INVESTMENT BANKING
Concepts, Analyses and Cases

Third Edition

About the Author

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Professor Pratap has several publications to his credit some of which in the corporate finance domain are—*Strategic Corporate Finance: The Definitive Approach to Structuring and Financing of Corporate Businesses,* published by Snow White, Mumbai and *Investment Banking: An Odyssey in High Finance,* published by McGraw-Hill Education India Pvt. Ltd. He has also written several articles and spoken at seminars and training programmes conducted by the ICAI, CII and others. He has also served on corporate boards and committees as subject expert.

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McGraw Hill Education (India) Private Limited
CHENNAI

McGraw Hill Education Offices
Chennai New York St Louis San Francisco Auckland Bogotá Caracas
Kuala Lumpur Lisbon London Madrid Mexico City Milan Montreal
San Juan Santiago Singapore Sydney Tokyo Toronto

McGraw Hill Education (India) Private Limited

Published by McGraw Hill Education (India) Private Limited
444/1, Sri Ekambara Naicker Industrial Estate, Alapakkam, Porur, Chennai - 600 116

Investment Banking: Concepts, Analyses and Cases, 3e

P-Book
ISBN 13: 978-93-5260-700-6
ISBN 10: 93-5260-700-7

E-Book
ISBN 13: 978-93-5260-701-3
ISBN 10: 93-5260-701-5

Managing Director: *Kaushik Bellani*

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Typeset at The Composers, 260, C.A. Apt., Paschim Vihar, New Delhi 110 063 and printed at

Cover Printer:

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Dedicated to

Mother Nature

for her Benevolence and Fortitude

and

The memory of my Parents

who bestowed me with

their love and care, conscience and my identity

General Disclaimer and Guidance to Readers

1. This book is primarily a work in Core Investment Banking in the Indian context coupled with perspectives on global investment banking to provide holistic learning of the subject. This book does not provide a commentary on accounting, law and taxation aspects since such an effort is outside its scope. It deliberately avoids questions of jurisprudence, current legal controversies and debatable questions of law. The book concentrates on bringing a holistic perspective to financial discussions by examining the relevant substantive law and delegated legislation at the minimum without delving into procedures and compliance matters. Depending on the facts of a particular case, one has to examine procedures, filings and other compliance in detail by referring to authoritative works therein and consulting relevant legal, taxation and accounting experts.
2. As mentioned above, this book has been written from an India perspective, though insights into corresponding overseas position have been discussed at important instances. Readers will need to examine respective overseas law, regulation and practice wherever necessary for practical application in cross-border financial transactions.
3. Information provided about several companies/organisations discussed in this book has been taken entirely from published sources and public domain.
4. The cases and problems discussed in Appendix C are entirely the creation of the author with imaginary names of people, places and companies discussed therein. Any resemblance thereof to any real-life person, place or company is completely unintended and purely coincidental.
5. The legal aspects discussed in this book incorporate the position as on **April 1, 2017**. Readers must appreciate that investment banking is a regulated activity and law and regulation are ever changing and can even reverse prevailing positions dramatically. While following the discussions in the book, readers are advised to update themselves suitably on legal aspects for any changes that may have taken place subsequently.

Preface to Third Edition

Introduction

From the time this book was originally conceived for the Indian market, investment banking industry has grown by leaps and bounds. With the evolution of this industry in India, rapid strides have been made in Core Investment Banking which is the focus of this book. Therefore, the need for a contemporary work in this area cannot be over-emphasised.

The third edition of this book has been presented with a thoroughly revised and re-organised content which takes into account the current need and context for understanding the subject. This book is positioned as a complete textbook for postgraduate level of study in Investment Banking covering in detail the history, market, business, industry, transaction and service perspective of this important area of financial services. It, therefore, caters to all postgraduate courses with focus on finance and capital markets in general and investment banking in particular.

Important Regulatory Developments

The Companies Act 2013 was enacted into law and came into effect from September 2013 bringing with it some landmark changes so far investment banking is concerned. The main areas of change are private placements, key provisions relating to public offers and OFS, schemes of arrangement and acquisitions. The SEBI Regulations have been continuously evolving and certain important changes have been seen in areas such as de-listing. The unification of securities and commodity market regulations is yet another important development. This edition has been completely rewritten to the extent of incorporating these important developments in regulatory framework.

Business of Investment Banking

The discussion on the business profile and services of investment banking has now been dealt with in a separate chapter so as to provide enough insights into the gamut of services of investment banks. Some of the major US banks have also been profiled. Separate sections have been added on investment banking careers, industry structure and service profile. The evolution of investment banking, the crisis of 2008 and its aftermath are dealt with in a separate chapter.

Secondary Markets

The activities in secondary markets though not forming part of 'Core Investment Banking' play an integral role in the business profile of full service investment banks. It was therefore felt that a separate chapter on secondary markets and systems is necessary for the complete treatment of the subject from a holistic perspective. This edition includes a chapter on these discussions with specific reference to rapid transformations such as Algorithmic High Frequency Trading, F&O market, Derivatives and Structured Products, demutualisation, listing of stock exchanges and more.

Private Placements

The Companies Act 2013 for the first time provided a statutory recognition to private placements, a hitherto under-addressed area of regulation. Considering the increasing level of private placements in the Indian market, especially in the debt segment, a separate chapter on this important capital market activity was felt necessary and has accordingly been provided for in this edition.

Mergers and Acquisitions

Keeping in view the fundamental architectural and regulatory differences between amalgamations and acquisitions under law, both the topics have been divided and dealt with separately in the new edition. Readers are now provided with a complete perspective on mergers as distinct from acquisitions. The areas of commonality and diversity between them in terms and strategy and transaction structure are also discussed in depth to make the discussions comprehensive. New numerical analysis has also been provided to explain the deal and valuation perspectives in depth.

Organisation of the Book

The organisation of chapters has been drastically revamped in the present edition by increasing the number of chapters. This has been done to divide each major area of discussion into a separate section, reduce the length of each chapter, to sub-divide some elaborate topics into smaller chapters and to incorporate new chapters. Accordingly, the number of chapters have been increased from 11 to 16. There is an introductory chapter on Financial Systems and Markets which includes additional discussions on monetary economics and its impact on securities markets.

The book is now structured in the following two sections:

- **Section I: Securities Markets and Investment Banking** provides in-depth coverage of Financial Markets overview, Securities Markets and Capital Market, Primary Market Securities issuances, Secondary Market Operations and Systems, Securities Law Framework, Global and Indian Investment Banking Paradigm, Industry Structure, Operating Environment and Business Profile of Full Service Investment Banking, Core Investment Banking, Investment Banking Regulation and the nuances of Business Valuation. It consists of Chapters 1 to 7.
- **Section II: Core Investment Banking** is entirely dedicated to Core Investment Banking and provides exhaustive discussions on all aspects of transactions that investment banks are associated with, both as regulated service providers and corporate advisors. Services rendered in Domestic Issue Management, Underwriting, Global Security Issuances, Buybacks and De-listing, Private Placements, Private Equity Advisory, Corporate Restructuring, Mergers and Amalgamations, Acquisitions, Takeovers, Divestitures and Control Buyouts, both LBOs and otherwise are discussed. Additional focus has been given to aspects such as transaction value and pricing for each type of transaction, financial evaluation and regulatory purview.

Highlights of the Third Edition

- New discussion on *Monetary Systems, Monetary Policy* and its impact on financial markets.
- Elaborate discussions on *Secondary Markets and Systems* including algorithmic trading, demutualisation of stock exchanges, block deals, insider trading, unfair trade practices and other contemporary discussions.
- *Private Placement*, a statutorily recognised transaction under the Companies Act 2013 has been discussed in detail. The entire gamut of private placement of debt and equity has been discussed.
- New discussion on *Structured Products* in the international and Indian securities market. Elaborate explanation of concepts such as Securitisation SPVs, Pass-through and Pay-through structures, CDOs, CDS and Synthetic CDOs has been provided.

- Inclusion of discussions on *Careers in Investment Banking, Business Profiles of leading investment banks of the world, Business, Regulatory and Technological impact on the Future of Investment Banking* have been included.
- Discussion on new instruments in the Indian capital market such as *Masala Bond* and *Municipal Bond*, new topics such as Corporate Inversions and Squeeze outs, additional discussions on Financial evaluation of M&A and LBOs have been included.
- Thoroughly revised, re-organised, enlarged and comprehensive coverage of *Core Investment Banking*. New discussions, cases and regulatory updates added in all chapters.
- More than *30 new additions* to the existing stock of about 150 caselets, illustrated cases and worked out problems and about 80 detailed case studies from the Indian corporate sector with some international cases as well. All new case discussions are drawn both from global and Indian capital markets. Self-test questions at the end of each chapter have also been increased.
- *Cases and Problems* included in Appendix C have been expanded by including 15 new cases that provide additional insights into various transactions. Changes required to existing problems and cases impacted by regulatory changes have also been carried out.

Acknowledgements

My thanks are due to the team at McGraw Hill Education for agreeing to do the third edition of this title. The team at MHE has done a commendable job in bringing out this edition in good time and with the requisite appeal.

I would like to acknowledge Dr. Prasanna Chandra's initiative for this title and several readers who sent their critical appreciation of the book through e-mails and also brought to light painstakingly some printer's devils and minor errors that had inadvertently crept into the previous editions despite best efforts. All these suggestions and corrections have been considered and incorporated to the best of my efforts and the matter has been rewritten in several chapters. Though the book has evolved significantly over the years as a leading publication in this space, I would like to continue to receive such e-mails which will continue the journey of refinement. I can be contacted at pratapgiri@yahoo.com.

Pratap Giri S.

Preface to Second Edition

The positive and encouraging response received for this book from both the student and the professional community at large reinforced my belief that investment banking as a separate branch of financial education has come to stay in India. Many B-schools in India have started to offer 'Investment Banking' as an independent elective course in their MBA programme in contrast to making it a sub-topic under the broad head of 'Financial Services'. Few others have started to offer 'MBA in Capital Markets' in which investment banking occupies an important place in the course curriculum. This book primarily intends to fill in the requirements of increasing the number of aspirants in the financial sector looking at a comprehensive learning experience about investment banking from a global and Indian perspective. It has been written to fit the role of a prescribed text book for the MBA curriculum perfectly. In addition, students pursuing other professional courses such as CA, Cost Accountancy, ACS, CFA, CFM and other capital market oriented courses have several common topics of discussion pertaining to capital market and investment banking in their courses for which this book would serve as a useful reference. It would also be of reference value to academicians and professionals in capital markets, corporate finance and financial services, who are looking for insights into the Indian capital market and investment banking industry. It would particularly appeal to investment banking professionals in India who require an understanding of transaction perspectives suitable to Indian capital markets.

The Global Financial Crisis and its Aftermath

The years following the Global Financial Crisis were tumultuous for the investment banking industry worldwide. The collapse of Bear Sterns and Lehmann Brothers, two of the crown jewels of Wall Street, created pandemonium in global capital markets and led to a general fear psychosis in the financial system. This was followed by the Euro Zone crisis and a recessionary trend across developed economies that further accentuated the negative investment sentiment in capital markets. The investment banking industry was at the receiving end for the better part of this period, be it in the form of reduced number of transactions or in declining bonuses for top bankers. However, this period also provided for a great learning experience for the future from the mistakes that were committed due to undesirable excesses in the capital market. An effort has been made in this edition to bring to the reader the perspective of the financial crisis insofar as it related to the investment banking domain. The discussion on the business profile of investment banking has been broad based to include insights into global financial conglomerates and the integration of investment banking with other financial verticals in the post-Glass Steagall era. The increased regulation of the industry in the aftermath of the financial crisis has also been dealt with.

Transformation of Capital Markets

The capital markets across the world and in India have been witnessing a rapid transformation led by the integration of global markets and technological developments. High frequency trading, deepening of the F&O market, introduction of more sophisticated and structured products, better regulatory framework, integration of inter-continental stock markets through M&A, demutualisation and listing of stock exchanges are some of the sweeping changes shaping capital markets of the future. In India, many of these global changes are happening simultaneously and very soon, both the premier stock exchanges, i.e., the NSE and the BSE could be listed companies. The introduction of new generation players, such as, the MCX-SX and others in waiting would add the required competitive edge to make Indian capital markets on par with their global peers. India could also become a favoured destination for overseas issuers from other jurisdictions through the IDR route in the years to come. Cross-border outbound mergers will get a fillip as well through this instrument. Discussions on the Indian and global capital markets have been extended in this edition to cover some of these important game changing developments.

Industry Developments and Leading Transactions

Notwithstanding the fact that investment banking did not experience the best of times between 2008 and 2012, the Indian investment banking industry witnessed some exciting transactions. The transformation of Axis Bank into a universal bank with the acquisition of Enam Securities, the growing infl uence of global investment banks in India and the breakaway of some of the high profile investment banking joint venture partners of earlier years made headlines at the industry level. There were also a good number of transactions in IPOs, QIPs, disinvestment offers, buybacks and de-listings and M&A. The corporate bond market also witnessed notable action. Many of these important transactions have been used as case studies in the discussions in this edition. The changes in the Indian regulatory landscape have been dealt with so as to provide a contemporary regulatory perspective for each type of transaction.

Business Valuation

Investment banking and valuation are bedfellows, one usually follows the other. The discussion on business valuation becomes extremely important as it engages the time and skill of investment bankers most of the time. At the same time, investment bankers also come up with their proprietary approaches to business valuation and as market makers, they contribute to the transaction multiples at a given time. Keeping in mind the close integration of business valuation with investment banking, the discussions on this chapter have been beefed up. In addition, each chapter in Section II includes a discussion on transaction valuation approaches that are used by investment bankers. Some of the path-breaking cases that have set the judicial approach to valuation issues have also been dealt with.

Organisation of Chapters

The organisation of chapters in the book has been modified in the present edition to refl ect a more cohesive approach to various topics of discussion. Accordingly the number of chapters has been reduced from 15 to 11 by including all connected discussions in one place. The separate chapter on capital market regulation has been done away with. Instead, the regulatory provisions affecting each type of transaction have been dealt with in the respective chapters appropriately.

The book is now structured in two sections:

- **Section I:** *Overview of Securities Markets and Investment Banking*—provides in-depth coverage of Financial Markets overview, Securities Markets and Capital Market, Global and Indian Investment Banking Paradigm, Industry Structure, Business Profile of Full Service Investment Banking, Primary Market Securities issuances and Business Valuation.
- **Section II:** *Core Investment Banking*—Services rendered in Domestic Issue Management, Underwriting, Global Security Issuances, Buybacks and De-listing, Private Equity and Placements, Corporate Restructuring, Mergers, Acquisitions, Divestitures and Buyouts.

Highlights of the Second Edition

- *Complete overview of Capital Markets*—both Global and Indian with extensive discussions on its various segments. New sections have been added to discussions on Financial Markets, Derivative Markets, G-Sec and Corporate Bond Markets.

- *Contemporary discussions* added on Investment Banking industry globally and in India. Separate discussions added on the genesis of the Global Financial Crisis and role attributable to investment banks therein, regulatory changes in the aftermath of the crisis and their impact. A new section has been added on Financial Conglomerates and their regulation in the context of investment banking.
- Further discussions added on *Business Valuation* under traditional approaches as well as transaction pricing techniques adopted by investment bankers for different transactions.
- Thoroughly revised, re-organised, enlarged and comprehensive coverage of *Core Investment Banking*. New discussions, cases and regulatory updates added in all chapters. Notable additions include new discussions on Public Offers, Private Equity, Institutional Placements, Buyouts and Strategic Divestitures and De-listings.
- More than *50 new additions* to the existing stock of about 100 caselets, illustrated cases and worked out problems and about 60 detailed case studies from the Indian corporate sector with some international cases as well. All new case discussions are drawn both from global and Indian capital markets.
- *Chapter outline and important terminology* listed at the beginning of each chapter. Self-test questions at the end of the each chapter for self-assessment have been provided in the MCQ format to suit the MBA curriculum. These questions are also intended to provide guidance to course instructors in various B-schools to frame their own questions for internal assessments and examinations.
- *End of the book cases and problems* expanded by including new cases that provide additional insights into various transactions. Changes required to existing problems and cases impacted by regulatory changes have also been carried out.

Acknowledgements

My thanks are due to Dr Prasanna Chandra and my publishers McGraw Hill Education (India), for agreeing to do the second edition of this title. The team at MHE (India), has done a commendable job in bringing out this edition in good time and with the requisite appeal.

I would like to thank several readers who sent their critical appreciation of the book through e-mails and also brought to light some printer's devils and minor errors that had inadvertently crept into the earlier edition. All these suggestions have been considered and reviewed and accordingly, the matter has been rectified or rewritten at several places in the book. However, I would like to continue to receive such mails which will refine my thinking and approach as an author for further betterment of the book in future editions. I would be grateful if your views, observations and suggestions for improvement are sent to me at **pratapsubramanyam@gmail.com**.

Pratap Giri S.

Preface to First Edition

My first endeavour, *'Investment Banking—An Odyssey in High Finance'*, was a great learning experience for me, as I had to think through the entire process that governs the domain of investment banking. The complexity of issues involved and the various perspectives that had to be looked into, was quite daunting. The encouraging response and feedback I received from various readers and professional quarters prompted me to come back with this second book on investment banking.

Aim of the Book and Intended Audience

The aim of writing this book is to present investment banking as a subject of study. On the other hand the purpose of the earlier book was to capture the scope of investment banking from a service provider's perspective. The present book introspects the conceptual issues underlying the various aspects of investment banking and analyses them in detail. The entire subject has been dealt with an analytical perspective to make this book handy for classroom application. It would also be a useful reference book for academicians and professionals in capital market, corporate finance and financial services from a conceptual perspective. It can be used by students of post-graduate management courses and various MBA programmes, CA, ICWA, ACS, CFA, CFM and other capital market oriented courses.

Structure and Orientation

The book has been structured in two parts. The first part deals with capital markets, securities and issuances. The evolution and development of the capital market, its structure and constituents, law and regulatory mechanisms are discussed. Various types of capital market securities and issues are explained in detail. The second part introduces the reader to the realm of global and Indian investment banking, and goes on to describe its various components. All the major functions of a full service investment bank such as underwriting, issue management, private equity, buybacks and de-listing, corporate restructuring, mergers and acquisitions are discussed thoroughly.

Highlights of the Book

- Exclusive chapter devoted to corporate valuation, which is emerging as an important branch of investment banking.
- An entire chapter covers the allied businesses of asset management, securities business and wealth management. The structure and business model of mutual funds, private equity funds and hedge funds have been explained in detail.
- Coverage of the subject from an Indian and international perspective with comparative analyses of systems followed in Indian and US capital markets.
- Easy treatment of the subject with initial introduction of basic conceptual issues and definitions in each chapter.
- The entire discussion in the book is laced with numerous exhibits, tables, illustrations, worked out problems and caselets for easier comprehension.
- The book contains 100 caselets, illustrated cases and worked out problems and 60 detailed case studies from the Indian corporate sector with some international cases as well.
- End of the book problems and cases with solutions are included to provide the reader with extensive working knowledge and practice.
- Chapter review at the end of each chapter helps in easier assimilation of information. Self-test questions at the end of each chapter for self-assessment.

- Important terms and terminology used in each chapter have been listed out at the end of the chapter for easier recall and reference.
- List of commonly used acronyms and terms along with their expansion is provided.

Acknowledgements

I am grateful to Dr. Prasanna Chandra, (Director, Centre for Financial Management, Bangalore, and former Professor at IIM Bangalore) who is the consulting editor for '*CFM-MH Professional Series in Finance*' to which this book belongs, for his thoughtful insights and comments. I look forward to his guidance and support in bringing more improvements and quality enhancements to this book in future editions.

I express sincere thanks to my publisher, McGraw Hill Education (India), for reposing their faith in me and bringing out a second title with me. My thanks are due to Mr. Chandra Sekhar, Mr. La'Porte and all the editors and proof readers who have done a commendable job.

My thanks are also due to my family for their support, understanding, patience and co-operation.

I would like to reiterate that this work is conceptual and intended for academic purposes and delivery of a course in investment banking at the post-graduate level. Therefore, I have tried to treat the topics from an analytical perspective. In doing so, there might have been some scope for inadvertent errors to creep in or lack of clarity at places. I invite valuable feedback and constructive criticism from readers. I would be grateful if observations and suggestions are sent to me at **pratapgiri@yahoo.com**, for making this book more relevant to its intended audience in future and enable it to stand the test of time.

PRATAP GIRI S.

Contents

List of Terms/Acronyms

Term/Acronym	Expansion
₹	The currency of India
ABS	Asset Backed Security
ACC	Associated Cement Companies Ltd.
ADB	Asian Development Bank
ADR	American Depository Receipt
AFI	All India Financial Institution
AIBI	Association of Investment Bankers of India
AIF Regulations	SEBI (Alternative Investment Funds) Regulations 2012
AIG	American International Group
AMC	Asset Management Company
AMFI	Association of Mutual Funds of India
AOA	Articles of Association
APM	Arbitrage Pricing Model
ARC	Asset Reconstruction Company
BIFR	Board for Industrial and Financial Reconstruction
BLRM	Book Running Lead Manager
BOD	Bought out Deal
BOLT	Bombay On-line Trading
BPCL	Bharat Petroleum Corporation Ltd.
BSE	The Stock Exchange, Mumbai, (formerly known as the Bombay Stock Exchange)
CAGR	Compounded Annual Growth Rate
CAPM	Capital Asset Pricing Model
CBDT	The Central Board of Direct Taxes
CBLO	Collateralised Borrowing and Lending Obligation
CCI	The Controller of Capital Issues
CCI	Competition Commission of India
CCIL	Clearing Corporation of India Ltd.
CDC	Commonwealth Development Corporation
CDSL	Central Depository Services Ltd.
CIM	Confidential Information Memorandum
CMP	Current Market Price

Companies Act	The Companies Act, 2013
Competition Act	The Competition Act, 2002
CRISIL	CRISIL Ltd. (formerly Credit Rating and Information Services of India Ltd.)
CSFB	Credit Suisse First Boston
DCF	Discounted Cash Flow
DDB	Deep Discount Bond
DEA	Department of Economic Affairs, MoF, GoI
De-listing Regulations	Securities and Exchange Board of India (De-listing of Securities) Regulations 2009
Depositories Act	The Depositories Act 1996
DFHI	Discount and Finance House of India Ltd.
DFI	Development Financial Institution
DII	Domestic Financial Institution
DOT	Department of Telecommunications, Government of India
DP	Depository Participant
DR	Depository Receipt
DRHP	Draft Red Herring Prospectus
DRR	Debenture Redemption Reserve
DTA	Deferred Tax Assets
DTAA	Double Taxation Avoidance Agreement
DTL	Deferred Tax Liabilities
E&Y	Ernst & Young
EBIT	Earnings Before Interest and Tax
EBITDA	Earnings Before Interest, Tax, Depreciation and Amortisations
ECB	External Commercial Borrowing
EPS	Earnings Per Share
ESOP	Employee Stock Option Plan
EU	European Union
EV	Enterprise Value
EV/EBITDA Multiple	Enterprise Value to EBITDA (no. of times)
EVA	Economic Value Added
EXIM Bank	Export Import Bank of India
F&O	Futures and Options
FASB	Federal Accounting Standards Board, USA
FCA	Financial Conduct Authority, UK
FCCB	Foreign Currency Convertible Bond

FCD	Fully Convertible Debenture
FCFE	Free Cash Flow to Equity
FCFF	Free Cash Flow to Firm
FCRA	Forward Contracts (Regulation) Act 1952 (since repealed)
FDI	Foreign Direct Investment
FEMA	The Foreign Exchange Management Act, 1999
FII	Foreign Institutional Investor
FIMMDA	Fixed Income Money Market and Derivatives Association
FIPB	Foreign Investment Promotion Board
FMC	Forward Markets Committee (since dismantled)
FMCG	Fast Moving Consumer Goods
FPI	Foreign Portfolio Investor (either institutional or non-institutional)
FPO	Follow on Public Offer (Further Public Offer)
FRBM Act	Fiscal Responsibility and Budget Management Act, 2003
FRN	Floating Rate Note
FVCI	Foreign Venture Capital Investor
GAAP	Generally Accepted Accounting Principles
GAIL	Gas Authority of India Ltd.
GBP	Great Britain Pound Sterling
GDP	Gross Domestic Product
GDR	Global Depository Receipt
GIC	General Insurance Corporation of India
GOI	The Government of India
HDFC	Housing Development Finance Corporation Ltd.
HLL	Hindustan Unilever Ltd. (Formerly Hindustan Lever Ltd.)
HMT	HMT Ltd. (formerly Hindustan Machine Tools Ltd.)
HNI	High Networth Investor
HPCL	Hindustan Petroleum Corporation Ltd.
HUDCO	Housing and Urban Development Corporation
HUF	Hindu Undivided Family
I(D&R) Act	The Industries (Development and Regulation) Act, 1951
IBRD	International Bank for Reconstruction and Development (World Bank Group)
ICAI	The Institute of Chartered Accountants of India
ICDR Regulations	SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2009
ICICI	ICICI Bank Ltd., (formerly The Industrial Credit and Investment Corporation of India Ltd.)

ICRA	ICRA Ltd. (one of India’s credit premier rating agencies)
ICSI	The Institute of Company Secretaries of India
IDBI	The Industrial Development Bank of India Ltd. (Presently IDBI Bank)
IDFC	Infrastructure Development Finance Company Ltd. (Now IDFC Bank)
IFC	International Finance Corporation
IFC	Infrastructure Finance Company (Under RBI Classification)
IFCI	IFCI Ltd. (formerly The Industrial Finance Corporation of India)
I-GAAP	Indian Generally Accepted Accounting Principles
IIBI	Industrial Investment Bank of India (Formerly IRBI, since liquidated)
IIFCL	India Infrastructure Finance Company Ltd.
IL & FS	Infrastructure Leasing & Financial Services Ltd.
ING	Internationale Nederlanden Groep
INVIT	Infrastructure Investment Trust
IOC	Indian Oil Corporation Ltd.
IOSCO	International Organisation of Securities Commissions
IPCL	IPCL Ltd., (merged with Reliance Industries Ltd)
IPO	Initial Public Offer
IRFC	Indian Railway Finance Corporation Ltd.
ISE	The Inter-connected Stock Exchange of India Ltd.
IT Act	The Income Tax Act, 1961
JV	Joint Venture
KKR	Kohlberg, Kravis and Roberts LLC
L of O	Letter of Offer
LBO	Leveraged Buyout
LIBOR	London Inter Bank Offered Rate
LIC	Life Insurance Corporation of India
LICHF	LIC Housing Finance Ltd.
LLP	Limited Liability Partnership
LM	Lead Manager
LODR Regulations	SEBI (Listing Obligations and Disclosure Requirements) Regulations 2015
LSE	London Stock Exchange
M & A	Mergers and Acquisitions
MAT	Minimum Alternate Tax
MBO	Management Buyout
MBS	Mortgage backed Security
MCA	The Ministry of Corporate Affairs, GoI

MDA	Management Discussion and Analysis
MIBID	Mumbai Inter Bank Bid Rate
MIBOR	Mumbai Inter Bank Offer Rate
MOA	Memorandum of Association
MoF	The Ministry of Finance, Government of India
MRPL	Mangalore Refinery and Petrochemicals Ltd
MVA	Market Value Added
NABARD	National Bank for Agriculture and Rural Development
NASDAQ	The National Association for Securities Dealers Automated Quotation System, The NASDAQ Stock Market, USA
NAV	Net Asset Value
NBFC	Non-banking Finance Company (as defined by RBI)
NCD	Non-convertible Debenture
NCLT	National Company Law Tribunal instituted under the Companies Act 2013
NFO	New Fund Offer
NHAI	National Highways Authority of India
NHB	National Housing Bank
NOPAT	Net Operating Profit After Tax
NOPLAT	Net Operating Profit Less Adjusted Tax
NPA	Non-performing Asset
NPO	Net Public Offer
NPV	Net Present Value
NRI	Non-resident Indian
NSDL	National Securities Depository Ltd.
NSE	The National Stock Exchange
NTPC	National Thermal Power Corporation Ltd.
NYSE	New York Stock Exchange
OCB	Overseas Corporate Body
ODI	Overseas Direct Investment
OECD	Organisation for Economic Co-operation and Development
OFCD	Optionally Fully Convertible Debenture
ONGC	Oil and Natural Gas Corporation Ltd.
OPEC	The Organisation of Petroleum Exporting Countries
OTC	Over the Counter
OTCEI	The OTC Exchange of India Ltd.
P/E Ratio	Price to Earnings Ratio

PAT	Profit After Tax
PBT	Profit Before Tax
PCD	Partly Convertible Debenture
PE	Private Equity
PIO	Person of Indian Origin
PIPE	Private investment in Public Equity
PLR	Prime Lending Rate
Preferential Offer Regulations	Chapter VII of the ICDR Regulations
PSE	Public Sector Enterprise
PSU	Public Sector Undertaking
PSU Bond	Bond issued by a PSU
PTC	Pass through certificate (also known as security receipt)
PWC	Price Waterhouse Coopers
QIB	Qualified Institutional Buyer
RBI	The Reserve Bank of India
REIT	Real Estate Investment Trust
RHP	Red Herring Prospectus
ROC	Registrar of Companies
ROCE	Return on Capital Employed
RONW	Return on Networth
SBI	The State Bank of India
SBU	Strategic Business Unit
SCR Rules	Securities Contracts (Regulation) Rules, 1957
SCRA	The Securities Contracts (Regulation) Act, 1956
SEBI	The Securities and Exchange Board of India
SEBI Act	The Securities and Exchange Board Act, 1992
SEC	Securities and Exchange Commission, USA
Securitisation Act	Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act 2002
SFC	State Financial Corporation
SFI	State Financial Institution
SHCI	Stock Holding Corporation of India Ltd.
SIA	Secretariat for Industrial Assistance
SICA	Sick Industrial Companies (Special Provisions) Act, 1985 (since repealed)
SIDBI	The Small Industries Development Bank of India
SIDC	State Industrial Development Corporation
SIPO	Secondary IPO (IPO through Offer for Sale)

SLR	Statutory Liquidity Ratio
SLR Bond	Bonds qualifying for SLR requirements
SME Segment	Small and Medium Enterprise Segment
SPN	Secured Premium Note
SPO	Secondary Public Offer (Offer for Sale)
SPV	Special Purpose Vehicle
SSI	Small Scale Industry
STA	Share Transfer Agent
Takeover Code	Securities Exchange Board of India (Substantial Acquisition of Shares and Takeovers) Regulations, 2011
TARP	Troubled Assets Relief Program
TBTF	Too Big to Fail
TCS	Tata Consultancy Services Ltd.
TELCO	Tate Electric and Locomotive Company Ltd. (Presently Tata Motors Ltd.)
TISCO	Tata Iron and Steel Company Ltd. (Presently Tata Steel)
TOMCO	Tata Oil Mills Co. Ltd (since merged with Hindustan Unilever Ltd.)
UB Group	United Breweries Group
UBS	Union Bank of Switzerland
UHNI	Ultra -High Net worth Investor
UKLA	UK Listing Authority
USA	United States of America
USD	US Dollar
UTI	Unit Trust of India
VC	Venture Capital
VCF	Venture Capital Fund
VCU	Venture Capital Undertaking
WACC	Weighted Average Cost of Capital
WDM	Wholesale Debt Market
YTM	Yield to Maturity
ZCB	Zero Interest Convertible Bond

Section 1

Securities Markets and Investment Banking

Overview of Securities Markets

1

LEARNING OUTCOMES

- This chapter explains the fundamentals of money supply, different connotations of fiat currency system—Monetary Base, M1 and M3, Money multiplier, credit creation, etc.
- Importance of generation of capital in an economic system.
- Institutional intermediation in capital flows—banking system and financial markets.
- Broad divisions in financial markets.
- Constituents and segments of the Securities Markets in general and Capital Market in particular.
- Regulatory framework for Securities Markets—main securities laws and role of different regulators under respective law.

1.1 Introduction

The economy of a country functions on the fundamental mechanism of savings and investment of financial capital into economic activities that help in the creation of economic wealth. Economic wealth in turn creates conducive atmosphere for consumption that creates economic demand for goods and services thereby stimulating production, employment and further investment. Therefore, this continuous economic cycle leads to growth in the economy which is usually measured by the gross domestic product (GDP). Economic growth when channelised optimally leads to economic development which is measured by the standard of living of the people and other parameters such as the availability of developed capital and money markets, the exchange value of the country's domestic currency and the level of infrastructural development to sustain economic activity.

1.2 Money Supply

One would always find it intriguing to know how money comes into existence and how it grows. It is common knowledge that money supply has been increasing over the centuries of human existence due to increased requirement. The population of the world has kept increasing and needs more money to transact. The Industrial Revolution brought permanent shifts to world economies. Trade and commerce grew tremendously within and between countries. People prospered through more opportunities to earn money and more of it. If we were to consider the explosive growth of earnings and profits happening all around the world, it's not hard to imagine that all this growth would have required a huge growth in money supply as well. In reality, money does tend to grow in time and it is not a zero sum game like the stock market. One person's gain in an economy need not be another person's loss. If so, the economy will never grow and prosper as a whole. It is possible for everyone in an economy to indulge in activities that accrue them money by way of earnings or profits.

The starting point to learn about money supply is to go back to the era of coins followed by paper notes backed by gold (known as the *gold standard*). Under this standard, since money was expressed as paper currency backed by gold there was always a physical limitation to how many notes could be printed and issued to the public in a country depending upon its gold reserves. The gold standard worked pretty well till the World War I for about 75 years. Thereafter, in the process of urgent rebuilding of their war ravaged economies, countries printed excessive paper currencies. Due to the war, the military expenditure of many countries had also soared exacerbating currency printing. These excesses made people lose faith in the paper currency that they were holding and they began to demand gold in exchange. Soon, governments of various countries realised that they could no longer convert their currencies into gold. At the Bretton Woods Conference in 1945, the gold standard was officially abandoned by industrialised nations after the US agreed to keep the gold standard alive. The US Dollar was pegged to gold at a fixed rate per troy ounce and a guarantee to redeem US dollars for gold was provided by the US government. Eventually, the US too abandoned the gold standard in 1973 after the second oil crisis making the US dollar the last currency in the world to become a *fiat currency*.

A 'fiat currency' is money by law and not because of its preciousness. One of the requirements for implementing fiat currency is that the government (read monetary authority) of the land should have the exclusive power to print it. By the beginning of the 20th century, this was made possible and most countries effectively had moved to fiat currencies. The US government's discontinuance of its dollar convertibility into gold brought the curtains down on the gold standard because by then all countries had predominantly switched over to fiat currencies. The ₹ is the fiat currency of India. The RBI (India's monetary authority) has the exclusive right to print currency notes in India under the Reserve Bank of India Act 1934.

1.2.1 Money Supply under Fiat Currency

Money supply in every country grows year-on-year in line with its GDP growth and other factors. According to World Bank estimates[1] in 2015, global money supply was 125% of global GDP and India's money supply was 79% of its GDP. Money grows when the RBI introduces new money through currency printing or by increasing the reserves held by banks in its books. Collectively, the sum of the currency in circulation and the reserves held by banks with RBI constitute *Reserve Money* in RBI's parlance. Generally speaking, this money is known as *Base Money* or *Monetary Base* in an economy and is denoted by *MB* or *M1*. It is also known as *Narrow Money*.

The creation of money by the monetary authority either by printing currency or through the process of increasing liquidity with book entries as described above is called *monetisation*. Such increase in reserves is possible by a process known as *repo trade* under which the RBI purchases government securities held by banks and increases their reserves in its books. This increase results in additional money supply and consequent liquidity for banks. This process can also be reversed through 'reverse repo trading' whereby M1

[1]http://data.worldbank.org

is contracted to reduce money supply. As per latest available data, about 76% of M1 consisted of currency notes and the rest was reserves held by banks. The currencies of most countries are represented only in part through physical currency notes. For instance, according to the US Federal Reserve, the dollar bills in circulation in 2016 were of the order of $1.48 trillion which represented 44% of its M1.

The second aspect of money supply is known as *Broad Money or M3* which is created due to *credit creation* or pushing of loans by banks. Through payments made and loans advanced by the bank to its customers, this additional money enters the economy and adds to money supply. This process is called *monetary transmission*. However, unlike the money created by the RBI which is *new money*, the money supply generated by banks is by rotating *existing money*, i.e. banks do not have the statutory power to 'manufacture money' like the RBI. Nonetheless, money rotated is money supplied because as money keeps changing hands, it becomes a resource for the next person. This phenomenon is called the *multiplier effect*. A higher money multiplier for a given period denotes that money has rotated faster reflecting the buoyant mood of the people to indulge in economic activity. It is usually observed that when the economic confidence of the people is low, the money multiplier also tends to be low because people are scared to part with their money not knowing whether they would be in a position to earn it back. Banks may also be hesitant to lend money in such times not knowing if the money would return to them. It can be said that a good way of measuring economic confidence in the system is to look at the money multiplier. It is typical of high growth economies to show a higher money multiplier.

The causal relationship between reserve money and money supply through the money multiplier was explained by Irving Fisher in 1911 through the following equation:

$$M \times V = P \times Q$$

where,

M stands for money supply (read reserve money)
V stands for money multiplier (also known as *velocity of money*)
P stands for price of goods and services
Q stands for quantity of such goods and services supplied

The total on the left-hand side ($M \times V$) is M3 or *Broad Money*. India's broad money stood at ₹161.6 trillion in late 2016 as per the RBI estimates on a M1 of ₹8.81 trillion.

The third major source of money supply is through foreign capital coming into a particular country by way of FDI, FPI, ECBs, banking remittances, private savings deposits and multilateral credit from financial institutions. Foreign capital adds to domestic money supply since the foreign currency money has to be converted into local currency by Indian banks. In order to provide liquidity to banks to keep making such conversion, RBI would buy foreign currency from banks from time to time by increasing their reserves. Therefore, it can be said that foreign capital adds to the reserve money or M1. In other words, higher the foreign capital received, higher would be the domestic money supply and consequent liquidity in the economy.

