locations. Concurrently, the issue is advertised in various media primarily targeted at retail investors.

The final phase of the IPO involves receiving *subscription and allotment* of shares. The subscription is normally kept open for five to ten days. During this period, investors can submit their bid-cum-application forms. After the subscription is closed, the merchant bankers fix the final issue price, determine the pattern of allotment, complete the allotment of shares, and secure the listing on one or more recognised stock exchanges.

Seasoned Equity Offering For most companies their IPO is seldom their last public issue. As companies need more finances, they are likely to make further trips to the capital market with seasoned equity offerings, also called secondary offerings.

While the process of a seasoned equity offering is similar to that of an IPO, it is much less complicated. The company may employ the merchant bankers who handled the IPO. Further, with the availability of secondary market prices, there is no need for elaborate valuation. Finally, prospectus preparation and road shows can be completed with less effort and time than that required for the IPO.

Bond Offering The bond offering process is similar to the IPO process. There are, however, some differences:

- The prospectus for a bond offering typically emphasises a company's stable cash flows, whereas the prospectus for an equity offering highlights the company's growth prospects.
- Pure debt securities are typically offered at a predetermined yield because the book building route is not considered appropriate for them.
- Debt securities are generally secured against the assets of the issuing company and that security should be created within six months of the close of the issue of debentures.
- A debt issue cannot be made unless credit rating from a credit rating agency is obtained and disclosed in the offer document.
- It is mandatory to create a debenture redemption reserve for every issue of debentures.
- It is necessary for a company to appoint one or more debenture trustees before a debenture issue.

Rights Issue

A rights issue involves selling securities in the primary market by issuing rights to the existing shareholders. When a company issues additional equity capital, it has to be offered in the first instance to the existing shareholders on a pro rata basis. This is required under Section 81 of the Companies Act, 1956. The shareholders, however, may by a special resolution forfeit this right, partially or fully, to enable a company to issue additional capital to the public.

Procedure for 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 the acceptance of the rights and application of additional shares. This form also 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 if the shareholder wants to renounce the rights in favour of someone else. 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 specific period, which is usually 30 days.

Rights Issue versus Public Issue A rights issue offers several advantages over a public issue. The floatation costs of a rights issue are significantly lower than those of a public issue. Theoretically, the subscription price of a rights issue is irrelevant because the wealth of a shareholder who subscribes to the rights issue or sells the rights remains unchanged, irrespective of what the subscription price is. Hence, the problem of transfer of wealth from existing shareholders to new shareholders does not arise in a rights issue.

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 When a listed company issues shares or debentures to a select group of persons in terms of the provisions of Chapter VII of SEBI (Issue of Capital and Disclosure Requirements) Regulations 2009, it is referred to as a preferential allotment. The issuer has to comply with various provisions, relating to pricing, disclosures, lock-in period and so on, apart from the requirements of the Companies Act.

Qualified Institutional Placement (QIP) A QIP is an issue of equity shares or convertible securities to Qualified Institutional Buyers in terms of the provisions of Chapter VII of SEBI (ICDR) Regulations.

Private Placement of Bonds From 1995 onwards private placement of debentures thrived, thanks to minimal regulation. Corporates, financial institutions, infrastructure companies, and others depended considerably on privately placed debentures which were subscribed to mainly by mutual funds, banks, insurance organisations, and provident funds.

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.
- Debt securities may be optionally listed.
- 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? Exhibit 18.2 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 positive under all the methods.

Exhibit 18.2 ***Summary Comparison of the Various 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

18.8 TERM LOANS

Firms obtain long-term debt mainly by raising term loans or issuing debentures. We have discussed at length the features and types of debentures. Now we turn our attention to term loans.

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 typically 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.[5]

Features of Term Loans

The following features of term loans are discussed below:

- Currency
- Security
- Interest payment and principal repayment
- Restrictive covenants

Currency Financial institutions (hereafter, we will, for the sake of simplicity, use the term financial institution to refer to all financial intermediaries like development financial institutions, commercial banks, and insurance companies) give rupee term 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 industrial concerns for setting up new projects as well as for expansion, modernisation, and renovation projects.

These funds are provided for incurring expenditure on land, building, plant and machinery, technical know-how, miscellaneous fixed assets, preliminary expenses, preoperative expenses, and margin money for working capital.

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 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:

1. First equitable mortgage of all immovable properties of the borrower, both present and future; and
2. 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. In case of default on payment of interest, the borrower is liable to pay further interest on interest (compound interest) at the document rate. For default in repayment of instalments of principal, the borrower is liable to pay by way of liquidated damages, additional interest at the rate of 2 percent per annum for the period of default on the amount of principal in default. In addition to interest, lending institutions levy an upfront fee on the sanctioned loan amount usually at the rate of one percent.

Institutions Providing Term Loans

Institutions that provide term loans in India may be divided into three broad categories as follows:

All India Financial Institutions These include IFCI, ICICI, and IDBI, the three oldest general term-lending institutions (ICICI and IDBI have been transformed into banks in recent years), and specialised institutions like Exim Bank, IL&FS, Power Finance Corporation, IDFC, and SI DBI, and insurance companies (LIC and GIC) with marginal exposure to term-lending.

State Level Financial Institutions Most of the states have a State Industrial Development Corporation (SIDC) and a State Financial Corporation (SFC).

Commercial Banks Historically, commercial banks were marginal players in the termlending arena, as their main thrust was on providing working capital finance. In recent years, commercial banks have stepped up their term-lending activities.

The principal amount of a term loan is generally repayable over a period of four to seven years after an initial grace period of one to two years. Typically, term loans provided by financial institutions are repayable in equal semi-annual instalments or equal quarterly instalments.

Note that the interest burden declines over time, 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 instalments.

Restrictive Covenants In order to protect their interest, financial institutions 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 the financial institutions.
- Refrain from additional borrowings or seek the consent of financial institutions for additional borrowings.

Further, loan agreements impose restrictions on the transfer of shareholding by promoters/associates.

Term Loan Procedure

The procedure associated with a term loan involves the following 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 the 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.

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 institutions permit interim disbursements.[6] 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.

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 terms and conditions of the loan agreement.

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 company, 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 performance reports 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 timely recovery of dues represented by interest and principal repayment.

Syndicated Loans Syndication is an arrangement wherein several banks participate in a single loan. The corporate seeking a syndicated loan chooses a lead bank to manage the same. The lead bank prepares an information memorandum which is sent to other banks potentially interested in participating in the syndicated loan. Based on the interest evinced by the participating banks, the lead bank works out the sharing arrangement.

While bilateral loans are preferred for small ticket loans, syndicated loans are becoming popular for large ticket loan. For example, IDBI Bank lead managed a ₹6,000 crore syndicated loan for HINDALCO in 2005. The loan has a tenor of 10 years with a re-set after five years. Thirty banks participated in this loan which was priced at five-year G-sec yield plus 65 basis points.

How is loan syndication different from consortium financing which was popular earlier? Consortium financing involved a presentation to be given by the company to a group of bankers and was more rule based. Further, under a consortium arrangement, participating banks offered other services like letter of credit, working capital credit, guarantees and so on and interacted regularly with the company.

18.9 WORKING CAPITAL ADVANCES

Working capital advance by commercial banks represents the most important source for financing current assets.

Forms of Bank Finance

Working capital advance is provided by commercial banks in three primary ways: (i) cash credits/overdrafts, (ii) loans, and (iii) purchase/discount of bills. In addition to these direct forms, commercial banks help their customers in obtaining credit from other sources through the letter of credit arrangement.

