# Financial Management

## Study Material for Session 1 - 10

## Introduction to Financial Management

### 1.1 Definition of Finance:

Any kind of business activity depends on the finance. Hence, it is called as lifeblood of business organization. According to Oxford dictionary, the word 'finance' connotes 'management of money'. According to Khan and Jain, "Finance is the art and science of managing money".

### 1.2 Definition of Business Finance:

According to the Guthumann and Dougall, "Business finance can broadly be defined as the activity concerned with planning, raising, controlling, administering of the funds used in the business". Corporate finance is concerned with budgeting, financial forecasting, cash management, credit administration, investment analysis and fund procurement of the business concern and the business concern needs to adopt modern technology and application suitable to the global environment.

### 1.3 Meaning of Financial Management:

Financial management is an integral part of overall management. Financial Management is managerial activity which is concerned with the planning and controlling of the firm's financial resources. Weston and Brigham define Financial Management "as an area of financial decision making, harmonizing individual motives and enterprise goal". The most popular and acceptable definition of financial management as given by S.C. Kuchal is that "Financial Management deals with procurement of funds and their effective utilization in the business".

### 1.4 Objectives of Financial Management:

Objectives of Financial Management may be broadly divided into two parts such as:

i. Profit maximization – Main aim of any kind of economic activity is earning profit. Profit is the measuring techniques to understand the business efficiency of the concern. Profit maximization aims at maximizes the profit of the concern.

ii. Wealth maximization – Wealth maximization is one of the modern approaches. Wealth maximization is also known as value maximization or net present worth maximization.

### 1.5 Functions and Scope of Financial Management:

The functions of Financial Management can be broadly classified into three major decisions, namely:

(a) Investment decisions – The investment decision is concerned with the selection of assets in which funds will be invested by a firm. The asset of a business firm includes long term assets (fixed assets) and short term assets (current assets).

(b) Financing decisions – The financing decision is concerned with capital – mix, (Financing – mix) or Capital Structure of a firm.

(c) Dividend decisions – Dividend policy decisions are concerned with the distribution of profits of a firm to the shareholders. How much of the profits should be paid as dividend? i.e. dividend pay-out ratio.

**1.6 Functions of Finance Manager:**

- Estimating Financial Requirements
- Deciding Capital Structure
- Selecting a Source of Finance
- Selecting a Pattern of Investment
- Proper Cash Management
- Implementing Financial Controls
- The use of various control techniques
- Proper use of Surpluses

**1.7 Interface of Financial Management with Other Functional Areas:**

- Determining Financial Needs
- Determining Sources of Funds
- Financial Analysis
- Optimal Capital Structure
- Cost Volume Profit Analysis
- Profit Planning and Control
- Fixed Assets Management
- Capital Budgeting
- Corporate Taxation
- Working Capital Management
- Dividend Policies
- Acquisitions and Mergers