Just as we are moving towards paperless offices, paperless financial securities and legal documents, the system of money is also progressing towards paperless money by reducing the usage of physical cash. In 2012, it was reported that Sweden had just 3% of its money represented in physical currency. In 2016, while USA had a cash-M1 Ratio of 44% (*ibid*), India's cash-M1 ratio was 76%.

1.2.2 Influence of Money Supply on the Economy

Since economic activity is fuelled by Broad Money supply, it has a profound influence on the level of economic activity at any given time. If there is too much money chasing too few goods and services, it would result in *inflation*, i.e. erosion in the value of money due to increase in prices. If there are too many goods and services on offer and too less money to buy them, it results in fall in their prices which will consequently breakdown the supply mechanism. Therefore, it is a national priority for the government and the monetary authority of a country to ensure a reasonable balance by targeting inflation in a given permissible range so as to spur economic growth without causing too much inflation and mis-allocation of resources that can cause asset bubbles.

However, this is easier said than done. Imagine controlling Broad Money supply which is a product of M1 and the money multiplier. If the money multiplier does not keep up to the desired level of GDP growth, it would result in slackening of growth. Similarly, if there is a broader over-heated economy, it would result in a price spiral that can go out of hand. As is normally the case, increase in M3 does not necessarily mean an increase in M1. The velocity of money determines to what extent a particular level of M1 can result in M3. There is probably no theoretical finding to suggest what can be an ideal level of M1 for a given country. Monetary authorities usually work on a targeted money supply based on the expected money multiplier and existing inflation rate. It would suffice here to say that while M1 is under the control of the monetary authority, money multiplier is not. Historically, India's money multiplier has been much higher than that of developed economies and was estimated at 5.8 in 2015 by Bloomberg.

The steps that a central bank takes on a continuous basis to calibrate money supply are collectively known as *monetary policy*. There are several quantitative techniques adopted under a monetary policy including setting of interest rates, fractional reserves such as SLR and CRR and open market operations in repos and reverse repos. In extra-ordinary circumstances, the central bank may also resort to *quantitative easing* which was adopted by the central banks of USA, UK and EU post the financial crisis in 2008. Correspondingly, the government should also ensure that the supply side of the economy is managed well through government spending, policy making for private investment and infrastructure development. The gamut of measures taken by the government to raise its resources through taxes and public debt and to determine the spending thereof are collectively known as the *fiscal policy*. Monetary and fiscal policies have to go in tandem to stimulate economic activity and its growth and to ensure that the fruits of such growth result in all round well-being.

1.2.3 Effect of Monetary and Fiscal Policy on Business

Monetary and fiscal policies have significant bearing on business outcome and to spur new investments in the economy. Two important macro-economic determinants for business are interest rate and inflation rate. Together they determine the financial cost of a business and the country's exchange rate. Interest rate risk and exchange risk are two major financial risks for a business. If interest rate moves up, it reduces bond yields and increases the cost of new borrowings. It can have a slow-down effect on further borrowings by businesses and consequent impact on their financial profile and overall productivity. New investments are also impacted by interest rates to a significant extent and financial viability becomes more difficult.

Business competitiveness is largely impacted by interest rates and exchange rates. Businesses that are import dependent are sensitive to depreciation in exchange rate. The converse is true of businesses that are export oriented. Similarly, businesses that have a big chunk of external borrowings are impacted adversely by exchange depreciation. Equity returns from business investments are also impacted by interest rate and exchange rate movements.

The components of fiscal policy that have a large impact on business are taxation policy and public spending policy. If the government allocates a major spending on infrastructure and other industry improvements through suitable policy making, it boosts the growth of business and encourages new capital formation. It will also have a positive impact on financial markets which are a major source of business finance. Similarly, a favourable tax policy framework stimulates equity investments by improving the bottom line of business and consequent return on equity.

1.3 Generation of Capital

With the above backdrop of broad economic considerations in mind, it is necessary to understand the role of economic capital and its movement in the economy. Economic capital is created through savings out of incomes earned by all types of economic activity. If the savings rate in an economy is not commensurate with its investment requirements, it becomes dependent on external resources for its investment requirements. This kind of external dependence beyond a point could lead to burgeoning external debt and depreciation in the exchange rate of the domestic currency, fiscal deficit and other long-term economic maladies. Similarly, under the present fiat currency system of the world with floating exchanges rates, if the government of a country runs large deficit budgets consistently without the backing of sustained economic growth and attendant increase in taxes, such deficits can only be financed through additional borrowings, both internal and external. In the absence of sufficient economic growth and savings rate, such debt-push economic spending policies would also culminate in economic bankruptcy of the kind witnessed in the Euro Zone in 2010–11. Such sovereign bankruptcies require huge bail outs with long-term economic and social costs to be paid by tax payers from present and future generations. The case of Greece in 2011–12 and those of Argentina (2001), Mexico (1994) and Ireland (2010) are examples of sovereign debt crisis. Other countries in the Euro Zone such as Portugal, Spain and Italy face stress from high levels of sovereign debt, fiscal deficits and stunted economic growth which was the main concern for global financial stability and the future of the Euro Zone as a currency block post 2012. The financial crisis of 2008 that began in USA was also a result of excessive debt-push by banks and their corresponding securitised products by investment banks in the financial markets. The collapse of banking institutions in USA and its contagion effect in Iceland, UK and Europe led to massive bailouts through *quantitative easing* by the US Federal Reserve and other central banks.

1.3.1 Institutional Intermediation in Capital Flows

Just as it is important for an economy to have a healthy savings rate, it is equally important to move capital from savings pool in the economy to the investment pool where it is required for capital formation. In this context, it would be necessary to understand how such movement actually takes place. The need for institutional intermediation in movement of capital cannot be over-emphasised. Savings by themselves do not create economic wealth unless they are channelised into productive uses that create it. Therefore, two things are paramount for sustained economic activity: (i) adequate domestic savings in the economy and more importantly (ii) the movement of such capital saved to productive investments in the economy. The second aspect is extremely critical since real growth in an economy is achieved only if real investments are made leading to increased supply of goods and services. Institutional intervention in the economy not only channelises savings into investments, but helps in moving investments from financial assets into real assets as well. If capital moves only within the orbit of one mode of saving to another, i.e. within the domain of financial assets without reaching the real investment channels, the economy would register financial growth but the real economy could suffer.

Further, perhaps the biggest contribution of institutional intervention in the economy is in the allocation of available capital. This function is also of vital importance since the available capital may not be sufficient to meet all the envisaged investment requirements. By rationing capital to the most efficient productive uses, these intermediaries help in optimising scarce and valuable economic capital. However, the extent to which institutional intervention can mobilise and allocate capital would depend upon the depth of the financial markets in the economy and the presence of a congenial legal and regulatory backbone to support such sophistication.

The movement of capital in the economy from the savings pool to the investment pool is performed by two main platforms of institutional intervention: (i) the financial institution and banking framework and (ii) the financial market framework. Commercial banks mobilise funds by raising deposits from domestic investors as well as through other means and re-deploy these resources in the economy through loans and advances to borrowers. Therefore, it can be said that banks perform the role of intermediation primarily through mobilisation and deployment of debt capital in the economy. However, banks confine themselves largely to the sourcing and deployment of short and medium-term debt capital. On the other hand, financial institutions perform the role of mobilising and deploying long-term capital through long-term resource mobilisation and term lending. In the Indian context, financial institutions perform a variety of roles such as direct term lending to business sector, housing finance, insurance and investments and also act as refinancing institutions to banks that are engaged in direct lending. According to the RBI[2], the total non-food credit resources in the economy stood at ₹14.81 trillion as at the end of March 2016 of which the contribution by the banking system was ₹7.75 trillion accounting for 52% of the total supply of credit capital.

The financial markets come into the picture to perform the other role, i.e. the primary role of a facilitator and an intermediary in raising capital and deployment thereof through the issue of financial securities. Financial markets bring the issuers of such instruments and the investors on a common platform to raise capital for productive deployment in creating economic wealth. At the same time, financial markets also offers investment avenues to investors for investments in investment options with a higher risk profile as compared to those with banks. From an issuer's perspective, the financial markets provide an alternative source of raising business capital through issue of equity and debt instruments. The financial markets consist of different segments and a variety of players who either perform the role of intermediation or facilitate such process by acting as support service providers.

The capital flows in an economy and institutional intervention therein are depicted in Exhibit 1.1.

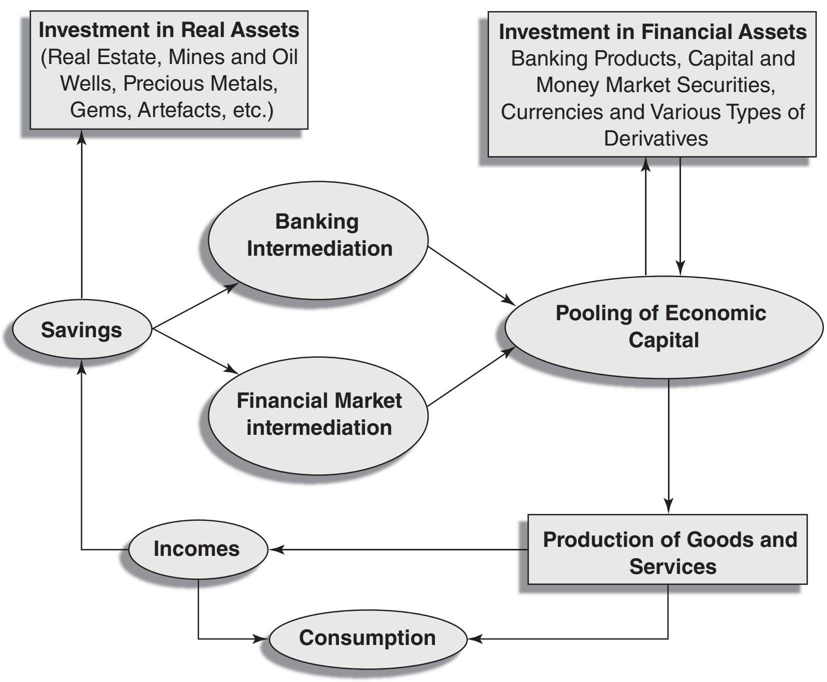


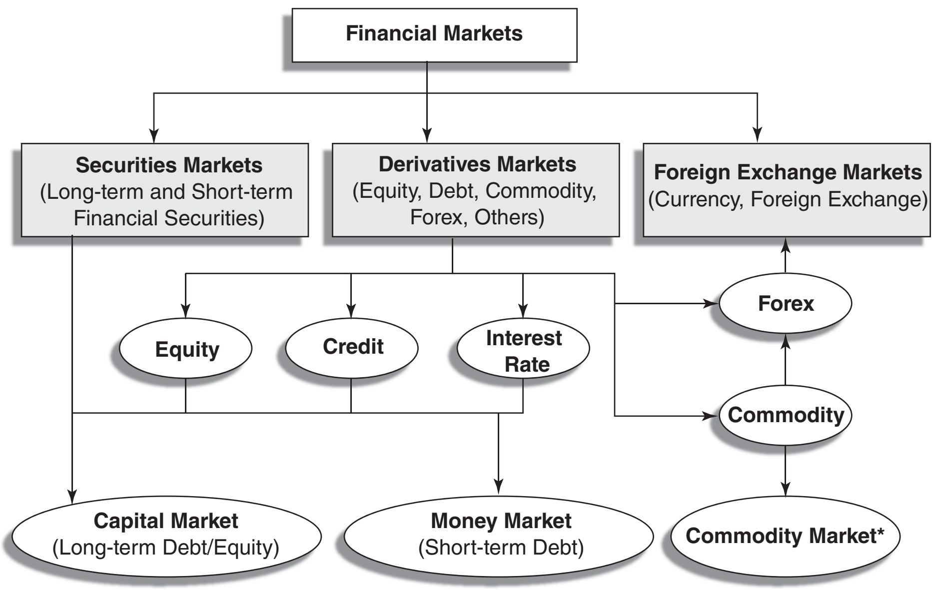
Exhibit 1.1 Institutional Intermediation in Capital Flows

[2]Reserve Bank of India Annual Report 2016

1.4 Financial Markets

Having discussed the role of capital flows in an economy and the need for institutional intervention, it would be necessary to appreciate the segments that comprise financial markets. *Financial Markets* is a generic term used to describe the market place for all financial investment and trading products into which investors can deploy their savings and capital. According to Business Insider, the global market for financial assets was estimated at close to US$ 230 trillion in 2015. If the size of the global derivative market estimated in 2015 by Financial Times at about US$ 550 trillion and the global foreign exchange market estimated by the Bank for International Settlements at just over US$ 5 trillion in early 2016 are added, the size of the global financial markets at the time would aggregate to about US$ 800 trillion. This amounted close to 11 times the global nominal GDP in 2015 as per World Bank estimates. These figures establish the importance of financial markets in the global economy as a platform for financial intermediation.

Broadly, financial markets may be classified as (i) Securities Market, (ii) Derivatives Market and (iii) Foreign Exchange Market. Securities market deals with long-term debt securities and equity/equity-linked instruments. Securities markets are further divided into (i) Capital Market, that deals with equity and long-term debt securities and (ii) Money Market that deals with short-term debt securities. These segments are depicted in Exhibit 1.2 and discussed in the following paragraphs.



*Note: Commodity market financial securities were integrated with financial markets in 2015 by unifying the regulatory functions of FMC with SEBI.

Exhibit 1.2 Overview of Financial Markets

1.5 Securities Markets

The word *security* as understood in the context of the securities market has a broad and inclusive definition which is contained in Section 2(h) of the SCRA 1956. According to it, *securities* are defined as follows:

- Shares, scrips, stocks, bonds, debentures, debenture stock or other marketable securities of a like nature in or of any incorporated company or other body corporate
- Derivative
- Units or any other instrument issued by any collective investment scheme to the investors in such schemes
- Security receipt as defined in clause (*zg*) of Section 2 of the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002
- Units or any other such instrument issued to the investors under any mutual fund scheme
- Any certificate or instrument (by whatever name called), issued to an investor by any issuer being a special purpose distinct entity which possesses any debt or receivable, including mortgage debt, assigned to such entity and acknowledging beneficial interest of such investor in such debt or receivable, including mortgage debt, as the case may be
- Government securities
- Such other instruments as may be declared by the Central Government to be securities
- Rights or interest in securities
- Commodity derivatives

From the above inclusive definition, it may be observed that a large variety of securities gets encapsulated into the ambit of the SCRA and therefore, there are sub-segments in the securities market specialising in particular types of securities. It may also be noted that the above definition covers both long-term and short-term securities and derivatives, but does not cover foreign currency assets. Therefore, foreign exchange markets are outside the purview of the word *securities* though they are a part of the wider *financial markets*. The sub-segments of the securities markets and the other components of the financial market, i.e. derivatives market and foreign exchange market as depicted in Exhibit 1.2 are discussed in the following paragraphs.

1.5.1 Capital Market

The *capital market* is a sub-segment of the securities market that deals with a variety of long-term debt and equity securities issued by companies (belonging to both private and public sectors), other bodies corporate and the government. The capital market consists of both the raising of capital by issuers through issue of various types of securities and the subsequent trading thereof between traders and investors. The trading of securities happens through an institutional mechanism called a *'stock exchange'* wherein securities are bought and sold publicly. Notwithstanding the clear roles played by banks in debt intermediation in the economy, the capital market also offers wide scope for raising long-term debt capital through issue of debt securities. This kind of debt capital being in the nature of tradable securities is more flexible both from an investor and an issuer's perspective. Therefore, the capital market also becomes an agency of bank disintermediation, in that it not only brings investors and issuers together on an alternative platform; it also helps in the movement of debt capital, a function that is primarily the domain of banks and financial institutions. However, banks and financial institutions on one hand and the capital market, on the other, continue to co-exist and perform their respective functions as it is not possible for each of them to completely substitute the other in taking care of the needs of the economy. However, considering the fact that the capital market has a wider role to play beyond merely being a catalyst for capital creation, a developed and vibrant capital market is the backbone of a healthy economy. However, capital market being an institution run on market mechanism does have its times of turbulence as well. Historically speaking, capital markets have seen great crashes as in 1927, 1987, 1991, 1997, 2001 and 2008 wiping out each time billions of dollars of investors' wealth.

Securities once issued into the market can be traded broadly in two ways (i) Over the Counter (OTC) deals and (ii) through a trading and settlement system administered by a stock exchange or other authorised institutional trading mechanism. All the spot trades where securities are traded for immediate delivery and payment take place in the OTC market. OTC trades are settled bilaterally and therefore, carry counter party risk. Stock exchange trading addresses counterparty risk as well as settlement mechanism in an efficient market based system. Therefore, over the years, OTC trading has largely been confined to institutional players in bulk quantities in the debt and money market segments. OTC trading becomes necessary when securities are not listed for trading on stock exchanges. This happens in the case of securities that are issued in *private placement* as distinguished from a *public issue*. OTC trading also becomes necessary for securities that are not homogenous like exchange traded instruments. Over the years, SEBI has brought in equity transactions in listed stocks to be compulsorily traded on stock exchanges including large deals among institutional investors. Similarly, SEBI has allowed even privately placed securities to be listed on a stock exchange so as to enable trading on stock exchange platforms. It may be understood that with the gradual development of capital market infrastructure and technological sophistication, trading shifts towards stock exchange based trading and OTC trading gets confined to trading in securities that are not eligible to be listed on a stock exchange or are more in the nature of bilateral agreements (such as loan swaps). Therefore, it is found that OTC trading mechanism largely exists in the *money market* while the capital market has become largely a stock exchange oriented system. Most transactions in OTC market are placed through brokers. Buyers and sellers confirm transactions through phone and fax, after the deal is made. This system is widely prevalent in inter-bank deals, money market deals in government securities and bilateral FOREX transactions. Sometimes, this system is also used in the initial deal making for large deals in capital market. For example, if an institutional investor wishes to sell through a *block deal* a large chunk of shares of a company, a broker may be used to find a buyer and after the deal is finalised, it would be put through the stock exchange mechanism. From a systemic perspective, stock exchange based trading is more desirable as it adds depth, liquidity and transparency to the securities market and obviates counterparty risk.

1.5.2 Money Market

The other sub-segment of the securities market is the *money market*, which is the marketplace for short-term debt capital issued both by the government and various corporate entities including government owned entities (PSUs). However, the money market is significantly different from the capital market. In this market, the government, banks and corporate issuers raise short-term capital either through issue of short-term securities or through short-term borrowings. Typically, short-term instruments in the Indian context have a life not exceeding twelve months. The money market is also supported by several investment institutions that mobilise funds from investors to be deployed in this market.

In India, the money market is characterised largely by institutional players such as banks, financial institutions, investment institutions, insurance companies, mutual funds and the Discount and Finance House of India (DFHI). It is also supported by the network of Primary Dealers who are active in the money market apart from the g-sec market. The DFHI is a specialised institution set up by the RBI in 1988 with the support of financial institutions and banks to provide depth in the primary and secondary segments of the money market. Unlike the capital market, the money market does not have an organised trading market place such as the stock exchange for its primary issues and secondary market trades (primary and secondary segments of the capital market are explained in subsequent discussions). The primary issues are subscribed by the market players through private placement and as far as the government treasury bills are concerned, these are auctioned by the RBI periodically. The secondary market functions mostly through the OTC market backed by intermediation from primary dealers. The RBI is the regulatory authority for the money market. The RBI set up several committees such as the Sukhamoy Chakraborty Committee in 1985 and the Vaghul Committee in 1987 to revamp the money market. As a fall out of their recommendations, the money market has been spared of controls on interest rates and several instruments such as the 182-day treasury bills (1986), certificates of deposit, commercial paper and inter-bank participation certificates (1989) and 364 day treasury bills were introduced. In 1992, the RBI permitted mutual funds into this market by allowing them to float dedicated money market funds.

It may, however, be noted that the term *money market* is confined only to the financial market for short-term debt products such as treasury bills (T-Bills) of the government of maturities up to 364 days, inter-bank short-term issuances such as overnight call/notice money and inter-bank certificates of deposit (CDs), repurchase options or *repos* and *reverse repos* operated by the RBI, *ready forward* deals in government securities between permitted players and short-term corporate securities known as *commercial paper*. In order to deepen the market, the RBI introduced ready forward transactions in corporate bonds.[3] These transactions have to be reported on the FIMMDA platform within 15 minutes of each trade.

The operations of the money market are largely influenced by the monetary management policies of the RBI from time to time which affect the liquidity in the system. The RBI conducts its *Open Market Operations* or OMO operations to inject or suck out liquidity from the financial system under a scheme known as the *Liquidity Adjustment Facility* introduced in 2001. In addition, the RBI resorts to the issue of government securities under the *Market Stabilisation Scheme* which is meant to suck out excess liquidity from the domestic economy due to increased foreign fund inflows. The OMO operations of RBI are conducted by purchase of securities, known as *repo* operations by which liquidity is injected into the system. Similarly, RBI absorbs liquidity from the system by conducting *reverse repo* operations whereby securities are auctioned and liquidity is reduced. The repo and reverse repo operations are conducted at interest rates that are regulated by the RBI from time to time under its monetary policy depending upon the state of liquidity in the economy. Over the years, the *bank rate* has been replaced by the *repo rate* and the *reverse repo rate* as tools for quantitative monetary policy management. The repo rate and the reverse repo rate are calibrated periodically by the RBI either as part of its credit policy announcements or even in between two such announcements. These rates would have a cascading effect on other interest rates in the system and the consequent impact on stock of money would temper inflation rate. The RBI also introduced an additional window called the *Marginal Standing Facility* to allow scheduled commercial banks to borrow overnight at their discretion, up to 1 percent of their respective net demand and time liabilities.

The money market also has deals known as *ready forward* deals which are transactions between market players in government securities. A ready forward is essentially a short-term (typically 15 days) financing arrangement by a bank or primary dealer to another such participant. The borrowing bank or primary dealer availing the financing sells securities to the lending bank and buys them back at the end of the period of the loan, typically at a slightly higher price to provide for the interest cost on the funds availed. Under prevailing RBI directions, ready forward transactions (and reverse ready forwards) in money market can be conducted on dated central government securities, treasury bills and dated state government securities through the SGL / CGSL account mechanism with settlement through the CCIL. No person is allowed to enter into a transaction without actually holding the securities in the portfolio.

Commercial paper is a money market instrument that is issued for the short term to finance working capital requirements of corporates. Originally, introduced in 1989 by the RBI pursuant to the recommendations of the Vaghul Committee, commercial paper guidelines went through several stages of liberalisation thereafter.

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[3]Repo in Corporate Debt Securities (Reserve Bank) Directions, 2010 and Notification dated January 08, 2010 bearing No. IDMD. DOD.04/11.08.38/2009-10 under Section 45W of the Reserve Bank of India Act 1934. A separate notification under Section 16 of the SCRA was also issued enabling such transactions to be legal within the ambit of the SCRA. *Brief Legislative Background*—In terms of Notification No.S.O.2561 dated 27th June 1969 issued by Government of India under Section 16 of the SCRA all forward contracts in securities had been banned excepting ready forward transactions specifically exempted by the Government. Government of India since rescinded the 1969 notification and delegated powers to the RBI under Section 16 of the SCRA for regulating contracts in government securities, money market securities, gold related securities and derivatives based on these securities.

The role that CPs are supposed to play in the financial market is to balance and rationalise corporate demand for short-term funds between banks and other short-term investors in the money market by making CPs a cheaper option of financing. However, since CPs are inherently substitutes for bank financing, in order to prevent a flight of corporate to the CP market, the RBI ensures that there are entry barriers and secondly, banks are allowed to invest in CPs themselves. There are also fee income opportunities for banks in CP issuances by companies. Though aimed at disintermediation of banks, historically, banks have been the largest investors in commercial paper globally. Apart from banks, primary dealers, investment banks, NBFCs, financial institutions such as the DFHI, mutual funds, insurance companies and FIIs are also large investors and market makers in CPs. Apart from non-financial companies, financial institutions and primary dealers are also allowed to issue CPs to fund their short-term capital requirements.

SEBI regulated entities were required to report their OTC trades in CPs and *Certificates of Deposit* (CDs) on the FIMMDA platform until March 2012. With effect from April 2012, all such OTC trades shall be reported through National Securities Clearing Corporation Limited (NSCCL) and Indian Clearing Corporation Limited (ICCL).

Benchmark Market Rate

Though the RBI allowed the market to evolve a benchmark reference rate, over the years the most widely used benchmark reference rate is the MIBOR disseminated by the NSE since 1998 and has been most widely accepted benchmark rate. It is also known as the FIMMDA-NSE-MIBOR/MIBID. The MIBOR is an overnight rate used widely for IRS and FRA transactions.[4] The NSE also publishes the 14-day, 1-month and 3-month MIBOR though these are thinly used. In the words of the Late Dr. R.H. Patil[5], *"despite availability of MIBID/MIBOR for periods up to 90 days since 1999 the market has not witnessed a term money market at which funds are actually lent even on a modest scale. The main reason is that market does not consider these rates as not being dependable for entering into actual transactions but more speculative/indicative in nature."* Since a term rate market does not exist in India, the traders find it difficult to provide any quotes for term rates. In recent years, efforts have been made by the CCIL to introduce other reference rates in the money market such as the CCIL-MIBOR/MIBID and CCBOR/CCBID. The FIMMDA has also been working on the need for an alternative to the MIBOR. It has been argued by several experts that a CBLO based term rate for lending and borrowing is to be developed for term products in the money market.

1.6 Derivatives Markets[6]

Derivatives are credited for the enormous explosion of global financial markets in the late 1980s, 1990s and in the new millennium. In the words of the former Chairman of the US Federal Reserve Mr. Alan Greenspan (who was also one of the steadfast champions of deregulation of financial markets in the USA), *"derivatives have been an extraordinarily useful vehicle to transfer risk from those who shouldn't be taking it to those who are willing to and are capable of doing so ....The vast increase in the size of the OTC derivatives markets is the result of the market finding them a very useful vehicle."* The OTC derivative market which was practically non-existent in 1980 became a revolution that would drive the shape of things to come until the

[4]Refer to Chapter 4 for discussions on IRS and FRA

[5]Derivatives Market in India 2003 – article by Late Dr. R.H.Patil, former CMD, NSE Mumbai.

[6]The purpose of this discussion is to provide the reader with a general appreciation of the derivatives markets within the overall architecture of securities markets. Additional discussion on derivative contracts and market segments is furnished in Chapter 4. However, readers may note that discussions on derivative theory, models and their application, derivative trading and portfolio strategies are outside the scope of this book.

financial crisis in 2008 exposed the systemic risks of excesses in OTC derivative markets in the USA. Indian derivative market is relatively small since most OTC derivatives are allowed only for hedging purposes and it is only in the exchange traded segment that speculative positions are allowed. This is quite in contrast to international derivative markets which are mainly driven by speculative interest. The global derivative market was estimated at US$ 550 trillion in 2015 according to a report by the Financial Times, of which the US market had the largest share.

1.7 Foreign Exchange Market[7]

Foreign exchange markets comprise of banks and foreign exchange dealers who buy and sell foreign exchange and their derivatives in various currencies including the home currency. Foreign exchange markets are also closely linked to economic variables and can be much more volatile than capital markets. An adverse movement in the economy can affect the foreign exchange markets and vice versa. The South-East Asian crash in 1997 in the currencies of countries such as Thailand, Malaysia, Indonesia, Hong Kong, Taiwan and Korea bled their economies to near bankruptcy. The Euro Zone crisis of 2011 was precipitated due to years of low economic growth in the backdrop of high spending by respective governments which ballooned their fiscal deficits and had a consequent impact on the stability and future of euro currency. Foreign exchange markets are closely dependent on balance of payments, net foreign exchange flow from FDI and other economic factors. The daily currency movements are dictated by market expectations and demand versus supply of the ₹ vis-a-vis its basket of currencies. The main players in the foreign exchange market are Indian banks, foreign banks in India and foreign branches of domestic banks. Foreign exchange market is largely OTC driven wherein one of the counter parties has to be an authorised dealer under RBI regulations. However, exchange driven foreign exchange products became quite popular in recent times with their introduction on NSE and MCX-SX. The global foreign exchange market was estimated to have an average daily trading of US$ 5.10 trillion as of 2016.

1.8 Summary of Discussion on Financial and Securities Markets

In conclusion, it is clear that there are two parallel segments in the economy, i.e. the real economy consisting of demand and supply of goods and services and the financial economy consisting of demand for financial assets and supply thereof. Institutional intervention performs the dual function of (i) mobilising savings to be converted into financial assets in the financial economy and (ii) allowing capital flows from the financial economy into the real economy so as to provide economic growth. The financial market is the more important means of institutional intervention that has grown phenomenally over the centuries and has helped the cause of economic growth and development of several countries. At the same time, with the evolution of sophistication and depth in the financial economy and the development of regulatory framework to protect investors, financial markets across the world have become mature marketplaces wherein several sophisticated instruments including risk-hedged derivatives are traded day after day with the volumes of trades amounting to billions of dollars. The capital market is arguably the most important segment of financial markets. With increased globalisation and cross border capital flows, capital markets across the globe are more integrated

[7]The purpose of this discussion is to provide the reader with a general appreciation of the foreign exchange market within the overall architecture of financial markets. More discussion on exchange traded forex derivative products is provided in Chapter 4. However, readers may note that discussions on foreign exchange theory, derivative products and their business application are outside the scope of this book.

today than ever before. The flip side of such integration is market excesses in terms of leverage and toxic asset build up coupled with what is known as the *contagion effect* as seen in the global financial crisis of 2008. Notwithstanding such hiccups from time to time, financial markets are the temples of capitalist economies within which the capital market has also grown in stature to become one of the important barometers in assessment of the economic development of a country.

To summarise the discussion on financial markets, i.e. securities market (capital market and money market), derivatives market and foreign exchange market are depicted in Exhibit 1.3 based on the broad categories of products dealt with both on OTC market and on stock exchanges.

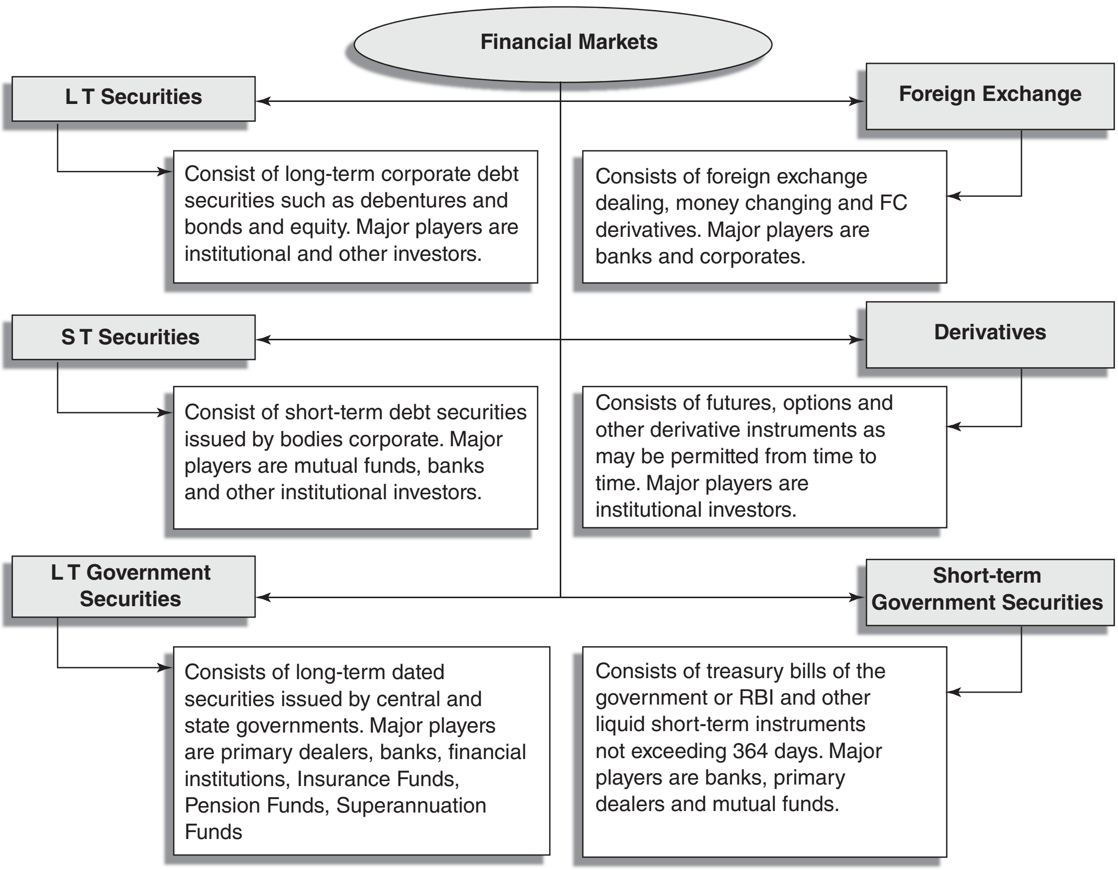

Exhibit 1.3 Activities in Financial Markets

1.9 Regulatory Framework for Securities Market

1.9.1 Overview of Securities Laws

The discussion in this chapter rests around the relevant provisions of corporate law relating to issue of securities and matters incidental thereto. Discussion on securities laws relating to secondary market operations is outside the scope of this book. However, a discussion on the regulatory framework concerning various service providers and investors in the capital market has been furnished at relevant places in the book. In addition, to begin with, an overview of these important legislations in corporate and securities law is provided in the following paragraphs so as to enable the reader to have an understanding of the scheme of these legislations. A discussion on the different regulators and their jurisdictions is also furnished in this chapter.

The securities laws framework in India consists of the Securities Contracts (Regulation) Act, 1956, The Securities and Exchange Board of India Act 1992 and The Depositories Act, 1996 and select provisions of the Companies Act, 2013 dealing with securities and issues. Besides the above, relevant provisions of the Foreign Exchange Management Act 1999 and the Income Tax Act 1961 also apply to securities. The securities business is also affected by the provisions of the stamp law, both under the central stamp law (the Indian Stamp Act 1899) and the relevant state legislations. Lastly, the relevant provisions of the Benami Transactions (Prohibition) Act 1988 and the Prevention of Money Laundering Act 2002 also influence certain types of transactions in securities.

The Companies Act 2013 concerns itself with the basic framework of law pertaining to the working of companies all other attendant matters. The provisions of this Act in so far as they are relevant to the capital market are listed in Table 1.1.

Table 1.1 The Companies Act, 2013

Chapter / Section No.	*Matters addressed*
Chapter II	Constitution and Incorporation of companies and matters connected therewith
Chapter III Part A Sec 23 - 41	Prospectus and allotment of securities through public offers in domestic and overseas markets
Chapter III Part B Sec 42	Law relating to private placement of securities
Chapter IV Sec 43 -72	Law relating to shares and debentures
Chapter VI Sec 77 - 87	Registration of charges
Chapter VII Several Sections	Matters relating to members, register of members, meetings, resolutions, voting rights etc.
Chapter VIII Sec 123 - 127	Dividends, rights, bonus issues, etc.
Chapter XII Sec 180	Restrictions on the borrowing powers of the Board
Chapter XII Sec 186	Inter-corporate loans and investments
Chapter XII Sec 230 - 240	Compromises, schemes of arrangement, mergers and amalgamation of companies

The preamble of the SCRA states that it is *an Act to prevent undesirable transactions in securities by regulating the business of dealing therein, by providing for certain other matters connected therewith*. The main provisions of this Act are listed in Table 1.2.

Table 1.2 The SCRA, 1956

Section No.	*Matters addressed*
Sec 2	Definitions of important terms such as 'contract', 'derivative', 'option in securities', 'securities', 'spot delivery contract' and 'stock exchange'
Sec 3–12	Recognition of stock exchanges and working of recognised stock exchanges
Sec 13–19	Contracts and options in securities
Sec 21–22F	Listing of securities by public companies

Transactions in securities markets in India are regulated inter alia, by the Securities Contracts Regulation Act 1956 and the SCRA Rules 1957 as amended from time to time. This Act applies to the whole of India and regulates all transactions in securities, whether they are performed through a stock exchange or otherwise except for *spot delivery* contracts which are exempted within the provisions of Section 18. Spot delivery contracts are those that are settled between a buyer and seller by delivery against cash.

The SEBI Act was passed in 1992 to bring into existence the SEBI and provide it with wide powers including the power of adjudication and making rules and regulations relating to the capital market, working of stock exchanges, intermediaries associated with the capital market and for investor protection. Since its inception, the SEBI has issued several directions under Section 11B and regulations under Section 30 of the SEBI Act for the orderly development of the capital market.

The Depositories Act was passed in 1996 to enable securities to be held and transacted in a scripless dematerialised form through book entries in electronic form. The advent of dematerialisation has revolutionised security trading on stock exchanges by removing several bottlenecks that existed with the system of holding securities in physical form. This Act also provides for the orderly development of the depository and participant business and regulates them suitably. This Act has also made consequential amendments to other laws such as the Companies Act, the Stamp Act and the Income Tax Act to enable creation, holding and trading in dematerialised securities.

The FEMA was enacted in 1999 as *an Act to consolidate and amend the law relating to foreign exchange with the objective of facilitating external trade and payments and for promoting the orderly development and maintenance of foreign exchange market in India*. Therefore, the main concern of the FEMA is preservation and proper utilisation of foreign exchange for which regulation is prescribed on transactions relating to foreign exchange. The provisions of FEMA in so far as they are relevant to the capital market are listed in Table 1.3.

Table 1.3 The Foreign Exchange Management Act 1999

Section No.	*Matters addressed*
Sec 2	Definition of 'security' and 'transfer'
Sec 6	Transactions on capital account pertaining to transfer or issue of securities, borrowing and lending in foreign exchange and issue or acceptance of guarantees
Sec 13–15	Contravention and penalties

The Income Tax Act prescribes tax liability on certain transactions relating to securities. These are listed in Table 1.4.