Cash Credits/Overdrafts Under a cash credit or overdraft arrangement, a pre-determined limit for borrowing is specified by the bank. The borrower can draw as often as required provided the outstanding does not exceed the cash credit/overdraft limit, subject to the availability of adequate security. The borrower also enjoys the facility for repaying the amount, partially or fully, as and when he desires. Interest is charged only on the running balance, and not on the limit sanctioned. A minimum charge may be payable irrespective of the level of borrowing, for availing of this facility. This form of advance is highly attractive from the borrower's point of view because while the borrower has the freedom of drawing the amount in parts as and when required, interest is payable only on the amount actually outstanding.

Loans These are advances of fixed amounts to the borrower. The borrower is charged with interest on the entire loan amount, irrespective of how much he draws. In this respect, this system differs markedly from the overdraft or cash credit arrangement wherein interest is payable only on the amount actually utilised. Loans are payable either on demand or in periodical instalments. When payable on demand, loans are supported by a demand promissory note executed by the borrower.

Purchase/Discount of Bills A bill usually arises out of a trade transaction. The seller of goods draws the bill on the purchaser. The bill may be either clean or documentary (a documentary bill is supported by a document of title to goods like a railway receipt or a bill of lading) and may be payable on demand or after a usance period. On acceptance of the bill by the purchaser, the seller offers it to the bank for discount/purchase. When the bank discounts/purchases the bill, it releases the funds to the seller. The bank presents the bill to the purchaser (the acceptor of the bill) on the due date and gets its payment.

Letter of Credit A letter of credit is an arrangement whereby a bank helps its customer to obtain credit from its (customer's) suppliers. When a bank opens a letter of credit in favour of its customer for some specific purchases, the bank undertakes the responsibility to honour the obligation of its customer, should the customer fail to do so.

Application and Processing

A customer seeking an advance is required to submit an appropriate application form—there are different types of application forms for different categories of advances. The information furnished in the application covers, *inter alia*, the following: the name and address of the borrower and his establishment; the details of the borrower's business; the nature and amount of security offered. The application form has to be supported by various ancillary statements like the financial statements and financial projections of the firm.

The application is processed by the branch manager. This primarily involves an examination of the following factors: (i) ability, integrity, and experience of the borrower in the particular business, (ii) general prospects of the borrower's business, (iii) purpose of advance,(iv) requirement of the borrower and its reasonableness, (v) adequacy of the margin,(vi) provision of security, and (vii) period of repayment and repayment capacity.

Sanction and Terms and Conditions

Once the application is duly processed, it is put up for sanction to the appropriate authority. The sanctioning powers of various officials—like Branch Manager, Regional Manager, General Manager, etc.—are defined by virtue of the position they occupy.

If the sanction is given by the appropriate authority, along with the sanction of advance, the bank specifies the terms and conditions applicable to the advance. These usually cover the following: (i) the amount of loan or the maximum limit of the advance, (ii) the nature of the advance, (iii) the period for which the advance will be valid, (iv) the rate of interest applicable to the advance, (v) the primary security to be charged, (vi) the insurance of the security, (vii) the details of the collateral security, if any, to be provided, (viii) the margin to be maintained, and (ix) other restrictions or obligations on the part of the borrower. It is a common banking practice to incorporate important terms and conditions on a stamped security document to be executed by the borrower. This helps the bank to create the required charge on the security offered and also obligates the borrower to observe the stipulated terms and conditions.

Security

For working capital advances, commercial banks seek primary security either in the form of hypothecation or in the form of pledge.

Hypothecation Under this arrangement, the owner of the goods borrows money against the security of movable property, usually inventories. The owner does not part with the possession of property. The rights of the lender (hypothecatee) depend upon the arrangement between the lender and the borrower. Should the borrower default in paying his dues, the lender (hypothecatee) can file a suit to realise his dues by selling the goods hypothecated.

Pledge In a pledge arrangement, the owner of the goods (pledgor) deposits the goods with the lender (pledgee) as security for the borrowing. Transfer of possession of goods is a precondition for pledge. The lender (pledgee) is expected to take reasonable care of goods pledged with him. The pledge contract gives the lender (pledgee) the right to sell goods and recover dues, should the borrower (pledgor) default in paying debt.

Margin Amount

Banks do not provide hundred percent finance. They insist that the customer should bring a portion of the required finance from other sources as margin amount. The margin amount is determined taking into account the type of security offered, the riskiness of the project, the value of business connection, and so on.

18.10 MISCELLANEOUS SOURCES

Apart from the sources of finance mentioned earlier, there are several other ways in which finance may be obtained. These include:

- Deferred credit
- Lease and hire purchase finance
- Unsecured loans and deposits
- Special schemes of institutions
- Subsidies and sales tax deferments and exemptions
- Short-term loans from financial institutions
- Commercial paper
- Factoring
- Securitisation

Deferred Credit

Many a time the suppliers of machinery provide deferred credit facility under which payment for the purchase of machinery is made over a period of time. The interest rate on deferred credit and the period of payment vary rather widely. Normally, the supplier of machinery, when he offers deferred credit facility, insists that a bank guarantee should be furnished by the buyer.

Lease Finance and Hire Purchase

Leasing and hire purchase are currently a supplementary form of debt finance.

Lease Finance A lease represents a contractual arrangement whereby the lessor grants the lessee the right to use an asset in return for periodic lease rental payments. While leasing of land, buildings, and animals has been known from times immemorial, the leasing of industrial equipments is a relatively recent phenomenon, particularly on the Indian scene.

There are two broad types of lease: finance lease and operating lease. A *finance lease* or capital lease is essentially a form of borrowing. Its salient features are:

- It is an intermediate term to long-term non-cancellable arrangement. During the initial lease period, referred to as the 'primary lease period', which is usually three years or five years or eight years, the lease cannot be cancelled.
- The lease is more or less fully amortised during the primary lease period.

This means that during this period, the lessor recovers, through the lease rentals, his investment in the equipment along with an acceptable rate of return. Thus, a finance lease transfers substantially all the risks and rewards incident to ownership to the lessee.

- The lessee is responsible for maintenance, insurance, and taxes.
- The lessee usually enjoys the option for renewing the lease for further periods at substantially reduced lease rentals.

An *operating lease* can be defined as any lease other than a finance lease. The salient features of an operating lease are:

- The lease term is significantly less than the economic life of the equipment.
- The lessee enjoys the right to terminate the lease at a short notice without any significant penalty.
- The lessor usually provides the operating know-how and the related services and undertakes the responsibility of insuring and maintaining the equipment. Such an operating lease is called a 'wet lease'. An operating lease where the lessee bears the costs of insuring and maintaining the leased equipment is called a 'dry lease'.

From the above features of an operating lease it is evident that this form of a lease does not result in a substantial transfer of the risks and rewards of ownership from the lessor to the lessee. The lessor structuring an operating lease transaction has to depend upon multiple leases or on the realisation of a substantial resale value (on expiry of the first lease) to recover the investment cost plus a reasonable rate of return thereon. Therefore, specialising in operating lease calls for an in-depth knowledge of the equipments and the secondary (resale) market for such equipments. Of course, the prerequisite is the existence of a resale market. Given the fact that the resale market for most of the used capital equipments in our country lacks breadth, operating leases are not in popular use. In recent years there have been attempts to structure car lease and computer lease transactions in the operating lease format.

At present, the following are the key features of lease finance in India:

- Most leases in India are finance leases, not operating leases
- Lease finance is available for identifiable performing assets
- Lease finance is available in small volume
- There is a great deal of flexibility in structuring lease finance
- Lease of immovable assets is not possible by banks
- Lease tenors up to eight years is available

Hire-Purchase Finance companies usually offer the facility of leasing as well as hire-purchase to its clients. What are the features of a hire-purchase arrangement? How are hire-purchase instalments split between interest and principal payments? How should the potential user of an asset choose between leasing and hire-purchase?