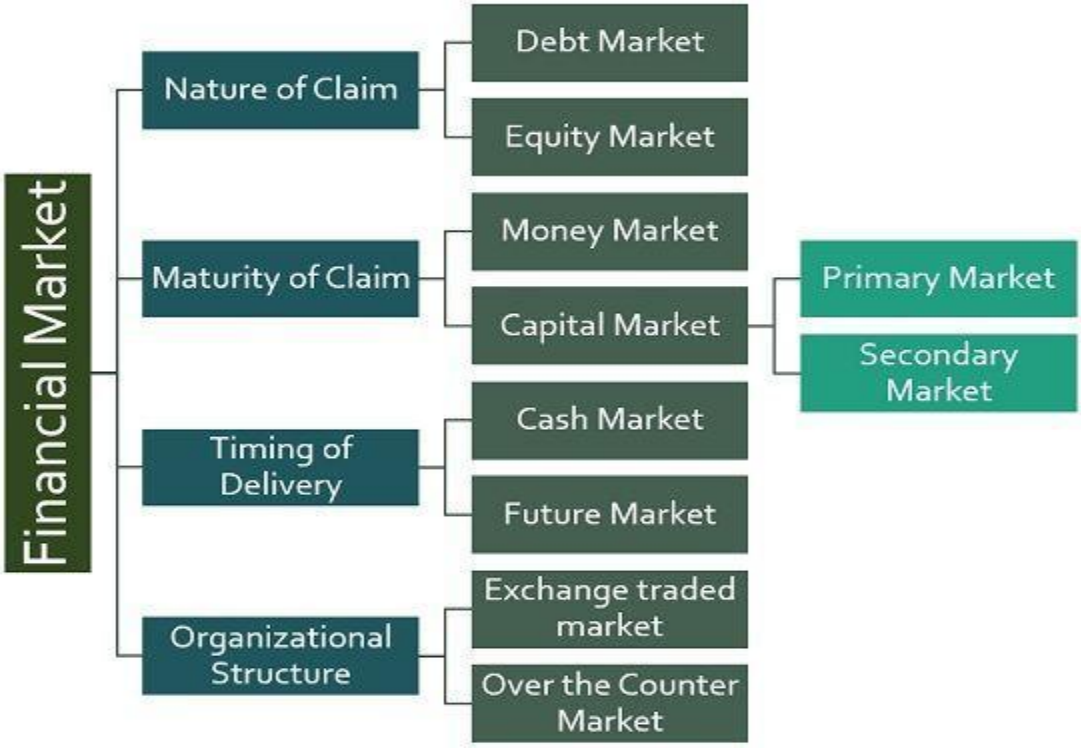
# Overview of Financial Markets

**2.1 Definition:** Financial Market refers to a marketplace, where creation and trading of financial assets, such as shares, debentures, bonds, derivatives, currencies, etc. take place. It plays a crucial role in allocating limited resources, in the country's economy. It acts as an intermediary between the savers and investors by mobilizing funds between them. The financial market provides a platform to the buyers and sellers, to meet, for trading assets at a price determined by the demand and supply forces.

**2.2 Functions of Financial Market:** The functions of the financial market are explained with the help of points below:

- It facilitates **mobilization of savings** and puts it to the most productive uses.
- It helps in **determining the price of the securities**. The frequent interaction between investors helps in fixing the price of securities, on the basis of their demand and supply in the market.
- It provides **liquidity to tradable assets**, by facilitating the exchange, as the investors can readily sell their securities and convert assets into cash.
- It **saves the time, money and efforts of the parties**, as they don't have to waste resources to find probable buyers or sellers of securities. Further, it reduces cost by providing valuable information, regarding the securities traded in the financial market.
- The financial market may or may not have a physical location, i.e. the exchange of asset between the parties can also take place over the internet or phone also.

**2.3 Classification of Financial Market:**



**Source:** *https://businessjargons.com/financial-market.html*

**2.3.1 By Nature of Claim:**

- **Debt Market:** The market where fixed claims or debt instruments, such as debentures or bonds are bought and sold between investors.
- **Equity Market:** Equity market is a market wherein the investors deal in equity instruments. It is the market for residual claims.

**2.3.2 By Maturity of Claim:** The financial markets have two major components:

- Money market;
- Capital market.

While the money market deals in short-term credit, the capital market handles the medium term and long-term credit.

The **Money market** refers to the market where borrowers and lenders exchange short-term funds to solve their liquidity needs. Money market instruments are generally financial claims that have low default risk, maturities under one year and high marketability.

The **Foreign Exchange Market** is a market where the buyers and sellers are involved in the sale and purchase of foreign currencies. In other words, a market where the currencies of different countries are bought and sold is called a foreign exchange market.

The **Capital market** is a market for financial investments that are direct or indirect claims to capital. It is wider than the Securities Market and embraces all forms of lending and borrowing, whether or not evidenced by the creation of a negotiable financial instrument. The Capital Market comprises the complex of institutions and mechanisms through which intermediate term funds and long-term funds are pooled and made available to business, government and individuals. The Capital Market also encompasses the process by which securities already outstanding are transferred.

The **Securities Market**, however, refers to the markets for those financial instruments/claims/obligations that are commonly and readily transferable by sale.

The Securities Market has two interdependent and inseparable segments, the new issues (primary) market and the stock (secondary) market.

The **Primary market** provides the channel for sale of new securities. The issuer of securities sells the securities in the primary market to raise funds for investment and/or to discharge some obligation.

The **Secondary market** deals in securities previously issued. The secondary market enables those who hold securities to adjust their holdings in response to charges in their assessment of risk and return. They also sell securities for cash to meet their liquidity needs.

This secondary market has further two components.

First, the **spot market** where securities are traded for immediate delivery and payment. The other is **forward market** where the securities are traded for future delivery and payment. This forward market is further divided into Futures and Options Market (Derivatives Markets).

In futures Market the securities are traded for conditional future delivery whereas in option market, two types of options are traded. A **put option** gives right but not an obligation to the owner to sell a security to the writer of the option at a predetermined price before a certain date, while a **call option** gives right but not an obligation to the buyer to purchase a security from the writer of the option at a particular price before a certain date.

### 2.3.3 By Timing of Delivery

- **Cash Market:** The market where the transaction between buyers and sellers are settled in real-time.
- **Futures Market:** Futures market is one where the delivery or settlement of commodities takes place at a future specified date.

### 2.3.4 By Organizational Structure:

- **Exchange-Traded Market:** A financial market, which has a centralized organization with the standardized procedure.
- **Over-the-Counter Market:** An OTC is characterized by a decentralized organization, having customized procedures.

Financial market can also be classified under the following heads:

### 2.3.5 By Nature of Assets

- **Stock market:** This is the market where shares of the company are listed and traded after their IPO.
- **Bond market:** This market allows companies and the government to raise money for a project or investment. Investors buy bonds from a company, which later returns the amount of bond with agreed interest.
- **Commodities market:** In this market, investors buy and sell natural resources or commodities, like corn, oil, meat, and gold.
- **Derivatives market:** This market deals in derivatives or contracts, whose value is based on the underlying asset being traded.

## 2.4 Money Market Instruments:

Following are some of the important money market instruments or securities.