Table 1.4 The Income Tax Act, 1961

Relevant parts/Sections/Chapters	*Matters addressed*
Sec 10	Incomes exempt from tax
Part E of Chapter IV	Income from Capital gains
Part F of Chapter IV	Income from other sources
Chapter VIA	Deductions from total income
Chapter IX	Double taxation relief
Chapter XII	Determination of income in special cases such as long-term capital gains, foreign investors etc.
Chapter XIIA	Special provisions relating to non-residents
Chapter XIID / XIIE	Tax on dividends distributed by domestic companies
Chapter XIIF	Income received from venture capital funds
Chapter XA	General Anti-avoidance Rules (GAAR)
Part B of Chapter XVII	Deduction of tax at source

1.9.2 Overview of Regulatory Authorities

The regulatory authorities for the capital market in India directly or indirectly are the SEBI, the Ministry of Corporate Affairs and Department of Economic Affairs under the Ministry of Finance, Government of India, the RBI and to a certain extent, the Stock Exchanges.

The MCA

The Ministry of Corporate Affairs (MCA) is the main regulator for compliance under the Companies Act by all companies and for prescribing rules and regulations for all capital market transactions to be made by unlisted companies. Some of the main areas wherein the MCA administers compliance inter alia are with respect to incorporation of companies, annual reporting by companies, registration of charges, allotments and refunds, acceptance of deposits, maintenance of statutory books including the register of members and debenture holders, holding of shareholder meetings et al. The MCA has three tier organisational setup for administration of the Act, namely, the Secretariat at New Delhi, the Regional Directors at Mumbai, Kolkata, Chennai and Kanpur and the Registrar of Companies in States and Union Territories and the Official Liquidators attached to respective NCLTs. The central organisation at New Delhi also consists of the Company Law Board, which functions independently and adjudicates on matters of company law administration. The other related institutions to the MCA are the Competition Commission of India working under the Competition Act 2002 and the National Company Law Tribunal that became operational in 2016 to adjudicate upon corporate matters relating to processes such as winding up, mergers and acquisitions, restructuring which require judicial approval.

The DEA

The Department of Economic affairs, functioning under the Ministry of Finance, Government of India, has under it the capital market division which regulates capital markets and securities transactions. The various Acts administered by the DEA are the SEBI Act, the SCRA, the Depositories Act, the Unit Trust of India Act (now a specified undertaking) and Section 20 of the Indian Trusts Act (eligible investments that can be made by trusts). The capital market division has been entrusted primarily with the responsibility of formulation of suitable policies for the development of the capital market in consultation, inter-alia, with SEBI, RBI and other agencies. It acts as the secretariat for the high level co-ordination committee on financial and capital markets and deals with all organisational matters relating to SEBI, including appointment of the chairman and members of the SEBI board. Under the SEBI Act, 1992, the Ministry of Finance is represented on the SEBI Board. The Ministry of Finance is also represented on the primary and secondary market advisory committees of SEBI. Inputs on policy issues related to capital markets are provided through these channels as well. The powers under SCRA are concurrently exercisable by SEBI. The day-to-day regulation or monitoring of capital markets is the primary responsibility of SEBI. However, the Government interacts with SEBI and other agencies concerned on a regular basis, to oversee the developments with a view to taking action that may be required at the level of the Government. The DEA also issues necessary approvals under the FEMA, wherever applicable, for transactions relating to the capital market to be made by issuers or investors.

The SEBI

The SEBI is the primary regulator for the working of the capital market in terms of new issues, listing agreements with stock exchanges, trading mechanisms, investor protection and corporate disclosures by listed companies. It functions under a full time Chairman appointed by the Government of India, two members of the its Board appointed by one each by the Ministry of Finance and the Ministry of Law, one appointee of the RBI and two other appointees of the Government of India. The SEBI is headquartered in Mumbai and has regional offices in metro cities. The statutory power of SEBI to administer the securities markets is derived from Section 11(1) of the SEBI Act which provides as follows, "*Subject to the provisions of this Act, it shall be the duty of the Board (SEBI) to protect the interests of investors in securities and to promote the development of, and to regulate the securities market, by such measures as it thinks fit.*" Sub-section (2) lists out several specific areas for the exercise of SEBI's regulatory powers. SEBI also has powers to call for information, conduct enquiries and audits of stock exchanges and intermediaries and has the powers of a civil court in such proceedings for recording evidence and examination of witnesses under oath.

The functions and powers of SEBI are prescribed under Sections 11 and 11A of the SEBI Act. Section 11 provides that *it shall be the duty of the Board to protect the interests of investors in securities and to promote the development of, and to regulate the securities market, by such measures as it thinks fit*. Over the years, the SEBI has contributed significantly to the orderly growth and development of the capital market.

SEBI's Strategic Action Plan (STA) identified four key spheres and has set strategic aims for each of the spheres as shown in Table 1.5.

Table 1.5 SEBI's Strategic Action Plan

Key sphere	*Strategic aim*
Investors	Investors are enabled to make informed choices and decisions and achieve fair dealings in their financial dealings.
Firms (Corporates)	Regulated firms and their senior management understand and meet their regulatory obligations.
Financial Markets (Exchanges, Intermediaries)	Consumers and other participants have confidence that markets are efficient, orderly and clean.
Regulatory regime	An appropriate, proportionate and effective regulatory regime is established in which all the stakeholders have confidence.

Source: SEBI Annual Report 2002–2003.

In 2003, SEBI also contemplated the institution of a Central Listing Authority as a new regulatory body for the primary market by delegating its own functions with respect to vetting of offer documents for public offerings and functions connected therewith. This move was in line with the model of the UK Listing Authority (UKLA). However, the proposal did not find favour with the Government and was dropped.

The RBI

The Reserve Bank of India is the banking and money market regulator of the country and is not the capital market regulator, which function is that of SEBI. However, it has an indirect influence on the capital market as well. The following are the broad areas wherein the policy regulations of RBI can affect the securities market.

- The RBI regulates the activities of banks and financial institution and other financial intermediaries in regulating their exposure to capital market instruments more particularly, equity related instruments and corporate debt.
- The RBI fixes norms for regulating the flow of funds from the banking system to the securities market. More particularly, it regulates the flow of funds from banks and financial institutions into the equity market through financing against shares and other securities, provision of working capital to stock brokers, market makers and for other stock market activities.
- The RBI determines the treasury operations of banks and other financial intermediaries by stipulating fund management and valuation norms for their investments in the securities market.
- The RBI regulates the capital flows in the money market as part of its monetary policy to regulate the liquidity in the financial system. This is done through the system of repurchase options or *repos* and *reverse repos* whereby the liquidity in the financial system is regulated by the RBI. The RBI conducts the borrowing programmes of the Government of India in the long-term debt market and the money market.
- The RBI determines the repo and reverse repo rates, which are presently the basic interest rates in the economy at which the RBI lends or borrows from banks. These rates have a bearing on other interest rates in the economy including the rates at which capital market and money market instruments are traded.
- The RBI is the regulatory authority that supervises the compliance with the FEMA as per the jurisdiction given to it under that Act. One of the main areas of such regulation that affects the working of the securities market is the flow of foreign funds. The RBI fixes norms and guidelines and also grants administrative approvals for foreign investors to invest in Indian securities markets. While the SEBI has been given the powers to frame investment guidelines for certain categories of foreign investors in the capital market that would be registered with SEBI, the RBI under FEMA has the powers to decide on regulation of other categories of foreign investors as well as on other policy matters relating to foreign investment.

The Stock Exchange

Though the stock exchange is not a regulatory authority but is a market body that is recognised by the Government under the SCRA, by virtue of the agreement that it enters into with each of the companies that are proposed to be listed on it, it wields some influence on such companies. This agreement is called the *listing agreement*. Therefore, though the stock market cannot regulate the primary market as such, it promotes discipline and adherence to corporate governance by listed companies thereby protecting the interests of the primary market in general and investors in particular. However, since the listing agreement is not a law but a contractual agreement between the stock exchange and a particular company, it does not have the teeth of law. Nevertheless, the stock exchange can take steps to initiate action against defaulters as provided in the listing agreement. In extreme cases, the stock exchange can enforce compulsory de-listing by such companies if so provided in the listing agreement.

The other area wherein a stock exchange influences market practices is in development of fair and transparent trading mechanism and in enforcing payments from market participants without defaults and bankruptcies. Several steps have been taken in recent times in this direction by stock exchanges at the instance of SEBI. The current trading mechanism and surveillance systems and risk management practices of stock exchanges are outlined in the following paragraphs. Exhibit 1.4 depicts the various roles played by regulators in Indian securities market.

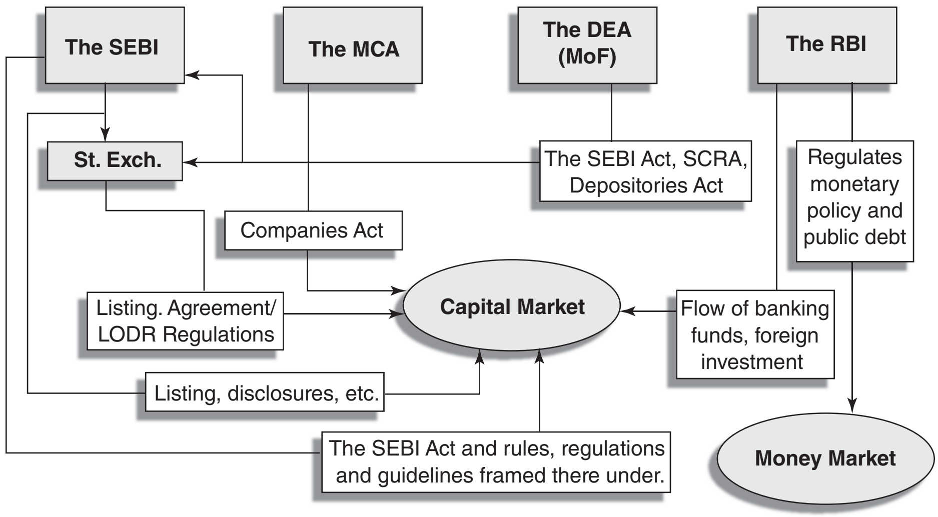

Exhibit 1.4 Regulators of Indian Securities Markets

IMPORTANT TERMINOLOGY

Base Money
Broad Money
Capital Market
Commercial Paper
Credit Creation
Derivative Market
Fiat Currency
Financial Markets
Fiscal Policy
Foreign Exchange Market
Institutional Intermediation
Liquidity Adjustment Facility
M1, M3
Market Stabilisation Scheme
Monetary Base
Monetary Policy
Monetary Transmission
Money Market
Multiplier Effect
Narrow Money
OMO
OTC
Ready Forward
Repo
Reserve Money
Reverse Repo
Securities Market
Security

TEST YOUR UNDERSTANDING

I. Pick the right answer(s) or the alternative that best fits the description from the alternatives provided under each question.

1. Institutional intermediation in capital flows in an economy is achieved through:
   (a) Issue of securities
   (b) Government borrowings
   (c) F&O operations
   (d) Financial markets and banks

2. Under the fiat currency system, the central bank of a country is responsible for the creation of:
   (a) Monetary base
   (b) Monetisation of money
   (c) Value of the currency
   (d) Exchange of money
3. Broad money or M3 is a result of:
   (a) Inflationary trends in the economy
   (b) Circulation of currency notes and bank credit
   (c) Government's taxation policy
   (d) Private savings
4. Under the monetary policy regime, the central bank:
   (a) Decides the level of M3 required for the growth of the economy
   (b) Ensures that there is an efficient functioning of the banking system
   (c) Influences the Government's fiscal policy
   (d) Influences the money supply in the economy based on a targeted rate of inflation
5. The following is a tool for the central bank to pursue quantitative monetarypolicy:
   (a) Cash Reserve Ratio to be maintained by banks
   (a) Administering the lending policies of banks
   (b) Administered exchange rate system
   (c) Interest rate on government sponsored savings schemes
6. Under the monetary policy regime, if the monetary base is increased by the central bank:
   (a) It can spur economic growth
   (b) It can increase M3
   (c) It can stoke inflation
   (d) It can lead to increase in interest rates
   (e) All of the above
   (f) None of the above
7. Which of the following financial instruments are not a part of Securities Markets:
   (a) Currency derivatives
   (b) Index futures
   (c) Units issued by REITs
   (d) Securitised debt instruments
   (e) PTCs
   (f) Repurchase options
   (g) Participatory notes
8. Financial markets are necessary in an economy:
   (a) Because they enable price discovery for public expenditure
   (b) Because they enable liquidity of investments when required
   (c) Because they complement the banking system by reducing risk concentration in financial intermediation
   (d) Because they determine interest rates in the system.
9. OTC market enables investors to:
   (a) Trade freely with any potential buyer or seller through the stock exchange mechanism.
   (b) Trade with counterparties in a bilateral negotiation without any risk of default arising from stock exchange regulations.
   (c) Trade with counterparties through the settlement mechanism of the stock exchange.
   (d) Trade freely with counterparties but the default risk has to be assumed by the respective party.
10. Commercial Paper is a money market instrument:
    (a) Used by banks to allocate their short-term surpluses with other players in the market.
    (b) Used by corporates to raise short term funds from banks.
    (c) Used by financial companies to raise money from banks and other institutions.
    (d) Used by corporates to raise short term funds from banks and other players in this market.
11. Under the OMO activity:
    (a) Repo trade refers to purchase of securities by the RBI in consideration for the banks offering collateral.
    (b) Repo trade refers to simultaneous purchase and sale of securities by the RBI.

(c) Repo trade refers to lending of securities by banks to the RBI.
(d) Repo trade refers to RBI making available enough securities in the money market.

12. Under the OMO activity:
    (a) Repo trades are meant to provide security to banks from interest rate risk.
    (b) Repo trades can lead to liquidity risk for the RBI.
    (c) Repo trades result in shortage of securities in the market.
    (d) Repo trades are inflationary in nature while reverse repos are the opposite.
13. The SCRA:
    (a) Is an enactment that provides the regulatory framework for securities to be listed on a stock exchange by way of a public offer.
    (b) Is a statute that regulates the working of stock exchanges and securities that are listed on a stock exchange.
    (c) Is a statute that regulates the working of stock exchanges, listing and trading of securities on stock exchanges and matters incidental thereto.
    (d) Is a statute to regulate the securities market in India.
    (e) Is a statute to regulate trading of securities in India.
14. FEMA plays a role in securities law to the extent of:
    (a) Enabling foreign exchange transactions in securities.
    (b) Enabling settlement of foreign exchange transactions in securities.
    (c) Enabling remittances connected with foreign exchange transactions in securities.
    (d) Dealing with foreign investment in securities of Indian companies, participation in Indian securities markets and matters connected therewith.
    (e) Prohibiting foreign investment in Indian securities without the prior approval of the RBI.
15. The Securities and Exchange Board of India:
    (a) Is a regulator for the securities market in India consisting of long term and short-term securities.
    (b) Is a regulator for the capital market while the money market is regulated by the RBI.
    (c) Is a regulator for primary market and secondary market for short term and long-term securities.
    (d) Is a regulator for the debt and equity markets and their trading on stock exchanges.
    (e) Is a regulator for public issue floatations on Indian stock markets.

For answers refer to Appendix B at the end of the Book.

2

Introduction to Capital Markets

LEARNING OUTCOMES

- The historical evolution of Capital Market and the overview of the functioning of the Indian Capital Market.
- Premier Global and Indian Stock Exchanges and role of intermediaries in such markets.
- Classification of Capital Markets, ECM and DCM segments, G-Sec and Bond markets.
- Performance of the Indian Capital Market, institutional changes and transformation therein.
- Capital market issuers, investors, intermediaries, infrastructure and instruments.
- Future directions in the growth of the Indian Capital Market.

2.1 Evolution and Growth of Capital Markets

The capital market as mentioned in the previous chapter is the marketplace for raising long-term equity and debt capital. Historically, the capital market had its beginnings in medieval Europe before the Industrial Revolution, but the structure of the market and investment options were quite primitive. While the issuers of debt securities were primarily landowners and municipal bodies, the equity market was proliferated by small business houses. However, the fundamental issues that concerned regulators of capital markets have been the same, right from those days, i.e. to reduce the level of risk on debt and ensure fair return on equity.

2.1.1 Pre-industrial Era

Prior to the industrial revolution in Europe, the need for business capital was mostly for trade and commercial applications which had everything but reliable cash flow. There was very little need for long-term finance, therefore, business houses did not enter the capital market for debt capital. On the other hand, the landowners and the government agencies which required deployment of long-term capital, possessed reliable cash flow as well in the form of taxes and revenues. Therefore, they were the principal issuers of debt securities. The main instruments that were used in those times for debt financing were the *pignus* or pawn, *hypothec* and mortgage which in later centuries gave place to sale of rents and annuities. Sale of annuities was a very popular instrument in the debt market with municipalities and the government which had steady revenue streams in the form of taxes. These annuities were either life annuities linked to the death of a person or perpetual redeemable annuities. The main investors in these instruments were the wealthy and middle class citizens. Annuities served both as investment and as life insurance for such people. Municipal annuities were safe, liquid and freely transferable. Over a period of time, municipal banks were set up to manage the municipal annuity debt. These banks managed the sale of fresh annuities and servicing of existing annuities. The *stadtwechsel* or public bank in Basel played the role of an underwriter charging issue fees of 2% on fresh issues. As the issue sizes of annuities grew, a secondary market developed which was brokered by the *kassiers*. In Antwerp in Belgium, these *kassiers* also brokered new issues.

While annuities were very popular debt instruments in Northern Europe, in Italy a different instrument known as the *compera* evolved to fund major public expenditure. The compera can be linked to a primitive form of the modern-day concept of *securitisation*. The compera consisted of a syndicate of investors who were vested with the ownership of a tax levied specially for that purpose. Over a period of time in cities like Venice, the compera gave place to forced loans called *imprestiti*. As these loans grew and the authorities found it difficult to keep track of them, Venice was the first to consolidate all its outstanding debt into a single fund called *Monte*. After such consolidation, existing claims were settled for shares in Monte and fresh issues were made in the form of Monte shares. Monte shares were fixed return instruments (5% payable semi-annually) and these were fully transferable by sale, gift or inheritance. The transactions in Monte shares were made through book entries recorded in special ledgers. The Monte grew in popularity with more cities in Italy such as Florence adopting the system. Trading in Monte shares was very active driven both by need for liquidity and speculative intent. These shares traded at market-determined prices, which were generally below par value. This was because the carrying rate of interest at 5% was less than the expected rate for sale of these shares in the open market. Hence, to improve the yield to the investor, these shares quoted below par. The trading market for Monte shares in Italy was well organised in the *piazzas* which was conducted through brokers. The active Monte share market led to the evolution of merchant banks which acted as dealers and market makers in such shares to provide liquidity to investors and used to take speculative positions as well. Soon, the deposit banks joined the merchant banks in similar activity.

While the debt market developed on the backbone of sustained and reliable tax cash flow, the business community could not tap the debt market for funds since they lacked the necessary cash flow strength. Since the capital market of those times lacked regulatory controls and legal protections, the issue of corporate governance (ensuring fair return and protection of interests of equity investors) was almost unaddressed. In order to overcome this hurdle, equity financing had to rely on a simpler mechanism of control, i.e. to wind up businesses periodically. If the business yielded profits, these would be divided among shareholders and the business would be reconstituted for a fresh term, otherwise the investors withdrew their funds after apportioning the losses. The early business organisations were venture partnerships or *commenda*, which were used to finance maritime voyages in Italy. Subsequently, these were replaced by continuing partnerships called *compagnia*. While trade and commerce was being financed through the compagnia, banking and international trade finance had to rely more on debt financing. The deposit banks and merchant banks raised funds through long-term deposits from the public. The compagnia were replaced by limited partnerships which had outside investors as passive partners with limited liability while the managing partners had unlimited liability. As businesses grew, the first forms of joint stock companies (known as 'loca') emerged in the ship construction industry. The main difference between loca and the partnership organisations was the free transferability of shares. As the joint stock company structure spread across Europe, it was seen in England in the sixteenth century. However, since there were no institutional mechanisms to protect corporate governance, shares were more personal rather than impersonal instruments. Shareholders had to necessarily take active involvement in the affairs of the company to protect their interests. Shareholders also had to rely on winding up as the mechanism to protect their interests.

2.1.2 Post-industrial Era

The early corporate structures provided the foundation for the later day joint stock company with limited liability and wide impersonal spread of shareholding wherein shares were freely transferable and tradable. The growth of the corporate form of organisation in Europe was largely due to the requirement of huge capital investments to set up large industries after the industrial revolution. This meant raising significant investments from public investors who were hitherto investing into public debt securities. The capital market, thus, grew on the strength of sustained appetite for funds from company issuers, on the one hand, and the emergence of regulatory and institutional control mechanisms, on the other hand. As investor confidence grew, the capital markets deepened and the role of merchant bankers who were primarily money market intermediaries till the sixteenth century, became that of being more of capital market intermediaries, thus, transforming them into investment banks. In later years, with the emergence of the American capital market, investment banks in USA became very strong mobilisers of capital and managers of wealth emerging from the capital market.

The evolution of the twentieth century capital market was also helped by the transformation of the family run businesses that emerged in the seventeenth century post-industrial revolution which were the dominant business houses till the end of the nineteenth century. Payne (1983) in a historical survey of family businesses in Britain comes to the conclusion that the family business was "the vehicle whereby the Industrial Revolution was accomplished."[1] Most of corporate America's big family business houses such as the Carnegies, the Du Ponts, the Fords, the Rockefellers and the Morgans transformed themselves into publicly held corporations. The Chaebols of Korea and the Zaibatsus of Japan were all family businesses that grew significantly after World War II.

After World War II, the US dollar became the main trading currency replacing the UK pound sterling. After the cold war started, the Communist countries of East Europe shifted their dollar deposits from US to western Europe. This eventually led to the emergence of the euro-dollar market. The euro-dollar market grew rapidly in the 1970s fuelled by the oil surpluses of the OPEC and other sources. The growing incidence of multinational companies tapping the euromarkets for finance coupled with the introduction of International Banking Facilities in the US in 1981 led to the consolidation of this market. The euromarkets have become globally pervasive trading round the clock in all major financial capitals of the world.

2.2 Evolution of Indian Capital Market

The Indian capital market is one of the oldest markets in Asia having found its initiation nearly 200 years ago. While the early days were characterised mostly by dealings of the East India Company, the first deals in shares and securities were witnessed in Bombay in the 1830s. Stock broking was initiated at this time and by the 1860s the number of stock brokers was around 60. By 1874, native brokers started assembling in the famous Dalal Street in South Bombay to conduct transactions in shares and securities. The Bombay Stock Exchange, now known as the BSE was established in 1875 as *The Native Share and Stock Brokers Association*. It is the oldest stock exchange in Asia, older than the Tokyo Stock Exchange, which was established in 1878. It was constituted as a voluntary non-profit association of brokers primarily to protect their interests in security

[1]See 'Capital Market and the Evolution of Family Businesses' by Utpal Bhattacharya (Kelley School of Business, Indiana University) and B. Ravi Kumar (Tippie College of Business, University of Iowa) – May 1999 page 1.

trading business. It was the first stock exchange in India to have been granted permanent recognition in 1956 by the Government of India under the Securities Contracts (Regulation) Act, 1956. The SCRA was the culmination of a process initiated by the government to regulate the several stock exchanges that had proliferated during the Second World War. After independence, regulation of securities business and stock exchanges became a central subject under the Constitution. The SCRA was passed in 1956 to substitute all state level legislations on the subject.

2.3 Transformation of Indian Capital Market

In 1991, with the liberalisation measures initiated by the Government of India, the setting was created for a capital market rebirth in the years to follow. The Capital Issues (Control) Act was abolished and a new regulatory authority called the Securities and Exchange Board of India was established under the Securities and Exchange Board of India Act 1992 to promote the orderly growth and development of the capital market. In the past eleven years, after the advent of SEBI, the capital market in India has undergone a sea change both in terms of growth and development. Indian capital market presently has global standards comparable to that of developed countries such as the NYSE Euronext, the NASDAQ, the London Stock Exchange, the Hong Kong and the Singapore Exchanges. The capital market has become the most important source of long-term capital for the Indian corporate sector due to the increase in capital mobilisation from investors, on one hand, and due to the decline of development banking activity of the financial institutions, on the other. In addition, with the spread of the equity cult among larger sections of the society, the capital market has acquired both depth and resource capability.

The Indian stock market crossed the ₹100 trillion mark in 2014 and was estimated by the World Bank at US$ 1.516 trillion (approximately ₹102 trillion) in 2015. The term *market capitalisation* refers to the aggregate market value of a company's issued capital expressed in current market price. From a larger perspective, the growth of the secondary market has been phenomenal considering that it was a meagre ₹110,279 crore (₹1.1 trillion) in 1991 at the beginning of the economic reform process. Indian stock exchanges are on par with the best in the world and offer contemporary screen based trading systems with sophisticated settlement and risk management with securities being held for trading in dematerialised mode.

2.4 Capital Market Segments

The broad segments of a capital market are: (i) *Debt Capital Market (DCM)*, (ii) *Equity Capital Market (ECM)*and (iii) *Derivatives Market (*also known as *F&O Segment)*. The DCM is the market that deals with the issue of long-term debt securities by the central and state governments and various bodies corporate including statutory corporations and government owned companies. It also includes the activities relating to trading on existing listed debt securities. The Debt Capital Market comprises of two sub-segments: (a) the *G-sec Market* for long-term dated government securities and (b) the *Corporate Bond Market* for debt securities issued by bodies corporate.

The ECM consists of equity shares and equity related securities issued by companies incorporated under the Companies Act 2013 or the erstwhile Companies Act 1956. The ECM also includes day-to-day trading in listed shares, popularly known as *stock trading*.

The F&O segment (also known as the *capital market derivative segment*) consists of stock derivatives in futures and options with equity and stock indices as underlying assets. While equity derivatives are traded on stock exchanges, some of the other types may only be OTC traded instruments that are traded bilaterally (OTC) among the counterparties. They, however, constitute an important part of the overall financial market.

2.4.1 Primary and Secondary Markets

Notwithstanding the ECM and DCM classification as stated above, the capital market can be vertically split into two functional segments: (i) *Primary Market* and (ii) *Secondary Market*. Since the capital market broadly deals with raising of capital, providing liquidity and trading between investors, the primary and secondary markets represent two faces of the capital market as a whole.

The *primary market* consists of the market for new security issuances whereby capital is mobilised by issuers from various investors who subscribe to such new issues of equity and debt securities. Thus, the term *primary markets* refer to the market for new security issuances of various types. On the other hand, the *secondary market* consists of providing trading mechanisms for day-to-day purchase and sale of securities and institutional support to create liquidity in existing securities through trade. In other words, it is the market for purchase and sale of existing securities by traders and market makers. The instruments that have been issued in the primary market are traded constantly in the secondary market providing the investors with a ready market, transparent pricing mechanism and liquidity for the securities. It may also be noted that not every security is traded on the stock exchange secondary market. There are many securities that are privately placed in the primary market and traded thereafter in the OTC market. Therefore, the connotation to secondary market would at times include reference to the OTC market in securities as well.

As can be appreciated, the primary and secondary markets complement each other in their functionality and one cannot exist without the other. While the primary market creates marketable securities, the secondary market provides the infrastructure for putting such marketability to work. Therefore, this classification of the capital market into primary and secondary markets is very fundamental in understanding its structure.

The division of the capital market into the above segments is done to facilitate regulation and effective supervision as also to provide investors with distinct platforms for trading in each of these types of securities. Stock exchanges, therefore, consist of separate trading platforms for equity segment, debt segment and derivatives.

Based on the above discussion, the segments of the capital market are depicted in Exhibit 2.1.

2.5 G-sec Market

In India, the government securities market is characterised by dated securities of the Central Government with maturities ranging from 2 to 30 years and similar securities issued by selected State governments with maturities ranging from 5 to 15 years. The RBI, commercial banks, insurance companies, provident funds, pension funds, debt mutual funds (also known as Gilt funds), *Primary Dealers* and to a lesser extent, the retail investors constitute the investor base in the G-sec market. In the post-liberalisation era, the government resorted increasingly to market borrowings to fund its deficit budgets which led to a significant growth in the G-sec market. Currently, more than 80% of the budgetary deficit is met through borrowings in the G-sec market while the rest is met through borrowings from RBI and other sources. Considering the rising fiscal deficits of the central government year-on-year (YOY), in aggregate terms, the G-sec market floatations by the government will only be on the increase. The Government Securities Act 2006 and the Government Securities Regulations 2007 provide the statutory framework for the present system of issuance and trading in G-secs.

2.5.1 G-sec Primary Market

G-secs are issued through an auction system, generally involving a multiple auction procedure which means that bidders bid at various prices and yield parameters. Successful bidders are those who bid at or above the cut-off yield and the allocations are made at the respective bid prices. State government securities are

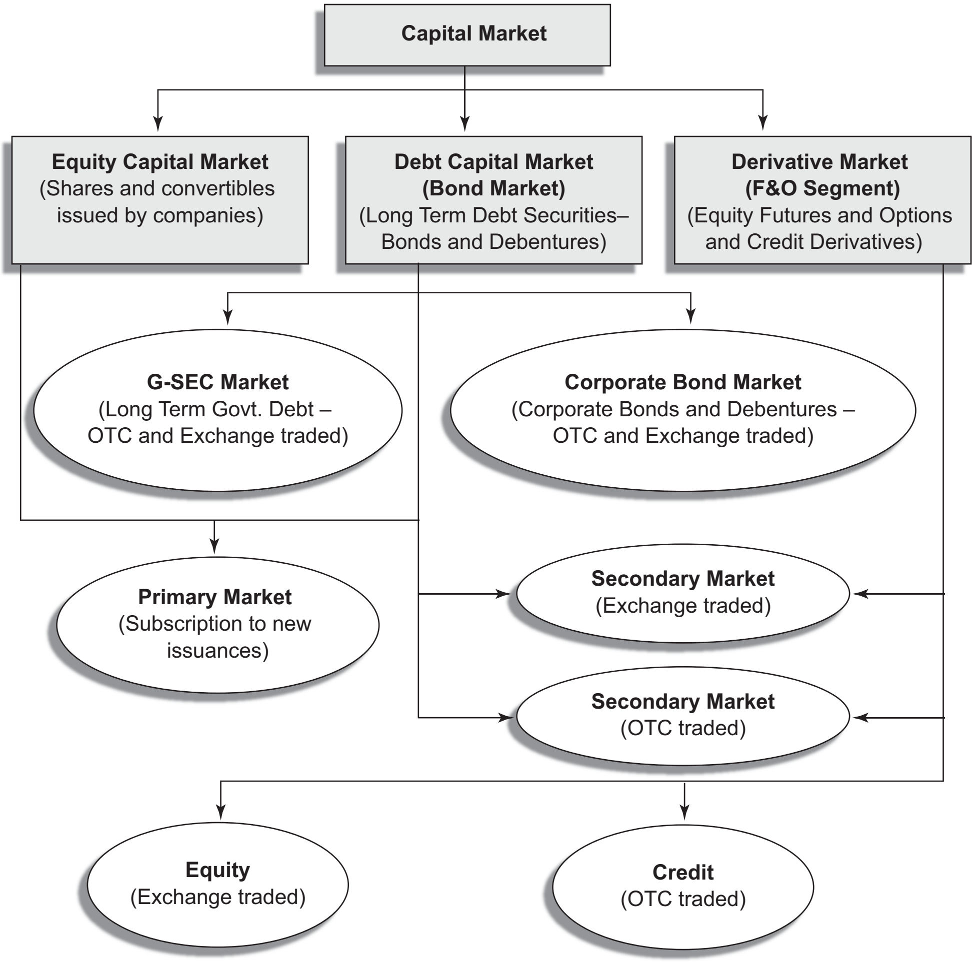

Exhibit 2.1 Segments of Capital Market in India

generally issued through a tap mechanism either directly or through the RBI. The provisions of the Fiscal Responsibility and Budget Management Act 2003 led to the withdrawal of RBI as a primary market player in the G-sec market. Instead, the G-secs issued by the government are subscribed to by the market players directly. Auctions of primary issuances of G-secs operate through auctions conducted by the RBI through the Public Debt Office though the public debt functions would, hereafter, be handled by the government in its own domain. These auctions introduce new issues of government securities from time to time into the primary G-sec market. The primary market investors in the government security market are banks and financial institutions, specialised debt and money market institutions such as the Discount and Finance House of India and Primary Dealers approved by the RBI who create an active primary and secondary market for such securities.

The above system of the government resorting to direct market borrowings under the provisions of the FRBM Act are akin to the global systems of developed countries such as US, UK and Euro Zone wherein the central bank of a country cannot directly monetise budgetary deficits of the government. Under US law, the US Federal Reserve cannot monetise government deficits. This happened when the Bretton Woods system was dismantled by USA in 1973 under Richard Nixon during the oil crisis. The Maastricht Treaty, under which the Euro Zone was formed, also prohibits the European Central Bank from directly financing respective governments of the Euro Zone. Instead of monetising budgetary deficits, the respective governments have to resort to market borrowings as per their sovereign ratings and the central banks will modulate the economic parameters arising there from through open market operations on their own. This is the reason why the ECB could not bail out the governments of Greece, Italy and Spain in their debt crises without the intervention of the governments of the Euro Zone. If automatic monetisation of budgetary deficits by the central bank of a country is permissible, it would lead to galloping inflation in a backdrop of slow economic growth. This would, in turn, lead to loss of faith in the domestic currency as has been the case with Zimbabwe which ultimately demonetised its own dollar and adopted the US dollar as fiat currency. Thus, most world economies presently work under independent monetary and fiscal systems, the former being regulated by the central bank and the latter administered by the government. In India, a somewhat similar system exists after the passage of the FRBM Act 2003.

The G-sec market in India is regulated by the RBI. As a fall-out of the FRBM Act, the role of market participants in the G-sec market, especially that of primary dealers has increased significantly. Primary dealer is a category of financial intermediaries set up by the RBI in 1995. These are responsible for providing depth in the G-sec market through their market operations. Primary dealers underwrite and bid in government securities auctions and also act as market makers by providing two-way quotes in G-sec trading. Most primary dealers licensed by the RBI have a commercial banking parentage. The others are floated by broking firms except the Securities Trading Corporation of India Ltd., which is a government owned entity.

Though the supply side of the G-sec market is driven by government's deficit financing requirements, the demand side is driven by statutory provisions regulating the market participants as well as prevailing economic conditions. Most of the market participants, namely banks, insurance companies, deposit taking NBFCs, provident and gratuity funds have to hold certain percentage of their assets in G-secs. Commercial banks are regulated under the provisions of the Banking Regulation Act which prescribes a *Statutory Liquidity Ratio* (SLR) for banks. The Banking Regulation Amendment Act 2007 provided a legislative framework for the SLR to be dropped below its then prevailing rate of 25%. However, SLR constitutes a statutory requirement in a bank's balance sheet, a substantial portion of which is met through holdings in G-secs. Similar requirements for mandatory holding of G-secs are also prevalent for insurance companies, non-government provident funds, superannuation funds, gratuity funds and NBFCs. In addition, FPIs were allowed to set up 100% debt funds as a way to boost the corporate bond market but a fair share of such funds is also invested in G-secs, especially when the yields are attractive. Most of the G-sec market is driven by fixed coupon bonds though more fancy structures with floating rates, zero coupon etc. were tried unsuccessfully in the past. G-secs with call and put options are also prevalent albeit to a lesser extent.

2.5.2 G-sec Secondary Market

Secondary market trading in the long-term G-sec market is dominated by outright transactions in dated securities and is an institutional wholesale market driven by volumes. However, trading interest in G-secs is largely influenced by trends in interest rates and the monetary policy of the RBI. At times, when interest rates are falling, there is increased demand for existing dated G-secs with higher coupon rates. The yields on such G-secs, therefore, improve and there is an opportunity for holders of such securities to make treasury profits. The situation is reversed in times of spiralling interest rates. By and large, secondary market trading in dated G-secs has remained smaller when compared to the outstanding stock at any given point of time.

The RBI is present in the G-sec secondary market only in *OpenMarket Operations* (OMO) whereby the RBI either buys or sells government securities as a part of its liquidity and inflation management function. Presently, OMO operations are conducted through specific liquidity windows developed by the RBI which are mentioned in the discussion on money markets in Chapter 1. OMO of the RBI are quite significant in that they regulate the effect of increased government market borrowings on liquidity, interest rates and inflation in the economy.

Over the years, several steps were taken to make structural improvements in the G-sec secondary market so as to improve trading environment and market infrastructure. Since it is an institutional market, it has always remained predominantly within the domain of the RBI and the banking system. The important steps taken in this regard are explained as follows:

- Completing phasing out of monetisation of budgetary deficits (as explained in a preceding paragraph). All budgetary deficits are presently financed through market borrowings by the central and state government and the RBI has no mandate to automatically monetise them. This provides a market based check on the government's borrowing programme and balance sheet health. At the same time, from a market perspective, it adds depth with fresh issuances by the government on a continuous basis.
- Introduction of primary dealers and other new players in the G-sec market. Primary dealers are specialised fixed income players in the G-sec, money market and Corporate Bond market and therefore, provide liquidity and depth to the market. Most primary dealers are promoted by banks and therefore, have the required expertise and financial muscle to be specialised players.
- Introduction of auction-based price determination for government securities for principal players like primary dealers and banks. The system of non-competitive bidding was also introduced for prescribed non-principal players upto specified limits so as to provide breadth to the primary and secondary G-sec markets.
- Dematerialisation and screen based trading systems. Presently, all holdings and trades in G-Secs are done in dematerialised form.
- The establishment of CCIL for settlements and counter party guarantee.
- Introduction of the NDS platform and inclusion of G-secs in the WDM platform of stock exchanges (NSE and BSE) as explained below.
- Introduction of delivery *versus* payment (D*v*P) in settlement of G-sec trades which settles both cash and securities.
- Introduction of Real-time Gross Settlement System (RTGS) which addresses settlement risk and facilitates transfer of funds instantly.
- The government has experimented with different structures such as fixed rate bond, floating rate bonds, zero coupon bonds and inflation index bonds.
- Development of the yield curve for upto 30 years for government securities to enable mark-to-market portfolios of banks and other institutional players.
- Emergence of self-regulatory bodies such as the Primary Dealers Association of India (PDAI) and the Fixed Income Money Markets and Derivatives Association (FIMMDA).
- Permitting short-sales in dated G-secs.
- Introduction by RBI of an auction calendar for dated securities.