The main features of a hire-purchase arrangement are as follows:

- The hiree (the counterpart of lessor) purchases the asset and gives it on hire to the hirer (the counterpart of lessee).
- The hirer pays regular hire–purchase instalments over a specified period of time. These instalments cover interest as well as principal repayment. When the hirer pays the last instalment, the title of the asset is transferred from the hiree to the hirer.
- The hiree charges interest on a flat basis. This means that a certain rate of interest, usually around 8 percent, is charged on the initial investment (made by the hiree) and not on the diminishing balance.
- The total interest collected by the hiree is allocated over various years. For this purpose, the 'sum of the years digits' method is commonly employed.

The following differences between leasing and hire–purchase, from the point of view of the lessee (hirer), may be noted.

Leasing	*Hire-Purchase*
■ The lessee cannot claim depreciation	■ The hirer is entitled to claim depreciation.
■ The entire lease rental is a tax-deductible expense for the lessee.	■ Only the interest component of the hire-purchase instalments is a tax- deductible expense for the hirer.
■ The lessee, not being the owner of the asset, does not enjoy the salvage value of the asset.	■ The hirer, being the owner of the asset, enjoys the salvage value of the asset.

Instalment Purchase An instalment purchase is similar to hire purchase in the sense that the buyer pays for the purchase by way of instalments over a period of time. However, there is one important difference. In a hire purchase arrangements, the title of the asset is transferred from the hiree to the hirer when the hirer pays the last instalment. But, in an instalment purchase arrangement, the title of the asset is passed to the buyer on payment of the first instalment itself. In case of default, the seller can force the buyer to sell the asset and make good the remaining instalments.

Unsecured Loans and Deposits

Unsecured loans are typically provided by the promoters to fill the gap between the promoters' contribution required by financial institutions and the equity capital subscribed to by the promoters. These loans are subordinated to the institutional loans. The rate of interest chargeable on these loans is required to be less than the rate of interest on the institutional loans. Finally these loans cannot be repaid without the prior approval of the financial institutions.

Deposits from the public, referred to as public deposits, represent unsecured borrowing of one to three years (five years in the case of non-banking finance companies) duration. Many existing companies prefer to raise public deposits instead of term loans from financial institutions because restrictive covenants do not accompany public deposits. However, it may not be possible for a new company to raise public deposits. Further, it may be difficult for it to repay public deposits within three years.

Special Schemes of Institutions

Financial institutions have designed special schemes to serve the varied needs of industry. The important ones are:

Bill Rediscounting Scheme Operated by the IDBI, the bill rediscounting scheme is meant to promote the sale of indigenous machinery on deferred payment basis. Under this scheme, the seller realises the sale proceeds by discounting the bills or promissory notes accepted by the buyer with a commercial bank which in turn rediscounts them with the IDBI. This scheme is meant primarily for balancing equipment and machinery required for expansion, modernisation, and replacement schemes.

Suppliers' Line of Credit Administered by the ICICI, the Suppliers' Line of Credit is some-what similar to the IDBI's Bill Rediscounting Scheme. Under this arrangement, ICICI directly pays to the machinery manufacturer against usance bills duly accepted or guaranteed by the bank of the purchaser.

Subsidies and Sales Tax Deferments and Exemptions

Governments and development agencies may provide subsidies for certain kinds of projects. Of late, however, these have decreased in importance. Previously, the central government as well as the state governments provided subsidies to industrial units located in backward areas. The central subsidy has been discontinued but the state subsidies continue. The state subsidies vary between 5 percent to 25 percent of the fixed capital investment in the project, subject to a ceiling varying between ₹0.5 million and ₹2.5 milliondepending on the location.

To attract industries, the states provide incentives, *inter alia*, in the form of sales tax deferments and sales tax exemptions.

Under the sales tax deferment scheme, the payment of sales tax on the sale of finished goods may be deferred for a period ranging between five to twelve years. Essentially it implies that the project gets an interest-free loan, represented by the quantum of sales tax deferred, during the deferment period.

Under the sales tax exemption scheme, some states exempt the payment of sales tax applicable on purchases of raw materials, consumables, packing, and processing materials from within the state which are used for manufacturing purposes. The period of exemption ranges from three to nine years depending upon the state and the specific location of the project within the state.

Short-term Loans from Financial Institutions

Financial institutions provide short-term loans to companies with a good track record. To be eligible for such a loan, a company must satisfy certain conditions relating to dividend track record, debt-equity ratio, current ratio, and interest coverage ratio.

Short-term loans provided by financial institutions have the following features:

- They are totally unsecured and are given on the strength of a demand promissory note.
- The loan is given for a period of one year and can be renewed for two consecutive years, provided the original eligibility criteria are satisfied.

Commercial Paper

A commercial paper represents a short-term unsecured promissory note issued by firms which enjoy a fairly high credit rating. Generally, large firms with considerable financial strength are able to issue commercial paper. The important features of commercial paper are as follows:

- The maturity period of commercial paper ranges from 90 to 180 days.
- Commercial paper is sold at a discount from its face value and redeemed at its face value. Hence the implicit interest rate is a function of the size

of the discount and the period of maturity.

- Commercial paper is directly placed with investors who mostly intend holding it till its maturity. Hence there is no well developed secondary market for commercial paper.

Factoring

A factor is a financial institution which offers services relating to management and financing of debts arising from credit sales. While factoring is well-established in western countries, only two factors, the SBI Factoring and Commercial Services Limited and Canbank Factoring Limited, which have been mandated by the Reserve Bank of India to operate in the western region and the southern region respectively, have made some tangible progress. The Punjab National Bank and the Bank of Allahabad are expected to set up factoring agencies to serve northern region and the eastern region, respectively.

Features of a Factoring Arrangement The key features of a factoring arrangement are as follows:

- The factor selects the accounts of the client that would be handled by it and establishes, along with the client, the credit limits applicable to the selected accounts.
- The factor assumes responsibility for collecting the debt of accounts handled by it. For each account, the factor pays to the client at the end of the credit period or when the account is collected, whichever comes earlier.
- The factor advances money to the client against not-yet-collected and not-yet-due debts. Typically, the amount advanced is 70 to 80 percent of the face value of the debt and carries an interest rate which may be equal to or marginally higher than the lending rate of commercial banks.
- Factoring may be on a recourse basis (this means that the credit risk is borne by the client) or on a non-recourse basis (this means that the credit risk is borne by the factor). Presently, factoring in India is done on a recourse basis.
- Besides the interest on advances against debt, the factor charges a commission which may be 1 to 2 percent of the face value of the debts factored.

Securitisation

Securitisation involves packaging a designated pool of assets (mortgage loans, consumer loans, hire purchase receivables, and so on) and issuing securities which are collateralised by the underlying assets and their associated cash flow stream. Securitisation is originated by a firm that seeks to liquefy its pool of assets. Securities backed by mortgage loans are referred to as *mortgage backed securities;* securities backed by other assets are called *asset based securities*.

Key Steps in Securitisation Securitisation can take place in different ways and assume complex structures. Broadly, the following steps are involved in a securitisation programme:

1. **Seasoning** The originator (the firm that seeks to liquefy its assets) identifies the assets to be securitised and packages them in a pool.
2. **Credit Enhancement** The originator or some other agency may enhance the credit quality of the pool of assets to be securitised by providing insurance, often of a limited kind, to the investors.
3. **Transfer to a Special Purpose Vehicle** The pool of assets is transferred to a Special Purpose Vehicle (SPV), usually organised as a Trust, for valuable consideration. Once the transfer is completed, the assets are taken off the balance sheet of the originator.
4. **Issuance of Securities** The SPV issues securities backed by the pool of assets held by it. These securities are called Pass Through Certificates (PTCs) because the cash flows received from the pool of assets are transmitted (passed) to the holders of these securities on a pro-rata basis after deduction of service fee. There may be one or more classes of PTCs with differing priorities. Where there are two or more classes of PTCs, the rules for the distribution of interest and principal repayments, derived from the underlying pool of assets, among different classes of PTC holders are specified upfront.