**(a) Call Money:** It is short term finance repayable on demand, with a maturity period of one day to 15 days. It is used for interbank transactions. Commercial banks are required to minimum cash balance called as cash reserve ratio. Call Money is a method by which banks borrow from each other in order to maintain the cash reserve ratio as per RBI rules. The interest rate paid on call money loans is known as the call rate.

**(b) Treasury Bill:** A treasury bill is a promissory note issued by the RBI to meet the short-term requirement of funds. Treasury bills are highly liquid instruments that means, at any time the holder of treasury bills can transfer of or get it discounted from RBI. These bills are normally issued at a price less than their face value; and redeemed at face value. So the difference between the issue price and the face value of the treasury bill represents the interest on the investment. These bills are secured instruments and are issued for a period of not exceeding 364 days. Banks, Financial institutions and corporations normally play major role in the Treasury bill market.

**(c) Commercial Paper:** Commercial paper (CP) is a popular instrument for financing working capital requirements of companies. The CP is an unsecured instrument issued in the form of promissory note. This instrument was introduced in 1990 to enable the corporate borrowers to raise short-term funds. It can be issued for period ranging from 15 days to one year. Commercial papers are transferable by endorsement and delivery. The highly reputed companies (Blue Chip companies) are the major player of commercial paper market.

**(d) Certificate of Deposit:** Certificate of Deposit (CDs) are short-term instruments issued by Commercial Banks and Special Financial Institutions (SFIs), which are freely transferable from one party to another. The maturity period of CDs ranges from 91 days to one year. These can be issued to individuals, co-operatives and companies.

**2.5 Participants in the Financial Market:**

**i) Banks:** Banks participate in the capital market and money market. Banks take active trading interest in the bond market and have certain exposures to the equity market also. Banks also participate in the market as clearing houses.

**ii) Primary Dealers (PDs):** PDs deal in government securities both in primary and secondary markets. Their basic responsibility is to provide two-way quotes and act as market makers for government securities and strengthen the government securities market.

**iii) Financial Institutions (FIs):** FIs provide/lend long term funds for industry and agriculture. FIs raise their resources through long-term bonds from financial system and borrowings from international financial institutions.

**iv) Stock Exchanges:** A Stock exchange is duly approved by the Regulators to provide sale and purchase of securities on behalf of investors through brokers. The stock exchanges provide clearing house facilities for netting of payments and securities delivery. Securities traded in stock exchanges include equities, debt, and derivatives.

**v) Brokers:** Only brokers approved by Capital Market Regulator can operate on stock exchange. Brokers perform the job of intermediating between buyers and seller of securities. For their services brokers earn a fee known as brokerage.

**vi) Investment Bankers (Merchant Bankers):** These are agencies/organizations regulated and licensed by SEBI, the Capital Markets Regulator.

**vii) Foreign Institutional Investors (FIIs):** FIIs are foreign based funds authorized by Capital Market Regulator to invest in countries' equity and debt market through stock exchanges.

**viii) Custodians:** Custodians are organizations which are allowed to hold securities on behalf of customers and carry out operations on their behalf. They handle both funds and securities of Qualified Institutional Borrowers (QIBs) including FIIs.

**ix) Depositories:** Depositories hold securities in demat (electronic) form, maintain accounts of depository participants who, in turn, maintain accounts of their customers. On instructions of stock exchange clearing house, supported by documentation, a depository transfers securities from buyers to sellers' accounts in electronic form.

# Primary Markets and Secondary Markets

**3.1 Primary Market:**

The Primary Market consists of arrangements, which facilitate the procurement of long-term funds by companies by making fresh issue of shares and debentures. Companies raise funds to finance their projects through various methods. The promoters can bring their own money of borrow from the financial institutions or mobilize capital by issuing securities. The funds may be raised through issue of fresh shares at par or premium, preferences shares, debentures or global depository receipts. The main objectives of a capital issue are given below:

- To promote a new company
- To expand an existing company
- To diversify the production
- To meet the regular working capital requirements
- To capitalize the reserves

The main service functions of the primary market are origination, under writing and distribution. Stocks available for the first time are offered through primary market and known as Initial Public Offerings (IPOs). The issuer may be a new company or an existing company. These issues may be of new type or the security used in the past. The issuing houses, investment bankers and brokers act as the channel of distribution for the new issues. They take the responsibility of selling the stocks to the public.

1. **Offer through Prospectus:**

- It is the most popular method of raising funds which involves inviting subscription from the public through the issue of prospectus.
- A prospectus makes a direct appeal to investors to raise capital through an advertisement in newspapers and magazines.

2. **Offer for Sale:**

- In this method, securities to be issued are offered for sale through intermediaries like issuing houses or stock brokers.
- The company sells securities to intermediary or broker at an agreed price and the broker resells them to investors at a higher price.

3. **Private Placements:**

- It refers to the process of allotment of securities by a company to institutional investors and some selected individuals.

4. **Rights Issue:**

- It refers to a method of issue in which new shares are offered to the existing shareholders in proportion to the number of shares they already possess.
- It is a right given to the existing shareholders to subscribe new shares.