The traditional trading platform available for G-secs is the RBI's *Subsidiary General Ledger* (SGL) account under which participating banks and financial institutions could open their accounts as well as client sub-accounts for permitted participants. Therefore, other permitted participants such as primary dealers and insurance companies can also open SGL accounts. It may be recalled that the genesis of the Harshad Mehta scam was through this mechanism whereby funds of banks and financial institutions were diverted to the stock market through manipulation in the SGL account. The settlement of the trades done on the SGL platform was hitherto managed by the RBI. However, since 2002 the clearing and settlement process and counter party risk in G-sec trading through the SGL platform is handled by the Clearing Corporation of India (CCIL), a GoI undertaking. The CCIL was established on February 15, 2002 to act as the clearing house and as a central counter party through novation for transactions in government securities.

Settlement happens in a standardised T+1 trading cycle. All G-secs are now held in dematerialised form in SGL accounts. Approved institutions and primary dealers are also allowed to open *Constituent SGL Accounts* (CSGL) for their clients so as to enable them to hold and trade in G-secs.

Besides the SGL facility, the RBI also operates a trading platform, called the Negotiated Dealing System (NDS), under which trades can be done by permitted players and are settled directly through the clearing house mechanism of the CCIL. All transactions in government securities concluded or reported on NDS have to necessarily be settled through the CCIL. The CCIL also developed an anonymous trading platform called the NDS-OM to provide order matching on time-priority basis for dated G-secs, anonymity, real time information dissemination, better price discovery and straight through processing and settlement. The establishment of CCIL is a landmark of sorts as it has ensured guaranteed settlement of trades in government securities, thereby imparting hitherto unavailable stability to the secondary market in G-secs. In addition, through the mechanism of multilateral netting of trades, it has reduced fund requirements of market players from gross to net basis, thereby mitigating liquidity and credit risk. On its part, the CCIL has been empowered with operational guidelines to have an efficient risk management system and limit its own settlement risk. For this purpose, CCIL may enter into an arrangement with any of its members for borrowing government securities for the purpose of handling securities shortage in any settlement. The net obligations of members are arrived at by the CCIL for both funds and securities and then sent to the Reserve Bank for settlement under the D*v*P mechanism.

In addition to the RBI's trading facilities, G-secs can also be traded in the Wholesale Debt Market (WDM) of the NSE and BSE, both of which are electronic trading platforms. G-sec trading on the BSE happens under the *compulsory rolling settlement* mechanism on a T+2 basis in the BOLT system. In the NSE, the WDM operates under the NEAT system with the same rolling settlement cycle of T+2.

It may be noted that G-sec trading on the stock exchange platform of NSE and BSE is subject to counterparty risk as it presently is not covered under a clearing corporation mechanism. Trading parties have to settle deals bilaterally for which they could set counterparty risk exposure limits. Under the instructions of SEBI, the BSE had set up, in 2003, a distinct trade guarantee fund known as GSEC Trade Guarantee Fund for trading in the Central Government Securities.

In terms of types of trade, G-secs are traded in two basic categories: (i) direct or outright trades and (ii) repurchase options or repo trades. The nature and purpose of repo trades have already been discussed under money market in Chapter 1. Direct trades are actual purchases and sales and constitute the long-term G-sec secondary market. In terms of volumes, the NDS platform of RBI dominates G-sec trading since counterparty risk is handled through the CCIL. On the stock exchange platform, the NSE leads in direct trades over the BSE.

2.6 Corporate Bond Market

The debt securities market for corporate issuers (non-G-secs) is often referred to as the *corporate bond market*. The presence of a vibrant corporate bond market is vital to economic growth and its sustenance. Primarily, as pointed out in Chapter 1, debt capital required for business investments can be raised from the banking system or from capital markets. If the corporate bond market is not well-developed, it puts additional strain on the banking system to finance corporate growth. Such risk concentration could prove to be a systemic risk for the economy, especially when the economy is under a recessionary stress. However, the Bank for International Settlements that compiles statistics on world financial markets cautioned that unbridled expansion of the bond markets without adequate safeguards could lead to over-leveraging and an asset bubble that could pose systemic risk. Therefore, an orderly development of bond markets backed by regulation and adequate infrastructure are paramount for an economy.

2.6.1 Global Scenario

Internationally, bond markets are several times bigger than their equity counterparts. In 2015, the global bond markets crossed the US$100 trillion mark with the US markets having the biggest share at about US$ 40 trillion according to the Wall Street Journal. The US, Japan and Germany are the biggest bond markets wherein decades of high capital formation fuelled their growth. Historically, some economies were developed based on bank financing while some others were financed by financial markets. The European economies consisting primarily of family oriented businesses were dominated by bank financing while the US economy was largely bond financed. The US markets also developed long-term debt structures with average maturities of over 12 years due to which there has been adequate availability for long-term debt capital for long term business investments. In addition, such long-term debt avenues facilitate the functioning of insurance and pension fund sectors well. International bond markets are primarily OTC markets and largely institution driven wholesale markets. Most bonds in international markets are unsecured paper and are priced based on their ratings.

2.6.2 Characteristics of Indian Bond Market

The corporate bond market in India is still in the evolutionary stage and accounts for less than 4% of the GDP which compares quite unfavourably with the developed markets and even Asian economies like Korea, Malaysia and China. The Debt Capital market in India is dominated by government securities which account for almost 95% of the market. Corporate bonds are crowded out in that sense and even within the meagre share that they have, bonds issued by financial institutions, statutory corporations and government companies proliferate. The use of bond financing by private sector companies is quite minimal while bond issues by municipal corporations and local authorities are virtually at the initial stage though SEBI regulations in this regard are already in place (Exhibit 2.2).

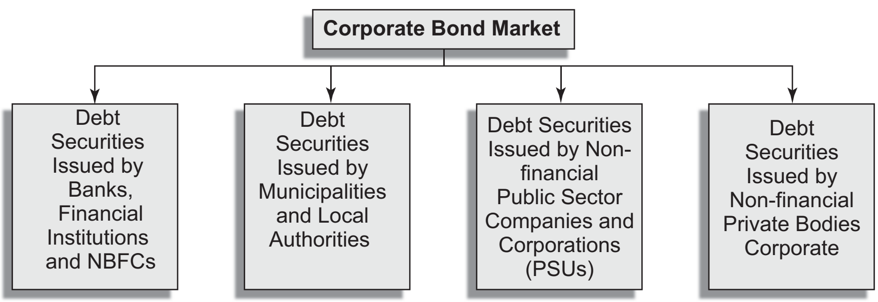

Exhibit 2.2 Segments of Corporate Bond Market in India

Due to moderate investor appetite for corporate debt, the primary debt market is more of a government security, PSU and institutional bond market rather than a market for debt securities issued by private sector companies. This trend has characterised the debt market for many years. During this time, it had been the financial institutions and the Government that were the effective raisers of debt capital. However, since the issue of government securities does not happen through public issues and through auctions conducted by the RBI, these need not be reckoned for the purpose of assessing the public issue debt market. As such almost 95% of the debt capital raised by private companies is through the private placement route from institutional investors. The third feature of the Indian corporate bond market is that there is no appetite from investors for bonds that do not have atleast AA rating. Most issuers are those that have AAA or AA+ rating. As such, only prime corporate or bonds with credit enhancements can raise funds from the bond market while the rest of the companies have to depend on banks for financing. However, bank financing being costlier than bond financing means higher cost of capital, lesser competitiveness and project viabilities for Indian corporate businesses.

This skewed pattern of the Indian corporate bond market creates imbalances in the system. Firstly, the large borrowers, especially infrastructure and core sector companies may not be able to tap the bond market due to their lower credit rating. When such companies fall back on the banking system, banks end up having a financing problem due to asset-liability mismatches. The failure of the securitisation market to take off in a big way also means that banks are saddled with longer tenor debt on their books and cannot recycle their capital. Fourthly, the smaller companies will be crowded out from the banking system and have nowhere to go to raise debt capital. Last but not least, it leads to high risk concentration in the banking system and the consequent systemic hazards that come with it. As of 2017, the gross NPA levels of the Indian banking system were alarming bringing serious concern to regulators and the government.

All the above factors show that the corporate bond market in India has a long way to go before it can become an effective source of debt capital for Indian companies and other types of issuers.

2.6.3 Structural Issues and Way Forward

Keeping in view the structural problems, demand side and supply side issues plaguing the Indian corporate bond market, the government from time to time initiated a lot of steps to revitalise the market. Based on the recommendations of a high-powered committee in 2005[2], the regulators RBI and SEBI brought in several liberalisation measures as well. The Raghuram Rajan Committee in 2009 also recommended more steps in this direction. In 2016, at the instance of the FSDC, a working group[3] was set up to examine the pending reforms required to deepen the bond market. The group came up with the following major findings:

- The corporate bond issuance is dominated by private placements as these accounts for more than 95% of the total issuance of corporate debt (2014–15).
- A majority of the issuances are concentrated in the 2–5-year tenor.
- The investor base is limited/narrow as the investment mandates of institutional investors such as insurance companies, pension funds and provident funds, despite review of the minimum credit rating from time to time, provide limited space for going down the credit curve as the investments are made in fiduciary capacity to protect the interests of subscribers.
- Small outstanding stock of individual issuances is one of the key factors impacting secondary market trading as re-issuances have not picked up inspite of the enabling provisions by SEBI.
- There is total lack of liquidity in credit risk protection instruments like CDS.
- Stamp duties on corporate bonds across various states have not been standardised; tax regime for financial instruments remains one of the key drivers of investor interest.
- In the current context (highly leveraged balance sheets as of 2017 and NPA status with banks), many large non-financial corporates who should normally be the preferred issuers of bonds cannot access the bond markets.

The group, however, identified some implementable steps as a way forward for the corporate bond market. The important recommendations are listed in following points:

- Large corporates with borrowings from the banking system above a cut-off level may be required to tap the market for a portion of their working capital and term loan needs.
- Necessary amendments may be made in FEMA regulations to allow investment by FPIs in unlisted debt securities and pass through securities issued by securitisations SPVs/Special Purpose Entities.

[2]Late Dr. R.H. Patil Committee
[3]The H.R. Khan Committee

- Amendments may also be carried out in both FEMA and SEBI regulations to facilitate direct trading in corporate bonds by FPIs in the OTC segment and on an electronic platform of a recognised stock exchange.
- Stock exchanges may operationalise market making scheme in corporate bonds.
- Presently, the secondary market yield of corporate bonds reported on the reporting platforms of the stock exchanges do not follow uniform standard. These are to be standardised.
- A centralised database for corporate bonds covering both primary and secondary market segments may be established.
- Insurance companies and EPFO may be allowed to invest in Basel III compliant Tier I perpetual bonds of banks subject to prudential limits with credit rating up to investment grade.
- Corporate bond index may be introduced by the Stock Exchanges/other entities.
- Separate regulatory framework may be formulated for providing credit enhancement of corporate bonds by NBFCs engaged in such activities. Credit enhancement function by banks to be liberalised.
- The stamp duty on debentures should be made uniform across states and be linked to the tenor of securities within an overall cap. Re-issuance of the same security should be included for the purpose of the cap, in order to encourage re-issuance.
- Expedite the implementation of the newly introduced Insolvency and Bankruptcy Code 2016.

2.7 Premier Global Stock Exchanges and Markets

In 2010[4], the United States ranked first in terms of traded value (US$ 30.46 trillion) and also in terms of market capitalisation (US$ 17.14 trillion). China ranked second with traded value of US$ 8.03 trillion followed by Japan and the UK. In terms of market capitalisation, China was second with US$ 4.76 trillion, followed by Japan. India ranked tenth in terms of traded value (US$ 1.06 trillion) and ranked seventh in market capitalisation (US$ 1.62 trillion) for 2010. In 2015, Hong Kong occupied the fourth position and India was ranked eighth with a market capitalisation of US$ 1.56 trillion. Therefore, USA continues to be ahead of other countries both in terms of traded volumes and market capitalisation.

2.7.1 The New York Stock Exchange

The New York Stock Exchange (NYSE) is the world's biggest stock market in terms of market capitalisation. In 2015, 2424 companies were listed on NYSE with a market capitalisation of US$ 17.79 trillion. It was started about 225 years ago in 1792. It was registered as a national securities exchange with the US Securities Exchange Commission in 1934. In 1971, it was incorporated as a non-profit organisation with a 25-member Board of Directors. It was demutualised in 2006 and was converted from a non-profit entity to a for-profit company upon its merger with Archipelago Holdings (based in Chicago) on March 7, 2006 and thus, became a wholly owned subsidiary of the NYSE Group. Consequent to its demutualisation, NYSE was taken public in 2006 and began trading on its own trading platform. On April 4, 2007 Euronext NV, based in Amsterdam which is a pan-European electronic exchange merged with NYSE to form NYSE Euronext as the holding company for the group, thus, making it the first global stock exchange group spread across USA and Europe. The Deutsche Borse (national stock exchange of Germany) had originally made a competing bid to that of NYSE to acquire Euronext but dropped out later, thus, paving the way for the formation of NYSE Euronext. The NYSE Group operates NYSE based in New York, Euronext based in Paris, NYSE AMEX Equities and other smaller platforms. Euronext also operates other trading platforms in Amsterdam, Brussels, Lisbon,

[4]According to S&P Global Stock Markets Factbook 2011, www.theglobaleconomy.com

London, Chicago and San Francisco. It also operates NYSE Liffe, a leading European derivatives business and the world's second-largest derivatives business by value of trading and NYSE Liffe U.S., which is a global, multi-asset class futures exchange. It currently has more than 8000 listings from across 55 countries and the NYSE Euronext's equities markets—the New York Stock Exchange, NYSE Euronext, NYSE Amex, NYSE Alternext and NYSE Arca—represent one-third of the world's equities trading volumes, thus, offering maximum liquidity of any global exchange group.

In 2011, there was a fresh bid from Deutsche Borse to merge with NYSE Euronext through an all-stock deal. There was a counter bid made by the NASDAQ and Inter Continental Exchange (an American commodities and OTC market service provider) consortium which was subsequently withdrawn due to lack of support from the Board of NYSE Euronext and regulatory concerns. The Deutsche Borse offer received the support of NYSE Euronext's Board and was subsequently put through the regulatory process of getting necessary approvals including clearing the anti-trust law of USA and Europe. The approvals required from shareholders were obtained in mid-2011 and by late 2011, the US Anti-trust authority had cleared the proposal. However, in 2012, the European Commission blocked the proposed merger due to anti-trust concerns in a transaction that could have created the world's largest and most powerful stock exchange group. The main concern was that it would have created a near monopoly situation in exchange-traded derivatives in Europe. In 2012, Inter Continental Exchange sweetened the bid to acquire NYSE and completed the transaction in 2013. In 2014, Euronext got split from NYSE through an IPO.

The NYSE over the long years of its existence has retained stringent entry criteria for companies to get listed on it and thereby maintains its premier position. The trading takes place on the trading floor through brokers and specialists. The specialists have a dual role to play on the trading floor, to trade on client account and to trade on own account, much like the jobbers in the Indian market. They provide two-way quotes and thus, become market makers on a continuous basis for the companies for whom they act as specialists. They offer to buy from the public, if suitable buy quotes are not available in the market and offer to sell in the absence of sellers in the market. As specialists, they deal only with other broker members and not with the general public. The trading in the NYSE continues to have the option of being physically conducted on the trading floor at designated counters although electronic screen based trading system was also introduced as an alternative. Besides, NYSE introduced extensive technological backbone to support its trading and settlement systems apart from providing dealers and brokers instant access to worldwide markets on real time basis. Trading is based on the auction system, which allows the buyer and seller to meet at the agreed price without the intervention of other brokers. The buy and sell orders are immediately matched and any mismatches that may occur, are taken care of by the specialists.

2.7.2 The NASDAQ Exchange

The National Association for Securities Dealers Automated Quotation System (NASDAQ) that was founded in 1971, is the most popular second exchange in USA after the NYSE It was the first American stock exchange to start screen based trading and has become the second largest stock exchange in the world after the NYSE Euronext in terms of market capitalisation, though it is the biggest exchange in terms of electronic trading turnover. The NASDAQ was initiated to eliminate the burden and inefficiency of physical transactions by closing the price gaps between buyers and sellers through the technology of screen based trading systems. In addition, it offers a friendly approach towards listing of stocks as compared to the NYSE, whereby companies that are either young or that cannot fulfil the NYSE criteria can access the NASDAQ to raise capital. The NASDAQ works on the market maker mechanism and each scrip should have atleast three market makers. There are about 500 market makers on NASDAQ who unlike the specialists of the NYSE, do not specialise in particular stocks. The NASDAQ lists more than 3000 companies both from the USA and outside. There are more American companies listed on the NASDAQ than on the NYSE. Several well-known companies such as Intel, Microsoft, Apple, Cisco, Oracle, Dell and others raised capital on NASDAQ exchange.

As part of the overall efforts to demutualise American stock exchanges, just as the NYSE was demutualised, the NASDAQ also got spun off from the National Association of Securities Dealers (NASD) in 2000 to become NASDAQ Stock Market Inc. In 2006, it was given the status of a national stock exchange. In the subsequent year, NASDAQ merged with the Scandinavian stock exchange OMX and officially became The NASDAQ OMX Group. The NASDAQ OMX Group has since grown significantly and currently operates 24 stock exchanges in six continents, three clearing houses and five central depositories. In addition, it provides technology services to stock exchanges worldwide in over 50 countries. The NASDAQ OMX Group was listed on NASDAQ in 2008. NASDAQ also made important acquisitions on its way to reaching its present status including that of EASDAQ. EASDAQ (European Association of Securities Dealers Automatic Quotation System) was a European electronic securities exchange headquartered in Brussels. Founded originally as a European equivalent to NASDAQ, it was purchased by NASDAQ in 2001 and became NASDAQ Europe but was subsequently discontinued.

2.7.3 The American Stock Exchange

USA had a third stock exchange called the American Stock Exchange (AMEX) which was located in Lower Manhattan in New York city. It was a mutual organisation owned by its members. AMEX was acquired by NYSE Euronext in 2008 and its corporate entity was merged with NYSE Euronext. However, the erstwhile trading platform of AMEX was rebranded as NYSE AMEX Equities and operates as a platform for smaller companies within the overall NYSE Euronext equities market. It also includes the Alternext Platform of NYSE Alternext European small cap exchange which was merged with AMEX post acquisition by NYSE Euronext.

2.7.4 European Stock Exchanges

Historically, the 15 major stock exchanges of EU member countries are Amsterdam, Athens, Brussels, Copenhagen, Dublin, Frankfurt, Helsinki, Lisbon, London, Luxembourg, Madrid, Milan, Paris, Stockholm and Vienna. Most of these markets went through substantial reforms in the mid-1980s. The London Stock Exchange (LSE), based on which the BSE was modelled, is also a very old exchange tracing its roots back to 1760. It was made into a stock exchange in 1773 and more than 200 years later, it became an incorporated company in 2000. It switched over to screen based trading quite recently. Apart from the normal functions of a stock exchange, the LSE has been a very active campaigner for investor awareness and runs a very successful program called Share Aware. The UK stock market went through radical reform in 1986 through integration of all stock exchanges in the UK into one unified International Stock Exchange of UK and Ireland based in London. This single stock exchange now functions across UK with trading terminals based on both an order-driven (SEAQ) system and a quote-driven (SEAF) system. Under the SEAQ, market makers provide two-way quotes to traders. Under the SEAF, the orders are executed by matching principle. The unification process known as the *Big Bang* that was launched by the LSE in 1986, helped the growth of the UK stock market considerably. This process was tried out in India as well with the setting up of the Interconnected Stock Exchange of India though the process did not yield the desired results. In 2016, the LSE and Deutchse Borse, in Frankfurt, Germany announced a US$ 31 billion merger of equals which looked all set to be achieved. However, the transaction met a roadblock in EU anti-trust regulators which imposed stiff conditions on LSE to agree for the merger. In early 2017, the deal was still in doubt.

In response to LSE's *Big Bang*, the Paris Stock Exchange (SBF-Paris Bourse) implemented its own set of reforms by bringing in inter alia, the screen-based system called *Contation Assistee en Continu* (CAC).

It became a fully automated exchange by 1995. Germany, on the other hand, lagged behind mainly because it was dominated by universal banks providing loan financing to corporates and the presence of several closely held large companies with cross holding structures. The electronic trading system was adopted by the Frankfurt stock exchange in 1991.

2.7.5 Other Major Global Stock Exchanges

The other major capital markets of the world outside of the US, UK and Western Europe are in Japan, China, Hong Kong and Singapore, though Dubai and Abu Dhabi are fast emerging as the next global financial centres. From the 1960s until the advent of the 1990s, the *Big Four* (Nomura, Daiwa, Nikko and Yamaichi) securities firms dominated the Japanese capital market. The market grew rapidly until the early 1990s when large-scale scandals and irregularities rocked the market and brought humiliation to Nomura and Yamaichi. In addition, the crisis of Japanese banks and the recession in the economy added to the problems of securities firms. However, the Japanese capital market went through similar crises in the 1960s and had bounced back through the 1980s. The Securities and Exchange Act that governs the issuance and trading of securities in Japan was strengthened in 1992 to provide for greater surveillance mechanisms. Tokyo stock exchange is the main financial and capital market centre in Japan. Shanghai stock exchange and Hong Kong stock exchange are the next largest capital markets in Asia. The Hong Kong stock exchange embarked on spreading its presence in China through joint ventures with the Shanghai and Shenzhen capital markets.

The global stock exchange industry has seen big shifts towards bigger technologically advanced operations. Consolidation in the industry to form big alliances has been a trend in the new millennium. The merger of NYSE and France based Euronext and NASDAQ-OMX and the attempted merger of NYSE-Deutsche Borse and LSE- Deutsche Borse are all steps in the same direction. The biggest hurdle to such mega inter-continental alliances is anti-trust regulation. However, consolidations between larger and smaller exchanges in different geographies are a distinct possibility.

2.8 Evolution and Growth of Indian Stock Exchanges

The Indian securities market history is more than a hundred and thirty years old, beginning with the Bombay Stock Exchange in 1875. In the initial years, it was localised initially in Bombay and then in Gujarat primarily driven by the textile trade and business. In 1894, the Ahmedabad Stock Exchange was established. Similarly, by the 1880s and 1890s, Calcutta was driven by the boom in jute, tea and coal businesses and in 1908, the Calcutta Stock Exchange in Lyons Range was established. As Indian industry grew in the twentieth century with the setting up of The Tata Iron and Steel Company (TISCO, now Tata Steel) in 1907, there were several shares of Indian companies by around 1920 in the capital market. The Madras Stock Exchange came into existence in 1920, which went out of existence and was re-established in 1937. Since India followed a controlled regime in bullion, exchange and commodity trade, the interest in stock markets grew and several other stock exchanges such as the Uttar Pradesh Stock Exchange (1940), the Nagpur Stock Exchange (1940), the Hyderabad Stock Exchange (1944) and the Delhi Stock Exchange 1947 were established. Bangalore Stock Exchange was given recognition in 1963. In the 1980s several other stock exchanges were set up such as the Cochin Stock Exchange (1980), Uttar Pradesh Stock Exchange, Kanpur (1982), Pune Stock Exchange (1982), Ludhiana Stock Exchange (1983), Gawahati Stock Exchange (1984), Canara Stock Exchange, Mangalore (1985), Magadh Stock Exchange, Patna (1986), Jaipur Stock Exchange (1989), Bhubaneshwar Stock Exchange (1989), Saurashtra Kutch Stock Exchange, Rajkot (1989), Vadodara Stock Exchange, Baroda (1990) and in more recent years, stock exchanges at Coimbatore and Meerut. With this, there were totally 23 recognised stock exchanges in India excluding the Over the Counter Exchange of India Limited, the

National Stock Exchange of India Limited and the Interconnected Stock Exchange of India Limited which were formed on a nation-wide basis using sophisticated screen-based trading mechanisms. Though the Indian capital market had breadth in terms of geographical reach, the pattern followed was that of setting up regional stock exchanges with their own distinct existence as compared to the practice in developed markets, which had few large exchanges in each country. India had developed its own model of multiple stock exchanges with a geographical spread covering almost the whole country during the development phase of the securities market post-independence.

2.8.1 The Consolidation Phase

The process of manifold increase in the number of regional stock exchanges till the mid-1990s was halted with the rapid technological developments and changes in market mechanisms that took place in that decade. With the rise of nation-wide screen based exchange in the form of the NSE, the importance of regional stock exchanges started to fade away. The NSE gradually attained market leadership with its sophisticated screen-based trading and state-of-the-art settlement and risk management systems. The passage of the Depositories Act in 1996 further consolidated the shift to modern securities trading platforms and holding systems. This led to a qualitative shift in secondary markets in India. Soon the BSE halted its traditional open outcry system on the stock exchange floor and migrated to screen based trading system. With increasing membership across the country, the NSE soon became a national stock exchange in the true sense of the term. The writing on the wall became evident for regional stock exchange which had lost their relevance that was based on geographical presence. The depth and reach offered by nation-wide screen based trading of NSE and BSE made regional stock exchanges redundant. This phenomenon can be noticed from the fact that the first big six stock exchanges in India accounted for 99.88% of the total trading turnover in 2001–02 while more than twelve regional exchanges reported nil turnover during that period. By 2006, all regional stock exchanges reported nil or close to nil turnover. The BSE and NSE accounted for 99.8% of the total turnover out of which NSE was the clear leader.

In order to stay relevant, the regional exchanges tried several strategies including floating broking subsidiaries that would become members of NSE and provide trading presence to their regional members. The ISE (discussed later) was also floated with a similar idea of inter-connecting the regional stock exchanges and providing a national trading platform. Despite all the efforts, in line with global trends, the country started to move clearly towards the model of large nation-wide exchanges instead of a proliferation of small exchanges. The happening of further events such as demutualisation of stock exchanges and the issue of MIMPS Regulations[5] further accentuated the problems of regional exchanges. Some of them could not comply with these regulations of SEBI within the prescribed time.

Keeping in view the unviable position of regional exchanges, SEBI also introduced a voluntary exit scheme for regional exchanges in 2008.[6] The scheme provided for an exit option to such regional stock exchanges whose recognition was withdrawn and/or renewal of recognition was refused by SEBI and those who might wish to surrender their recognition. In all such cases, an appropriate order shall be passed by SEBI. The guidelines inter alia provide for de-recognition of exiting exchanges under the SCRA by SEBI by allowing such exchanges or their successor entities to retain their movable and immovable assets and to deal with such assets as they deem fit subject to compliance of necessary conditions. Consequent upon de-recognition, the trading members of such exchanges shall cease to be trading members and therefore, liable to be de-registered as stock brokers and their certificate of registration granted by SEBI shall accordingly stand automatically cancelled. In case of sale/distribution/transfer of assets/winding up of such

[5]Now known as Securities Contracts (Regulation) (Stock Exchanges And Clearing Corporations) Regulations, 2012

[6]Guidelines in respect of exit option to Regional Stock Exchanges - MRD/DoP/SE/Cir- 36 /2008 dated December 29, 2008.

exchanges/companies, the relevant provisions of the various laws such as Income Tax Act, 1961, the Companies Act, 2013, Stamp Act, etc. would apply. In case of companies exclusively listed on those de-recognised stock exchanges, it shall be mandatory for such companies to either seek listing at other stock exchanges or provide for exit option to the shareholders as per SEBI Delisting Guidelines after taking shareholders' approval for the same, within a time frame, to be specified by SEBI, failing which the companies shall stand delisted through operation of law.

2.8.2 The National Stock Exchange

The NSE is the culmination of the recommendations made by a high-powered study group that was set up to examine the issue of establishment of new stock exchanges in the early 1990s. The NSE was promoted in 1992 at the instance of the Government of India as a sponsored institution of the financial institutions led by IDBI, insurance companies and commercial banks as a nation-wide stock exchange with the objectives of: (i) providing access on equal and fair basis to investors across the country through efficient and transparent securities trading system, (ii) provide shorter settlement cycles and book entry settlements, (iii) to provide international standards in market mechanisms through appropriate technology and (iv) to activate and promote a deeper secondary market for long-term corporate and government debt paper. NSE is a tax paying company unlike the other stock exchanges in India. NSE received recognition under the SCRA from the Government of India in April 1993. It has three main trading segments: (i) the Wholesale Debt Market (WDM) that started operations from June 1994, (ii) the Capital Market Segment (CMS) that started operations from November 1994 and (iii) the Futures and Options (F&O) segment that started operations in June 2000. The NSE is a fully system driven and automated stock exchange that allows its members to deal from their own premises as it does not have the concept of a trading ring. The system is order driven and not quote driven and provides trading terminals all over the country linked via satellite communication device.

The WDM caters to institutional debt investors such as financial institutions, mutual funds, banks and FIIs and it deals in fixed income securities consisting of both long-term debt paper such as dated government securities, PSU bonds, corporate debentures, bonds of financial institutions and short-term debt paper such as treasury bills, call money, commercial paper, certificates of deposit and repurchase options (repos). The CMS deals with equity and equity related instruments such as convertible debentures of companies that have made issues in the primary market either on the NSE or other stock exchanges. The CMS offers real time quotes to traders and provides vast information on trading systems, clearing and settlement and risk management. The derivatives segment of the NSE (the F&O segment) commenced operations by offering exchange traded derivative instruments such as index futures and registered a modest turnover of ₹4018 crore in the first year. Index options were introduced in June 2001 followed by stock options and stock futures on individual stocks in the same year. The volumes since then showed a significant increase with the introduction of index options in June 2001, stock options in July 2001 and stock futures in November 2001. At present, the NSE accounts for most of the turnover in the derivative segment in India.

The NSE follows the NSE-50 stock index for measuring the performance of the market based on trades made on the exchange. It is a very complexly constructed index that reflects the price movement of fifty selected scrips (which have a market capitalisation of ₹50 crore each) with respect to the base value of 1000 which was set on November 3, 1995. It is a value weighted index that measures the stock price movements on the basis of market capitalisation of the selected scrips. Since the NSE was set up in collaboration with Standard & Poor, the rating agency based in USA and CRISIL in India for introducing index based derivative business in India, the NSE-50 was rechristened the S&P CNX Nifty. The NSE introduced two other indices, the NSE Junior Index for mid-cap companies which is now known as the CNX Midcap (CNX Nifty Junior) and a dollar denominated index called the Defty which was later rechristened as S&P CNX Defty.

The NSE was set up as a company and is completely demutualised since inception, i.e. its ownership is distinct and separate from its membership. In other words, its shareholders are different from its members. The NSE has several prestigious investors including Goldman Sachs and NYSE Euronext. The NSE initiated the process of getting itself listed through an IPO in 2017.

2.8.3 The Bombay Stock Exchange, Mumbai

The Bombay Stock Exchange (BSE), which is Asia's oldest stock exchange and which was also the only nation-wide stock exchange for a long time until the setting up of the NSE and the OTCEI, evolved over the years from a ring-based exchange into a ringless screen based exchange. It provides efficient trading systems for equity, debt and derivative segments across the country. BSE became a listed company when it made its IPO in 2017 and got listed on NSE. It was the first stock exchange allowed to list in the Indian capital market. Earlier, the stage was already set when the leading commodity exchange MCXregulated by the erstwhile FMC was taken public in 2012. The BSE is the biggest exchange in the country (as of 2017) in terms of fresh capital issuances and the number of companies listed on it. It also enjoys the distinction of permanent recognition from the Government of India. According to the SEBI Handbook of Statistics for 2015, BSE had an average market capitalisation of ₹1,00,37,734 crore (₹100.37 trillion) during 2015.

Keeping in line with technological developments and the setting up of the NSE as a competitor with screen based trading, the BSE switched over from physical ring-based trading to screen-based ringless trading under the name of Bombay On-line Trading (BOLT) in 1995 which is a quote-driven system unlike the order-driven system of the NSE. By July 1995, all the scrips traded on the BSE were shifted to BOLT system and currently, the BOLT system offers trading in all the three segments, i.e. equity, debt and derivatives.

The BSE operates two main stock indices: the widely-followed BSE Sensitive Index (popularly known as the BSE Sensex) and the BSE National Index. The BSE Sensex has for generations been the barometer of the stock market in India and measures the movement of thirty selected scrips with respect to the base value of these scrips in the year 1978-79. It is a value-weighted index and measures the aggregate market capitalisation of the chosen shares on a particular day with respect to their average market value in the base year. The BSE Sensex continues to enjoy significant patronage in India. This index is shortly being reset using market float of the selected companies as one of the value weightages.

The BSE National Index is based on a broader sample of 100 scrips that are actively traded in five important stock exchanges in India; namely the BSE, Kolkata, Chennai, Delhi and Ahmedabad. This index has been set up with the reference to 1983 as the base year and is computed on similar lines to the BSE Sensex. Over the years, the BSE set up other indices such as the BSE 200, 500, BSE Mid Cap Index and the BSE Small Cap Index as well.

2.8.4 The ISE

The new entrant into the system of screen based online trading is the Interconnected Stock Exchange of India Ltd., which was dubbed as a futuristic exchange and was promoted by fifteen regional stock exchanges to provide cost-effective trading linkage/connectivity to all the members of the participating exchanges. With the advent of on-line trading from the NSE and the BSE, regional stock exchanges were made virtually defunct over the past several years for which the ISE was supposed to provide the answer. The genesis of the ISE lay in the gradual demise of the regional stock exchanges after the abolition of the Badla System of roll over in trades and introduction of uniform settlement cycles by SEBI in 2001. These market reforms did away with a large proportion of trading interest among the regional brokers who were specialised in Badla and arbitrage trading in different stock exchanges. As members graduated to NSE and BSE and migrated from regional trading, these exchanges lost turnovers and things came to nought around 2005. The Ministry of Finance also withdrew in 2003 the mandatory requirement of regional listing for companies listed on NSE/BSE. This spelt the death knell for regional stock exchanges as more and more companies delisted from regional exchanges.

The purpose of the ISE was to widen the market for the securities listed on the participating exchanges. ISE was launched with an objective of converting small, fragmented and illiquid markets of regional exchanges into large, liquid national-level markets. ISE is, therefore, a national-level stock exchange and provides trading, clearing, settlement, risk management and surveillance support to its traders and dealers. While the bigger exchanges such as NSE and BSE cater to the larger companies and their own members, the ISE aims to provide level playing field to smaller companies in particular and to the brokers acting on regional stock exchanges. ISE also aims to provide adequate infrastructure in terms of connectivity, state-of-the-art trading systems and transparent mechanisms to member stock exchanges so as to optimise their existence and promote regional markets. The ISE has been in business since February 1999 and its current trader membership includes about 850 brokers from participating exchanges. In addition, the ISE has around 500 dealers across 70 cities other than the participating exchange centres. In effect, the ISE was positioned as a national exchange of exchanges for the regional stock exchanges of India.

With the aim of providing wider access to its members and dealers outside the interconnected regional market, ISE floated a wholly-owned subsidiary, ISE Securities & Services Limited (ISS), which took up corporate membership of the National Stock Exchange of India Ltd. (NSE) in both the Capital Market and Futures & Options segments and in the BSE Equities segment. The ISE, thus, provides the investors in smaller cities a one-stop solution for cost-effective and efficient trading and settlement in securities. ISE has set up clearing house facilities at various locations for the convenience of its traders and dealers. Settlements on the ISE are guaranteed its own Settlement Guarantee Fund. It has also registered with the Stock Holding Corporation of India as its registered custodian for institutional trades. ISE also set up direct connectivity with NSDL to facilitate settlements of securities in physical and dematerialised form as well.

Despite all the efforts in trying to promote regional stock exchanges with a nationally integrated platform in the form of the ISE, the writing on the wall for regional stock exchanges is imminent. The ISE failed to take off in a big way due to lack of trading support from regional members and no regulatory backing to bring more companies from regional markets to the ISE. Though it took off on an encouraging note, the ISE quickly lost trading turnover and had to remain content with its subsidiary's activities as a member of the NSE and BSE and other peripheral activities such as depository services, research and investor education. The ISE's future depends on legislative backing to make listing on the exchange mandatory for existing and new issuers on NSE and BSE. However, that may not be the case. Moreover, the NSE and BSE continue to have lower threshold of paid up capital for listing companies which were fixed in the mid-nineties when issuers were smaller companies. Unless the BSE and NSE increase these thresholds, there is no compulsion for smaller companies to list on the ISE. Lastly, with the introduction of the SME platforms for smaller companies both on NSE and BSE, the future for ISE looks extremely bleak.

2.8.5 The SME Exchange

Due to the virtual demise of the OTCEI, since 2010, SEBI was in the process of directing the major stock exchanges (BSE and NSE) to set up separate trading platforms for small and medium enterprises under the name of SME Exchange. Both NSE and BSE received approvals to set up SME Exchange platforms from SEBI by late 2011. SEBI also issued a separate set of regulations for listing of SMEs on main stock exchanges. As small enterprises typically find it difficult to get investors and raise money, the guidelines for SMEs have several relaxations compared with the ICDR Regulations for other listed companies. The proposal was delayed due to certain reservations expressed by merchant bankers on certain proposed rules of SEBI that require market making to SME offerings upto 3 years from the date of listing. After protracted consultations by SEBI with small firms, industry representatives, merchant bankers, the BSE platform finally took off with its first IPO of BCB Finance Ltd., a NBFC in February 2012. The NSE simultaneously announced the launch of its own SME platform brand named as *Emerge*. Several other small and medium companies listed on the SME exchange of BSE and NSE in the subsequent years and the platform is expected to stabilise as a viable platform for small companies to raise public equity in the years to come.