18.11 RAISING VENTURE CAPITAL

A young company that is not yet ready or willing to tap the public financial market may seek venture capital. Such capital is provided by venture capital funds which are prepared to finance an untried company that appears to have promising prospects. Venture capital represents financial investment in a risky proposition made in the hope of earning a high rate of return.

Preparing a Business Plan

If you are approaching a venture capitalist 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 to five years with emphasis on cash flows.
- Identify risks and develop a strategy to cope with the same.
- Convince them that the management team is talented, experienced, committed, and determined.

18.12 RAISING CAPITAL IN INTERNATIONAL MARKETS

Thanks to the globalisation of capital markets, Indian firms can raise capital from euromarkets or from the domestic markets of various countries or from export credit agencies.

Euromarkets

The term euromarkets seems to be a misnomer because they do not have a physical location. *Euromarkets*, more accurately offshore markets, refer to a collection of international banks that help firms in raising capital in a global market which is beyond the purview of any national regulatory body.

An Indian firm can access the euromarkets to raise a eurocurrency loan or issue a euro bond or issue global depository receipts or issue eurocurrency convertible bonds.

Eurocurrency Loans Subject to certain terms and conditions, the Government of India permits Indian firms to resort to external commercial borrowings for the import of plant and machinery. The most common instrument of external commercial borrowing is the *eurocurrency loan*.

A eurocurrency is simply a deposit of currency in a bank outside the country of the currency. For example, a eurodollar is a dollar deposit in a bank outside the US. Likewise, a euroyen is a yen deposited in a bank outside Japan. How do eurocurrency deposits arise? This may be explained with an example. Suppose an American oil company buys oil from a Sheikh in the Middle East and pays US $10 million drawn on the Chase Manhattan Bank and the Sheikh deposits the cheque in his account with a Swiss bank. The dollar deposit, placed outside the United States, the country of the dollar currency, is a eurodollar deposit. The Swiss bank can use this deposit for granting eurodollar loans.

The main features of eurocurrency loans, which represent the principal form of external commercial borrowings are:

- Eurocurrency loans are often syndicated loans, wherein a group of lenders, particularly banks, participate jointly in the process of lending under a single loan agreement. The syndicate of lenders is represented by the lead bank. The borrower is required to pay a syndication fee, which is a front-end payment, usually ranging between ½ percent and 2 percent, to the lead bank. This represents the management fees payable to the lead bank, participation fee to the other banks, and other charges.
- The rate of interest on eurocurrency loans is a floating rate. It is usually linked to LIBOR (London Inter Bank Offer Rate) or SIBOR (Singapore Inter Bank Offer Rate). The spread over the LIBOR or SIBOR rate is mainly a function of the creditworthiness of the borrower and size of the loan. Air India International, for example, obtained a eurodollar loan of US $88 million in 1982, at an interest rate of 3/8 percent above the LIBOR. While the rate is determined at the beginning of each interest period, the interest is payable at the end of each period.
- The interest period may be 3, 6, 9, or 12 months in duration. It is largely left to the option of the borrower.
- The borrower often enjoys the multi-currency option which enables it to denominate the interest and principal in the new currency opted for. This option is exercisable at the end of each interest period.
- The eurocurrency loans are repayable in a bullet payment or in instalments, which are typically equal, over a period of time as agreed to by the parties. The borrower may prepay the loan after giving due notice to the lead bank. When prepayment is done, some premium is payable. The lender may also reserve the right to recall the outstanding loan under certain circumstances.

The features of eurocurrency loans are illustrated by the following example.

Syndicated Eurocurrency Loans Raised by Power Finance Corporation

	1st Issue (January 1997)	*2nd Issue (July 1998)*
■ Amount Initially Targeted	US $ 50 million	US $ 100 million
■ Amount Actually Collected	US $ 75 million	US $ 100 million

■ Actual Pricing	50 bp over LIBOR	115 bp* over LIBOR
■ Maturity	Average five years	Seven years put 5
■ Repayment Terms	Repayment in 5 equal installments after end of four years	Bullet
■ Other Costs (approx.)	0.07 bps annualised	0.20 bps annualised
■ Lenders Meet/Roadshows	Hong Kong, Singapore	Bombay, Bahrain, London, Singapore
■ Availability Period	60 days from date of signing	30 days from date of signing
■ Number of Participating Banks	Fourteen	Fourteen
■ Lead Manager	Nat West Markets	ANZ Investment Bank

* One basis point (bp) is one -hundredth of one percent.

Evaluation Overseas debt, particularly in the form of eurocurrency loans, offers the following advantages:

- Participating institutions have deep pockets and a very professional approach.
- There is a great deal of flexibility in structuring these loans.
- Tenors up to 10 years are easily available.

The disadvantages of overseas debt are:

- It is not economical for small projects due to high appraisal and syndication costs.
- Pricing of loans depends on risk perception.
- It may be difficult to negotiate changes with investors.

Eurocurrency Bonds Firms using the euromarkets for debt financing can take out loans (called eurocurrency loans) or sell bonds (referred to as eurocurrency bonds). The important features of a eurocurrency bond are:

- It is issued outside the country in whose currency it is denominated. For example, eurodollar bonds are sold outside the US and euroyen bonds are sold outside Japan.
- It is usually managed by a syndicate of investment banks and offered to

investors in many countries.

- It is a bearer bond. This means that it is unregistered and payable to the person who carries it.
- The interest on it is usually paid annually or half-yearly.

While the eurocurrency loan is the most popular form of external commercial borrowing, some firms have raised money by issuing eurocurrency bonds (or eurocurrency notes). Power Finance Corporation, for example, raised overseas debt by issuing euronotes in 1997 that had the following features:

Power Finance Corporation Limited

Euro Notes Issue

■ Amount	:	US $ 100 million
■ Maturity Period	:	12 years bullet
■ Interest rate	:	7.5% p.a. fixed (135 bp over US Treasury) payable half yearly
■ Type of Instrument	:	Unsecured Global Bond Issue tradable in stock exchanges abroad.
■ Other Costs (approx.)	:	.02 bp annualised
■ Lenders Meet/Roadshows	:	Hong Kong, USA, UK
■ Availability Period	:	On signing
■ Lead Manager	:	ING Barings
■ Other Agents	:	Paying agent, Listing agent, Trustee

Note that the lending rates in the eurodebt market tend to be lower than those in domestic markets. Why? There are several reasons. First, on eurodeposits, banks have no reserve requirements. Second, borrowers in eurocurrency market are typically large, reputed companies with good credit ratings. Third, banks price these loans aggressively as there are no regulators.

Global Depository Receipts From the early 1990s, Indian companies have issued global depository receipts (GDRs), which represent indirect equity investment, in the euromarkets.

In the depository receipts mechanism, the shares issued by a firm are held by a depository, usually a large international bank, who receives dividends, reports, etc. and issues claims against these shares. These claims are called depository receipts—in euromarkets they are called GDRs—with each receipt being a claim on a specified number of shares. The underlying shares are called *depository shares*. The GDRs are denominated in a convertible currency—usually US dollars. GDRs may be listed and traded on major stock exchanges or may trade in the OTC market. The issuer firm pays dividends in its home currency which is converted into dollars by the depository and distributed to the holders of GDRs. This way the issuing firm avoids listing fees and onerous disclosure and reporting requirements which would be obligatory if it were to be directly listed on the stock exchange. Holders of GDR can convert them into the underlying share by surrendering the depository receipts to the depository.

A company planning a GDR issue must obtain the approval from the ministry of finance as well as the FIPB (Foreign Investment Promotion Board) since GDR issues are deemed to be foreign direct investment. The government periodically issues guidelines for GDR issues. These guidelines set out the criteria a potential issuer must satisfy, the permissible uses of the funds raised, and the manner in which the funds are to be deployed till the issuing company is ready to use them. The custodian is required to be an Indian institution.