5. **e-IPOs:**

- It is a method of issuing securities through an on-line system of stock exchange.
- A company proposing to issue capital to the public through the on-line system of the stock exchange has to enter into an agreement with the stock exchange. This is called an e-initial public offer.
- Registered brokers of SEBI, have to be appointed for the purpose of accepting applications and placing orders with the company.

**3.2 Secondary Market:** The secondary market known as stock market or stock exchange plays an equally important role in mobilizing long-term funds by providing the necessary liquidity to holdings in shares and debentures. It provides a place where these securities can be encashed without any difficulty and delay. It is an organised market where shares, and debentures are traded regularly with high degree of transparency and security. In fact, an active secondary market facilitates the growth of primary market as the investors in the primary market are assured of a continuous market for liquidity of their holdings. The major players in the primary market are merchant bankers, mutual funds, financial institutions, and the individual investors; and in the secondary market you have all these and the stockbrokers who are members of the stock exchange who facilitate the trading.

**3.3 Procedural Aspects of Primary Issues:**

**1. Pre-issues Decision Making –** The Initial Public Offer (IPO) is the first public offer of equity shares by a company since its inception. IT is a financing strategy to raise funds or as an exit strategy to offload holdings to the general public. An IPO is unique in many ways since it changes permanently the profile of a company and the way the promoters and the management need to think thereafter. Here, the responsibility of living up to the expectation of the market and the shareholders is a major task. The Merchant Banker (MBR) managing an issue has onerous responsibility towards promoters, issuing company and investors. Sections 1-10 of SEBI guidelines cover respectively (i) Eligibility norms, (ii) Pricing of issue, (iii) Promoters' Contribution and Lock-in Requirements, (iv) Contents of Offer Document, (v) Issue Advertisement, (vi) Issue of Debt Instruments, (vii) Book-Building, (viii) Issue by 1 Designated FIs, (ix) Preferential Issues, and (x) OTCE issues.

**2. Shares Issues and Its Types –**

**Public Issue:** When the issue is for the general public and anyone interested in to invest in the company can buy the shares. It can be further of two types as follows:

- **Initial Public Offer (IPO):** When an unlisted company wants to go public for the first time, it can be done through Initial Public Offer. Here, the investors bid for the company within a band (generally given by the company). The bidding value depends upon the valuation of the company. IPO helps the company to get listed and generate funds from public. Sometimes, IPO is riskier than other stocks investment as the small investors are

not able to evaluate the correct bid rate. So, the stock price decline (may also appreciate) just after the final issue.

- **Further Public Offer (FPO):** Here the already listed company generate the funds from the public (anyone interested) for few projects, expansion etc.

**Rights Issue:** The listed company issues the securities only to the existing shareholders of its company. It is based on the ratio in which the shareholders are holding number of shares on any fixed date. Generally, the rights issue are on the discounted rate and are beneficial for the shareholders, so, they prefer to invest.

**Bonus Issue:** The shares given to the existing shareholders only without any consideration from them. These are issued on a fixed date based on the ratio to the number on shares held by the shareholder.

**Private Placement:** Here the company issues the securities to the selected group of investors not exceeding more than 49. It can be done in two ways as follows:

- **Preferential Issue:** The listed company issues the equity shares which have some more benefits over the normal equity shares like in terms of dividends etc. These benefits are mentioned at the time of issue. These are done as per SEBI guidelines.
- **Qualified Institutional Placement (QIP):** Here, the listed company issues equity shares or shares convertible into equity shares to Qualified Institutional Buyers only as per SEBI guidelines.

**Employee Stock Option Plan (ESOPs):** These are a special kind of stock options which are issued only to the employees of the company. The shares are issued at a discounted price and many have cash benefits also. This is done to develop the interest of the employees as the stakeholders of the company for its wellbeing. This plan have the tax benefits for the employees. And the employee can hold the shares only till retirement or till the person is employee of the company.

**3. Pricing of Public Issues –** Part II of Chapter III of the Securities and Exchange Board of India (Issue of Capital and Disclosure Requirements) Regulations, 2009 stipulates the following provisions with regard to pricing of securities:

- **Pricing (regulation 28):**

(1) An issuer may determine the price of specified securities in consultation with the lead merchant banker or through the book building process.

(2) An issuer may determine the coupon rate and conversion price of convertible debt instruments in consultation with the lead merchant banker or through the book building process.

(3) The issuer shall undertake the book building process in a manner specified in Schedule XI.

- **Differential pricing (regulation 29):**

An issuer may offer specified securities at different prices, subject to the following:

(a) Retail individual investors or retail individual shareholders or employees entitled for reservation made under regulation 42 making an application for specified securities of value not more than two lakhs rupees, may be offered specified securities at a price lower than the price at which net offer is made to other categories of applicants:

Provided that such difference shall not be more than ten per cent of the price at which specified securities are offered to other categories of applicants;

(b) In case of a book built issue, the price of the specified securities offered to an anchor investor shall not be lower than the price offered to other applicants;

(c) In case of a composite issue, the price of the specified securities offered in the public issue may be different from the price offered in rights issue and justification for such price difference shall be given in the offer document.