The key factor that would determine the future of this initiative of SEBI is the liquidity in SME scrips and investor interest therein. In the past, the experiment with OTCEI did not materialise primarily due to the lack of liquidity in OTCEI scrips as compared to their illustrious peers on the main exchanges. Price volatility and investor support could remain a challenge till the SME platforms take off in a big way. The other challenge would be the viability of market makers and their continued interest in bringing more IPOs to this platform. Market makers could land up with large inventories of scrips, increased holding cost and significant losses when markets are flat or bearish over longer terms. There is also significant concern on trying to create liquidity artificially through the market making mechanism for what would essentially be a large investor market. Since SEBI specified a minimum threshold of ₹one lakh for investment in SME issues, the market would essentially be confined to HNIs and institutions.All these structural issues need to be evaluated over time to make the SME platform successful and ensure that it does not meet the same fate as the OTCEI.

2.8.6 The Metropolitan Stock Exchange

The Metropolitan Stock Exchange (formerly MCX-SX) is one of the new generation stock exchanges in India which was promoted jointly by MCX and Financial Technologies India Ltd. (FTIL). FTIL was promoted by a first-generation entrepreneur named as Jignesh Shah. However, many leading PSU banks of India, IL &FS Financial Services Ltd., HDFC Bank and IFCI Ltd. also became significant shareholders in this exchange (MSEI). The MSEI started operations in October 2008 after it received approval from SEBI only to commence FOREX derivative trading by launching monthly contracts in the USD/₹ currency pair. It later expanded its product offering to ₹/GBP, ₹/EURO and ₹/YEN pair categories as well. All futures contracts on the exchange are notional and settled in cash with no physical contracts. All participants on the MSE trading platform have to participate only through trading members of the Exchange. Since futures are exchange traded products, MSE eliminates counterparty risk.

In July 2012, pursuant to the order of the Supreme Court in April 2012, the SEBI gave approval to MCX-SX to operate as a full-fledged stock exchange by adding the equity, debt market and derivative segments. The main bone of contention between SEBI and the exchange was about its ownership. Accordingly, the approval given by SEBI was with the rider that both FTIL and MCX, being the promoters of the exchange would cut their combined shareholding and voting rights to 5% of its paid up capital within the stipulated time, i.e. 18 months from the date of the approval. They were also to reduce their equity entitlements arising from warrants and other instruments to within the prescribed limits under the Regulations of SEBI[7] within three years. SEBI's approval marked the end of a two year wait period for MSEI to become a full-fledged stock exchange. Subsequent to the National Spot Exchange Ltd. (NSEL) scam in which FTIL was involved, MSEI suffered a dent to its image. However, in subsequent years, it could bring serious competition in the stock exchange business to the market leader NSE and its close rival the BSE. The MSEI is jointly regulated by SEBI and the RBI. While SEBI regulates its administration, the RBI regulates the currency derivative products offered by the exchange.

[7]Securities Contracts (Regulation) (Stock Exchanges And Clearing Corporations) Regulations, 2012

2.8.7 The USE

The United Stock Exchange of India is the latest entrant into the stock exchange arena in India. It has been promoted as a full-fledged stock exchange to offer all financial products progressively. The exchange received the status of a recognised stock exchange under the SCRA from the Government of India and became operational in September 2010 offering currency options and currency futures.

According to its official website information, USE's stakeholders include the Bombay Stock Exchange (BSE), 28 banks and three major corporate houses. In 2011, Standard Chartered Bank Plc took a stake in the exchange representing its first strategic investment in an exchange worldwide. The USE offers trading in currency futures on the USD/GBP/Euro/Yen currency pairs all trading against the ₹ as well as currency options on the USD-₹ pair. USE offers access through its front-end, Fastrade. The exchange also allows various other platforms for automated trading, including the NEST platform developed by Omnesys Technologies. In the next stage, USE will offer exchange traded interest rate derivatives such as interest rate futures. The USE had more than 550 registered members in waiting in 2011.

The initial objective of the USE was to provide exchange traded currency derivatives to large corporates and Small and Medium Enterprises (SMEs) for managing foreign exchange risk through sound risk management practices and standardisation processes. Several Indian corporates had booked significant losses in forward contracts against the USD and other currencies in the wake of the financial crisis in 2008. Exchange traded currency futures provide better risk management as compared to forward contracts that are sold by banks on a bilateral basis to corporates. The strategic objective of USE in having a parentage of all major banks of India seems to be to offer currency futures and options to their clients and gradually move them away from bilateral forward trades. The other major area of interest for USE is the interest rate derivative segment offering interest rate futures and options. These are new generation products in India and hold immense potential in future due to interest rate volatility and high borrowings of Indian corporates. The strategic presence of the BSE provides expertise in exchange technology, clearing and settlement, regulatory structure and governance to the USE during its formative years. It would be reasonable to assume that the USE could apply to SEBI for a permission to become a full-fledged stock exchange in future offering equity, debt and stock derivative products as well.

2.9 Capital Market Constituents

The discussion on the capital market is best understood, if the basic constituents are listed first. The basic constituents of a capital market are the five 'I's which are shown in Exhibit 2.3.

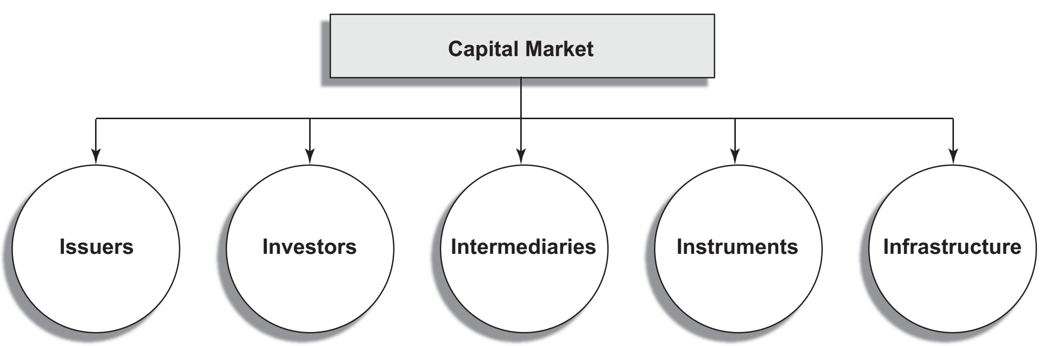

Exhibit 2.3 Constituents of Capital Market

- *Issuers* of securities are incorporates entities, usually joint stock companies with limited liability incorporated under the statute governing such companies in respective countries. In India, these are public companies incorporated under the Companies Act, 2013 or under the erstwhile Companies Act 1956. These companies can again be privately owned or owned by the government (either central or state). Apart from companies, other entities that can issue securities in the capital market are bodies corporate incorporated under special Acts of the Parliament or the State Legislature. The Government can also raise finance from the capital market using the long-term debt route. This is the reason why a major portion of the debt being issued and traded in the debt market consists of dated government securities. Various types of issuers are detailed in Chapter 3.
- *Investors* in securities can be either wholesale investors or retail investors. The wholesale segment primarily comprises of institutional investors such as mutual funds, investment institutions and wealthy non-institutional investors known as High Networth Investors or HNIs. The retail segment consists of households and other small investors. The discussions on each type of investors in the Indian capital market are provided in Chapter 3.
- *Intermediaries* and service providers help in the mobilisation of resources from the investors and provide other support services. Capital market intermediaries consist of brokers, merchant bankers, underwriters and market makers. Support service providers include custodians, depository participants, registrars and share transfer agents. Capital market intermediaries and support service providers are discussed in this chapter while those with specific reference to primary markets are discussed in Chapter 3.
- *Instruments* are securities floated in the capital market for the purpose of raising capital in both debt and equity. These include equity securities such as equity shares, preference shares, convertibles such as fully or partly convertible debentures, warrants and pure debt instruments such as non-convertible debentures and bonds. Debt securities carry interest, which is usually fixed beforehand so that the investor knows the return that can be made in the investment. Equity securities (called shares) are more akin to ownership in the underlying business of the company that issues such shares. Therefore, shares do not carry any assured return and can either provide high returns in the form of share in profits of the business (known as dividends) or can wipe out the entire investment itself, if the underlying business makes a loss. Thus, equity and equity linked securities are perceived as risky and require thorough knowledge of the relevant businesses before one chooses to invest in them. Capital market related securities in equity and debt categories are discussed in detail in Chapter 3.
- *Infrastructure* is required for the efficient functioning of the capital market, which consists of the stock exchanges, the depositories, the regulators and the necessary statutory framework. Moving further, since the capital market cannot function without the development of adequate infrastructure, the stock exchanges play a pivotal role in providing trading and settlement platforms backed by technology backbones that create efficiency in transactions. The stock exchanges also provide stock indices, which are the barometers for judging which way the market will move and in taking up positions in stocks accordingly. There are currently two depositories functioning in India, the NSDL and CDSL. The role of these agencies has been discussed in a subsequent paragraph of this Chapter.

In order to maintain the orderly functioning, growth and efficiency of the capital market, most economies have capital market regulators and a framework of securities laws to instil confidence and legal protection among the players in the market. The distinction between the capital markets of the medieval era and that of the modern era is the presence of sophisticated default protection mechanisms and legal framework to prevent moral hazards and promote corporate governance. The securities laws and regulators governing the functioning of capital markets in India is described in Chapter 1.

2.10 Capital Market Intermediaries and Service Providers

In all the segments of financial markets, there exist several intermediaries whose main function is to act as facilitators to the functioning of the financial markets. In the capital markets, there are intermediaries such as broking houses, investment firms, mutual funds, underwriters, investment banks and merchant banks. In the foreign exchange markets, there are intermediaries such as authorised dealers and money changers.

The most important capital market intermediaries are investment banks, stock brokers, merchant bankers, underwriters and market makers. Support service providers include custodians, depository participants, registrars, share transfer agents and debenture trustees. Apart from stock exchanges that provide market infrastructure, the other important agencies are the depositories who provide electronic connectivity so that securities can be traded and held electronically without the need for physical holdings. In this paragraph, we discuss the functions of stock brokers and sub-brokers, depositories and depository participants, custodians, share transfer agents, debenture trustees, credit rating agencies and portfolio managers. The roles played by primary market intermediaries such as investment banks, merchant bankers, market makers, registrars to issues, underwriters and others are discussed at appropriate places in subsequent chapters of the book.

2.10.1 Stock Brokers and Sub-brokers

Brokers are the primary link between the securities market and the investors. The association of stock brokers with the stock exchanges is more than a hundred years old in India. The function of a broker is to deal on behalf of his clients who are the actual investors in the market. This is because actual investors cannot trade on the stock exchange directly and can do so only through brokers who are members of the stock exchange. The broker either buys or sells on client account for a brokerage, which is charged for every such deal. Therefore, a broker's service is that of an intermediary and is non-fund based.

2.10.2 Depositories and Participants

The depository system in securities dealing was the culmination of a long-felt need in the securities market in India for a reliable and efficient way of handling security dealings. The way out of the ill-effects of physical handling of securities was to convert them into electronic form and deal with them through electronic transfers much the same way as electronic fund transfer has eliminated actual transportation and dealings in physical currency. Such a method of conversion of physical securities into electronic form is known as *dematerialisation*. The conversion of it wherein electronically held securities are re-converted back into their physical form is known as *re-materialisation*. Both de-materialisation and re-materialisation can be made possible with the existence of a *depository*, which is the central agency that maintains electronic records of securities. In the depository system, the holding and trading of the securities is in scripless form (without physical certificates). In addition, unlike in the physical system, in the depository system, the securities become fungible, i.e. the securities do not have individual existence through distinctive numbers.

The Depositories Act 1996 is the law under which dematerialisation was legalised in India. This law provides for more than one depository to be set up in the country in order to promote healthy competition in the industry. However, since depositories are essentially public institutions that provide infrastructural support to the securities market, it would be essential for them to have shareholding upto 60% by stock exchanges, banks and other eligible sponsors.

Presently, there are two depository institutions functioning in India: the National Securities Depository Limited (NSDL) promoted by the IDBI, UTI and the NSE as a company under the Companies Act on June 7, 1996 and the Central Depository Services Limited promoted by the BSE and Bank of India in

February 1999. The business of depositories is regulated by SEBI. The depository system works with the following structure:

- Depository (presently either NSDL or CDSL) which keeps the electronic ledgers for the securities of all issuers that are listed in the stock market.
- Depository Participant (DP) who acts on behalf of the depository as an agent and becomes the interface between the investor and the depository. According to SEBI guidelines, eligible institutions that can be registered as participants include financial institutions, SFCs, banks, custodians, clearing corporations of stock exchanges, stock brokers and NBFCs. The DP maintains individual transaction ledger of each investor who has opened an account with such DP for all security dealings made by such investor. In order to keep track of investors and DPs, each DP is provided a unique identification number by the depository and each investor who opens a demat account with a particular DP, is also provided a unique investor number.
- The Issuer company in the case of a fresh issue of securities and all existing listed companies in the case of existing securities need to enable dematerialised trading in their shares or other securities. For this purpose, they enter into an agreement with the concerned depository.
- The registrar to the issue in the case of a fresh issue should also enter into an agreement with the depository for enabling issue of the proposed securities in dematerialised form. Usually, a tripartite agreement is drawn up involving the issuer, the registrar and the depository.
- Clearing members who are members of the clearing corporation that handles the clearing operations of security deals in electronic form.
- Clearing corporations that are institutions in the business of handling clearing operations for respective stock exchanges.
- The beneficial owners are the actual investors in securities. In the depository system, the depository is the registered owner of the shares in the register of members maintained by the issuer company while the actual investors are the beneficial owners whose details are kept by the depository participants.

2.10.3 Custodial Services

A custodian as defined in the SEBI (Custodian of Securities) Regulations, 1996 is a person carrying on the business of providing custodial services which relate to safekeeping of securities of a client and providing services incidental thereto such as:

- Maintaining accounts of securities of a client.
- Collecting the benefits or rights accruing to the client in respect of securities.
- Keeping the client informed of the actions taken or to be taken by the issuer of securities, having a bearing on the benefits or rights accruing to the client.
- Maintaining and reconciling records of the services referred to above.
- Over the years, the Regulations have been extended to the services relating to gold including safekeeping thereof with respect to clients engaged in gold traded mutual funds.

The Regulations provide for a minimum net worth requirement of ₹50 crore for custodians and for compulsory registration. The other requirements include general obligations such as adherence to the code of conduct, maintenance of separate accounts with respect to each client, entering into agreement with each client, maintenance of records and documents and furnishing of periodic information.

2.10.4 Share Transfer Agents

Share Transfer Agents (STA) are service providers who maintain ledger records of all shareholders of a company and of transfers in shares arising out of day to day trades on stock exchanges with respect to such company's shares on an on-going basis. The shares of a listed company are traded on daily basis on the stock exchange which results in frequent updation of records of shareholders and the register of members. Therefore, it becomes a specialised service and is often outsourced by several listed companies. The business of a STA is clubbed with that of an issue registrar by all the service providers since it is a logical extension thereof. However, this is not mandatory and these businesses can be carried on separately, if so desired. The business of a STA is regulated by the SEBI (Registrars to an Issue and Share Transfer Agents) Regulations 1993. These regulations provide for compulsory registration, minimum capital adequacy requirements, general obligations and responsibilities such as maintenance of books and records and more importantly, appointment of a compliance officer. The role of a compliance officer of a STA is to monitor the compliance of all statutory requirements either issued by SEBI or the Government for addressing investors' grievances. The compliance officer has a reporting responsibility as well to SEBI, of any non-compliance observed in the operations of the STA.

2.10.5 Debenture Trustees

The concept of trustees being appointed to address the interests of investors in debentures which are basically long-term debt instruments issued by companies has been in vogue for sometime. Initially, it was the commercial banks which used to take up this function and later on financial institutions such as the ICICI, IFCI and IDBI entered the fray as well. The task of a debenture trustee is cut out quite clearly and is essentially a support service function. Since debentures holders are normally many who cannot be expected to safeguard their rights individually, the trust structure is evolved whereby the assets that are required to be secured for the debentures are secured in favour of the trust. The debenture trustee is appointed to administer the trust mechanism in the interests of the debenture-holders who are made the beneficiaries to the trust. The whole structure is built through a debenture trust deed or a trusteeship agreement which provides for terms and conditions that govern the issue of the debentures, creation of security, enforcement thereof in case of default and other provisions intended to protect the interests of the debenture holders.

The debenture trusteeship business is regulated under the SEBI (Debenture Trustees) Rules 1993 and the SEBI (Debenture Trustees) Regulations, 1993. These provide for compulsory registration of persons acting as debenture trustees and for responsibilities and obligations thereof. There is also a code of conduct prescribed for the performance of this function.

2.10.6 Credit Rating Agencies

Credit rating is an independent third party assessment of a particular security issue by an issuer with the purpose of conveying to the investor the expected capacity and inclination of the issuer to service the issue obligations based on quantitative and qualitative appraisal of the issuer. In other words, credit rating assesses issue-specific default risk associated with an instrument to be subscribed to by an investor. Though internationally, credit rating services have been in vogue, they have been offered in India only in the past 15 years. Internationally, the US based Standard & Poor and Moody's are the largest credit rating agencies. In India, credit rating was kicked off with the setting up of Credit Rating Information Services of India Ltd. (CRISIL) in 1988 as a jointly promoted company of ICICI, the erstwhile UTI, GIC and LIC. The other shareholders of CRISIL were the Asian Development Bank, SBI, the Mitsui Bank, Bank of Tokyo, HSBC and the HDFC. CRISIL has since become a part of the McGraw Hill Companies Group after Standard & Poor acquired majority stake in it. The second institution to come up in this service area was the IFCI promoted Investment Information and Credit Rating Agency of India Ltd. (now known as ICRA Ltd.) in 1991. Later on, IDBI promoted Credit Analysis and Research Ltd. as the third rating agency in 1993. Currently, the other rating agencies in India areIndia Ratings and Research (formerly Fitch Ratings), Duff & Phelps Credit Rating India, Brickworks Ratings and Onicra Credit Rating Agency of India offering credit rating services in India.

Credit rating is both a one-time and a continuing process as the rating is specific to certain parameters considered at the time of rating. Since most parameters are variable, the rating agencies usually have an annual review of the ratings issued by them for which an annual fee is charged. Rating can be specific to a financing instrument or a proposed financing structure. In the latter case, the rating is issued for the structured obligation. Ratings are designated through symbols adopted by each rating agency and these ratings have been made mandatory in several issues in the capital market by SEBI. Like any other capital market related service, credit rating is also regulated by the SEBI under the SEBI (Credit Rating Agencies) Regulations 1999. In order to make the parentage of a credit rating agency credible, SEBI prescribed that it shall not consider an application for registration of a rating agency unless the applicant is promoted by a person belonging to any of the following categories:

1. A public financial institution, as defined in the Companies Act, 2013;
2. A scheduled commercial bank included for the time being in the second schedule to the Reserve Bank of India Act, 1934;
3. A foreign bank operating in India with the approval of the RBI;
4. A foreign credit rating agency recognised by or under any law for the time being in force in the country of its incorporation, having at least five years' experience in rating securities;
5. Any company or a body corporate, having continuous net worth of minimum ₹100 crore as per its audited annual accounts for the previous five years prior to filing of the application with the SEBI for the grant of certificate under these regulations.

These regulations inter alia provide for a minimum net worth of ₹5 crore for the rating agency and prevention of conflict of interest by preventing a rating agency from rating of issues made by the promoter of such rating agency.

As an initiative of the Small Industries Development Bank of India (SIBDI) in association with Dun & Bradstreet Information Services India Pvt. Ltd., the SME Rating Agency of India (SMERA) was started in 2005 based in Mumbai. Apart from the two principal shareholders, the rest of the equity is held by prime Indian banks including ICICI Bank and SBI. SMERA received registration with SEBI under Securities and Exchange Board of India (Credit Rating Agencies) Regulations, 1999 in 2011. The SEBI registration makes SMERA, only the sixth rating agency in India to rate issues related to capital market. SEBI registration enables SMERA to rate the capital market instruments, such as, IPO, bonds, commercial paper, security receipts and others. SMERA is the country's first rating agency that focuses primarily on the Indian Micro, Small and Medium Enterprises (MSME) segment. SMERA's primary objective is to provide ratings that are comprehensive, transparent and reliable. This would facilitate greater and easier flow of credit from the banking sector to MSMEs. The recognition and acceptance of SMERA's ratings within the banking sector would help MSMEs save time, effort and money while approaching different banks for credit. It would also simplify and quicken the process of lending to MSMEs, while simultaneously reducing lending costs to the sector as a whole. SMERA has entered into more than 30 MOUs with banks, financial institutions and trade associations. The patronage of leading banks as its shareholders adds further impetus to promoting SMERA as the premier rating agency for the MSME sector in India.

2.10.7 Portfolio Managers

Portfolio means the total holdings of securities of a person which shall include shares, scrips, stocks, bonds, debentures, debenture stock or other marketable securities of a like nature in or of any incorporated company or other body corporate, Government securities and rights or interest in such securities.

Portfolio manager is any person who pursuant to a contract or arrangement with a client, advises or directs the client or undertakes on behalf of such client, the management or administration of a portfolio of securities or the funds of the client, as the case may be. A discretionary portfolio manager means a portfolio manager who exercises or may, under a contract relating to portfolio management, exercise any degree of discretion in respect of the investments or management of the portfolio of securities or the funds of the client, as the case may be. The portfolio manager shall individually and independently manage the funds of each client in accordance with the needs of the client in a manner, which does not resemble a mutual fund. A non-discretionary portfolio manager shall manage the funds in accordance with the directions of the client. The portfolio manager charges a service fee by way of a percentage of the corpus managed.

Portfolio managers are subject to regulation by SEBI under the SEBI (Portfolio Managers) Rules 1993 and the SEBI (Portfolio Managers) Regulations 1993. The regulations provide for complete transparency and strict regulation of the business processes of the portfolio manager. The portfolio manager shall act in a fiduciary capacity with respect to the securities and the funds handled on behalf of clients. A portfolio manager provides the following services:

- Conducts in-depth research into corporate performance with a view to spotting good investment opportunities.
- Invests the clients' money judiciously in a diversified portfolio of shares, debentures etc. to form a rewarding package for the client. However, the SEBI regulations prohibit portfolio managers from promising assured returns to clients.
- Monitors the portfolio and tracks corporate and market developments.
- Arranges for lodging of securities for transfer and for custodial service in case of physical shares. In addition, the manager maintains the file of the client's investments with the background papers on all transactions which form the basis for filing tax returns.
- Provides tax management services on investments.
- In the case of portfolio management for non-residents, the portfolio manager takes care of the following additional matters as well:
  - Obtaining permissions from the RBI, whenever necessary, on behalf of the client for making investments.
  - Opening and handling bank accounts under a General Power of Attorney to operate such accounts for the purpose of portfolio management.
  - Arranging for repatriation of funds as and when necessary.
  - Filing statutory returns with the authorities from time to time under the Income Tax Act and other laws.

2.11 Future Directions

Considering the pace at which the transformation has happened in the Indian securities market and the capital market in particular, it presently ranks as one of the most contemporary and vibrant markets in the world. However, SEBI has a continuous agenda in the key areas that it has identified for future initiatives. The Government of India is also working hard on the reforms process in the area of keeping the corporate and security laws up-to-date with the changes taking place in the market place. In addition, the process of involving professional think tanks in the form of various advisory bodies and committees being set up on various issues concerning the capital market has gained significant momentum in recent years.

The broad areas of future direction in capital market development and functioning in the Indian context could be looked at as follows:

- Due to the sustained growth in the dependence on the capital market by the government and the corporate sector, there is a gradual shift towards better quality paper accessing the market so as not to saturate it and at the same time whet the appetite of investors. The entry criteria into capital markets would get stiffer and continuing disclosures would cover more areas.
- Over the years, the MCA and SEBI have taken initiatives to develop a sustainable corporate bond market in India. The creation of separate corporate bond platforms within the NSE and BSE was a step in this direction. However, the corporate bonds are crowded out by government securities which still dominate the DCM in India. Though bond issuances showed steady increase over the years, especially in the private placement market, liquidity issues still remain in the secondary market. With the broadening of the DCM through introduction of new debt instruments from the corporate sector and municipal bonds, the future holds a great potential for this market. Going by international trends, the corporate bond market in India should eventually have a variety of bonds and securitised instruments to cater to institutional and retail investors. This would provide a viable and long-term alternative source of financing infrastructure and other long gestation projects. It would also help de-risk the financial system by easing the burden on the banking system to provide financing for corporate investments.
- SEBI and MCA attempted to create a separate platform for smaller companies to tap the capital market. The objective was to provide an entry for the medium and small companies that did not satisfy the regular criteria to be able to approach investors to raise capital. Unlike in the past, when the OTCEI was formed as a separate exchange with the same objective, the SME platform is a part of the regular exchanges (NSE and BSE). The OTCEI was unsuccessful in creating a workable ecosystem for small and medium listed companies. The viability of this initiative in future would depend upon investors' fancy for small stocks.
- The structure of stock exchanges in the country transformed due to de-mutualisation and corporatisation. Eventually it appears that both policy and technological trends are moving in the direction of existing and new nation-wide stock exchanges. The current wave of consolidation happening in overseas stock exchanges is an indicator of the fact that India would have large nation-wide state-of-the-art stock exchanges in future handling multiple trading platforms.
- The efforts towards ensuring optimal share of returns from corporate performance to equity investors, which is the underlying idea in the concept of corporate governance, would intensify to educate Indian corporates to follow international best practices. There are already initiatives such as the Institutional Investors Advisory Services Ltd. for advising institutional shareholders on exercising their rights on resolutions passed by listed companies. Such specialist shareholder advisory firms would proliferate in future to cater to the wider demand for shareholder activism.
- The domestic retail investor community would continue to grow at a healthy rate and get distinct market segments and instruments engineered for varying levels of risk. With the introduction of more variety of instruments including securitised debt, government securities, tax free bonds, derivatives etc., the investors have more to choose from. The massive drive on investor education by MCA and SEBI would promote more informed decision making by retail investors. This would put higher demand on issuers and intermediaries. In parallel, the increasing institutionalisation of the investor community through proliferation of mutual funds would accentuate in future. The growth of HNIs and family offices of UHNIs as a distinct investor community is well perceived in the Indian capital market in recent years. HNIs look for customised advice due to which wealth management is catching on in a big way. UHNIs also look for investment opportunities in the unlisted space due to which the domestic VC and PE

industry has become a force in recent times. Though foreign capital dominates the PE industry in India, the emergence of home grown PE funds is a trend that will grow in future.

- Intermediaries in the capital market have become more organised and their quality of services would get better due to certifications, adherence to a code of conduct and regulation. In the broking area, there are more corporate brokers in the capital market than ever before. This trend will continue to build bigger and stronger security houses in future which would provide the entire gamut of capital market securities business under one-fold. This trend emulates the US market wherein securities houses such as Wells Fargo, Charles Schwab and Fidelity perform the same function.
- The security laws in the country would get fine tuned to market requirements especially in the area of global integration and the regulatory overlaps in the roles of SEBI, MCA, DEA and RBI that may be presently exist, would get weeded out. Self-regulatory organisations would gain importance and play a bigger role with the initiatives coming from SEBI which presently regulates the capital market and commodity derivative market after the merger of FMC with itself and the repeal of the Forward Contracts Regulation Act 1952 with effect from 28th September 2015.
- The benefits of technology in the working of the securities markets would be reaped in terms of efficiency in transactions, transparency in markets and enabling integration with global markets. There is already a massive IT backbone governing the securities markets in India and dematerialisation is almost universal across securities. Investors can presently hold equities, bonds, mutual fund units and other securities in dematerialised mode. The convergence of technologies has enabled internet trading and internet banking on real time basis. With fund transfers, stock trading and stock holdings getting digitised, the future holds exciting times for securities markets and investors. SEBI is also looking closely at fine tuning the working of algorithmic trading (high frequency trading) in Indian capital market. The setbacks to algorithmic trading in the case of BATS Exchange and Facebook IPOs in the US and the issues that emerged in the NSE in India provided an opportunity for a rehaul of the system. Eventually, high frequency could dominate the stock trading in India in line with the trends in US markets.
- The avenues available for foreign investors in Indian capital market have been going up in recent years. SEBI and the RBI have been trying hard to curb the excessive use of PNs by foreign investors as also the FDI route for investment by unregulated investors. The current liberalised regime for portfolio investment by both institutional and non-institutional investors through the FPI Regulations of SEBI allows more flexibility to foreign investors. The IDR regulations were also overhauled to attract more foreign issuers to domestic capital market. While these measures prove to be beneficial, Indian market still lags behind in certain areas while attracting foreign capital due to capital flow restrictions under FEMA. While larger financial reform in the capital account convertibility area is dependent upon economic and exchange rate scenario, measures such as allowing dual listing for Indian corporates abroad, entry of foreign investors in areas such as OTC derivatives could prove to be the future developments to further integrate Indian capital markets with their global counterparts.
- The interest of FPIs in Indian stock markets in future would depend on economic fundamentals as well as the GAAR provisions that would take effect from 2017 or thereafter as may be decided which to a certain extent, could vitiate the tax benefits under double taxation avoidance agreements presently enjoyed by such investors. The future could see more Indian broking houses getting enlisted to trade on Singapore Stock Exchange (SGX) on behalf of their overseas clients. The Nifty futures on the SGX became popular in the wake of changes in treatment of international transactions under domestic tax law in India. Several prominent Indian broking houses such as ICICI Securities, Edelweiss, Kotak and IDFC Securities could have their presence in Singapore or other overseas markets.

IMPORTANT TERMINOLOGY

Big Bang
BOLT
BOLT
BSE
BSE Sensex
Capital Market Derivative Segment
CARE
CDSL
CMS
Corporate Bond Market
CRA
CRISIL
Custodian
DCM
Debenture Trustee
Dematerialisation and Rematerialisation
Depositories
Depository Participant
ECM
Exchange Traded
F&O
F&O Segment
G-Sec Market
ICRA
ISE
LSE
Metropolitan Exchange
NASDAQ OMX
NSDL
NSE
NYSE Euronext
OTC Traded
OTCEI
Portfolio Manager
Primary Dealers
Primary Market
Registrar
S&P CNX Nifty
SEAF
SEAQ
Secondary Market
STA
Stock Exchange
Stock Exchange
WDM

TEST YOUR UNDERSTANDING

I. Pick the right answer(s) or the alternative that best fits the description from the alternatives provided under each question.

1. In the capital market, securities are traded:
   (a) Only on stock exchanges under the electronic trading system
   (b) In the secondary market only under the surveillance of the stock exchange as per SEBI regulations.
   (c) In the secondary market, as per the settlement system of the stock exchange
   (d) In the secondary market after they are issued in the primary market
2. In the G-Sec, primary market auctions:
   (a) The RBI provides liquidity to the market through its OMO activities.
   (b) The RBI cannot subscribe to the issue but can underwrite it.
   (c) The primary dealers bid for the auctions and the RBI provides them refinancing through its OMO.
   (d) The RBI cannot participate though it may subsequently trade in such securities through its OMO.
3. The Corporate Bond Market in India consists of:
   (a) Corporate long-term secured debt paper, unsecured long-term bonds issued by banks, financial institutions, corporations, local authorities and PSUs.
   (b) Government securities, SLR bonds and Commercial Paper.
   (c) G-Secs, SLR Bonds, Institutional Bonds and Public Deposits.
   (d) PSU Bonds, Bonds issued by banks and financial institutions and corporates.
4. The SME exchange:
   (a) Is an initiative by SEBI to promote a stock exchange exclusively for SME companies in India.
   (b) Is a separate exchange floated by BSE and NSE to list SME companies in India.
   (c) Is an initiative to help SME companies in India to list in NSE and BSE as a special category of companies.

(d) Is a separate listing and trading platform for SME companies within the existing organisation of NSE and BSE respectively.
(e) Is a separate platform set up jointly by NSE and BSE to promote the listing of SME companies in India.

5. The principal responsibility of a debenture trustee is to provide a safety net to debenture holders that theirinterests will be protected in all circumstances for the timely debt servicing on their securities:
   (a) Yes (b) No
6. Under the depository system:
   (a) The depository participant keeps the accounts of the shares held by the shareholders and therefore maintains the register of members of each company.
   (b) The list of beneficiaries of the shares is held by the depository participant while the depository keeps the record of shares of each company.
   (c) The depository is recorded in the register of members maintained by the company while individual accounts of members are maintained by the depository participants.
   (d) The accounts of beneficiaries are maintained by the depository participants while the accounts of the depository participants are kept by the depository.
7. A debenture trustee mechanism works as follows:
   (a) The beneficiary is the representative of the trust.
   (b) The debenture trust is the representative of the debenture trustee.
   (c) The trustee is appointed to hold the debentures on behalf of the beneficiaries of the trust.
   (d) The debenture holders are the beneficiaries of the trust which is managed by the trustee.
8. The following market intermediaries and support service providers are not regulated by SEBI:
   (a) Portfolio managers (b) Insurance brokers and risk advisors
   (c) Depository participants (d) Custodians
9. A credit rating agency provides:
   (a) Market intelligence to an investor on various companies and investment options.
   (b) Relative strength of a particular debt option with regard to the regular and timely servicing of interest and repayment of principal.
   (c) Market intelligence on defaulters, potential defaulters and companies staring at bankruptcy.
   (d) Guidance to investors on the probable outcome of their investment in a particular security or transaction.
10. One of the drawbacks of the corporate bond market in India has been:
   (a) Lack of credit rating on bond issues by companies.
   (b) Lack of awareness among investors about the merits of investing in corporate bonds vis-a-vis bank deposits.
   (c) Lack of interest in secondary trades in the non-institutional secondary market.
   (d) Complicated structure of bonds issued by companies without adequate guidance to investors.
11. One of the pre-requisites for the development of a municipal bond market is:
   (a) Ensuring that municipal bodies have credit limits from banks.
   (b) Transparency and GAAP compliant accounting system for municipal bodies.
   (c) Government guarantee for all municipal bond issues.
   (d) Budgetary allocations by governments for timely servicing of municipal bonds.
12. Identify the category of securities that is not a part of the Corporate Bond Market:
   (a) Corporate long-term secured debt paper, unsecured long-term bonds issued by banks, financial institutions, corporations, local authorities and PSUs.
   (b) Government securities, SLR bonds and Commercial Paper.

(c) G-Secs, SLR bonds, Institutional Bonds and Public Deposits.
(d) PSU bonds, bonds issued by banks and financial institutions and corporates.

13. Which of the following financial instruments are not a part of Capital Markets:
    (a) Index futures
    (b) Units issued by REITs
    (c) Securitised debt instruments
    (d) PTCs
    (e) Repurchase Options
    (f) Currency Derivatives
14. When the corporate bond market cannot meet debt financing needs of issuers:
    (a) The banking system has to step in and increase its risk concentration with consequent systemic risks
    (b) The government has to increase its budgetary spending on the economy
    (c) The RBI has to increase the monetary base
    (d) Interest rates have to be increased to match the increased risk to the investors
    (e) SEBI has to intervene to provide risk protection
15. Government securities are dated long-term debt while corporate bonds can be both long-term and short-term securities:
    (a) True
    (b) False

For answers refer to Appendix B at the end of the Book.

3 Primary Markets and Securities Issuances

LEARNING OUTCOMES

- Overview of the primary markets in equity and debt segments.
- Constitution of Primary Market Issuers and Investors.
- Different types of institutional and non-institutional investors.
- Primary Market Intermediaries and Support Service Providers.
- Primary Market Instruments—concepts relating to Debt and Equity Instruments used in capital market issuances.
- Securitisation, Structured Products and Obligations.
- Types of Primary Market Securities Issuances.
- General Statutory Provisions for Issuance of Securities.

3.1 Introduction

As indicated in Chapter 2, the primary market is the segment in the capital market that deals with new issuances of securities by eligible issuers. These new securities are subscribed to by investors which enable these issuers to raise capital for their business activities. Therefore, the primary market is the fund-raising platform in the capital market. An essential feature of the primary market is that it has to be driven by new *issues* of securities by different issuers. Each new issue adds to the floating stock of such securities in the secondary market. As far as investment banks are concerned, their core activity of financial intermediation is closely linked to the primary market. Therefore, discussion on primary market and security issuances is central to the scope of this book.

In terms of capital issues, post-independence, the activity of fresh capital issues both in equity and debt became heavily controlled processes under the Capital Issues (Control) Act 1947. There were very restrictive rules under this enactment that prevented companies accessing the capital market in accordance with their capital requirements. Every public offer required the approval of the central government and pricing of shares was subject to a restrictive pricing formula under the CCI Guidelines. The concept of *free pricing* of a share was non-existent and the right of a company to charge a particular price for its share in the capital market was determined through an administrative clearance rather than through market validation. This regime led to very few Indian companies making issues and raising capital from the capital market. Most of them depended on the development financial institutions such as IDBI, IFCI, ICICI and the SFIs for their capital requirements and remained unlisted. The capital gearing of Indian companies was also high due to the fact that most of their capital comprised of long-term loans from such institutions and commercial banks.