Foreign Domestic Markets

A second way to raise money internationally is to sell securities directly in the domestic capital markets of foreign countries. This is referred to as direct issuance. For example, a British firm may issue dollar-denominated equity stocks in the US capital market or a German firm may issue yen-denominated bonds in the Japanese capital market. A foreign issuer has to satisfy all regulations applicable to domestic firms. In addition, it may be required to fulfill certain special obligations applicable to foreign issuers.

Indian firms can also issue bonds and equities in the domestic capital market of a foreign country. In recent years, Indian firms have tapped the domestic capital markets of countries like the US, Japan, UK, and Switzerland.

US Capital Market The US capital market is the largest national capital market, complemented by a very active derivatives market. The most prestigious funding option in the US market is a public issue of *Yankee Bonds* (dollar denominated bonds issued in the US capital market by foreign borrowers). A public issue of Yankee bonds has to comply with stringent listing requirements of the SEC in the US. Yankee bonds can also be offered on a private placement basis to QIBs (qualified institutional buyers) under what is popularly known as rule 144A. Such bonds do not have to comply with the stringent listing requirements under the Securities Act, 1933. Reliance Industries Limited was perhaps the first Indian company to issue Yankee bonds in the US.

Apart from tapping the US bond market, Indian companies can raise funds in the US equity market by issuing American Depository Shares (ADSs). Like GDRs, ADSs represent claims on a specific number of shares. The principal difference between the two is that the GDRs are issued in the euromarket whereas ADSs are issued in the US domestic capital market.

Other Markets Besides the US domestic capital market, Indian companies have tapped the domestic capital markets of other countries such as Japan and UK, issuing mainly debt instruments such as *Samurai Bonds* (publicly issued bonds in the Japanese market), *Shibosai Bonds* (privately issued bonds in the Japanese market), *Bulldog Bonds* (UK market), and *Rembrant Bonds* (Dutch market).

Export Credit Schemes

Export credit agencies have been established by the governments of major industrialised countries for financing exports of capital goods and related technical services. The prominent export credit agencies are US EXIM, JEXIM, HERMES, and COFACE. These agencies follow certain consensus guidelines for supporting exports under a convention known as the Berne Union. As per these guidelines, the interest rate applicable for export credits to Indian companies for various maturities are regulated. Two kinds of export credit are provided: buyer's credit and supplier's credit.

Buyer's Credit Under this arrangement, credit is provided directly to the Indian buyer for purchase of capital goods and/or technical services from the overseas exporter. The buyer's credit facility operates as follows:

- The overseas exporter and the Indian buyer negotiate a contract.
- An application for the buyer's credit facility is made to the export credit agency of the exporter's country along with relevant details (like the types of goods/services to be exported, approximate value of the contract, terms of payments, schedule of projected shipment of goods or provision of services, percentage of financing required, etc.).
- The buyer's credit facility is approved by the export credit agency of the exporter's country.
- A loan agreement delineating the terms and conditions of the buyer's credit is negotiated between the overseas exporter's bank, the Indian borrower, and where applicable the Indian guarantor.

Supplier's Credit This is a credit provided to the overseas exporters so that they can make available medium-term finance to Indian importers. The supplier's credit facility operates as follows:

- The overseas exporter notifies his bank and the export credit agency of a potential export order of an Indian buyer who requires medium-term finance.
- The export credit agency communicates to the bank its willingness to provide the facility.
- The terms of the facility are incorporated in the contract between the overseas exporter and the Indian buyer.

Salient Features The salient features of finance provided by export credit agencies are:

- The finance is tied to import of goods and services
- Up to 85 percent of the value of imports is available as finance.
- The finance is available for long tenors at reasonable cost.
- Export credit agencies insist on a bank guarantee.

Financing of Non-Manufacturing Businesses

Non-manufacturing businesses, such as trading and service businesses, do not normally, in their earlier stages, involve investment in real estate. They tend to be essentially working capital intensive and/or knowledge intensive. Hence they are financed mainly by way of equity and working capital borrowings. In addition, their requirements of assets such as furniture and office equipment, vehicles, and material handling systems are met through asset financing arrangements such as leasing, hire purchase, and instalment purchase.

As these businesses expand, on the strength of profitable performance, they may invest in land, buildings, warehouses, and other fixed assets. To support such investment they may rely on long-term borrowings as well.

18.13 PROJECT FINANCING STRUCTURES

Two principal project financing structures have evolved over the years: full recourse structure and limited recourse structure.

Full Resource Structure

Traditionally, project financing involved "full recourse" asset-backed lending. The salient features of a "full recourse" financing structure are as follows:

- If a new company is set up for implementing the project, the proposed borrowings for the project are fully secured by a first charge on all the existing and future assets of the borrowing company, by way of mortgage of immovable assets and hypothecation of current assets. If the project is implemented as an expansion or diversification project of an existing company, which already has lenders with charges on assets, the lenders for the new project get a *pari passu* charge on the entire block of assets, including the assets of the new project. Put differently, the existing and proposed assets are thrown into a common pool on which new and existing lenders acquire rights that are proportional to the amounts financed by them.
- Although the viability of the proposed project is assessed on a stand-alone basis, the cash flows from the existing as well as proposed activities are considered to judge whether the existing as well as the proposed debt can be serviced.
- Apart from the charge on the assets, the project sponsors provide personal guarantee for debt servicing. Further, in some cases the lenders may insist on a corporate guarantee from a group company.

Limited Recourse Structure

Private sector participation in infrastructure projects, a relatively new phenomenon on the Indian scene, has been accompanied by a limited recourse, cash-flow based financing structure, in line with international practice. The salient features of this structure are as follows:

- The project is set up at as a separate company, called a Special Purpose Vehicle (SPV). The SPV is not supposed to handle any other business activity without the prior approval of the lenders.
- The private sector promoter who sponsors the project usually takes a substantial stake in the equity of the project and enjoys the over-all responsibility for running the project.
- The sponsor provides standby support for cost overruns in the project, provided the quantum of such support is crystallised prior to the financial closure.
- The security package for the lenders includes a registered mortgage/hypothecation of all assets, a pledge of sponsor holdings in the SPV, an assignment of all project contracts and documents, and a charge

on future receivables.

- The cash flow of the SPV is handled by an independent agent (acting on behalf of the security trustee). The cash flow is allocated in a pre-determined manner to various requirements including debt servicing. After all the requirements are met, the residual cash flow is available to the project company.
- In some cases, the payment risk is mitigated by a state or central government guarantee.
- Lenders do not have recourse to the sponsors and their other businesses.
- Being a separate entity, the SPV is bankruptcy remote from the other businesses of the sponsor.

18.14 FINANCIAL CLOSURE

Financial closure means that all the sources of funds required for the project have been tied up. A key milestone in project implementation, financial closure may take a long time, particularly for infrastructure projects, because several things have to be sorted out to make the project structure fundable. For example, it took about three years to hammer out a model power purchase agreement to be signed by the independent power producers with the respective state electricity boards.

In general, financial closure is achieved soon when:

- Suitable credit enhancement is done to the satisfaction of lenders.
- Adequate underwriting arrangements are made for market-related offerings.
- The resourcefulness of the promoters is well established.
- The process is started early and concurrent appraisal is initiated if several lending agencies are involved.

18.15 FINANCIAL INSTITUTIONS: WHAT INFORMATION THEY WANT AND HOW THEY APPRAISE

This section describes the information sought by financial institutions and the dimensions along which financial institution appraise a project.