(d) In case the issuer opts for the alternate method of book building in terms of Part D of Schedule XI, the issuer may offer specified securities to its employees at a price lower than the floor price:

Provided that the difference between the floor price and the price at which specified securities are offered to employees shall not be more than ten per cent of the floor price.

- **Price and price band (regulation 30):**

(1) The issuer may mention a price or price band in the draft prospectus (in case of a fixed price issue) and floor price or price band in the red herring prospectus (in case of a book built issue) and determine the price at a later date before registering the prospectus with the Registrar of Companies:

Provided that the prospectus registered with the Registrar of Companies shall contain only one price or the specific coupon rate, as the case may be.

(2) The issuer shall announce the floor price or price band at least five working days before the opening of the bid (in case of an initial public offer) and at least one working day before the opening of the bid (in case of a further public offer), in all the newspapers in which the pre issue advertisement was released.

(3) The announcement referred to in sub-regulation (2) shall contain relevant financial ratios computed for both upper and lower end of the price band and also a statement drawing attention of the investors to the section titled "basis of issue price" in the prospectus.

(3A) The announcement referred to in sub-regulation (2) and the relevant financial ratios referred to in sub-regulation (3) shall be disclosed on the websites of those stock exchanges where the securities are proposed to be listed and shall also be pre-filled in the application forms available on the websites of the stock exchanges.

(4) The cap on the price band shall be less than or equal to one hundred and twenty per cent. of the floor price.

(5) The floor price or the final price shall not be less than the face value of the specified securities.

Explanation: For the purposes of sub-regulation (4), the "cap on the price band" includes cap on the coupon rate in case of convertible debt instruments.

- **Face value of equity shares (regulation 31):**

(1) Subject to the provisions of the Companies Act, 1956, the Act and these regulations, an issuer making an initial public offer may determine the face value of the equity shares in the following manner:

(a) If the issue price per equity share is five hundred rupees or more, the issuer shall have the option to determine the face value at less than ten rupees per equity share:

Provided that the face value shall not be less than one rupee per equity share;

(b) If the issue price per equity share is less than five hundred rupees, the face value of the equity shares shall be ten rupees per equity share:

Provided that nothing contained in this sub-regulation shall apply to initial public offer made by any government company, statutory authority or corporation or any special purpose vehicle set up by any of them, which is engaged in infrastructure sector.

(2) The disclosure about the face value of equity shares (including the statement about the issue price being "X" times of the face value) shall be made in the advertisements, offer documents and application forms in identical font size as that of issue price or price band.

**4. Pre-Issue Management –** Pre issue management is time bound program and concerned with following:

- Issue of shares
- Marketing, Coordination and underwriting of the issue.
- Pricing of issues

**5. Advertising and Marketing**

**6. Post Issue Management –**

- Collection of application forms and amount received
- Scrutinizing application
- Deciding allotment procedure
- Mailing of share certificates/refund or allotment orders

**7. Rights Issue**

### 3.4 Securities and Exchange Board of India (SEBI)

SEBI was established by Government of India on 12 April 1988 as an interim administrative body to promote orderly and healthy growth of securities market and for investor protection. It was given a statutory status on 30 January1992 through an ordinance which was later replaced by an Act of Parliament known as the SEBI Act, 1992. It seeks to protect the interest of investors in new and second hand securities.

#### 3.4.1 Purpose and Role of SEBI

1. To the issuers, it provide a market place.

2. To the investors, it should provide protection of their rights and interests.

3. To the intermediaries, it should offer a competitive, professionalized and expanding market.

#### 3.4.2 Objectives of SEBI

1. To regulate stock exchange and the securities market for its efficient functioning.

2. To protect the rights and interests of investors and to guide & educate them from fraudulent activities.

3. To prevent trade malpractices such as insider trading etc.

4. To regulate and develop a code of conduct and fair practices by intermediaries like brokers, merchant bankers etc.

**3.4.3 Functions of SEBI:**

SEBI has two main tasks of regulation and development of securities markets and some protective functions also.

- **Regulatory Functions:**

1. Registration of brokers and sub brokers and other players in the market.

2. Registration of collective investment schemes and Mutual Funds.

3. Regulation of stock brokers, portfolio exchanges, underwriters and merchant bankers and the business in stock exchanges and any other securities market.

4. Regulation of takeover bids by companies.

5. Calling for information by undertaking inspection, conducting enquiries and audits of stock exchanges and intermediaries.

6. Levying fee or other charges for carrying out the purposes of the Act.

7. Performing and exercising such power under Securities Contracts (Regulation) Act 1956, as may be delegated by the Government of India.