3.2 Evolution and Growth of Primary Market in India

The primary equity market went through historic changes with the abolition of the Capital Issues (Control) Act 1947 in 1991 and the subsequent advent of SEBI as the capital market regulator with the passage of the SEBI Act in 1992. During the first decade of its regulation, the SEBI has brought in a paradigm shift in Indian capital market and the primary market has had its share of reforms. Some of these are listed below:

- The most fundamental change in the primary market was the introduction of free pricing of equity, which meant that issuers could price their shares based on market forces and their fundamentals without recourse to administrative clearance. SEBI has brought about significant improvement to this concept with the introduction of the book building mechanism that helps in better price discovery.
- The second landmark change was in the area of improving the disclosure requirements for issuers so that investors could take more informed investment decisions. The introduction of the DIP guidelines (now ICDR Regulations) and their constant improvement since their introduction in 1992 led to quite elaborate disclosure requirements. Prior to the DIP guidelines, the only disclosure requirements were in terms of Section 56 read with Schedule II of the Companies Act 1956. Apart from disclosures, the DIP guidelines ushered in investor-friendly measures such as eligibility norms for issuers, lock-in of shares, minimum contribution from promoters, compulsory rating for debt instruments, reservation in allotment for small investors, IPO grading, etc.
- SEBI introduced statutory recognition to merchant bankers by making them responsible for issue management. The issue manager brings in the professional expertise to the entire process of a public offer.
- SEBI brought the activities of all issue intermediaries under its purview through suitable regulation to improve the quality of primary market services.
- The issue delivery mechanism was brought in tune with technological improvements. SEBI made it mandatory for all new IPOs to be made only in the dematerialised form. Similarly, the process of making an issue by uploading through the system platforms of brokers of the stock exchange was also introduced. In future, SEBI proposes to make provisions for a completely online issue through internet access (e-issue).
- Over the years, SEBI reduced considerably the time between closure of an issue and listing of the shares. Since the statutory requirements on delay in allotments and listing under the Companies Act are quite weak, SEBI began to use its powers under the SEBI Act to curb excessive delays in the public offer process. The gap between closure of an issue and listing of the shares was initially reduced to 30 days. In 2011, it was brought down to 12 days. It was further brought down to 6 days in line with several international markets. SEBI is constantly working on further reforms in primary market to improve investor perception and efficiency in the system. The reduction in time to listing was enabled mainly due to the introduction of *Application Supported by Blocked Amount or ASBA* which was made mandatory for all retail applicants.
- SEBI is working with the MCA and external agencies such as the ICAI, ICSI and the stock exchanges on promoting the equity cult, providing investor education and better awareness of equity investments. In this connection, SEBI has already circulated a *risk disclosure document* as per which investors have to be furnished by brokers while dealing with them. Streamlining the broker-client contracts, corporatisation of broking houses, introduction of KYC in capital market transactions and transparency in services are steps that have enhanced the efficiency of market functioning and service quality.

3.3 Primary Equity Market

The primary equity market deals with new equity issues by *issuers'* and investors in such securities and is a part of the ECM. New issues of equity can be made through *public offers* or through *private placements* to few investors. While public offers are a heavily regulated process world over, the extent of regulation on private placement is selective depending upon the type of investors being targeted. Investment banks are required to act as issue managers in the primary equity market. All public offers of equity and related instruments and private placements are governed primarily by the ICDR Regulations of SEBI which form the core of equity primary market regulation. In addition, they are also partly regulated under the Companies Act. Both public offers and private placements are discussed extensively in Section 2 of the book.

3.4 Primary Debt Market for Corporate Bonds

The primary debt market for corporate bonds is the segment which is engaged in the issuance of new long-term debt securities by companies, corporations, municipal bodies and local authorities and is a part of the DCM. As in the case of the primary equity market, the primary debt market is also fed continuously by new issues of debt securities. Investment bankers play an active role in the public offerings and private placements made by companies and other corporations in the corporate bond market. The regulatory framework for corporate bond issues is governed by the SEBI (Issue and Listing of Debt Securities) Regulations, 2008 apart from applicable provisions of the Companies Act.

3.5 Constituents in the Primary Market

The constituents of the primary market are very much akin to the overall structure of the capital market as may be appreciated by a comparison of Exhibit 3.1 and Exhibit 2.2 of Chapter 2. The primary market has specialist service providers led by investment bankers. The issuers and investors are the backbone of the business conducted in the primary market and the various securities on offer enable capital to be moved from investors to issuers. All these aspects are discussed in subsequent parts of this Chapter.

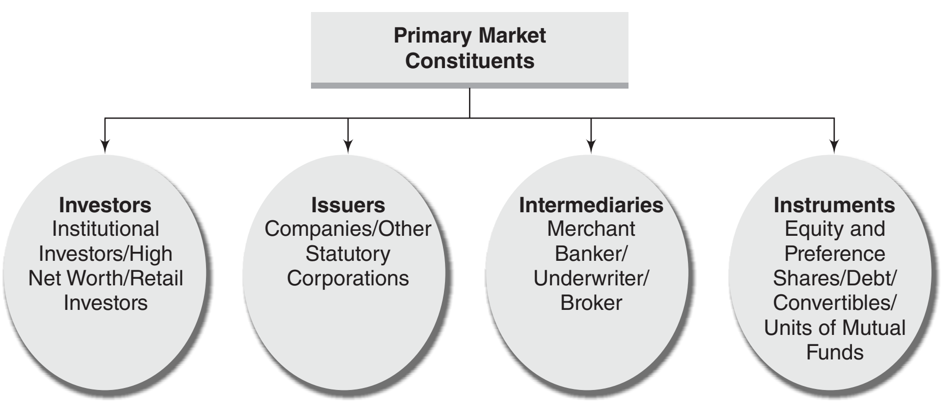

Exhibit 3.1 Constituents in the Primary Market

3.6 Primary Market Issuers

Indian primary market consists of public equity offers made by companies registered under the Companies Act as public companies limited by shares. Other entities that can make such primary market offerings are corporations that are incorporated under a special statute of the Central or the State legislature. These aspects are discussed as follows:

- Companies incorporated under the Companies Act: The Act prescribes that only a public company having a share capital can issue shares to the public for subscription. A public company has been defined as a company that is not a private company. Section 2(68) of the Companies Act throws light on what a private company is. According to it, a private company is one that has the following restrictions in its articles of association.
  - It restricts the right to transfer of its shares, if any.
  - Limits the number of its members to two hundred not including former employee-members.
  - Prohibits any invitation to the public to subscribe for any securities of the company.

From the above, it is clear that a public company shall not have any of the above restrictions in its articles of association that shall preclude it from making a public offer of equity or debt. The second condition to be eligible for making a public offer is that a public company shall have a share capital. As per Section 2(21) the Act, it is possible to incorporate companies that are limited by guarantee and not by shares. Such companies are ineligible to make public offers.

Under the Act, companies can be privately owned or owned by the Government, either Central or State. Government companies, according to Section 2(45) of the Act are those wherein not less than 51% of the paid-up capital is held by the central or a state government or a combination of both. A subsidiary of a government company shall also be deemed to be a government company. There are several instances of a government company that is listed in the stock market. The oil companies such as IOC, BPCL, HPCL and ONGC and others such as HMT listed on the stock exchange without making a public offer. This was possible by the government exempting them from the minimum public holding stipulated under the SCRA. Among other government companies that made public issues are Maruti Udyog Ltd. (subsequently disinvested to Suzuki of Japan), SAIL, BHEL, etc.

- The other type of entities that make public offer of shares are erstwhile corporations incorporated either under a Central Act, or a State Act or a Provincial or Local law. Examples of central corporations are the LIC, GIC, SBI, NTPC, Konkan Railway Corporation, National Power Corporation, National Highways Authority of India, Airports Authority of India and several others. State corporations are incorporated under respective Acts passed by state legislatures such as the transport corporations, urban development, infrastructure and housing corporations, etc. Local and provincial bodies include municipal bodies and others that have a revenue collecting authority in a particular area. These corporations when required, are corporatised, i.e. they are converted into companies incorporated under the Companies Act to become eligible to offer shares in the capital market. Such erstwhile corporations that made public issues in the past after their corporatisation include the IDBI, IFCI, ONGC and IRBI (subsequently converted into IIBI which was wound up). The State Bank of India is an exception in point which continues to exist as a corporation under the SBI Act 1955 but was still been permitted to go public under suitable provisions of the said Act.

3.7 Primary Market Investors

Primary market investors can be basically differentiated into three categories: institutional investors, non-institutional large investors such as NBFCs, UHNIs or HNIs and their family offices, and small or retail investors. The institutional investors and non-institutional large investors comprise the non-retail category. The essential feature that distinguishes retail investors from the non-retail category is their status and the size and purpose of investment. While retail investors are mostly investment oriented, non-retail investors are mostly in the business of investments. All the three categories have been discussed in the upcoming sections:

3.7.1 Institutional Investors and UHNIs/HNIs

There are several categories of large investors in Indian capital markets, some of whom are institutional investors and the rest are non-institutional UHNIs/HNIs. In common parlance, large non-institutional investors are those who invest large corpus of funds in the securities market either because they are investment companies or other bodies corporate such as trusts, societies or HUFs which have large investible funds. The distinguishing feature of institutional investors from other large investors is their stature. Usually, institutional investors are financial institutions that have an important role in the financial markets such as banks, institutions and mutual funds. The various categories of large investors in the Indian capital market are listed as follows:

- Multilateral or bilateral development financial institutions.
- Domestic financial or investment institutions such as the IFCI, IIBI, SIDBI, NABARD, NHB, LIC, GIC, SHCIL, IL&FS, state industrial development corporations, commercial banks, mutual funds, provident funds and pension funds.
- Foreign Portfolio Investors (FPIs) registered with SEBI.
- Domestic Alternative Investment Funds registered with SEBI.
- Foreign venture capital investors registered with SEBI.
- Domestic corporate investors such as Non-Banking Financial Companies (NBFCs), investment companies, private insurance companies, investment banks, underwriters, primary dealers, stock broking companies, portfolio management companies, investment trusts, non-profit societies and others.
- Domestic non-corporate investors who have large investment corpuses such as UHNIs and Family Offices, HUFs, firms and unincorporated bodies.
- Non-Resident Indians (NRIs) and other foreign investors investing under the FDI policy of the Government of India.

Among all the above investor categories, some of them have been designated as *Qualified Institutional Buyers or QIBs* as per SEBI law. QIBs have a preferential treatment for investment in new issues of securities. The investor categories that comprise QIBs are the following:

- Public financial institution as defined in Section 2(72) of the Companies Act
- Scheduled commercial banks
- Mutual funds
- Institutional FPIs registered with SEBI
- Multilateral and bilateral development financial institutions
- Venture capital funds registered with SEBI
- Foreign venture capital investors registered with SEBI
- State industrial development corporations
- Insurance companies registered with the Insurance Regulatory and Development Authority (IRDA)
- Provident funds with minimum corpus of ₹25 crore
- Pension funds with minimum corpus of ₹25 crore

Each of the categories comprising QIBs are briefly discussed below so as to provide a better understanding of their activity profile.

Public Financial Institutions

The term *financial institution* has been defined in the RBI Act as any non-banking institution (company, corporation or co-operative society) engaged primarily in the activity of financing other entities through loans and advances or in investment into shares, bonds, debentures and government securities. There are several types of non-banking institutions but those that have been defined under Section 2(72) of the Companies Act are given the status of *public financial institutions* keeping in view their economic significance and public involvement. All the development financial institutions of India (IDBI, IFCI and ICICI) were given this status. Two of them, IDBI and ICICI, converted into commercial banks regulated under the Banking Regulation Act and IFCI converted into a NBFC. The other notified public financial institutions include LIC, IDFC, ARCIL, GIC, TFCI, PFC, NHB, SIDBI, REC, IRFC, several state financial corporations, EXIM Bank and NABARD.

Scheduled Commercial Banks

According to the Banking Regulation Act, banking is defined as *the accepting, for the purpose of lending or investment, of deposits of money from the public, repayable on demand or otherwise, and withdrawable by cheque, draft, order or otherwise*. All banking companies have to comply with the provisions of this act and by the guidelines issued by the RBI which is the banking regulator under this Act. These banks are popularly referred to as commercial banks. A scheduled commercial bank is one that is notified under the Second Schedule of the RBI Act. A scheduled bank has to maintain the specified cash reserve ratio from time to time with the RBI.

Commercial banks can make investments in corporate securities and are as such included under the definition of QIBs. As per prevalent law, the exposure limits of a bank to capital market are capped at 40% of its net worth as on March 31 of the previous financial year. The said ceiling of 40% applies to all forms of capital market exposure, both funded and non-funded. Within this overall ceiling, the bank's direct investment exposure in shares, convertible bonds / debentures, units of equity-oriented mutual funds and all exposures to Venture Capital Funds (VCFs) should not exceed 20 percent of its net worth. The said limit excludes *inter alia,* investments in non-convertible debentures, preference shares and debt-oriented mutual fund schemes.

Mutual Funds

Domestic mutual funds in India that are registered with SEBI under the Securities and Exchange Board of India (Mutual Funds) Regulations, 1996 are a category of eligible QIBs. SEBI regulates these funds through the said regulations. It may be noted that all mutual funds constituted in India have to be compulsorily registered with SEBI. The business of mutual funds and the main provisions of the regulations are dealt with in Chapter 6.

Institutional Foreign Portfolio Investors

FPIs are a separate category of non-resident investors who are provided the facility of investing in Indian capital market both in the primary and secondary segments. Institutional FPIs such as pension funds, mutual funds, investment trusts, asset management companies, nominee companies, universities, incorporated/ institutional portfolio managers or their power of attorney holders (providing discretionary and non-discretionary portfolio management services) are the types of institutions that are eligible to invest in Indian capital market under the FPI route. Investments made by FPIs are regulated by the SEBI (Foreign Portfolio Investors) Regulations, 2014. All FPIs intending to invest in India through this route need to register with SEBI under the said regulations. Under the regulations, a domestic asset management company or a portfolio manager in India which is registered with SEBI can also register itself as an FPI to manage sub-accounts belonging to FPIs abroad. The eligibility criteria for registration under these regulations are quite stiff and the foreign investor should be resident in a country whose securities market regulator is a signatory to International Organisation of Securities Commissions' Multilateral Memorandum of Understanding or other prescribed criteria. FPIs are registered under three categories: (i) Governmental and multilateral agencies, (ii) broad based and well-regulated institutional funds and (iii) all other types of investors.

Under the regulations, FPIs can invest in a variety of debt and equity securities both in primary and secondary markets which are listed or to be listed. These would include shares, debentures, warrants and the schemes floated by domestic mutual funds. They can also invest in dated government securities, treasury bills, derivatives, commercial paper, security receipts and IDRs floated in India. SEBI may add further categories of securities from time to time. The purchase of equity shares of each company by a single foreign portfolio investor or an investor group shall be below ten percent of the total issued capital of the company. Additional conditions as may be stipulated by the RBI or the GoI may also apply to investments made by FPIs.

The total foreign holding in a company by FPIs and their sub-accounts should not exceed 24% of its paid-up capital or its convertible debentures either through the primary or the secondary market or both. This limit can go up to the permitted FDI cap in a particular company if such company passes a board resolution followed by a special resolution in its general meeting having the effect of increasing the FDI limit and subject to prior intimation to the RBI. The maximum holdings of 24% or the FDI cap as the case may be, will not include the following:

- Investments by NRIs/OCBs and PIOs.
- Investments by FIIs through the following alternative routes, i.e. through GDR/ADR issues, euro convertibles and offshore single/regional funds.

As far as pure debt investments are concerned, FPI caps for investments in government securities, corporate bonds and infrastructure bonds issued by infrastructure developers are fixed on an annual basis by the MoF in consultation with SEBI and the RBI. These limits and sub-limits are subject to variation based on the government's policy response to inflow of foreign capital, exchange rate of the ` and other macroeconomic fundamentals.

Disinvestment will be allowed only through stock exchanges in India. In exceptional cases, SEBI may permit sales other than through stock exchanges, provided the sale price is not significantly different from the stock market quotations, where available.

Multilateral and Bilateral Development Financial Institutions

These are a special category of financial institutions that have been set up under international conventions with a mandate for global or regional financing and economic development. The International Finance Corporation, an affiliate of the IBRD, invests in private sector companies in different countries. Similarly, there are government sponsored development financial institutions in several countries that have the same functions. In India, the IDBI Bank still retains its development financing function to some extent. SIDBI, NABARD, NHB, EXIM Bank and State level SFCs and SIDCs are some of the other domestic financial institutions that may be regarded as playing a development role. The development financial institutions of the SAARC region, Asia-Pacific, European Union and other regions and banks such as the ADB, KFW, etc. form this category of investors.

Domestic Alternative Investment Funds

Venture capital funds, private equity funds and other investment domestic investment pools that look for alternative investments such as direct investment in unlisted companies are known as Alternative Investment Funds (AIFs). These are regulated under the SEBI (Alternative Investment Funds) Regulations, 2012. These investors are eligible to invest in primary market securities subject to conditions stipulated under the regulations. Further discussion on these funds is provided in Chapter 6.

Foreign Venture Capital Funds

Foreign Venture Capital Investors (FVCIs) are those funds that are not constituted in India but make investments in Indian capital market. In the year 2000, foreign venture capital investors were brought under the purview of SEBI for such investments. A FVCI has been defined as *an investor incorporated and established outside India which proposes to make investment in Venture Capital Fund(s) or Venture Capital Undertaking(s) in India and is registered with SEBI under the SEBI (Foreign Venture Capital Funds) Regulations, 2000*.

There are two types of foreign venture capital investments that are possible under the current regulatory framework of SEBI:

- By Foreign Venture Capital Investors (FVCIs) registered with SEBI under the SEBI (Foreign Venture Capital Funds) Regulations, 2000 investing in a domestic AIF that is registered with SEBI under the SEBI (Alternative Investment Funds) Regulations, 2012. Under this route, the FVCI would take a one-time approval from RBI for making investment into the fund in India and all subsequent investments made by the fund shall be governed the same way as they are governed for domestic AIFs.
- FVCIs registered with SEBI, directly investing in venture capital undertakings in India. These investments have to be made as per the norms prescribed under the SEBI (Foreign Venture Capital Funds) Regulations, 2000 as amended from time to time.

State Industrial Development Corporations

State Industrial Development Corporations (SIDCs) are special companies (or corporations) set up by the respective state governments of various states in India with the objective of promoting industrial development of their states. These corporations are usually owned entirely by the state governments or public financial institutions. SIDCs are to be distinguished from State Financial Corporations (SFCs) which form part of public financial institutions. Though SIDCs are also primarily financing institutions, they also play the role of catalysing industrial development through facilitation, research and creation of infrastructure.

Insurance Companies

Insurance companies that are registered with the Insurance Regulatory and Development Authority (IRDA) also form a category of eligible QIBs. These are the private insurance companies that operate under the Insurance Act, 1938 and the guidelines issued by IRDA which is the insurance sector regulator in India. The amount of investments that can be made by these companies in the capital market is regulated under the provisions of the said Act and IRDA Regulations.

Provident Funds and Pension Funds

Provident funds in India are governed by the Provident Fund Act 1952 as also the Provident Fund Act, 1925. The investments made by these funds are decided by the governing board under the investment guidelines. The National Pension Scheme is a central government scheme for providing basic provident funds and pension funds have traditionally been conservative and their investment in capital market has been very limited. This sector is, however, going through liberalisation and there would be more funds that would flow from this sector into the capital market. As far as the QIB definition is concerned, SEBI has fixed an eligibility criterion of minimum corpus size of ₹25 crore for a provident fund or pension fund to be classified as a QIB. The pension sector is presently under a process of re-organisation and is awaiting legislative reform and setting up of a full-fledged statutory regulatory authority.

3.7.2 Non-institutional Foreign Portfolio Investors

In the non-institutional category, other non-resident investors such as individuals, family trusts, private investment vehicles etc. can register with SEBI under these regulations and participate both in primary and secondary markets. These investors are also registered and regulated as FPIs under the SEBI (Foreign Portfolio Investors) Regulations, 2014.

The transactions of non-institutional FPIs, for all purposes, shall be treated at par with that of Indian non-institutional investors with regard to margins, voting rights, public issues, etc. Their investment in listed equity shares under this foreign investment window shall also be subject to the relevant and extant FEMA regulations and guidelines issued by the RBI under FEMA from time-to-time.

3.7.3 Domestic Retail Investors

The first ever survey of Indian investors was conducted in 1999 jointly by the SEBI and the National Council for Applied Economic Research (NCAER). According to this survey and as quoted in the Indian Stock Market Review, 2002 published by the NSE, the following picture emerged. About 7.6% of all Indian households were direct investors in equity or debentures in 1998–99 with an investor base of 19 million. This meant that more than 92% were non-investors in such instruments. However, about 15 million investors representing about 9% of the households were investors in mutual funds. This accounts for about 23% of the market capitalisation and compares poorly with that of developed countries where the comparative figure is more than double. The number of demat accounts in India do not commensurate with the size of the overall population. As per estimates available in 2016, the total number of demat accounts were about 25 million. The investor base in urban areas is denser than in rural areas but the growth of investor households has been more pronounced in the nineties than in the eighties. However, the study finds that there are several factors such as market imperfections, lack of awareness and investor education that are responsible for the low penetration of the equity culture and mutual fund culture in India. Investors perceive equity as risky investment primarily because several retail investors have burnt their fingers with equity. Most Indian households preferred safer investment options such as bank deposits, LIC, government savings and of late, corporate debt instruments. Among the equity investors, the study found that there is very poor allocation of portfolio risk and the absence of a scientific method of investing. Investors are swayed by market trends and grapevine and when a bull run is strong, very little attention is paid to scientific methods of investing. In the past, this trend led to over-pricing by issuers and overheating of the market only to be followed by prolonged phases of dullness in market sentiment.

Among the retail investors, SEBI floated the concept of retail individual investors, in relation to the primary market. A retail individual investor is one who applies for securities of a value not exceeding ₹200,000 in a public offer. Formerly, in India, most companies had a market lot of 100 shares, whereby a retail investor was one who applied for 1000 shares or less. With the advent of dematerialised trading, the minimum market lot was reduced to one share. Presently, the retail investors are defined in terms of value of the application as stated above. In book-built public issues, a retail individual investor is one who puts in a bid for a value not exceeding ₹200,000. The year 2012 saw a new scheme being introduced by the government for retail investors known as the Rajiv Gandhi Equity Scheme to promote retail savings in the capital market.

3.7.4 Criteria Applicable to Institutional and Retail Investors

As far as primary market investments are concerned, large investors look at primary issues from the perspective of medium-term growth while retail investors look for short-term profit booking within the first three to six months after listing. Large investors are driven more by the fundamentals of the issue and are therefore, keen to wait for appreciation in the market price over a longer time frame of one to two years. A lot depends on factors such as the pricing of the issue, fundamentals at the time of issue, the company's capability to live up to promises made in the issue, the level of identification and communication with the market post-listing, corporate governance, etc. These factors determine the equilibrium price of the company's share in the market that a large investor looks for. However, retail investors are driven more by profit motive and arbitrage opportunities than by fundamentals. This is the reason why the retail demand in scrip is driven by events such as dividend, bonus and rights announcements while the institutional investors look for more fundamental factors such as industry growth, economic or government policy impacting the company, contracts and large orders etc. Most of the time, institutional demand in particular issue scrip makes it a market favourite and retail investors identify it as a profit-making opportunity.

3.8 Investment Routes in Primary Market for Institutional Investors

Institutional investors investing in primary market (new security issues) have the following available routes for such investments:

- Subscribing to public issues either through firm allotments or through the general public offer.
- Investment by taking up unsubscribed portions of underwritten commitments (devolvements), book-building commitments, bought out deal obligations which are part of merchant banking and underwriting activity.
- Taking up of devolvements, renouncements or under-subscriptions in rights issues.
- Subscribing to private placements, preferential issues and PIPEs of listed and unlisted companies,
- Investment in unlisted companies through the AIF route.

More discussion on all the above are provided in subsequent chapters wherein the aspects of different types of offers and private placements have been dealt with.

3.9 Primary Market Intermediaries and Support Service Providers

3.9.1 Issue Managers, Underwriters and Brokers

The primary market intermediaries are the merchant bankers, underwriters to issues and brokers to issues. The merchant bankers are the issue managers who bring the issues to the primary market investors. Issue management is an onerous job and is closely regulated by SEBI in order to ensure strict discipline among merchant bankers so as to be careful in bringing only quality issues to the market. Therefore, the regulators in many countries enforce a licensing mechanism for issue managers. Issue management is a fee-based service and one of the prime functions of an investment bank. The detailed aspects of issue management are discussed in Chapter 8.

Underwriters provide the much-needed safety net for issuers bringing their issues to the market. Underwriting is a fund-based service provided by a market intermediary, which consists of taking a contingent obligation to subscribe to an agreed number of securities in an issue, if such securities are not subscribed to by the intended investors. If the issue is fully subscribed to by the investors, the underwriter has no fund obligation to the issue but collects the underwriting fee. However, if investors do not subscribe to the issue fully, the obligation devolves on the underwriter to the extent of the unsubscribed portion of the issue. Underwriting, however, has different forms in other countries based on the regulatory framework and methodology of offers. The detailed aspects of underwriting as used in India and in the US are elaborated in Chapter 9.

Brokers to an issue are appointed specifically by the issuer to market the issue on its behalf with the investors. Brokers are registered trading members of a stock exchange whose primary activity is to trade on behalf of clients in the secondary market. By appointing them specifically to market a public issue, the issuer ensures that there is adequate marketing support to promote the issue. Unlike underwriters, pure brokers to an issue do not have any financial commitment to the issue. Their remuneration is purely in terms of brokerage earned on the subscriptions received through them for the issue. If they cannot procure anything, they do not earn anything and neither do they have any guarantee obligation like the underwriters. Brokers usually have many sub-brokers working for them through whom they market an issue and share the brokerage they earn from the issuer with them. The activities of brokers and sub-brokers in India are regulated by the SEBI.

3.9.2 Registrars to Issues

Registrars perform the back-office functions for an issue by providing the necessary infrastructure and automated processing capability. The role of the registrar to an issue is invaluable considering the volume of applications that need to be processed for an issue within a very short time. The support services provided by a registrar to the issue include:

- Obtaining day-to-day collection figures from controlling branches of each bank and reporting the same to the lead manager and the company while the issue is in progress.
- Processing the application forms received from various collecting bankers and other collection centers and arriving at appropriate classification.
- Determining the valid applications and overall subscription to the issue and the over-subscription ration, if any.
- Assisting the lead manager and the company in the allotment process.
- Sending out allotment advices and refund orders.
- Providing allotment of securities to individual allottees in de-materialised form via connectivity to the depository.
- Providing support to the lead manager and the company in fulfilment of post-issue reporting to the regulator.

The services provided by a registrar are both capital and labour intensive. Therefore, in order to ensure that registrars provide quality service, SEBI has brought such activity under regulation through the SEBI (Registrars to an Issue and Share Transfer Agents) Rules, 1993 and the SEBI (Registrars to an Issue and Share Transfer Agents) Regulations, 1993. Under these provisions, registration with SEBI is compulsory to provide these services. Among the general obligations and responsibilities imposed on registrars, the notable provision relates to prohibition on the registrar acting in such capacity on behalf of an associate company making an issue. The registrar has to abide by the code of conduct as well. The other responsibilities include maintenance of books and records in the prescribed manner and making such books and records available for inspection by the authority appointed by SEBI and appointment of a compliance officer.

3.9.3 Bankers to Issues

Bankers to an issue perform a significant function in providing remittance facilities to applicants from various parts of the country in an issue through their collection branches. Applicants fill up the application forms for the issue and either make a bank remittance or provide an ASBA facility and lodge the applications with collecting agents. The remittances are received through various collection accounts and daily subscription lists from the collection centres. The issue banker gets the funds cleared through the inter-bank clearing house mechanism, aggregates the funds and transfers it to the designated issue escrow account maintained by the company with its bankers. While the issue is in progress, the bankers also provide daily collection figures through their controlling branches.

A similar but opposite service is provided by the bankers for refunds to be made to unsuccessful applicants or partly successful applicants. Such service is known as refund banking. Refund bankers provide the facility of getting refund orders of the company encashed by the payees across the countries at par from the designated account maintained by the company with them. Refund banking got considerably reduced after the mandatory ASBA rule was made operational by SEBI.

Bankers to issue are also regulated by SEBI on similar lines through compulsory registration, a prescribed code of conduct and observance of general obligations and responsibilities. These are contained in the SEBI (Bankers to an Issue) Rules, 1994 and the SEBI (Bankers to an Issue) Regulations, 1994.

3.9.4 Support Service Providers

The support service providers in the primary market include stationery printers, advertisement agencies, courier services, the press and the financial analysts. A public offer would require issue related stationery to be printed or digitally circulated since many of the retail applicants prefer to apply through physical application forms. Issue stationery printers are specialised in this job since they are familiar with the requirements. Apart from printers, courier agencies play an important role in ensuring that the issue stationery is dispatched to all the requisite centres in time and in good condition. The advertisement agencies prepare the media plan, organise meetings with the press, analysts and investor associations at important locations across the country. The importance of the advertisement agency in giving the issue a good coverage and taking care of organisational matters in such publicity campaign cannot be over-emphasised.

Apart from the above service providers, the credit rating agency, press and the media analysts, legal advisors and auditors play important roles in public offers. The rating agency and analysts provide important external perspective, i.e. rating the issue from an independent perspective and providing suitable opinion to investors. Since the issuer makes attempts to publicise the issue from its perspective, an independent opinion on the issue is very much necessary.

3.10 Introduction to Primary Market Securities

Investment banking is all about capital market activity that requires a deep understanding of various securities that are used by issuers to raise capital. Investment bankers are acknowledged to be expert designers of securities and sometimes, this process is extremely complicated in order to address various conflicting issues. As far as a learning approach is concerned, in order to understand the characteristics of primary market securities, it is necessary to begin with the universal financial concepts that underlay such instruments. The important fundamental financial concepts that are relevant for evaluation of financial instruments are discussed in Appendix A of the book. While financial concepts and cost of funds are fundamental to investment bankers in designing securities, the investor perspective should also be kept in mind in order to address the aspect of their marketability. Last but not least, the regulatory framework governing various securities has to be factored in so as to make them compliant with law and tax efficient. All these aspects are covered in the following paragraphs. It may, however, be noted that the discussion in this chapter is restricted to capital market based financial instruments issued in the primary market only. Other securities and instruments used in money market such as government securities, treasury bills, commercial paper, certificates of deposit etc. are outside the scope of this book. An overview of the securities issued in primary markets is furnished in Exhibit 3.2.

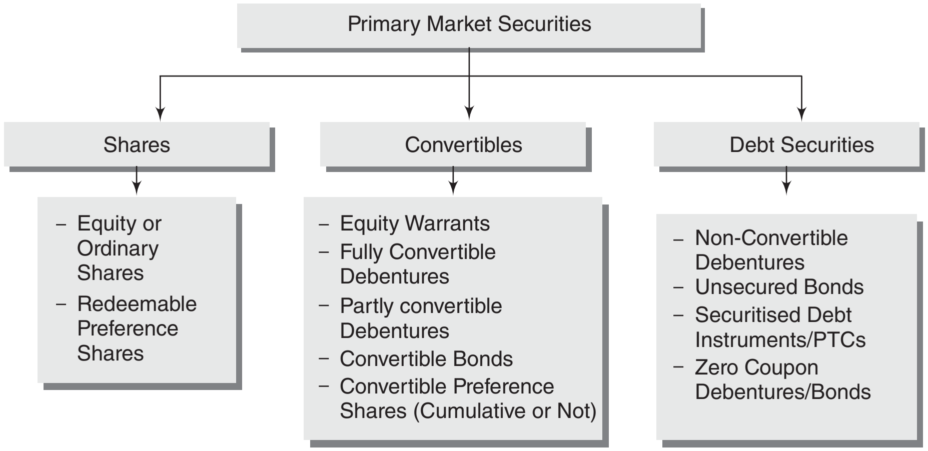

Exhibit 3.2 Primary Market Securities

3.11 Fundamental Concepts on Equity

The owned capital of a joint-stock company is represented by shares. Each share represents a unit of measurement of the capital and creates proportionate ownership in the capital of the company to the extent of its value. This value by which a share is designated is known as its *nominal value* or *par value* or *face value*. According to the Companies Act, a company can issue only as much shares as it has been authorised to by its Memorandum of Association (its charter document). Such capital is known as the *authorised capital*. The actual amount of shares at their face value that have been issued to investors out of the authorised capital is known as the *issued capital*. The actual amount subscribed to by the investors out of the issued capital by making commitments to pay for the shares and take delivery is known as the *subscribed capital*. The amount that has been asked of the investors to be paid is known as the *called-up capital*. The amount actually paid by the investors on the calls is called the *paid-up capital*. The amount that remains unpaid is known as *calls-in-arrears*.

ILLUSTRATION 1

The capital clause in ABC Ltd.'s Memorandum of Association discloses a capital of 100,000 shares of ₹10 each. Out of the above, the company decides to issue 75,000 shares to investors. The company requires the shareholders to pay ₹5 on application and allotment and the balance as a call after 6 months. Applicants have applied for 70,000 shares. All applicants except those who have subscribed to 5000 shares have paid the call amount. The various capital components after the call are shown below:

Authorised capital = ₹1,000,000 (100,000 equity shares each with a face value of ₹10/- each).
Issued capital = ₹750,000 (75000 × 10)
Subscribed Capital = ₹700,000 (70,000 × 10)
Called up Capital = ₹700,000 (70,000 × (5 + 5))
Paid up Capital = ₹675,000 (70000 × 5+65000 × 5)
Calls in arrears = ₹25,000 (5000 × 5)

3.11.1 Types of Shares

The Companies Act defines a share as *movable property transferable in the manner provided by the articles of the company*. The Companies Act provides for the following types of shares[1] that can be issued by a company registered under it:

- ***Equity shares or ordinary shares:*** These represent common ownership of the company without any special rights or privileges. Such shares have normal proportionate voting rights based on the capital they represent in the company. Equity shares represent the residual ownership of a company after all other types of capital contributors have been paid off on a winding up. Therefore, equity shareholders also carry a risk of not receiving anything at all in the event of an insufficiency of capital at the time of such winding up. Similarly, equity shares do not carry any guaranteed return. They may be paid a dividend based on the recommendations made by the board of directors of the company. The directors may do so at their discretion based on the performance of the company and the availability of distributable profits from time to time.
- ***Equity shares with differential rights:*** These shares can be issued with variable or disproportionate rights as to dividends, voting or otherwise subject to the prescribed rules. As per the rules, such shares should not exceed 26% of the issued capital of the company and no inter-se conversion between such shares and ordinary equity shares would be permitted. The company issuing such shares should also be profit making for at least three preceding financial years. Such issue shall also be approved by the shareholders in general meeting. The type and extent of differential rights that can be attached to such shares have been left to the discretion of the shareholders.
- ***Preference shares*****:** The category of shares that has both a preferential right to be paid a fixed rate of dividend and a preferential right to repayment of capital on winding up of the company. The preference referred to herein is over equity shares.

3.11.2 At Par, Premium and Discount

As mentioned above, equity shares have a designated face value. The price at which shares are issued may, however, be face value or any other value that is either more or less than the face value. The term *at par* denotes that the issue price of the share is equal to its face value. If the issue price is more than the face value, the issue is called *at premium* and if it is less than the face value, it is termed as *at discount*.

Under the current guidelines, each company may fix the face value of its shares as it may find desirable provided such face value is equal to or greater than ₹1/-. SEBI had modified the earlier guidelines in this regard with a circular in 1999 to provide flexibility to companies to adopt different par values to their shares, both for existing shares listed on stock exchanges and new shares proposed to be listed in future. The guidelines in this regard are as follows:

- The companies shall have the freedom to issue shares in any denomination to be determined by them. While doing so, the companies will have to ensure that shares are not issued in decimal of a rupee. In other words, a share cannot be denominated with say ₹3.50 as par value.
- The companies, which seek to change the standard denomination, may do so after amending the Memorandum and Articles of Association, if required.
- The existing companies, which have issued shares at ₹10/- or ₹100/-, may also change the standard denomination into any denomination other than decimal of a rupee by splitting or consolidating the existing shares after amending their Memorandum and Articles of Association. At any given time, there shall be only one denomination for the shares of a company.

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[1]Applicable provisions of the Act read with the Companies (Share Capital and Debentures) Rules 2014.

- Only companies whose shares are dematerialised shall be eligible to alter the *standard denomination*.
- The companies desirous to avail of this facility would be required to adhere to disclosure and accounting norms as may be specified from time to time.

Therefore, it is now possible for each company to have a different face value for its shares. However, when shares are issued under a public offer, the ICDR Regulations have to be followed for the denomination of the face value. The most commonly used denomination for face value is ₹10 per share. However, companies whose shares are highly priced in the market have adopted lesser denominations such as ₹5 and ₹2 to make their shares affordable to the retail investor.

3.11.3 Listed and Unlisted Shares

The next concept to be discussed is that of a listed share vis-à-vis an unlisted share. The word *listing* refers to enabling a share to be included for trading and a continuous price quotation in the secondary market in a stock exchange. Once a company's shares have been listed, dealers can buy and sell such shares at market determined prices, which would be continuously reflected on the trading screens. The shareholders can buy or sell listed shares during the trading hours of the stock exchange without any restrictions at the prevailing market prices. In this respect, buying and selling of listed shares is an impersonal affair without the buyer or the seller knowing each other. The shareholders of listed companies are on the lookout for market opportunities to make gains on trading which in turn drives the volume of shares traded every day on the stock exchange. There are highly volatile scrips in the market and there are also scrips that drive the market trends. The investor demand for a particular share in the market determines its market price from time to time. Companies that have listed their shares on the stock exchange are called listed companies while the rest are called unlisted companies.

At this stage, it is pertinent to note that while a listed share is freely tradable in the stock exchange, an unlisted share does not have a secondary market and to that extent, is restricted in its transferability from one person to another. An unlisted share can be bought or sold between two persons only through a private arrangement that brings them together. Further, if an unlisted share belongs to a private company, its transferability is restricted by the articles of association of the company.

3.11.4 Properties of Equity Shares

Equity shares are the common stock of the company that represents ownership in a company. However, since equity shares do not have defined returns, the equity shareholders do undertake a risk in such investments. At the same time, they enjoy the benefits as well if the company performs well either in terms of appreciation in the value of the shares or through receipt of periodic dividends. Keeping in view the position of equity shareholders, the Companies Act vests them with certain rights so that they are able to protect their interests.

- Equity shares carry voting rights at the general meetings of the company both in person and by proxy (except in a poll) and by postal ballot. These rights are meant to provide shareholders the right of taking management decisions.
- The company law has several provisions relating to approval of shareholders by special resolution whereby such decisions cannot be taken unless there is a three-fourths majority in agreement.
- The company law expressly provides under Section 180, certain powers which cannot be exercised by the Board. These are powers that can be exercised only with the approval of shareholders.
- Equity shares are eligible for distribution of profits as dividends or as surplus in the event of liquidation of the company.
- Since equity shares carry common ownership, these are the residual rights available on a company in the event of liquidation after all the outside creditors and preference shareholders have been paid off in full.