Information to be Furnished for Term Loan Appraisals Along With the Project Report/Information Memorandum[7]

Most of the financial institutions both at the state and national level have very detailed application forms which seek elaborate details of various aspects of the borrowing company, the promoters, and the project. The loan application can be prepared by attaching additional enclosures wherever necessary or by preparation of a separate Project Report. The standard information to be furnished by the borrowing company is as follows:

Particulars	*Enclosures*
(a) Name of the company, constitution, registered office, list of the promoters, shareholding pattern, paid up capital, licensed and installed capacity, name of auditors, bankers, location and particulars of production facilities, number of employees etc.	1. Memorandum & Articles 2. List of Directors 3. IT and WT returns for the past three years of the company and promoters 4. Bankers' references 5. Board resolution 6. Shareholder resolutions for 239(1) (d)
(b) Details of the present activities of the company, past financial performance, details of associated companies and their performances.	1. Past audited accounts for three years of the company and associated entities. 2. Details of existing term loans, unsecured loans and existing charge holders. 3. Group company details with Annual Reports. 4. Banker's Report on the company and the main promoters 5. Copies of income tax returns filed by main promoters 6. NOC for ceding exclusive/pari passu charge from the existing charge holders
(c) Promoters and management structure and profiles of whole time directors and key management personnel	1. Details of Shareholders Agreement and copies thereof. 2. Details of Board of Directors, management and organisational set-up. 3. Copies of Joint Venture/technical collaboration agreement, if any 4. Banker's report on Foreign Collaborator 5. Employment contracts with MD/Whole time directors Particulars Enclosures 6. Documents to substantiate the proposed promoter's contribution 7. Names of promoters who would furnish personal guarantees and net worth statement of promoters
(d) Particulars of the project	1. Copies of Statutory approvals such as

1. Cost break-up 2. Proposed financing pattern 3. Products and uses 4. Key raw materials and sourcing arrangements 5. Location and justification 6. Technology arrangements and equipment sourcing 7. Manpower requirement and availability 8. Details of utilities and arrangements 9. Schedule of implementation 10. Statutory approvals obtained and to be obtained	RBI/FIPB approval, industrial license if required. 2. Clearance from the Ministry of Environment and Forests for larger projects costing above ₹1500 crore 3. Other regulatory clearances from CEA/TRAI/ERC or other such authorities 4. State level government approvals and application for NOC from Pollution Control Board 5. Key documents such as copies of title deeds of land, location map, copies of key project contracts, collaboration or technology agreements 6. Back-up documents justifying the estimation of cost of the project such as civil work estimates, quotations for machinery, etc. 7. In case of second hand machinery, a chartered engineer's certificate regarding the residual life of the machines 8. Fuel supply/raw material sourcing agreement 9. Details of tie-up for marketing, firm enquiries if any and buy-back agreements 10. Sources of market information 11. Details of orders on hand, supply schedules, etc. 12. Details of effluents produced and measures for treatment and discharge
(e) Financial workings for the project justifying the viability of the project.	1. Detailed bases of assumptions made for the workings and back-up statements.

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
- Building
- Plant and equipments
- Manpower requirements
- 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 : 1.5 to 1.75

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 financing pattern:

- A general debt-equity ratio norm of 1 : 1
- 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 (also referred to as social cost benefit analysis) 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 following questions are raised:

How resourceful are the promoters?

How sound is the understanding of the project by the promoters?

How committed are the promoters?

Resourcefulness This is judged in terms of the prior experience of the promoters and the progress achieved in organising various aspects of the project.

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.

Some Norms of Financing

While hammering out the financing structure of a business, the following norms should generally be borne in mind.

1. Generally, the debt–equity ratio should not exceed 1:1 for service companies, 2:1 for manufacturing companies, and 4:1 for infrastructure companies.
2. Secured loans should normally have a fixed assets coverage ratio (FACR) of 1.25:1.
3. The annual debt-service coverage ratio (DSCR) should be at least 1.5.
4. The 'total outside liabilities' to 'total net worth,' i.e., TOL/TNW, ratio should not exceed 3:1.
5. Current liabilities including working capital borrowings are not more than 75 percent of current assets.

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.

18.16 CREDIT RISK RATING[8]

Credit risk rating is a rating assigned by a bank to its borrowers based on an analysis of their ability and willingness to repay the debt. It covers various parameters like financials, management, business and industry.

RBI guidelines require banks to have a comprehensive risk rating system that serves as a single point indicator of diverse risk factors. Such a system calls for substantial degree of standardisation in ratings across borrowers. Also, subjectivity, which is an unavoidable factor in any lending decision, is sought to be kept at a minimum in credit risk rating systems. Banks can use the rating for taking credit decisions in a consistent manner, as a valuable/primary input in pricing of loans and for purposes of review by management, Basel II accord also mandates that banks desirous of minimising their capital adequacy requirements should have a proper credit risk rating system in place.

The rating models followed by different banks vary in details and possibly on the emphasis laid on the different risk factors. Also, over time, the models will undergo changes in the light of new experiences, changes in assessment methodology in response to regulatory requirements, and so on. For instance, large banks in India will eventually incorporate factors like the probability of default to comply with the requirements of thelatest Basel accord.

Salient Features

The salient features of the rating systems presently followed by banks in India are as follows:

1. For large loans, companies usually submit detailed actual and projected operating and financial data in a set of forms called the CMA format. A detailed analysis of this data together with all other needed information is then done and scores are awarded on various risk parameters.
2. To qualify for rating, the company will have to first come clean on certain aspects: the conduct of the account should be satisfactory; there should not be instances of wilful default; there should not be any corporate governance or environmental issues; the management should possess the minimum needed commitment and competence; there should be no audit remarks casting aspersion on integrity and so on.
3. The rating is usually done across the following dimensions.
    - *Financial risk*: For existing borrowers financial risk carries nearly 50 percent of the total weightage, whereas for new borrowers it carries nearly 25 to 40 percent of the total weightage. Assessment of financial risk relies mainly on financial ratio analysis. In addition, future prospects of the borrower as well as risk mitigation by way of collateral security or financial standing are considered.
    - *Business and industry risk*: This usually gets about half the weightage given to financial risk for existing borrowers while for new businesses, understandably, the weightage is on par with financial risk. Product quality and acceptance, cash flow pattern, capacity utilisation, competition, industry outlook, regulatory issues, and the impact of WTO are some of the factors considered.
    - *Management Risk*: For new borrowers this is the major risk, carrying a weightage of nearly fifty percent. It is evaluated in terms of management's integrity, credibility, competence, commitment, structure, and so on. Existing borrowers with good track record, experience, and so on will normally get a higher score.
4. A minimum fifty percent score is generally set as the hurdle rate for

sanction of new credit facilities or for continuation of existing ones. The rating exercise is an ongoing one and the RBI guidelines want the banks to do this on a half yearly basis quite independent of the ritual of periodic renewal of credit facilities. In practice though, it is, at best, an annual exercise.

Key Financial Ratios

For evaluating financial risk, the following ratios are most commonly considered.

For Working Capital Loans	***For Term Loans***
■ Current ratio	■ Project debt-equity ratio.
■ Total outside liabilities / Tangible net worth (TOL/TNW)	■ TOL / TNW
■ Profit after tax / Net sales	■ Gross average debt service coverage ratio of project and all loans separately.
■ Profit before depreciation interest and tax / Interest	■ Term of payments in years
■ Return on capital employed	■ Return on capital employed
■ Current assets turnover	■ Fixed asset coverage ratio

In addition, there are other financials like the availability of collaterals and guarantees which are common to all credit facilities including non-fund based support.

SUMMARY

- A capital project may be regarded as a mini-firm. So the issues to be considered in financing a project are identical to those considered in financing a business firm.
- Although the number of complex and exotic financing instruments is expanding, the financing decision, compared to the investment decision, is relatively easier to make and has a lesser impact on value.
- The two broad sources of finance available to a firm are: shareholders' funds (equity funds) and loan funds (debt funds).