- **Development Functions:**

1. Promotes training of intermediaries of the securities market.

2. Investor education

3. Promotion of fair practices code of conduct of all SRO‘s.

4. Conducting research & publish information useful to all market participants

- **Protective Functions**

1. Prohibit fraudulent & unfair trade practices in secondary market (e.g. Price rigging & misleading statement).

2. Prohibit insider trading.

3. Educate investors Promote fair practice & code of conduct in securities market.

**3.4.4 SEBI Guidelines for Public Issues:**

Refer to the following link –

https://www.sebi.gov.in/legal/circulars/nov-2000/guidelines-for-offering-securities-in-public-issues-through-the-stock-exchange-mechanism-_17539.html

# Sources and Raising of Long-Term Finance

**4.1 Introduction:** Long-term financing means capital requirements for a period of more than 5 years to 10, 15, 20 years or maybe more depending on other factors. Capital expenditures in fixed assets like plant and machinery, land and building, etc. of business are funded using long-term sources of finance. Part of working capital which permanently stays with the business is also financed with long-term sources of funds.

**4.2 Long-Term Financing Sources:** Long-term financing sources can be in the form of any of them:

- **Share Capital or Equity Shares – Equity-Shares:**

A public limited company may raise funds from promoters or from the investing public by way of owner's capital or equity capital by issuing ordinary equity shares. Equity Shares, also known as ordinary shares, represent the ownership capital in a company. The holders of these shares are the legal owners of the company. They have unrestricted claim on income and assets of the company and possess all the voting power in the company.

In fact, the foremost objective of a company is to maximize the value of its equity shares. Being the owners of the company, they bear the risk of ownership also. They are entitled to dividends after paying the preference dividends. The rate of dividend on these shares is not fixed and depends upon the availability of divisible profits and the intention of the directors.

They may be paid a higher rate of dividend in times of prosperity and also run the risk of no dividends in the period of adversity. Similarly, when the company is wound up, they can exercise their claim on those assets which are left after the payment of all other claims including that of preference shareholders.

- **Preference Capital or Preference Shares:**

Preference share capital is another source of long-term financing for a company. These are a special kind of shares; the holders of such shares enjoy priority, both as regards to the payment of a fixed amount of dividend and also towards repayment of capital on winding up of the company. These shares carry a fixed rate of dividend and such dividend must be paid in full before the payment of any dividend on equity shares. Similarly, at the time of liquidation, the whole of preference capital must be paid before any payment is made to equity shareholders.

Various types of Preference shares can be as below:

| Sl. No. | Type of Preference Shares | Salient Features |
|---|---|---|
| 1 | Cumulative | Arrear Dividend will accumulative |
| 2 | Non-cumulative | No right to arrear dividend |
| 3 | Redeemable | Redemption should be done |
| 4 | Participating | Participate also in the surplus of firm |
| 5 | Non- Participating | Over fixed rate of Dividend |

| | | |
|---|---|---|
| 6 | Convertible | Option of Convert into equity Shares |

- **Retained Earnings or Internal Accruals:**

Long-term funds may also be provided by accumulating the profits of the company and by ploughing them back into business. Such funds belong to the ordinary shareholders and increase the net worth of the company. A public limited company must plough back a reasonable amount of profit every year keeping in view the legal requirements in this regard and its own expansion plans. Such funds also entail almost no risk. Further, control of present owners is also not diluted by retaining profits.

- **Debenture / Bonds:**

Debentures are one of the frequently used methods by which a company raises long-term funds. Funds acquired by issue of debentures represent loans taken by the company and are also known as 'debt capital'. A debenture is a certificate issued by a company under its seal acknowledging a debt due by it to its holders. In USA there is a distinction between debentures and bonds. There, the term bond refers to an instrument which is secured on the assets of the company whereas the debentures refer to unsecured instruments.

But, in India no such distinction is made between bonds and debentures and the two terms are used as synonymous. According to Section 2 (30) of the Companies Act, 2013, "the term debenture includes debenture stock, bonds and any other securities of a company whether constituting a charge on the assets of the company or not."

Debentures can be divided into the following three categories based on their convertibility:

(i) **Non-convertible debentures** – These types of debentures do not have any feature of conversion and are repayable on maturity.

(ii) **Fully convertible debentures** – Such debentures are converted into equity shares as per the terms of issue in relation to price and the time of conversion. Interest rates on such debentures are generally less than the non-convertible debentures because of their carrying the attractive feature of getting themselves converted into shares.

(iii) **Partly convertible debentures** – Those debentures which carry features of both convertible and non-convertible debentures belong to this category. The investor has the advantage of having both the features in one debenture.

Other types of Debentures with their features are as follows:

| Sl. No. | Type of Debenture | Salient Feature |
|---|---|---|
| 1 | Bearer | Transferable like negotiable instruments |
| 2 | Registered | Interest payable to registered person |
| 3 | Mortgage | Secured by a charge on Asset(s) |
| 4 | Naked or simple | Unsecured |
| 5 | Redeemable | Repaid after a certain period |
| 6 | Non-Redeemable | Not repayable |

- **Term Loans from Financial Institutes, Government, and Commercial Banks:**

Financial Institutions are another important source of long-term finance. In India, a number of special financial institutions have been established by the Government at the national level and state level to provide medium-term and long-term loans to the industrial undertakings.

Financial institutions established at the national level include Industrial Development Bank of India (IDBI), Industrial Finance Corporation of India (IFCI), Industrial Credit and Investment Corporation of India (ICICI), Industrial Reconstruction Corporation of India (IRCI), Unit Trust of India (UTI), Life Insurance Corporation of India (LIC), General Insurance Corporation (GIC) etc.