- The company cannot issue fresh equity shares to any person unless they are offered first to the existing equity shareholders as per the provisions of Section 62.
- Equity shareholders can protect their rights under several provisions of the Companies Act.
- Equity shareholders are entitled to receive the annual accounts of the company.
- Equity shareholders are entitled to the right of inspection of certain books and records of the company.
- Under the current income tax law, dividend on shares declared by domestic companies is free from tax in the hands of the shareholder. However, the company has to pay an additional distribution tax of around 20% of the amount being distributed as dividend. Dividend received from non-domestic companies is taxable as income from other sources in the hands of the shareholder.

3.11.5 Properties of Preference Shares

Preference shares, as mentioned earlier carry a right of preference over equity shares for receipt of dividend and capital. However, due to this preference, they carry a fixed rate of dividend unlike equity shares that have no fixed returns. Therefore, preference shares are ideal for investors whose risk appetite is limited. Based on the terms of issue of preference shares, they can be further categorised as follows:

- *Cumulative shares*: Preference shares are cumulative, if the dividend receivable in each financial year can be accumulated, if such dividend is not paid immediately on becoming due. Dividends become due on preference shares on the last day specified for the payment of such dividend, if the company has earned enough distributable profit during a particular year. However, the articles of association of the company should authorise payment of arrears of dividend of earlier years, especially in circumstances of winding up of the company. In the case of non-payment of dividends for more than two years, cumulative preference shares shall carry voting rights as are available to equity shareholders. Non-cumulative preference shares are those that do not carry such accumulation rights and if the company has not earned enough distributable profit during a particular year, such dividends lapse. Non-cumulative shares also acquire voting rights upon non-payment of dividend either for two immediately preceding financial years or for three out of six preceding financial years.
- *Participating* shares: Participating shares carry a right to participate in either dividends or for repayment of capital on winding up on par with equity shareholders after their preferential rights have been satisfied. In other words, after receipt of dividend or capital on preferential basis, if a distributable surplus is available to equity shareholders, these preference shares would be eligible for such surplus along with the equity shares. The articles of association have to provide for issue of such participating shares.
- *Redeemable shares:* Preference shares by definition are redeemable in a period not exceeding twenty years from the date of their issue. Further these shares can be redeemed at a premium to their face value, if the terms of issue so prescribe. For example, a preference share of ₹100/- could be redeemed at a price of ₹110/-. The premium on redemption can be notwithstanding all other rights carried by such share. As per the Companies Act, preference shares can be redeemed only out of accumulated profits or from the proceeds of a fresh issue of shares of any type. However, as discussed earlier, the premium part alone can be met out of the share premium account, if any, existing in the balance sheet. Further, the amount of accumulated profits that are utilised for redemption of preference shares have to be transferred to a special reserve known as the *Capital Redemption Reserve.*
- *Coupon rate:* Coupon rate on a preference share is the rate at which it is entitled to dividend every year. For example, a 12% cumulative preference share carries a right of dividend of 12% per year on cumulative basis. The coupon rate is fixed on the basis of the post-tax return that an investor would expect. This would mean that the tax treatment of the dividend received by the investor has to be considered while fixing the coupon rate. Under the prevailing tax law, dividend from preference shares

of domestic companies is exempted from tax in the hands of the shareholder. However, the issuer has to pay a distribution tax of about 20%. Therefore, for a 12% coupon, while the post-tax return to the investor would remain at 12%, the cost to the company would actually be 14.4% [12% + (20% × 12%)]. Considering the fact that this payment by the company is dividend, it is not tax deductible since it is an appropriation of profit. If one were to factor in the loss of tax shield at a tax rate of 33%, the comparable cost of the preference share would be 21.5% to the company on a pre-tax basis vis-à-vis a debt instrument on which interest payments are tax deductible. Therefore, the company has to also keep in mind the overall cost to itself while fixing the coupon rate on preference shares.

3.11.6 Convertible Instruments

By definition, the word *convertible* refers to the property of an instrument to get converted into equity share. The amount of conversion, the time of such conversion and other terms would depend upon the terms and conditions subject to which such convertible had been issued. Generally, instruments that are either in the nature of debt instruments or hybrids have the property of convertibility into equity shares. In the case of listed or to be listed companies, issue of convertibles has to comply with the ICDR Regulations. In the case of unlisted companies, there are presently no stipulated terms for issues of convertibles.

The main advantage of convertibles lies in the fact that they can be structured so as to increase the equity capital at an appropriate time depending upon the earnings profile of the company. The disadvantage of a pure equity issue is that while it takes time for a company to make earnings out of the funds received from the issue, the equity capital is expanded instantly on the issue thereby leading to immediate impact on the EPS and RONW. A convertible smoothens out this process by staggering the conversion of the funds raised into equity capital so that there is no immediate impact on the EPS. When the company starts to earn out of the fresh funds raised from the issue, the bottom line would expands sufficiently to absorb the expansion in equity caused by the conversion. Another benefit of a convertible is in structuring the conversion price into equity. Since the conversion takes place after a conversion period, the conversion price could be pegged higher than the price existing on the date of issue of the convertible.

All convertibles are issued with protection to the rights of the holders of such convertibles in matters concerning dividends, rights and *pari passu* status of the underlying shares upon conversion. This would mean that after the conversion takes place, the resultant equity shares would rank identical to other equity shares in the company and shall be entitled to all the rights and benefits that would accrue after the said conversion date. This *pari passu* status includes listing as well. In other words, if the existing shares are already listed, the company has to seek automatic listing for the shares resulting out of the conversion.

Convertibles can be broadly classified as *debt convertibles* and *equity convertibles*. While the former are debt instruments till the date of their conversion into equity and therefore could accrue interest, equity convertibles do not accrue interest till their conversion. They are near to equity instruments and can be structured with or without any return till their conversion. Therefore, these are considered as equity in the computation of the debt-equity ratio of the company's capital structure. This is a significant advantage as it enhances the leveraging capacity of the company further. There are basically two popular equity convertibles, namely convertible preference shares and equity warrants.

3.11.7 Pure Equity and Equity Convertibles

Pure equity offering is the most straight forward investment proposition to an investor by an issuer company. Equity has the advantage of being a simple structure for the investor. For the issuer company, it has no servicing cash cost, if the company can grow the funds at higher than the opportunity cost to the investor. Dividend distributions, though necessary are not a charge on profits as in the case of debt servicing obligations.

Therefore, equity has no impact on the profitability of the company. In addition, in a buoyant market, equity sells at a considerable premium and therefore, shores up the net worth and provides long-term capital to the company.

When the company is of the view that straight equity will depress EPS and market price in the short-term, equity convertible is a good option. The common structures are equity warrants and convertible preference shares. Unlike debt convertibles, equity convertible has the advantage of staggering expansion of the equity base without depressing profits till the time of conversion.

Convertible Preference Shares

A preference share (either cumulative or non-cumulative) may be issued with a conversion option into an equity share. The conversion ratio (how many preference shares to how many equity shares) and other issues are defined by the terms of issue. These are hybrid instruments since they carry the preferential rights till the date of conversion and become equity shares on par with other equity shares after such conversion. In the case of cumulative convertible preference shares, the outstanding dividend would also be eligible for conversion to equity.

The convertibility of a preference share could also be structured so as to be optional on the investor. In such a case, the investor can decide on the stipulated date of conversion, if such option should be exercised or not. If the investor finds it desirable and the option is exercised, they get converted into equity shares. On the other hand, if the conversion is not exercised, they would continue to be preference shares to be redeemed as per the terms of issue.

A convertible preference share can be made optional by providing a put option to the investor. An optionally convertible preference share has dual advantage for the investor. While dividends received are exempted from tax (assuming the issuer is a domestic company), the option can be exercised, if there is reasonable scope for appreciation in the underlying equity share based on the conversion price. As has been discussed earlier, the post-tax yield from a preference share is much higher due to its tax-free status.

Equity Warrants

Warrants are instruments that carry an *option* for the holder to receive a particular benefit that the instrument carries as per its definition. Therefore, a dividend warrant carries the right to be paid dividend and an interest warrant carries a right to receive interest. An equity warrant carries the right but not the obligation to pay for and receive equity share(s). Equity warrants are useful instruments and are generally used in combination with other instruments. However, they can even be issued as separate instruments in isolation. Warrants are also used as a means to provide investors with the benefit of paying for and receiving equity shares at a later date at pre-determined conversion price. The time allowed for such conversion is known as the *exercise period*, which would also be equal to the life of the warrant. The option entitles the holder to three alternatives:

- To pay for and receive the equity shares in full based on the terms of conversion.
- To reject the offer in full.
- To pay for and receive shares in part and reject the balance.

The price at which the warrant entitles the holder to one or more equity shares is known as the *conversion price* or the *exercise price*. For example: if a warrant entitles the holder to two equity shares of ₹10/- each at a premium of ₹20/- per share, the conversion price of the warrant is ₹30/- per share. Both the conversion price and the conversion ratio are defined by the terms of issue. The economic value of a warrant is the excess of the market price of the share on the date of conversion over the exercise price. In the above example, if the market price of the share is ₹40/- on the date of conversion, the economic value of the warrant is ₹20 ($40 \times 2 - 30 \times 2$). The economic value of a warrant may also be calculated using the option pricing model treating it as an option.

Warrants can be tradable and detachable. In other words, if the warrants have been issued in conjunction with any other instrument, the terms may stipulate that warrants are detachable and tradable separately. This would imply that if an investor acquires the warrant as part of another investment and finds that the option is not attractive, the warrant can be de-linked from the original instrument and sold off separately. In such a case, the original instrument remains with the investor while the warrant gets traded and converted in the hands of the person holding it on the conversion date. In order to enable such secondary market trading, detachable warrants can even be listed as separate instruments in the stock exchange. The market price of the warrant would be determined by the price of the underlying share and its own economic value.

Warrants are mostly issued either by promoters for increase of their stakes at a later date or to make debt issues more attractive with warrants being the sweeteners. Some of the companies that have issued warrants along with other instruments in the past are HPCL, Apollo Tyres, Phoenix International, Deepak Fertilisers and Petrochemicals, Escorts, Ranbaxy, Shriram Industies and others. Phoenix was a unique case wherein warrants were issued along with equity shares while in most other cases, they were issued with debt instruments as sweeteners. Phoenix made a premium equity issue in March 1994 at a price of ₹95 per share. The investors were offered equity warrants in the ratio of one warrant for every two shares. Each warrant was to be converted into an equity share at a price not exceeding ₹150 between June 1996 and January 1998. The warrants were listed separately and traded on the stock exchange. Investors willing to convert them into shares could look for a price arbitrage since the share was quoting in excess of ₹250 during the conversion period. In 2007, a company known as Orbit Corporation Ltd. made a public issue of equity shares each with a detachable warrant. Each warrant was to be converted into one equity share of the company between the 18th and 30th month after issue. If the prevalent market price at that time was less than the issue price, then conversion would take place at a discount to the prevailing market price. If such market price were more than the issue price, the conversion was proposed at 10% to the market price.

Case Study

HDFC Warrant Issue

In 2009, Housing Development Finance Corporation Ltd. (HDFC), the largest mortgage lender in India, issued equity warrants as a sweetener for its zero coupon NCD issue. It was reported to be one of the few composite issue of NCDs with warrants by any company in Asia, excluding Japan. In 1993, Garware Polyester Ltd. had made the first ever composite issue of this sort. The warrants were eligible for subscription by investors who were subscribing for the NCD Issue. The issue was made as a QIP issue by the company[2].

The warrants were issued at an issue price of ₹275 per share with an exercise period of three years. At the time of exercise, the investor was to pay the exercise price of ₹3000 per share with a face value of ₹10. Subsequently in 2012, upon completion of the exercise period, the company was successful in converting almost all the warrants into equity. In the intervening period, the company decided to split its ₹10 shares into five shares of a face value of ₹2 each. So, the number of warrants was increased to ₹55 million and the issue and conversion prices were revised to ₹55 and ₹600 respectively. The terms of issue of the warrants also stipulated that the issue price of the warrant would not be adjusted towards the exercise price and that if a warrant is not converted, it would lapse and the issue price would stand forfeited.

Pursuant to the conversion of the warrants, HDFC issued and allotted 5.47 crore equity shares of ₹2 each and realised an amount of ₹3,285 crore as equity capital. The market price on the date of the

[2] For details on a QIP issue, please refer to Chapter 11.

exercise of the warrant was around ₹740 while the conversion price was ₹600. Thereby the investors, who made a moderate return on their NCDs were rewarded with shares in the company at a discount to market price of close to 20%. According to the company, the proceeds from the exchange of warrants were proposed to be utilised to replace the repay the NCDs which were due for maturity at that time.

3.11.8 Statutory Provisions on Equity Convertibles

- As pointed out earlier, there are presently no stipulations on issue of equity convertibles by unlisted companies.
- If an unlisted company is in the process of making a public issue of equity convertibles such as convertible preference shares or warrants as part of its initial listing, the applicable provisions are contained in the ICDR Regulations.
- If a listed company plans to issue equity convertibles to all existing shareholders through a rights issue or plans to make a FPO, the relevant provisions are the same as above.
- If the issue of equity convertibles is being planned by a listed company selectively to a few persons or existing shareholders to the exclusion of other shareholders, such issue would be governed by the relevant provisions of the ICDR Regulations relating to preferential allotments.

3.11.9 Performance Indicators for Equity Shareholders

The equity share being common stock and residual ownership in the company would need to be looked at from the shareholder's perspective closely. There are several measures of how a company has performed for its shareholders. Some of the popular ratios are Earnings Per Share (EPS), Return on Net worth (RONW) and in the case of listed shares, the Price to Earnings multiple (P/E ratio). Apart from these, there are others such as Dividend Yield, Dividend Payout Ratio and Economic Value Added (EVA) and Market Value Added (MVA). These are explained below:

1. *EPS* = Profit after Tax (PAT)/Number of equity shares outstanding. This ratio measures the earnings made by the company with respect to the face value of each share for a given financial year. For example, if the EPS on share of face value ₹10/- is ₹4.50, it would mean that the earnings capacity is 45% on the face value. This measure is also calculated on an annualised basis, if the shares have been allotted during the course of a financial year. When a company has outstanding convertibles that would get converted into shares in future, the EPS can also be calculated as if the convertibles have been fully converted as of date. Such a measure taken on the basis of the fully expanded equity base is called *fully diluted EPS*. The EPS is a very popular measure of performance of a company from a shareholder perspective.

ILLUSTRATION 2

Profit after Tax (PAT) = ₹5 million
Paid up capital = ₹1 million (shares of ₹10 each)
Convertible debentures pending conversion = ₹2 million
Each debenture has face value of ₹100 and gets converted into two shares.
Current EPS = ₹50 (5,000,000 / 100,000)
No. of shares pending conversion = (2,000,000 /100 × 2) = 40,000
Fully diluted EPS = ₹35.71 (5,000,000/140,000)

2. RONW = PAT/Net worth wherein
   Net worth = paid-up capital + accumulated cash reserves and surplus.
   The RONW measures the return generated by the company on the shareholders' funds. It takes into account the operational, financial, depreciation and tax efficiencies of the company and is therefore, the ultimate measure of its profitability. If the RONW is significantly higher than the cost of equity, it would mean that the company is creating shareholder wealth. In such a case, the company is a high growth company and should adopt a low or no dividend policy to protect shareholder value. On the other hand, if the RONW is lower than the cost of equity, either the company's business is unprofitable or the company is over-capitalised with equity. It could do well to increase the gearing in the capital structure to improve returns to equity shareholders. If the company has more capital overall than necessary, it would be necessary to return some of the capital to the shareholders through a high dividend payout policy or through return of capital. This step would protect shareholder value.
3. *P/E ratio* = Current Market price of share (CMP)/EPS. This is a good measure to gauge the market expectation on the share. The P/E ratio indicates the number of times of the current EPS that the market is willing to pay for the share. Therefore, higher the P/E multiple, greater is the expectation on the future potential of the share. Well performing companies and industries enjoy high P/E multiples in the market as compared to their lesser-known counterparts.
4. *Dividend yield* = Dividend per share (DPS)/CMP. This ratio denotes how much return a shareholder makes by buying the share from the market before the dividend payout (cum-dividend) thereby becoming a recipient of such dividend. If the cum-dividend price in the market is low, the dividend yield is high and vice versa. Dividend yield is used as a tool by fund managers to improve upon their returns by looking at traditionally high dividend paying companies. Since dividend yield is realised in a short time, it provides a good return on an annualised basis.

ILLUSTRATION 3

Current Market Price of Share = ₹125
Dividend announced = 40%
Nominal Value of Share = ₹10
Dividend per share = ₹4
Period of holding estimated = 1 month
Dividend Yield = 4/125 =3.2%
Dividend Yield annualised = $(1 + 0.032/12)^{12} - 1 = 46\%$

5. *Dividend Payout Percentage* = Dividend/PAT. This measure denotes how much of current earnings are being paid out as dividend. It helps investors who have appetite for dividend income rather than capital gain to identify companies with high dividend payout as compared to those which are not. High dividend payout is a difficult policy to sustain since the funds go out of the company permanently. Most management are conservative in dividend payout unless the industry has extraordinary margins and long-term stability.

ILLUSTRATION 4

Declared PAT of a company = ₹500 million
Dividend announced = 40%
Nominal Value of Share = ₹10
No. of shares outstanding = 10 million

Dividend per share = ₹4
Total Dividend Payout Amount = ₹40 million
Dividend Payout = 40/500 = 8%

6. *EVA* = NOPAT – (WACC × Capital Employed)
   where,
   NOPAT = Net Operating Profit after Tax
   WACC = Weighted Average Cost of Capital employed
   Capital employed = Shareholders' funds (Net worth) + long-term borrowings
   The EVA is a very effective measure of shareholder value created by a company. It measures in absolute terms the surplus generated by the operations for a given year over the expected cost of equity and debt. The WACC is an average measure of the cost of debt and equity which when multiplied with the capital employed, results in the expected return to the long-term capital providers in absolute terms. The excess of the NOPAT over such normal return is the EVA, which denotes the extraordinary return to the shareholder. The EVA is fast becoming an accepted measure of shareholder wealth creation.

ILLUSTRATION 5

NOPAT of a company = ₹50 million
WACC = 12.5%
Capital Employed = ₹250 million
WACC amount = ₹31.25 million
EVA Amount = ₹18.75 million
EVA as a percentage of NOPAT = 37.5%

7. *MVA* = Market capitalisation – Capital Employed. While the EVA is measure of shareholder value from a flow approach, the MVA is a measure from a stock approach. The MVA tries to measure the excess of the company's aggregate market value over the book value of its capital employed. The MVA can be linked to the EVA as the aggregate of the present values of all the future EVAs of the company. The MVA can be modified further to consider the book value of equity and market value of debt. From an individual shareholder's perspective, the MVA is clearly the excess of the CMP of the investment in the company over the amount invested.

ILLUSTRATION 6

Current Market Price of Share = ₹150
No. of shares outstanding = 50 million
Market Capitalisation = ₹7.5 billion
Capital Employed (Book Value) = ₹500 million
MVA Amount = ₹7 billion
MVA as percentage of Capital Employed = 1500%

3.11.10 Issuer's Perspective of Equity Capital

From an issuer's perspective, equity capital is more expensive than debt capital. This is because an equity investor's expected return is much higher than that of an investor in debt due to the risk attached to equity investments.[3] Therefore, the issuer has to service equity at a higher cost as compared to debt. Secondly, the regular dividend payout to service an equity investor is much higher than the interest paid on debt due to the differential tax treatment of interest and dividend as deductible items. As has been shown earlier, a 12% post-tax return on equity paid by a company works out to an equivalent of 20.6% pre-tax cost on debt capital. This is unduly high and therefore, equity capital is undoubtedly more expensive to service.

If the above argument holds good all the time, companies should refrain from raising equity and look at raising more debt. However, companies are all the time on the look out to raise equity in preference to debt capital. This is because, the benefits of equity capital far outweigh the additional cost of servicing equity. Some of the important benefits of raising equity are listed as follows:

- Equity capital does not involve a committed cost in terms of regular servicing. Even the dividend payout is not an essential feature. If the company is listed, there is a secondary market that values the company based on its performance and is, therefore, willing to price it accordingly. If a company performs well, this would be reflected in its P/E multiple. An equity shareholder could look at exit through the secondary market and book capital gain as a return on investment. By this mechanism, the company ends up rewarding the shareholders through the market mechanism while conserving its own cash. This is a significant advantage to a company.
- Since equity capital does not involve a fixed servicing cost, it reduces financial leverage and brings down the fixed costs. This in turn reflects in better margins and profitability.
- Equity capital reduces the debt-equity ratio by increasing the net worth, thereby providing a cushion for future leveraging. Companies regularly employ this method of balancing debt and equity in their capital structure with respect to further fund raising. When debt capital is high, they raise equity, which in turn enables further debt in future.
- The most important advantage of equity is in its pricing. By pricing equity at a premium, a company can shore up its balance sheet with further fund infusion as share premium. This has a twin advantage: (i) it significantly bolsters the net worth and more importantly, (ii) it does not increase the capital base. Therefore, the EPS gets computed only with respect to the share capital while the company enjoys the benefit of deploying the entire capital including the share premium in generating the earnings. Free pricing of equity is, therefore, the biggest factor in favour of an issuer provided the pricing is fair and the company can live up to it.
- Lastly, as long as a company lives up to the expectations, it need not look at the eventuality of returning equity capital to its shareholders. This argument holds good not only for the initial investment made by the shareholders but for the accumulated profits as well. Therefore, shareholders' funds make up the permanent fund base of the company. The liquidity for the shareholder is provided by the secondary market. This is a win-win situation for both. While the company takes capital from the shareholder, the return of such capital is provided by the market. However, reasonable dividends are also declared from time to time to keep the shareholder happy with some periodic cash return from the company.

Notwithstanding the benefits listed above, an equity issuance results in the expansion of equity capital with an addition to the number of outstanding shares. Therefore, the company would face the immediate effect of dilution in its EPS, as the post-tax profit gets distributed over a wider equity base. Similarly, the Return on Net Worth (RONW) would also face pressure since the net worth base of the company would go up as well. There could be repercussions on the market price of the share as a result of the dilution, if the shares of the company are already listed. Due to this reason, companies have the tendency to raise as much equity capital as possible with as little dilution of the equity base as the situation permits through a premium valuation for their share. This method has the twin benefits of raising finance for the company, on one hand and not putting the company's EPS and RONW under pressure, on the other.

[3]Section 2(31) read with Sections 73, 74 and Companies (Acceptance of Deposits) Rules, 2014.

3.12 Fundamental Concepts of Fixed Income Securities

3.12.1 Nature of Debt Securities

A debt security is an instrument that evidences an amount owed by one person to another. Viewed from an investor's perspective, it is also known as a *fixed income security*, i.e. it provides a fixed rate of interest income to the investor according to its coupon rate. Notwithstanding the basic feature of fixed income provided by a debt security, they exist in different forms because of which they have different properties and are thereby treated with different legal status. The simplest form of a debt security is a *promissory note* which is an obligation undertaken by the drawer to pay the drawee a certain sum. A *bond* is an instrument that evidences an obligation to pay money or other consideration either with or without conditions. It is defined in Section 2(5) of the Indian Stamp Act 1899 as an instrument that includes the following:

- Any instrument whereby a person obliges himself to pay money to another, on condition that the obligation shall be void if a specified act is performed or is not performed, as the case may be.
- Any instrument attested by a witness and not payable to order or bearer whereby a person obliges himself to pay money to another.
- Any instrument so attested whereby a person obliges himself to deliver gain or other agricultural produce to another.

From the above definition, it is clear that what is available under law is an inclusive definition but the essential feature is that a bond is *an obligation whereby a person binds oneself to a debt or other obligation evidenced by such instrument.* A bond is also specific in obligation to another person and is not meant to be a negotiable instrument. An extension of this concept is a 'bill of exchange' under which the drawer states that the drawee has to pay a certain sum for value received and the drawee accepts the same. A bill of exchange can be endorsed in favour of another person and therefore, becomes a negotiable instrument.

A *debenture* is born out of the corporate concept of proportionate ownership and representation. While equity represents proportionate ownership and representation in share capital of a company, a debenture is its counterpart in debt capital. It is, thus, a corporate security that evidences the company's debt obligation towards the person whose is the holder thereof. Section 2(30) of the Companies Act defines a debenture in an inclusive way stating that it includes *debenture stock, bonds and any other securities of a company, whether constituting a charge on the assets of the company or not. It may, thus, be noted that a debenture is a generic term used for a transferable debt security whether secured or not that includes a bond or any other debt security issued by a body corporate*.

3.12.2 Transferability

Debt instruments can be distinguished from one another by their features such as security and transferability. A debt security can be both secured as well as unsecured. A debt instrument can be secured by creating a charge on some property or assets so that if the debt due on the instrument is not repaid, the assets can be liquidated and used for satisfaction of the debt. A charge can be created either on fixed assets by a mortgage or on movable assets by a hypothecation or pledge. The creation of a security, especially on immovable property is expensive as it involves payment of stamp duty on the mortgage deed and registration charges in the case of a registered mortgage. The second aspect relates to transferability of a debt instrument. A debt instrument can be made transferable either by endorsement and delivery or mere delivery or through execution of a transfer deed and subsequent registration. In the first case, the transferor has to sign on the instrument and endorse it to a third party as is the case with a bill of exchange. In the second case, the instrument is transferable by merely delivering it to another person. Such instruments are called bearer notes or bonds on which the name of the holder is not mentioned. Examples of such notes are some of the debt paper issued by the Government such as the Indira Vikas Patra. The third category of instruments is those that require to be registered in the name of the transferee to pass on the title. Examples of these are debentures and bonds issued by corporate entities that carry the name of the registered holders and can, therefore, be transferred only through transfer of title with the issuer through execution of an instrument for transfer. A debenture cannot be issued as a bearer instrument or an instrument transferable by mere endorsement and delivery.

3.12.3 Secured and Unsecured Debentures

In the theoretical sense, though a company registered under the Companies Act can issue unsecured debentures and bonds for raising debt finance, in practice, it is seldom the case. This is because of the provisions of the Companies Act. These provisions stipulate that any borrowing or deposit taken by a company is deemed to be a *public deposit* unless it falls under the category of exempted borrowings as specified in Rule 2(c) of the said rules. If a particular borrowing gets attracted to these provisions, the company has to comply with all requirements relating to invitation of public deposits such as making public advertisements in the prescribed form, maintenance of liquid assets to service such borrowings, filing of periodical returns and a host of other compliances. Therefore, where a company wishes to raise funds through a debt security, it would not want to get the same classified as public deposits. In the context of a debenture or a bond, the following have been exempted from the above provisions:

- Amounts raised by issue of bonds or issue of debentures secured by mortgage of any immovable property of the company or with an option to convert them into shares in the company provided that the amount of such bonds or debentures shall not exceed the market value of such immovable property or the conversion period does not exceed five years.
- It has been clarified by the MCA that unsecured debentures with an option to convert a part of them into shares of the company do not fall under the category of exemptions under Rule 2(c). In other words, unsecured partly convertible debentures would rank as deposits to the extent they are non-convertible and the convertible part would be exempt. In addition, the convertible part would be exempted only till the conversion option is exercisable and if it has not been exercised or has lapsed, such convertible part would rank as an unsecured deposit thereafter and would fall within the purview of a deposit.

From the above discussion, it is clear that unsecured bonds and debentures issued by a company, unless they are fully convertible, would attract the deposit provisions under the Act and thereby rank as unsecured deposits. There is, however, an exemption provided under Section 73 to banking companies and NBFCs. Therefore, banking companies and NBFCs can issue unsecured bonds and debentures without worrying about the operation of the deposit rules. In practice, banking companies and other corporate entities not registered under the Companies Act issue both unsecured and secured bonds and debentures while non-banking companies registered under the Companies Act issue only mortgage-backed debentures unless they are fully convertible into shares.

3.12.4 Features of Debt Securities

Coupon Rate

A debt security can be structured with several varying features such as coupon rates, tenor and cash flows. Coupon rate on a debenture or a bond is the rate at which the interest is computed on the amount of the debt instrument. In other words, it is the accounting rate that would be applied in the calculation of interest. For example, if a 10% Non-convertible debenture is issued with a face value of ₹100, it means that the debenture would be entitled to a simple interest of 10% per year on ₹100, i.e. ₹10/-. The coupon rate on debt instruments is fixed based on the credit rating of the issuer, interest rates in the economy and prevailing market rates of interest for corporate debt. However, unlike dividend, in the case of interest, it is taxable in the hands of the investor. Therefore, an investor has to reckon the post-tax interest as the return for making the investment decision. For example, a 10% coupon rate could translate into a 7% [10 × (1 – 0.30)] post-tax return for a person with 30% tax liability. Therefore, while the coupon rate is indicative of the accounting rate of interest, the net rate earned by the investor could be lower depending on the person's tax status. Considering the above situation, the issuer is inclined to pass on some of the benefit of the tax shield earned on the interest payment to the investor by way of a higher coupon rate. This is because the borrower gets a tax break on the interest paid to the investor. Therefore, the cost to the borrower works out to 6.43% [10 × (1 – 0.357)] wherein the tax rate considered is 35.7% for a company. Since the post-tax cost is lower for the borrowing company, it can afford to pay a higher coupon rate to the investor to make the debt security more marketable.

Yield

The second aspect wherein debt securities can be structured is in terms of their yields. According to Bloomberg, *yield* is the *effective interest paid on a bond or note*. Yield is, therefore, the effective rate of interest earned on an investment taking into account the periodicity of the cash flows arising there from either on account of interest payments or principal repayments. The comparison between nominal rate (coupon rate) and effective rate of interest has already been discussed earlier. For the computation of yield, what is important is the timing of the investment outflow and the inflows arising from receipt of interest and repayment of principal on the debt security.

It may be noted that while coupon rate generates the accounting rate of return on a fixed income security, yield is measured in terms of the cash flow generated by the instrument and the timing of such cash flow. Thus, the yield on a debt instrument is the effective rate of interest that is generated by the given streams of cash flow. It follows that for the same given coupon rate, the annual yield could be different based on the periodicity of the interest payment. The following example illustrates the point.

ILLUSTRATION 7

In the example given below, a bond with a face value of ₹100 and a coupon rate of 10% has been considered for computation of yield with different streams of cash flow. The *tenor* of the bond is one calendar year and the principal is repaid at the end of the twelfth month. However, the interest payments are varied in each case because of which the yields vary. In the first case, the interest flows are at the end of the year and therefore, the yield is same as the coupon rate. In the second case, the interest flows are half-yearly because of which the yield improves to 15.56%. If the interest payments are made quarterly, the yield improves further to 15.87% and on a monthly interest payment schedule, it goes up further to 16.08%. Therefore, the faster the cash flows come back to the investor, the higher is the yield on the instrument. This is, of course, under the assumption that the investor is in a position to reinvest the cash flows in other investment opportunities providing the same yield. The detailed computations drawn through an excel sheet are shown in Table 3.1.

Table 3.1 Computation of Bond Yields

Bond Face Value			*100*	
Coupon rate			15%	
Time periods	Annual	Half-yearly	Quarterly	Monthly
Y0	–100			
Y1	115			

(*Contd.*)

Y0		–100		
HY1		7.5		
HY2		107.5		
Y0			–100	
Q1			3.75	
Q2			3.75	
Q3			3.75	
Q4			103.75	
Y0				–100
M1				1.25
M2				1.25
M3				1.25
M4				1.25
M5				1.25
M6				1.25
M7				1.25
M8				1.25
M9				1.25
M10				1.25
M11				1.25
M12				101.25
Basic Yield	**15.00%**	**7.50%**	**3.75%**	**1.25%**
Annualised Yield	**15.00%**	**15.56%**	**15.87%**	**16.08%**
Yo denotes the time of investment.				
HY denotes half-year.				
Q denotes a quarter of three months.				
M denotes a calendar month.				

Working with the formula on effective rates*,

Effective Rate $r = (1 + k/m)^m - 1$

where r is the effective rate of interest, k is the nominal rate of interest and m is the frequency of compounding per year, the yields shown above may also be computed using the formula.

Basic yield for annual payment = 15%

Effective Yield = $(1 + 0.15/1)^1 - 1 = 1.15 - 1 = 0.15 = 15\%$

Basic yield for annual payment = 7.5% for half year, i.e. 15% p.a.

Effective Yield = $(1 + 0.15/2)^2 - 1 = (1.075)^2 - 1 = 0.1556 = 15.56\%$

Basic yield for annual payment = 3.75% for a quarter, i.e. 15% p.a.

Effective Yield = $(1 + 0.15/4)^4 - 1 = (1.0375)^4 - 1 = 0.1587 = 15.87\%$

Basic yield for annual payment = 1.25% for a month, i.e. 15% p.a.

Effective Yield = $(1 + 0.15/12)^{12} - 1 = 1.1608 - 1 = 0.1608 = 16.08\%$

*Please refer to Appendix A at the end of the book.

Yield to Maturity

Yield to maturity or YTM is the percentage rate of return paid on a bond, note or other fixed income security, if the investor buys and holds it to its maturity date. The calculation for YTM is based on the coupon rate, length of time to maturity and market price. It assumes that coupon interest paid over the life of the bond will be reinvested at the same rate. In short, YTM is the computation of the yield of a fixed income security over its life until the maturity date. YTM is the yield that an investor would realise, if the security is held from the date of its issue till the maturity date. However, if an investor acquires the security during its life, YTM for the investor would be the yield computed over its remaining life till maturity. Depending upon the price at which it is acquired, the YTM for the investor could be different from the YTM that could have been realised, if the security was bought at the issue price.

Expressed in different terms, YTM of a bond is the interest rate that makes the present value of the cash flows receivable from owning the bond equal to the price of the bond. Mathematically, it is the interest rate (r) which satisfies the equation:

$$P = \frac{C}{(1+r)} + \frac{C}{(1+r)^2} + \cdots + \frac{C}{(1+r)^n} \frac{M}{(1+r)^n}$$

where P is the price of the bond, C is the annual interest, M is the maturity value and n is the number of years left to maturity. The computation of YTM as per the above equation requires a trial and error procedure.

ILLUSTRATION 8

Consider a ₹1,000 par value bond, carrying a coupon rate of 9 percent, maturing after 8 years. The bond is currently selling for ₹800. What is the YTM on this bond? The YTM is the value of 'r' in the following equation:

$$800 = \sum_{t=1}^{n} \frac{90}{(1+r)^t} + \frac{1000}{(1+r)^8}$$

$$= 90\ (\text{PVIFA}_{r,8\text{yrs}}) + 1{,}000\ (\text{PVIF}_{r,8\text{yrs}})$$

Let us begin with a discount rate of 12 percent. Putting a value of 12 percent for r, we find that the right-hand side of the above expression is

$$₹90\ (\text{PVIFA}_{12\%,8\text{yrs}}) + ₹1{,}000\ (\text{PVIF}_{12\%,8\text{yrs}})$$

$$= ₹90(4.968) + ₹1{,}000(0.404) = ₹851.0$$

Since this value is greater than ₹800, we may have to try a higher value for 'r'. Let us try, 'r' = 14 percent. This makes the right-hand side equal to:

$$₹90\ (\text{PVIFA}_{14\%,8\text{yrs}}) + ₹1{,}000\ (\text{PVIF}_{14\%,8\text{yrs}})$$

$$= ₹90\ (4.639) + ₹1{,}000\ (0.351) = ₹768.1$$

Since this value is less than ₹800, we try a lower value for 'r'. Let us try, r = 13 percent. This makes the right-hand side equal to:

$$₹90\ (\text{PVIFA}_{13\%,8\text{yrs}}) + ₹1{,}000\ (\text{PVIF}_{13\%,8\text{yrs}})$$

$$= ₹90\ (4.800) + ₹1{,}000\ (0.376) = ₹808$$

Thus, r lies between 13 percent and 14 percent. Using a linear interpolation in the range 13 percent to 14 percent, we find that r is equal to 13.2 percent.

$$13\% + (14\% - 13\%) \cdot \frac{808 - 800}{808 - 768.1} = 13.2\%$$

An Approximation: If you are not inclined to follow the trialanderror approach described above, you can employ the following formula to find the approximate YTM on a bond:

$$\text{YTM} \simeq \frac{C + (M - P)/n}{0.4M + 0.6P}$$

where YTM is the yield to maturity, C is the annual interest payment, M is the maturity value, P is the present price of bond, and n is the years to maturity.

To illustrate the use of this formula, let us consider the bond discussed above. The approximate YTM of the bond works out to:

$$\text{YTM} = \frac{90 + (1000 - 800)/8}{0.4 \times 1000 + 0.6 \times 800} = 13.1\%$$

Thus, we find that this formula gives a value which is very close to the true value. Hence, it is very useful.

The YTM calculation considers the current coupon income as well as the capital gain or loss the investor will realise by holding the bond to maturity. In addition, it takes into account the timing of the cash flows.

Tenor

Tenor is the maturity period of a debt instrument. It is the time from the time of issue of the instrument to the full and final repayment of the principal and interest thereon. The longer the tenor, the coupon rate remaining the same, the yield is maintained for the entire duration. This is brought out in the working below.

ILLUSTRATION 9

Continuing the same illustration used for computation of bond yields above, the yield calculations for various *tenors* are shown in Table 3.2:

Table 3.2 Tenor and Yield

Bond Face Value			*100*	
Coupon rate			15%	
Tenor	1 year	2 years	3 years	4 years
Y0	–100	–100	–100	–100
Y1	115	15	15	15
Y2		115	15	15
Y3			115	15
Y4				115
Cum. Cash Inflow	115	130	145	160
Annualised Yield	15%	15%	15%	15%

It may, thus, be observed that as far as the borrower is concerned, the longer the tenor of a debt instrument, the borrower is locked in servicing the same cost of borrowing. Therefore, in fixing tenor of an instrument, the borrower has to examine the necessity for use of the borrowed funds, repayment capacity and prevailing interest costs. As far as the investor is concerned, if the yield on the instrument is good, it would be better to lock it in for a longer tenor assuming that the credit rating of the borrower remains unchanged during that period.