- The key factors in determining the debt-equity ratio for a project are: cost, nature of assets, business risk, norms of lenders, control considerations, and market conditions.
- A firm should use more equity when the corporate tax rate is negligible, the business risk exposure is high, the dilution of control is not an important issue, the assets of the firm are mostly intangible in nature, and the firm has many valuable growth options. The firm should use more debt under opposite circumstances.
- When a company is formed, it first issues equity shares to the promoters (founders) and also, in most cases, to a select group of investors. As the company grows, it may rely on the following methods of raising equity capital: initial public offering, seasoned offering, rights issue, and private placement.
- The internal accruals of a firm consist of depreciation charges and retained earnings.
- Equity and debt come in a variety of forms and are raised in different ways.
- Equity capital represents ownership capital as equity shareholders collectively own the firm. Equity shareholders enjoy the rewards as well as bear the risk of ownership.
- The rights of equity shareholders consist of: (i) the right to residual income, (ii) the right to control, (iii) the pre-emptive right to purchase additional equity shares issued by the firm, and (iv) the residual claim over assets in the event of liquidation.
- The first public offering of equity shares of a company, which is followed by a listing of its shares on the market, is called an initial public offering (IPO). A public issue by a listed company is called a seasoned offering. A rights issue involves selling securities in the primary market by issuing rights to the existing shareholders. Private placement involves sale of securities to a limited number of sophisticated investors such as financial institutions, mutual funds, venture capital funds, banks, and so on.
- Preference capital represents a hybrid form of financing—it partakes some characteristics of equity and some attributes of debentures.
- For large firms, debentures are a viable alternative to term loans. Debentures are instruments for raising debt finance. Debentures often provide more flexibility than term loans as they offer greater choice with respect to maturity, interest rate, security, repayment, and special features.

- Thanks to the latitude enjoyed by companies, a variety of debt instruments like deep discount bonds, convertible debentures, floating rate bonds, secured premium notes, and indexed bonds have been employed.
- Term loans represent a source of debt finance which is generally repayable in less than 10 years. They are typically employed to finance acquisition of fixed assets and working capital margin.
- Financial institutions give rupee term loans as well as foreign currency term loans. Term loans represent secured borrowing. Usually assets, which are financed with the term loan, provide the prime security. Other assets of the firm or promoters may serve as collateral security. The principal amount of a term loan is generally repayable over a period of four to seven years after an initial grace period of one to two years. In order to protect their interest, financial institutions impose restrictive covenants on the borrowers.
- Financial institutions appraise a project from the marketing, technical, financial, economic, and managerial angles.
- Working capital advance by commercial banks represents the most important source for financing current assets. Working capital advance is provided by commercial banks in three primary ways: (i) cash credits/overdrafts, (ii) loans, and (iii) purchase/discount of bills.
- Apart from the principal sources like equity, internal accruals, term loans, debentures, and working capital advance there are several other ways in which finance may be obtained. These include deferred credit, lease finance, hire purchase, unsecured loans and deposits, special schemes of institutions, subsidies, sales tax deferments and exemptions, commercial paper, factoring, and securitisation.
- A young company that is not yet ready or willing to tap the public financial market may seek venture capital which represents financial investment in a risky proposition made in the hope of earning a high rate of return.
- Thanks to globalisation of capital markets, Indian firms can raise capital from euromarkets or from the domestic markets of various countries or from export credit agencies.
- Euromarkets refer to a collection of international banks that help firms in raising capital in a global market which is beyond the purview of any national regulatory body.
- An Indian firm can access the euromarkets to raise a eurocurrency loan

or issue a eurobond.

- Eurocurrency loans, which represent the principal form of external commercial borrowings are syndicated loans carrying a floating rate generally linked to LIBOR.
- While the eurocurrency loan is the most popular form of external commercial borrowing, Indian firms also raise money by issuing eurocurrency bonds (or notes).
- From early 1990s, Indian companies have issued global depository receipts (GDRs), which represent indirect equity investment, in the euromarkets.
- Indian firms can also issue bonds and equities in the domestic capital market of a foreign country.
- Export credit agencies have been established by the governments of major industrialised countries for financing exports of capital goods and related services. Two kinds of export credit are provided: buyer's credit and supplier's credit.
- Two principal project financing structures have evolved over the years: full recourse structure and limited recourse structure.
- Financial closure means that all the sources of funds required for a project are tied up.
- Financial institutions appraise a project from the marketing, technical, financial, economic, and managerial angles.
- Credit risk rating is a rating assigned by a bank to its borrowers based on an analysis of their ability and willingness to repay the debt.

QUESTIONS

1. Discuss the key considerations in determining the debt-equity ratio of a firm.
2. When should a firm use more equity and when should a firm use more debt?
3. Discuss the rights of equity shareholders.
4. What are the pros and cons of going public?
5. List the principal steps involved in a public issue.
6. Describe briefly a rights issue and a private placement.
7. How do the three methods of raising finance, viz. public issue, rights issue, and private placement differ.

8. What are the advantages and disadvantages of equity capital?
9. What are the advantages and disadvantages of internal accruals?
10. Discuss the key features of term loans.
11. Describe the procedure involved in obtaining a term loan.
12. Discuss the key issues considered by financial institutions while appraising a project for term financing.
13. What are the features of debentures?
14. Describe the important innovations in debenture.
15. Discuss the conventional and modern finance explanations for convertible debentures.
16. Why is private placement of debentures so common in India?
17. What are the advantages and disadvantages of debt financing?
18. Describe the various ways in which banks provide working capital advance.
19. What are the salient features of a finance lease and an operating lease?
20. Discuss the features of hire purchase. How does it differ from leasing?
21. What are the features of commercial paper? factoring?
22. Discuss the guidelines for preparing a business plan to be given to a venture capitalist.
23. What are the main features of eurocurrency loans and eurobonds?
24. What is a GDR?
25. Discuss how the export credit schemes operate.
26. Describe the salient features of: (a) full recourse structure, and (b) limited recourse structure in project financing.
27. What are the principal issues considered and the criteria employed by financial institutions in appraising projects.
28. Discuss the salient features of the rating systems presently followed by banks in India.

MINICASE

Consider the following situations.

A. Vikram, Naresh, and Ravi worked in the R&D centre of a multinational company in Bangalore for about five years. Bitten by the entrepreneurial bug, they quit their jobs recently and set up a company called VNR Informatics Private Limited with the immediate object of developing a software product for the telecom sector. At present the company has an equity capital of ₹1.5 crore contributed equally by the three promoters. According to the business plan for the proposed software product, the company needs additional financing of ₹1.5 crore.

B. Manas Textiles, a leading producer of cotton fabrics, is based in Ahmedabad. Nearly three-fourths of its production is exported to customers in the U.S. the company's plant and equipment have been financed to the extent of 50 percent by a consortium of lenders, who are not inclined as of now to increase their exposure to the company as the company went through debt restructuring sometime back. The company buys its inputs in cash but offers 90 days credit to its customers in the U.S. Thanks to a recent spurt in export sales, the company needs ₹50 crore of additional financing.

C. Bharat Oil Company needs ₹150 crore for doing test drilling in a certain block awarded to it by the Government of India. If the outcome of the test drilling is favourable, Bharat Oil Company will require ₹350 crore for developing the site. As per the latest balance sheet, the total assets of Bharat Oil Company are ₹2500 crore. The market price per share of the company is ₹270 and the earnings per share are ₹30. Other firms in the oil industry sell at an earnings multiple between 11 and 13. Bharat Oil Company's debt-equity ratio is 30 percent, compared to the industry's average of 40 percent.

D. ADCL is a movie production company set up by three persons with experience in the movie industry about six years ago. One of them is a leading star and he owns 50 percent equity of ADCL; the other two own 25 percent each. ADCL's recent movie, *The Indian Dream* turned out to be a blockbuster at the box office. Enthused by this success, the promoters want to double the number of movies produced by the company. To achieve this goal the company plans to raise ₹50 crore from external sources.