Financial institutions established at the state level include State Financial Corporations (SFCs) and State Industrial Development Corporations (SIDCs).

- **Venture Funding:**

The venture capital financing refers to financing of new high risky venture promoted by qualified entrepreneurs who lack experience and funds to give shape to their ideas. In broad sense, under venture capital financing venture capitalist make investment to purchase equity or debt securities from inexperienced entrepreneurs who undertake highly risky ventures with a potential of success.

Venture Capital typically comes from institutional investors and high net worth individuals and is pooled together by dedicated investment firms.

- **Asset Securitization:**

Securitization is a process in which illiquid assets are pooled into marketable securities that can be sold to investors. The process leads to the creation of financial instruments that represent ownership interest in, or are secured by a segregated income producing asset or pool of assets. These assets are generally secured by personal or real property such as automobiles, real estate, or equipment loans but in some cases are unsecured.

This method of raising finance is often used by businesses in non-financial sectors to support bond issues and raise cash for expansion, acquisition or to reduce bank debt. These sectors could include: logistics; utilities; leisure; healthcare; intellectual property;

- **Lease Financing:**

Leasing is a general contract between the owner and user of the asset over a specified period of time. The asset is purchased initially by the lessor (leasing company) and thereafter leased to the user (Lessee Company) which pays a specified rent at periodical intervals. Thus, leasing is an alternative to the purchase of an asset out of own or borrowed funds. Moreover, lease finance can be arranged much faster as compared to term loans from financial institutions.

- **Foreign direct investment (FDI):**

It is an investment from a party in one country into a business or corporation in another country with the intention of establishing a lasting interest. Lasting interest differentiates FDI from foreign portfolio investments, where investors passively hold securities from a foreign country. A

foreign direct investment can be made by obtaining a lasting interest or by expanding one's business into a foreign country.

- **International Financing by way of Euro Issue, Foreign Currency Loans, ADR, GDR, etc.:**

**External Commercial Borrowings(ECB):** ECBs refer to commercial loans [in the form of bank loans , buyers credit, suppliers credit, securitized instruments (e.g. floating rate notes and fixed rate bonds)] availed from non-resident lenders with minimum average maturity of 3 years. Borrowers can raise ECBs through internationally recognized sources like

(i) International banks, (ii) international capital markets, (iii) multilateral financial institutions such as the IFC, ADB etc., (iv) export credit agencies, (v) suppliers of equipment, (vi) foreign collaborators and (vii) foreign equity holders.

External Commercial Borrowings can be accessed under two routes viz (i) Automatic route and (ii) Approval route. Under the Automatic route there is no need to take the RBI/Government approval whereas such approval is necessary under the Approval route. Company's registered under the Companies Act and NGOs engaged in micro finance activities are eligible for the Automatic Route whereas Financial Institutions and Banks dealing exclusively in infrastructure or export finance and the ones which had participated in the textile and steel sector restructuring packages as approved by the government are required to take the Approval Route.

**Euro Issue:** The term `euro' denotes that the issue is listed on a European Stock Exchange. A euro issue is an issue where the securities are issued in a currency different from the currency of the country of issue and the securities are sold in international market to individual and institutional investors. Euro securities are negotiable and transferable securities distributed by a syndicate of market intermediaries and underwriters, by a euro issue, a company is able to raise funds at a cheaper rate, Euro bond is an international bond issued to investors from throughout the world. These are issued as unsecured obligations. Indian Companies issue foreign currency convertible bonds (FCCB) which are equity linked debt instruments, convertible into equity at a specified later date. They carry a fixed rate of interest which is lower than the rate.

**Depository Receipts (DRs):** A depository receipt is basically a negotiable certificate denominated in US dollars, that represents a non-US company's publicly traded, local currency (Indian Rupee) shares. Currently. The underlying shares can only be equity shares. In theory, though a DR can also represent debt instruments, in practice it rarely does.

DRs are created when the local currency shares of an Indian Company are delivered to the depository's local custodian bank, against which the depository bank issues DRs in US dollars. These DRs may trade freely in the overseas markets like any other dollar denominated security, either on a stock exchange or in the over-the counter market or among a restricted group such as Qualified Institutional Buyers (QIB). Whenever a DR holder wishes, for whatever reason, not to hold the DR or to trade it overseas, he always has the option to approach the depository bank for the cancellation of the DR and the release of the underlying share(s) by the bank in India into the Indian Stock Market for sale. The custodian releases the shares into the Indian Market and remits the proceeds abroad.

Dividend payments are made by the company in rupees which the depository converts into dollars and pays to the investor after deducting the withholding tax. The issue of DRs is very simple. First, a board resolution has to be passed to adopt the issue. An application is then made to the Ministry of Finance. The approval from the Ministry only specifies the price range at which the issue is to be made. Pricing is finalized only at the last stage. A prospectus, called the red herring, is then prepared. Prospectus leaves a blank space for the issue price. The underwriter then markets the issue by organizing roadshows. Shares are issued by the Company to the depository but delivered to the custodian.

**Global Depository Receipts (GDRs):** GDRs are traded and settled outside the United States. Rule 144A of the Securities and Exchange Commission (SEC) of U.S.A., however, permits the companies from outside USA to offer their GDRs to Qualified Institutional Buyers (QIB). American Depository Receipts (ADR) are DRs issued in the United States and have to be in accordance with the stringent provisions stipulated by the Securities and Exchange Commission. Global Depository Receipt is in the nature of a depository receipt or certificate created by an overseas depository bank (authorized by the issuing company) outside India and is issued to non-resident investors against the issue of FCCB's or shares of the issuer company. It is a negotiable certificate in US dollars, and traded freely in foreign markets like other securities and can be issued by way of private placement also. Prior permission of Ministry of Finance, Government of India, is required for issue of GDRs.

Since the start of the practice of issue of ECBs and GDRs by Indian Companies, substantial foreign investment has come to India and Indian Stocks are now listed on London and Luxembourg Stock Exchanges

**American Depository Receipts (ADR):** ADR's are depository receipts issued in United States of America (USA) in accordance with the provisions of Securities and Exchange Commission. Since US market exposes to a higher level of responsibility, disclosures, costs and liability, Indian Companies have resorted to GDR's only. Listing provisions in USA are very stringent. Issue of ADR is costlier. Legal fees, underwriting, road show costs, investor relations and registration fees are also higher. The broader the investor base in USA, the higher is the potential of legal liability for inadequate disclosures.

ADRs are US dollar denominated negotiable instruments issued in the US by a depository bank, representing ownership in non-US securities (underlying ordinary shares). In case of ADR issues, companies have to comply with strict reporting requirements of SEC and US GAAP which requires the total issue cost to be written off in the year of issue. ADRs are subject to two-way fungibility and apprehends large capital inflows. ADRs can be listed on New York Stock Exchange, American Stock Exchange or NASDAQ.

Depository receipts permit investors to trade in foreign securities and at the same time giving the issuing companies an access to major international markets. American Depository Receipts are an offshoot of DR's and are US dollar denominated negotiable instruments issued in the US by a depository bank, representing ownership in non-US securities. ADR's provide non-US companies with access to the US capital markets which has the world's largest domestic investor base.

**Indian Depository Receipts (IDRs):** The concept of the depository receipt mechanism which is used to raise funds in foreign currency has been applied in the Indian Capital Market through the issue of Indian Depository Receipts (IDRs). IDRs are similar to ADRs/GDRs in the sense that

foreign companies can issue IDRs to raise funds from the Indian Capital Market in the same lines as an Indian company uses ADRs/GDRs to raise foreign capital. The IDRs are listed and traded in India in the same way as other Indian securities are traded.

**Foreign Currency Convertible Bonds (FCCBs):** Foreign Currency Convertible Bond is an equity linked debt security which can be converted into shares or into DRs. It is a foreign currency debt instrument that an Indian Company issues. The investor in the FCCB has the option to convert it into equity usually in accordance with a predetermined formula and sometimes also at a predetermined exchange rate. This offers capital appreciation on sale. He has also the option to retain it as a bond. Investors have an option to convert the bond if the market price of the stock goes up beyond a percentage of the share price at the time of issue at a predetermined premium. Alternatively, some companies retain the right to convert compulsorily.

FCCBs are bonds which are convertible into underlying equity, shares of the company, at a predetermined price, at any time at the investor's option, but after 1-2 years after the issue. The maturity of bond can be upto 10-12 years and if the option to convert equity is not exercised, the bond is redeemed. Most FCCB issues are listed at London or Luxembourg stock exchanges. These are bearer securities and generally such issues incorporate put and call options.

**Foreign Currency Options:** Authorized dealers of foreign exchange are permitted to write and trade in cross currency options, to facilitate hedging of foreign exchange risk subject to Reserve Bank of India guidelines, dated 13th September, 1993.

**Other International Instruments:** Instruments such as Yankee Bonds, Samurai Bonds etc. which are found in US and Japanese markets are also being considered now by Indian Companies. Reliance Industries Ltd. issued Yankee bonds in August 1996. The opportunities in the Indian Capital Markets has also attracted foreign investors. With the opening up of Indian market to the world investors, the following instruments have been recognized as essential instruments for trading in the secondary market, these are options, futures and derivatives.

### 4.3 Structural analysis of investment banking industry:

Investment banking deals primarily with the creation of capital for other companies, governments, and other entities.

Investment banking activities include underwriting new debt and equity securities for all types of corporations, aiding in the sale of securities, and helping to facilitate mergers and acquisitions, reorganizations, and broker trades for both institutions and private investors.

Investment bankers help corporations, governments, and other groups plan and manage financial aspects of large projects.

Many large investment banking systems are affiliated with or subsidiaries of larger banking institutions, and many have become household names, the largest being Goldman Sachs, Morgan Stanley, JPMorgan Chase, Bank of America Merrill Lynch, and Deutsche Bank.