E. Tasty Foods Private Limited runs a chain of food stores in western India. It is owned by three Patil brothers each of whom holds one-third equity in the company. Though profitable, the company is experiencing financial strain due to its rapid growth rate. Its real estate is mortgaged, its inventories are hypothecated, and its debtors are largely factored. Presently the company has ₹20 crore of total assets. It needs equipment costing ₹2 crore for its shipping department.

Required

Suggest the financing method that seems most appropriate for each situation and give your reasons for the same.

APPENDIX 18A

TYPES OF CHARGES CREATED ON ASSETS FOR SECURING ADVANCES

The types of charges created on assets for securing advances are as follows:

- Pledge
- Hypothecation

- Mortgage
- Assignment of debt
- Lien

Pledge The salient features of a pledge are:

(i) The ownership of the asset remains with the borrower (pledger) but the possession of the asset is in the hands of the lender (pledge).

(ii) The lender hands over the possession of the asset to the borrower when the loan is fully repaid.

(iii) The lender enjoys the "right of sale" if the loan is not repaid, after giving proper notice to the borrower.

(iv) The lender is expected to take care of the asset pledged. The borrower is required to execute an "Agreement to Pledge."

Hypothecation Under hypothecation, the possession of the asset remains with the borrower. In case the borrower defaults, the lender has the right to take possession of the hypothecated asset and sell it to realise the dues. However, before doing that the lender has to, unlike in the case of pledge, file a suit and take the permission of the court. The hypothecation charge is created by the borrower by executing a "Deed of Hypothecation" in favour of the lender.

Mortgage While movable assets can be pledged or hypothecated, immovable assets such as land and buildings can only be mortgaged. As in the case of hypothecation, the ownership and possession remain with the borrower (mortgagor) but the lender (mortgagee) gets the right to take possession and sell the mortgaged property after filing a suit and getting permission from the court. If the mortgage deed expressly authorises the mortgagee to sell the property without filing a suit, the mortgagee can sell the property without the intervention of court. Although there are many types of mortgage, the most common ones are the registered mortgage and the equitable mortgage.

A **registered mortgage** is one which is registered with the Registrar of Properties. The Registrar will record the mortgage in the land records which is made known to anyone who checks the land records. While the registered mortgage is the most secure way of creating a charge over an immovable property, it entails stamp duty, payable by the borrower, which can be a substantial sum. The lender should satisfy himself that the property is not charged to anyone else, by requesting the Registrar of Properties to issue a Non-Encumbrance Certificate. The Non-Encumbrance Certificate issued by the Registrar states all the subsisting chargers created on the property during the past 30 years. The lender should also ensure that the property is registered in the name of the owner in the records of the municipality/panchayat and property taxes have been paid up to date.

Under **equitable mortgage** (EM), no stamped deed of mortgage is prepared or registered. The mortgage is created by the borrower by handing over the title deed, katha (or a document evidencing that the name of the owner is recorded in the municipal or panchayat records), and the latest tax paid receipt. Of course, the bank will have to get the title verified and get a Non-Encumbrance Certificate, before accepting the documents in creation of the mortgage. The advantage of an EM is that it can be easily executed on plain paper and it does not involve stamp cost. The disadvantage is that the creation of mortgage is not noted in the land records maintained by the Registrar of Properties and the future buyers of the property will not be aware of the existence of mortgage in favour of the bank.

Assignment of Debt While tangible assets are pledged or hypothecated or mortgaged, "actionable claims" are charged to a lender through a "Deed of Assignment." An "actionable claim" represents a right to claim an amount from another person. Examples of actionable claims are (a) debts or receivables, (b) amounts receivable under an Insurance Policy, (c) amounts receivable under a legally valid contract such as a guarantee or indemnity, and (d) subsidies or duty drawbacks or any other amount receivable from the government.

The person who assigns the actionable claim is called the assignor and the person in whose favor the actionable claim is assigned is called the assignee. The assignor retains the ownership and possession of the actionable claim. The assignee gets the right to recover the same.

There are two types of assignment: legal assignment and equitable assignment. In a *legal assignment*, the assignor executes a deed of assignment in favour of the assignee. Banks create such a charge when they give loans against life insurance policies. In an *equitable assignment*, the assignor executes an irrevocable power of attorney (POA) in favor of the assignee (say a bank) to collect payment. For example, in bill purchase and bill discounting the invoice is accompanied by a bill of exchange which gives the bank the authority to demand payment from the drawee.

Lien A "lien" is the right to hold another's property till the debt is repaid. Banks enjoy the right of general lien, meaning that in the absence of any specific document or charge, banks can exercise the right of lien on any asset of the borrower which comes into their possession. According to section 171 of the Indian Contract Act, 1872 "Bankers may, in the absence of a contract to the contrary retain as a security for a general balance of account any goods bailed to them".

APPENDIX 18B

DUE DILIGENCE REVIEW

Due diligence has been defined as "a measure of prudence, activity, or assiduity, as is properly to be expected from, and ordinarily exercised by, a reasonable and prudent person under the particular circumstances, not measured by any absolute standard but depends on the relative facts of the special case".

For corporate investments, a due diligence review (DDR) involves a comprehensive examination of the representations and affairs of the company by potential investors so that an informed decision can be taken. DDR is normally broken down into three parts: (a) Business, commercial, and technical DDR; (b) Financial DDR; and (c) Legal DDR.

The business, commercial, and technical DDR is generally conducted by the potential investors themselves, thanks to their in-house expertise and industry network. Occasionally, they may engage technical consultants.

The financial DDR involves verifying the books of account, financial statements, and business transactions of the company to determine how true and fair are the financial statements of the company and how accurate are the oral and written representations (as given in the information memorandum and other literature) of the company. The financial DDR may almost tantamount to the financial audit of the firm and is carried out for the past three years or so. In some cases, financial DDR may also involve vetting the financial forecast of the company as provided in the information memorandum. The financial DDR is carried out by an accounting firm or an investment bank, on behalf of the potential investor.

The legal DDR covers the legal aspects of the business and includes, *inter alia*, the IPRs of the company, material contracts and agreements of the companies with third parties and the legal implications thereof, statutory compliance under various laws and defaults, if any, and outstanding litigations and their possible consequences. The legal DDR is generally conducted by a law firm—a part of the work may be contracted out to a practising company secretary or covered in the financial DDR.

Based on the DDR report that the potential investor typically regards as a confidential report, the investor may seek clarifications or explanations from the company.

The company that seeks finance from a potential investor has to provide information for the DDR exercise. Typically, it sets up a 'Data Room,' where all the information required by the agency conducting the DDR is made available. Nowadays, companies set up a 'Virtual Data Room' which gives a web-enabled access to DDR information and documents to the authorised agencies. The information to be furnished by a company for financial and legal due diligence will, inter alia, cover the following: capital and shareholding, details of the group, details of promoters and directors, details of secured and unsecured borrowings, minutes of board and general meetings, books of account, financial statements, and audit reports, direct and indirect taxes, capital WIP and capitalisations, HR, labour law compliance and retirement benefits, other statutory compliances, outstanding litigations, material agreements and contracts, and financial forecasts. Naturally, a company contemplating a transaction has to be well prepared for a DDR exercise.

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[1] This, however, does not apply when a firm raises fixed deposits or issues commercial paper.

[2] Over the years preference shares have declined in importance.

[3] Technically, shares may be issued at a discount although procedural complexity makes it infrequent.

[4] The guidelines for making an IPO tend to change. Readers are advised to refer to the latest guidelines at www.sebi.com

[5] In practice, of course, due to the phenomenon of "roll over", their effective maturity may be longer.

[6] The interim security, prior to the creation of the final security, usually comprises all the stipulated security, but the mortgage.

[7] This section has been extracted from the book *Investment Banking* by Pratap Subramanyam, published by Tata McGraw-Hill Publishing Company.

[8] This section has been contributed by Pradip Lath.