Fixed and Floating Rates

Debt instruments can be structured with fixed or floating coupon rates. Under the fixed rate structure, the coupon rate is fixed for the entire tenor of the instrument while under the floating rate structure, the coupon rate keeps changing with changes in the base rate to which it is pegged. In India, the most common rate used is the MIBOR (Mumbai Inter Bank Offer Rate), which is more of a short-term rate. Therefore, it may not be a good benchmark rate for longer tenors. The other term rate available is the prime lending rate of banks such as the SBI. In a floating rate structure, the coupon rate is pegged at a certain number of basis points above the base rate, for example, MIBOR + 150 basis points. The coupon rate gets reset at regular intervals based on movement in the benchmark rate.

Call and Put Option

Debt instruments are quite often structured with *call* or *put* options or both. A *call option* provides the right but not the obligation to the issuer to buyback the security from the holder at a pre-determined time during the currency of the security. A *put option* is the converse which provides the right but not the obligation to the investor to sell the security back to the issuer on pre-determined terms. A call option is generally used in debt instruments when the issuer apprehends that the coupon rate or yield provided on the instrument may be high due to the prevailing market conditions and that interest rates would ebb in the future. When such an event occurs, the call option can be exercised and the issuer can redeem the instrument by refinancing it with lower coupon instrument. In the absence of a call option, the issuer would be struck in the high cost security till its maturity date. Likewise, a put option enables the investor to hedge against the risk of being stuck with a low yielding instrument when market rates are higher. It enables the investor to exit the low yield instrument and migrate to higher yielding opportunities. Call and put options may also be used in the context of equity shares in bilateral shareholder agreements. Such features are common in private equity and joint venture agreements. However, in the context of a public issue of shares, call and put options are rare.

Case Study

Infinity Retail

In a private placement of unlisted NCDs made in 2012, Infinity Retail, a subsidiary of Tata Sons (the promoters' holding company of the Tata group), provided an interesting put option to investors. The investors could trigger the put option, if the stake of the Tata group were to go down below 51% in the company either due to foreign investment or the company opting to go public. The put option was necessitated since the company was unlisted at the time of issue of the NCDs and the NCDs themselves were not listed. So, it was necessary to provide an exit option to the investors in the event of change of ownership in the company. The private placement was for an amount of ₹150 crore (1.5 billion) with a face value of ₹10 lakh (1 million) per debenture to finance the expansion, refinancing of debt and general corporate purposes.

3.13 Types of Debt Instruments

The Indian capital market has seen a number of corporate debt instruments. As has been stated above, non-banking corporates issue secured debentures or bonds while banking companies issue both unsecured and secured bonds. The different types of corporate debt instruments are discussed in the following sections.

3.13.1 Non-Convertible Debentures

These are the most commonly understood and simple type of debentures that are issued with a specific coupon rate and tenor and the repayment is usually structured in one or more tranches. These are pure debt instruments and the yield depends upon the structuring of the cash flow streams from the instrument and its market price at a given time. NCDs coupon rates are usually matched to the credit rating of the issuer and the prevailing market yields for similar instruments. NCDs are typically structured with 5–7 years maturity redeemable either in a bullet repayment or in tranches. As mentioned in a previous discussion, non-financial companies issue NCDs as fully secured instruments while banks and NBFCs issue NCDs as unsecured bonds in the nature of promissory notes.

NCDs were not a popular instrument with investors in India primarily due to lack of a good secondary market for liquidity. In the pre-1991 era, most NCDs had a tenor of seven years and that made investors wary of getting locked in a particular interest rate for a fairly long-term. For instance, in the year 1992, a NCD of East India Hotels (the Oberoi chain) was providing a yield of more than 17% but the market price of this ₹50 debenture was only ₹39 (*as reported in the Economic Times dated 2nd August 1992*). If an investor had to maximise the yield by buying the debenture at ₹39 from the market and encashing it at ₹50, there had to be an opportunity to be able to buy it in the secondary market. In such a case, the yield would have jumped to 34.8%. But the fact that the NCD was quoting at a steep discount was due to lack of demand in the secondary market. At that time, the NCDs of most leading companies such as Larsen & Toubro, Ashok Leyland, Raymonds, TTK Pharma and others were quoting at a discount of 10–50% to their redemption price. As recent as in 2012, in somewhat a continuation of the same trend, the tax-free bonds issued by PSU entities such as the NHAI, HUDCO and REC were trading at a discount to their redemption price, thereby, providing a higher yield to investors who invested in them through the secondary market than those who had invested in the primary issue.

One of the reasons for a lacklustre secondary market for NCDs has been that the ordinary investor has regarded it much like a bank deposit and has never looked at the opportunity of rotating his investment. Due to the non-availability of NCDs in the secondary market, the opportunity of yield maximisation is lost. With the advent of mutual fund debt schemes, the position of the secondary market for pure debt instruments has improved since institutional demand for pure debt securities keeps the market buoyant. In spite of it, many merchant bankers are of the view that pure debt instrument such as a NCD is a non-starter for a public offering. Therefore, NCDs have found more favour in the private placement market. In the years succeeding the global crisis of 2008, when the Indian capital market remained subdued, corporate used the NCD route to gain access to capital through public issues. Tata Motors, Shriram group, L&T Finance and Tata Capital were successful in public issues of non-convertible debentures. Similarly, the public-sector corporations issued tax free bonds which were received well by the market. All such bonds were listed in the market to provide liquidity to the investors and develop a secondary market for them. In 2012, the tax-free bond issued by NHAI listed at a premium on the stock market providing current yields that were less than its coupon rate. Mutual funds were big buyers in the secondary market and short-term investors made 3% returns in less than a month by flipping them on listing. The resurgence of NCDs in the capital market through the public issue route is a good indicator for the corporate bond market in India in the years to come.

3.13.2 Partly Convertible Debentures

PCDs have two portions: one convertible and the other non-convertible. The non-convertible portion, which is also known as the *khoka* takes the character of a NCD with a coupon rate and tenor for repayment. The convertible part gets converted into one or more equity shares depending upon the terms of conversion and is, thus, a convertible debt instrument. A PCD is usually perceived to have better saleability than a pure NCD. The convertible portion is usually bigger than the non-convertible part. Some issuers make arrangements to get the khoka bought back from the issuer at some upfront discount upon allotment of the PCD itself so that the investor need not sail with it till its retirement. Such a facility is known as a *khoka buyback*. The khoka is usually bought back by involving a financial services intermediary who finances the buyback. The discount that the investor pays on the khoka should be construed as a part of the conversion price of the share underlying the convertible part. The following example illustrates the point.

ILLUSTRATION 10

ABC Ltd. issues a PCD of face value ₹100/- which consists of two parts A and B. Part A of ₹40 is non-convertible and carries a coupon rate of 10% with a *tenor* of 2 years with interest payable annually. Part B of ₹60 gets converted at the end of three years into two equity shares at a conversion price of ₹30 per share. The investor has an option to surrender the khoka immediately on allotment under a khoka buyback facility for ₹30. Otherwise, the investor can retain the khoka and redeem it after two years.

In the above example, the annualised yield on the khoka works out to 10% since interest payments are structured annually. Therefore, if the investor is not satisfied with the yield, he or she could opt for the khoka buyback on allotment and get back ₹30. Therefore, the net investment in the PCD would get reduced to ₹70. Since the investor gets two shares at the end of the third year on conversion of Part B, the effective conversion price works out to ₹35 per share under the khoka buyback scheme. In other words, the discount on the khoka of ₹10 gets pro-rated on the conversion price of the share.

SEBI had issued directions that all such khoka buyback proposals should be disclosed in the offer document itself and the transaction shall comply with the provisions of the SCRA in terms of being treated as *spot contracts*. Therefore, the khoka buyback shall be completed with cash payment immediately on receipt of the khoka instrument.

3.13.3 Fully Convertible Debentures

These are basically debt convertibles that have the characteristics of debt till the date of conversion and equity after such date. Since a FCD is fully convertible, the usual practice is to provide for a lower coupon rate during the time it is a debt instrument but to provide an incentive to the investor with a favourable conversion price. This way the company economises on interest cost on a comparable pure debt instrument. FCDs are very popular debt convertibles and carry the same advantages as quasi-equity convertibles such as warrants and convertible preference shares.

3.13.4 Zero Coupon Bonds/Debentures

Zero Coupon Bonds or ZCBs as the name suggests, do not offer any interest payment to the investor. Instead, they are issued at a discount to their face value and redeemed at par so that the return to the investor is built into the price differential. ZCBs originated in the USA with names such as Treasury Investment Growth Receipts and Certificates of Accrual on Treasury Securities. These were instruments created by investment bankers who bought large chunks of treasury securities and used them as underlying assets to issue the above said securities in smaller lots to retail investors.

The implicit rate of return in a ZCB is computed as the yield on the redemption amount as compared to the initial investment since there is no coupon rate or regular interest payments. It is the rate at which if the face value of the bond is discounted over the term of the bond, it would be equal to the initial amount invested. This can be shown as follows:

$$\text{Amount invested} = \frac{\text{Face Value of the Bond}}{(1+r)^n}$$

wherein 'r' is the yield or the implicit rate and 'n' is the number of time periods of tenor.

In India, ZCBs were introduced for the first time by Mahindra & Mahindra Ltd. in 1990.

Case Study

Mahindra and Mahindra ZCD issue in 1990

ZCDs were issued in combination with FCDs. The terms of the issue were as follows:

- The company issued secured 12.5% FCDs with a face value of ₹110 which would be converted into two shares on the basis of a two-stage conversion at a conversion price of ₹55 per share. The first conversion was to be after 12 months and the second after 18 months.
- Alternatively, the investors were offered secured ZCBs of face value ₹90 with a two-stage conversion as in the FCDs but the conversion price was pegged at ₹45 per share since the investors did not enjoy the benefit of any interest during the holding period of the ZCBs.

For a comparison of two alternatives, the outflow on the ZCB can be equated to the conversion price proposed on the FCD and the interest earned during the intervening period.

$$90 = \frac{55}{(1+r)^1} + \frac{55}{(1+r)^{1.5}}$$

This equation yields a return of about 17.5% which is the intrinsic yield of the ZCB. This is superior to the yield on the ZCD which can be worked out as follows:

$$110 = \frac{68.75}{(1+r)^1} + \frac{61.875}{(1+r)^{1.5}}$$

This works out to around 14.96%.

3.13.5 Deep Discount Bonds and other Institutional Bonds

An extension of the concept of a ZCB, the DDB is a very long tenor unsecured bond issued by financial institutions such as IDBI, SIDBI, ICICI and others that is issued at a discount and redeemed at its face value. The first ever DDB was floated by IDBI in 1992 at a face value of ₹2700 and redeemable after 25 years for ₹100,000. The life of the bond was divided into blocks of five years each, at the end of each block, there would be a 'call' and a 'put' option whereby either the issuer or the investor can exit the bond. The redemption prices at the end of each of the blocks is also fixed beforehand such that the longer the investor stays with the bond, the higher is the yield on the bond. The bonds were transferable by endorsement and delivery and they were listed on the stock exchange as well. Since then SIDBI and ICICI also issued these bonds and IDBI re-issued them with modified features in 1996.

Based on the principle of a discounted instrument such as the DDB, several types of bonds with varying features are being floated every year by the financial institutions and other corporations. The IDBI floated the Flexibond series, the ICICI floated the Safety Bonds series and IFCI floated Family Bonds. These bonds are issued in several varieties to suit each type of investment requirement. There were regular income bonds, tax saving bonds, discounted bonds and cumulated bonds. The discounted and cumulated bonds came with 'wait periods' during which time, the investor did not earn anything. The longer the wait period, the higher was the yield on the instrument. Some of the bonds also had the feature of stepped up interest rate, i.e. the coupon rate gets increased progressively starting with a low rate based on the holding period of the bond. Therefore, the interest rate could be as low as 5% to start with and could get stepped up to even 20% so as to give a good yield to maturity over its entire life. A standard feature of all institutional bonds was that they were issued as unsecured bonds in the nature of promissory notes. IDBI and SIDBI have obtained stamp duty exemptions for their DDBs.

Apart from ZCBs and institutional bonds, several other innovative instruments have been tried out in the primary debt market in the past. One of the most talked about was the Secured Premium Note (SPN) issued by TISCO in 1992. These were debt securities issued with innovative features for coupon rate and repayment.

Case Study

TISCO SPN issue in 1992

Each SPN with a face value of ₹300 has four parts. Each part would to be redeemed at a redemption price of ₹150 at the end of the 4^{th}, 5^{th}, 6^{th} and 7^{th} year respectively. The differential of ₹75 paid with each part would be broken down into interest component and premium on redemption and the investor has the option of choosing the relative components according to one's tax status. In addition, each SPN comes with a detachable warrant, which can be converted, into a share of TISCO for an exercise price of ₹100 and the exercise period is between the 12^{th} and the 18^{th} month from the date of allotment of the SPN. The investor is also given the option at the end of the third year to return the SPN to the company and take back the initial investment of ₹300 without any return. In such a case, the only entitlement would be that on the warrant. The SPNs are issued as listed instruments and are fully secured by mortgage.

IIBI DDB issue

The Industrial Investment Bank of India (IIBI), issued a DDB that has a unique feature. It has a face value of ₹100,000 and an issue price of ₹16000. The *tenor* of the bond is 25 years. However, as an added attraction, the DDB holder is entitled to the first four years of interest payment at the rate for ₹1430 per annum, which is stripped and issued as a separate zero coupon instrument. Therefore, there are four interest securities that are issued to the investor representing the annual interest payments. Since these have been stripped and issued separately, the DDB can be bought and sold without reference to the interest securities. The DDB is listed in the secondary market and is transferable through an instrument of transfer.

Other Cases

Apart from the above issues, there have been several issues in the past with debt offerings tied to equity convertibles or equity options such as Garware Polyester NCD with warrants offering, Deepak Fertilisers secured FCDs with equity warrants offering, Gujarat Ambuja Cements NCD with warrant offering, the TISCO SPN offering (discussed above), MRPL NCD with equity warrant offerings and many more such issues.

3.13.6 Floating Rate Bonds

Floating Rate Notes or Bonds, as they may be called, originated in the US markets in the 1970s but they are not new in the Indian debt market. Erstwhile financial institutions such as the ICICI and the IDBI and banks such as the SBI floated similar instruments in the past. The SBI floating rate bonds were pegged to the bank's medium-term deposit rate with refixation every six months. The spread offered was 3% over the benchmark rate with a minimum of 12% being the coupon rate. In the case of ICICI, the floating rate notes were pegged to the 91-day Treasury Bill rate with a spread of 3.5% and the interest rate was to fluctuate in a band with a floor of 10% and a cap of 15%. Interest was to be refixed on a quarterly basis. In the IDBI floating rate bond, the interest rate was pegged to the 364-day treasury bill rate with a spread of 2% and interest being reset half-yearly. All these bonds had call and put options to provide exit at periodic intervals.

3.13.7 Debt Convertibles, Sweeteners and Options

Debt convertibles are basically debt instruments that are either fully or partly convertible into equity. Therefore, till the date of conversion into par, they take the character of debt and accrue interest on them. After conversion into equity, they lose the character of debt. FCDs and PCDs are examples of debt convertibles apart from others such as convertible bonds. The sweeteners would be the issue of warrants or conversion options to holders of debt instruments so that the investment in the non-convertible debt becomes attractive. Typically, the coupon rate on the non-convertible debt is pegged at less than the market rate since the conversion of the warrant entitles the holder to equity at marginally reduced prices. Sometimes, the debt instrument does not carry interest at all and the return is built into the conversion price on equity. Some of the convertibles have been issued with novel features such as optional conversion and sweeteners in the past. Examples of such issues are those made by Reliance Petroleum, Essar Oil and Noida Toll Bridge Company.

Use of 'Sweeteners' in Debt Securities

As may be observed from the case analysis of several issues made above, in most debt instruments, an equity component is structured for the investor so that there is scope for upside in his returns, if the company performs very well. These are known in investment banking parlance as *sweeteners*. The most used sweetener structure is that of equity warrants either attached or detachable. The detachable warrant can even be listed and tradable separately so that the investor has the choice of retaining the warrant and opting for conversion or to sell the warrant itself depending upon the conversion price. Most warrants sell at a premium if the conversion date is closer and the conversion price is lesser than the ruling market price. In such a case, the investor can book profits on the warrant and improve the yield on the debt component. However, if the investor has appetite for equity, the conversion option can be exercised and the equity can be held for trading or investment gains at a later date.

3.14 Introduction to Securitisation and Securitised Debt Instruments

Securitisation is a financial transaction that was invented primarily to address the locking up of funds in the books of a lender, i.e. a bank or a financial company as *receivables*. Unlike manufacturing, trading and service businesses wherein receivables are a part of the operating cycle and get converted into cash within a short time, the receivables appearing in the books of lenders are long term. Banks and other types of lending companies are primarily in the business of making loans which are repayable over a period of time. Therefore, as long as the borrower is repaying the loan as per the schedule of amortisation specified in the loan contract, the lender has no right of recall or foreclosure. In other words, the funds lent out by the lender remain as 'assets' in his books over a fairly long time depending upon the tenor of the loan. To meet its growing requirements, a bank has to continue to raise additional funds even while the existing assets continue to remain on its books. This adversely affects the capital adequacy and debt equity ratio of a lender and may also increase the risk and consequent marginal cost of capital. Over a period of time, the lender's growth would be inhibited by the tenor of the receivables in its books.

Securitisation was primarily invented as a process whereby the illiquid receivables or *financial assets* appearing in the books of a lender are made liquid by converting them into *tradable securities* which can realise cash for the lender immediately without waiting for the receivables to trickle in. The Dictionary of Banking and Finance[3], thus, defines securitisation as *"the process of making a loan or mortgage into a tradable security by issuing a bill of exchange or other negotiable paper in place of it."* Securitisation is, thus, a specialised financial transaction which involves packaging designated pools of mortgages and receivables in a company's (often a lender) books and selling these assets with the underlying mortgages (collaterals) to investors in the form of securities that have income streams based on the original receivables. Though the end-result of securitisation is financing, it does not perform the function of financing in its true sense, since the entity securitising its assets is not borrowing money, but is selling a stream of cash flows that were otherwise to accrue to it.

According to one of his papers, Jure Skarabot contends that, securitisation started as early as 1432 in Italy and not in the US. It existed as a mortgage credit system, which has existed in Denmark for over two centuries now. There is also the *pfandbrief* market in Germany, which is a secondary mortgage market, but the Danish mortgage trading system is very close to the US *pass-through*. The first securitisation deal in US was executed with a pass-through structure involving home loan mortgage receivables through mortgage-backed securities (GNMA – I) in 1970. Since the beginning of the 1980s, securitisation has become a global financing tool. However, the US dominates the world market and is the largest, deepest and widest securitisation market in the world. In terms of depth, it is the only market where the securitisation market draws participation from institutional as well as individual investors. In terms of width, the US market has far more applications of securitisation than any other market. Approximately 75% or more of the global volumes in securitisation are from the US. Also, securitisation issues originating from countries like Japan and European countries such as the Netherlands, France and Germany draw investors from the US. Securitisation markets in Australia, Far East, South Asia and Latin America are much smaller and predominantly in residential mortgages and commercial property leases.

Characteristically speaking, any present or future receivables in part or in whole can be securitised. However, it may be observed that receivables can either be *present* or *future*. Present receivables are those that appear as assets in the balance sheet of the receiving company pertaining to claims that have already accrued or arisen. This would be the case for loan instalments or other charges that have already fallen due or trade receivables for value already received by the customer such as overdue loan instalments, credit card payables etc. Future receivables pertain to claims that are yet to accrue or arise in the books of the receiver either because they have not fallen due yet or the value is yet to be received by the payer such as future lease rentals or future home mortgage instalments. Securitisation may be made both for present as well as future receivables. The latter, for the sake of distinction, is sometimes called *future flows securitisation.* Similarly, securitisation could encompass (i) the securitisation of loan assets by a lender and (ii) any receivable by a non-financial company. Lastly, securitisation can also be executed either for cash or cash equivalent consideration such as a bill of exchange, bond or other future payment obligation on the buyer in favour of the seller.

Though, predominantly, a technique meant for refinancing banks and financial businesses, securitisation as a tool is used extensively in strategic corporate finance as a financing structure and is often found in parts or in combination with other tools in several structured finance transactions to enhance efficiency in fund raising for corporates. In the global market, securitisation encompasses several types of receivables such as credit card receivables, airline tickets, residential mortgages, car loans, swap contracts, tax lien, trade and export receivables, insurance premia, telephone receivables, oil and gas receivables, time-share cash flows, parking fines, cinema tickets, hire purchase / lease receivables and trade receivables. Hence, the range of assets

[3]The Dictionary of Banking and Finance, P.H. Collin, Bloomsbury Third edition 1999 p 319.

that can be securitised is quite extensive. The Indian market for securitisation transactions is quite nascent in comparison and has been used selectively in the financial sector. In the years after 2000, securitisation concepts were introduced in corporate financing selectively in unlocking cash flow from receivables both present and future.

Securitisation as a form of financing has several benefits some of which are listed below:

- It unlocks financial assets which exist in the form of both present and future receivables in the balance sheet of the creditor or a company. While assets in the form of future receivables can only be liquidated over time, present receivables may even consist of sticky advances for which the recovery process may be frustrating. Therefore, in many instances, it improves the liquidity position of the creditor or lender by replacing receivables by immediately available funds. Therefore, it is a form of off-balance sheet financing by substituting assets as held as receivables into cash without having any impact on the liability side of the balance sheet. Since this form of financing re-aligns only the asset side of the balance sheet, it becomes a form of off-balance sheet financing.
- From a lender's perspective, securitisation removes loan assets from the balance sheet, thereby freeing up capital for other uses including new lending. This can facilitate restructuring of loan portfolio from time to time and re-align lending strategies by reducing large exposures or sectoral concentrations. It leads to better asset liability management by reducing market risks resulting from interest rate mismatches. By unlocking idle receivables from the balance sheet, assets are more frequently recycled leading to additional capital turnover and consequent increase in ROCE and RONW. It also leads to better asset quality for a lender, better transparency and disclosures in the balance sheet. In addition, it improves asset-liability management or ALM.
- From a purchaser or investor's perspective, it provides additional avenue for investment in quality paper backed by cash flow. Furthermore, it enhances the credit-worthiness of the receivables being securitised by providing suitable credit enhancements. The underlying objective is to lower the cost of funds to the seller and at the same time make it near to being risk-free or less risky for the purchaser.
- From a systemic perspective, securitisation is a transaction that bridges the flow of capital from the capital market into the banking system by converting loans into tradable debt securities and making investors buy into such securities. By doing so, it has helped to create depth and liquidity in the debt markets in developed countries. By providing relatively risk-free investment opportunity for investors and good-quality assets to purchasers, securitisation helps in spreading credit risk across the market and neutralise credit concentration that prevails in the banking system prior to securitisation. This not only helps to create liquidity and depth in the capital market, but make banks and financial companies more robust as well, thus, improving overall financial stability and growth.

3.14.1 Anatomy of Securitisation Structure

The anatomy of securitisation begins with the type of receivables (assets) being securitised. Based on this criterion, assets can be divided into two broad categories: (i) mortgages and (ii) other types of assets. *Mortgages* are loans that are backed by mortgage of immovable assets such as housing loans and industrial loans backed by mortgage of fixed assets, for example, project financing loans. Other assets would include receivables that are claims not backed by any mortgage such as credit card receivables, car loans, gold loans, lease rentals, personal loans, hire-purchase receivables, health care receivables, stock receivables etc. which are secured by movable assets or by simply by actionable claims such as a promissory note or a bill of exchange. Depending upon the underlying category of receivables, securitisation structure is classified either as *mortgage backed structures* or *asset backed structures*. Globally, securitisation started off with the mortgage-backed structure, which was widely popular before the advent of the asset-backed security structure.

The second aspect in the discussion of the anatomy is about the sale of the assets. Since securitisation is a process of converting loans and financial claims into tradable securities, there has to be a *true sale* of such assets by the seller, i.e. the assets have to be removed from the balance sheet of the seller without any future recourse. Only then can the sale be effective and the assets be replaced by cash or cash equivalent consideration. So, there is a requirement for another balance sheet to which the *sold* assets would be transferred. The underlying idea is to create a bankruptcy remote structure to which there is a transfer of receivables by the originator, it has to be a legal transfer of title to such receivables and not merely a borrowing arrangement on the security of the receivables. Therefore, the transaction is structured by way of an *assignment of receivables* by the originator to the SPV. The assignment of receivables shall be without recourse, i.e. the transfer of receivables has to be a true sale of the receivables with all the attendant legal rights which are irreversible. Many a time, the buyer forms a SPV to house the assets but that need not always be the case. If there is no purchaser and the selling bank simply wishes to convert its loans into tradable securities, it may incorporate its own SPV for this purpose. Similarly, if a bank is selling assets to another bank, the purchasing bank may prefer to acquire the loans in its own balance sheet.

The third aspect of the discussion relates to the payment options available to the purchaser of the financial assets. One option for the buyer is to pay cash or cash equivalent paper to the buyer. This is mostly the case when one lender buys loan assets from another buyer. However, this mechanism amounts to only a *sale of assets* and does not achieve the stated objective of securitisation. It only helps to transfer loans from one lender to another but falls short of the character of a true securitisation, i.e. conversion of loans into tradable debt securities. It may be noted that a securitisation structure shall have two aspects: (i) true sale of assets (loans) and (ii) conversion of loan assets into tradable securities.

Since the objective of securitisation is to convert loan assets into tradable debt securities, in most cases, the cash required to pay the seller is raised by the purchaser or its constituents through the issue of tradable debt securities in the capital market. Such securities are known as *securitised debt instruments*. Securitised debt instruments can be issued under a *pass through mechanism* because of which they are also known as *pass through certificates* or PTCs. Alternatively, they can also be issued as regular bonds or debentures under a *pay through mechanism*. Both these structures are explained in a subsequent paragraph. Securitised debt instruments issued by the purchaser or its SPV are collateralised with the purchased financial assets including their underlying securities. Based on the type of collateralisation, securitised debt instruments are classified either as *mortgage backed securities* or MBS and *asset backed securities* or ABS. As the name suggests, MBS are collateralised with loan assets that are secured with underlying mortgages while ABS are collateralised with loan assets that represent other types of financial claims. MBS are very popular in the US and European markets and the US is the largest market for MBS. The MBS market saw a large growth fed mainly by the demand generated by fixed income retail investors. The ABS asset-backed security market started off much later than the MBS market and the first ever ABS were issued in USA in 1985. Since then the USA has grown to be the largest market for ABS as well with about three-fourths of the ABS offerings being made through the public issue route in USA. ABS being a derivative product was developed in US market using a fine blend of the financial engineering and legal expertise. The product gained market acceptability in a very short time and its volumes since then touched trillions of dollars in the US market.

The other important aspect of securitisation is the securitised debt instruments that are issued to investors. Securitisation is both a structured finance and a capital market product. While on one hand, it enables financing based on receivables over a period of time, on the other hand, its objective is to create OTC products for capital market investors to provide such financing. The OTC product referred to herein means a financial claim which is generally manifested in form of a document; its essential feature being marketability. To ensure marketability, the instrument must have general acceptability as an instrument of value. Hence, it is generally either rated by credit rating agencies or it is secured by charge over substantial assets. Further, to ensure liquidity, the instrument is generally made in homogenous lots.

3.14.2 Stakeholders in a Securitisation Structure

The entity that securitises its assets is called the *originator*, which owns the financial assets that are the subject matter of the securitisation transaction. The originator is the creditor who has either loans or other financial claims in its books. It is the originator who initiates the process for securitisation and is the major beneficiary there from. The counter party to the originator is the *obligor* (borrower) who takes the loan or uses some service of the originator that he has to return. His debt and underlying collateral constitutes the financial asset for securitisation. There is no distinctive name for the investors who invest their money in the instrument and therefore, they are known only as *investors*.

The receivables of the originator are transferred to a special purpose vehicle or SPV formed for this purpose. Though it is not essential to create the SPV all the time, it has its advantages, as explained in Chapter 2. For convenience, these are reiterated below:

- The SPV creates *bankruptcy remoteness*, i.e. to separate the risks of the newly created securities from the risk of the originator. Due to this process, the investors who take up the ultimate financing are protected from the business risk of the originator that could affect their prospects of recovering their dues.
- The SPV acts as a repository of the assets or claims that are being securitised, i.e. while the charge is held by the SPV, the beneficial interest is made into a marketable security. The function of the SPV in a securitisation transaction could stretch from being a pure conduit or intermediary vehicle, to a more active role in reshaping the cash flows arising from the assets transferred to it.
- The SPV structure helps in creating suitable credit enhancements to make the structure more marketable and investor-friendly. The enhancements could be in the form of external financial guarantee or over-collateralisation, letter of credit or other such contractual obligations.
- The SPV structure helps in the identification of the risks attached to the underlying collaterals.

The facilitators and support service providers involved in a securitisation transaction play a very crucial role in the entire securitisation chain. Their services are instrumental in enhancing the credit worthiness of the product which is one of the prime reasons apart from collateral for the popularity of securitised debt instruments with investors. The facilitators are the banks/investment banks that act as the underwriters, the trustee company, the receiving and paying agent and the credit rating agency. The lead underwriters provide cover against under-subscription in the issue of securitised debt instruments by the SPV and eventual redemption risk to investors. The priority interest in the financial assets underlying the securitised debt instruments is created in favour of the trustee company or bank that acts on behalf of the investors. Trustee oversee the performance of other parties involved in securitisation transaction, review periodic information on the status of the pool, superintend the distribution of the cash flow to the investors and if necessary, declare the issue in default and take legal action necessary to protect investors interest. The receiving and paying agent (generally a bank) is the entity responsible for collecting periodic payment from obligors and paying it to investors. If the originator is a bank, it is generally assigned this activity. The rating agency performs the crucial function of rating the securitisation structure and assigns a credit rating to it. Based on the above discussion, the general structure for securitisation may be depicted as shown in Exhibit 3.3.

3.14.3 Pass Through Structure

As explained and illustrated above, securitisation involves the non-recourse transfer of assets by the originator to the SPV which then become the collaterals to the securitised debt instruments to be issued by the SPV. The cash flow arising from the assets by way of principal and interest servicing by the obligor become the debt servicing cash flow for such instruments. However, the pattern in which the claims of the instrument holders are structured on the underlying cash flows from the assets (loans) can be classified into two broad structures: (i) *pass through structure* and (ii) *pay through structure*. In a pass-through structure, the cash

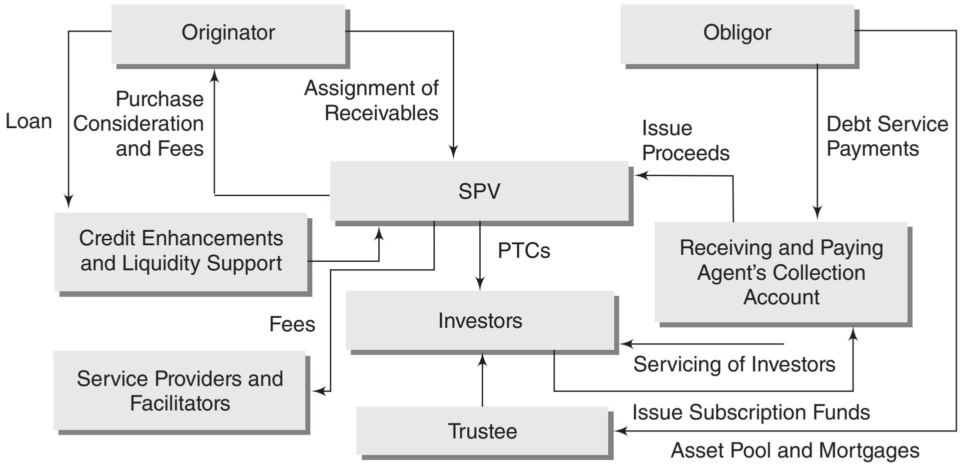


Exhibit 3.3 General Securitisation Structure

flow rights and asset recourse rights of the originator on the assets are passed on to the *pass through security* holders in the same way as the originator held them without any reconfiguration whatsoever. The PTCs are, thus, homogenous instruments that represent a direct and undivided interest in the cash flow and assets of the SPV, akin to the units of a mutual fund. The cash flows which include principal, interest and pre-payments received from the financial asset are passed on to investors on a pro rata basis after deducting the service fee, taxes, if any and other operational costs for administering the structure. In other words, the payments made to the PTC holders on account of principal and interest will be a mirror image of the pattern in which the underlying cash flows accrue to the SPV. The PTC holder has to assume the responsibility of reinvesting such cash flow which has been paid out to him. The timing risks underlying such cash flows, i.e. the reinvestment rate risk and prepayment risk (the risk of the obligor making a prepayment) are assumed by the PTC holder as and when they occur, since there is no reconfiguration of their claims on the cash flows. Thus, under the pass-through structure, the PTCs have a long life and unpredictable cash flows that inhibit participation by some of the fixed income investors in the capital market. The pass-through structure as depicted in Exhibit 3.4.

Exhibit 3.4 Pass-through Structure

3.14.4 Pay Through Structure

The pay through structure was an innovation primarily to address the limitations of a pass-through structure. Under this structure, the securitised debt instruments are not floated as PTCs (i.e. with undivided interest) but as bonds or debentures which are collateralised by the financial assets held by the SPV or its trustee. In other words, the cash flow rights of the originator are not passed on to the bond or debenture holders as in the case of a PTC. They are re-organised so as to reduce the term to maturity and provide some certainty regarding timing of cash flows to the investors. These securitised debt instruments (bonds or debenture) may also be issued in various tranches by varying the terms of issue such as tenor, coupon rate, yield and tradability features so as to customise to the needs of different investors. The debt instrument is issued in the form of a tranche and each tranche is redeemed one at a time. In this case, cash flows are to be reconfigured since they have to match the maturity profile of the debt security. The payment to investors is at different time intervals as distinguished from that of the underlying assets. Therefore, the reinvestment rate risk and prepayment risk on the cash flows is carried by the SPV till the time payout is made to the investors. The advent of the *pay through structure* revolutionised the world of securitisation by making it the underlying technique for the world of derivatives and structured finance instruments in the capital market. A discussion on this topic is provided in a subsequent paragraph. The generics of a pass-through structure are depicted in Exhibit 3.5.

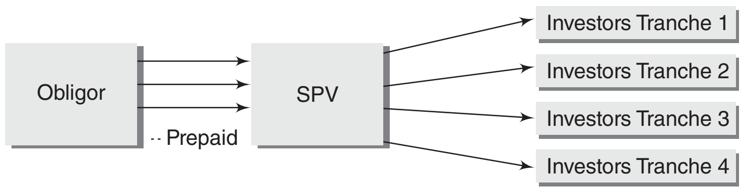


Exhibit 3.5 Pay Through Structure

3.14.5 Risk Profiling and Credit Enhancements

For securitisation to be successful as a capital market product, it is very essential that PTCs and other securitised debt instruments (bonds and debentures) are credit worthy and the risk to the investors is minimised. It should also enable the originator to raise funds at optimal cost by liquidating the assets in its balance sheet. To meet these twin objectives, a securitised product should be made into a distinct bundle whose credit risk is based on the intrinsic quality of the financial assets and is independent of the credit risk of the originator. This lowers the cost of funds for the originator as the new security is not clubbed with the rating of the originator and is used to raise funds at much lower cost. Furthermore, there should be a risk profiling of the structure and if necessary, suitable credit enhancements should be provided by the originator so as to attain the desired levels of credit risk rating for the entire securitisation structure.

The starting point for risk profiling should be to determine the quality of the underlying cash flow of the financial assets being securitised. Assets with similar ageing and cash flow and credit profile should be bundled together to make them more or less homogenous. Identification and bundling of similar assets is the core feature contributing to risk profiling and lowering the risk associated with securitised products. Further, the pool of borrowers creates a natural diversification in terms of capacity to pay, geography, type of the loan etc. and thereby lowers the variability of cash flows in comparison to cash flows from a single loan. So, lower the variability, lower is the risk associated with the resulting securitised instrument. By bundling similar assets together, it is possible to arrive at a group risk profile for the purpose of getting them rated.

As explained earlier, in a pass-through structure, the primary risks associated with a PTC are pre-payment risk and credit risk which get passed on by the originator to the PTC holders. While credit risk (risk of delay and/or default by obligor in making timely payments) is inherent in a debt product, prepayment risk arises when interest rates fall and the obligor gets the existing loan refinanced at a lower cost and repays the more expensive prior loan. Most loan contracts provide the facility to the borrower to prepay a loan in part or in full subject to certain conditions. Prepayment by the obligor disturbs the yield and the investment horizon of the PTC investors. Consequently, investors have to predict the average life of such securities and may have to look for alternate investment opportunities in a changed interest rate scenario.

While several sophisticated structured products have been evolved in the developed markets using the pay through structure to overcome the risks associated with securitised paper, a limited amount of risk mitigation mechanisms are also available under the pass-through structure. Generally speaking, *credit enhancements* are mechanisms used for risk mitigation. Depending upon the risk profile associated with a bundle of assets, every tranche of securitised debt instruments may have varying levels and types of credit enhancements. *Over-collateralisation* is the mechanism of providing additional collateral securities to cover the risk for investors over and above the amount at risk. It is also known as *margin*. Under this mechanism, the originator creates additional securities through mortgages or other asset securities with a margin of say 10 to 20% over and above the value of the paper issued to cover credit risk. However, over-collateralisation pre-supposes the availability of additional assets with the originator that can be offered as security.

Other credit enhancement measures which can be used in conjunction with or as alternatives to over-collateralisation are provision of a debt service reserve, corporate guarantee of the originator or a third party, *credit default swap*, insurance and a revolving letter of credit. All these measures may be used in different combinations depending upon the level of credit rating desired for the securitisation programme initiated by the originator. Third party credit enhancement such as insurance and guarantee are also possible through appropriate agencies on the payment of requisite credit enhancement fees.

3.14.6 Credit Default Swaps

Credit Default Swap (CDS) is a financial contract between the seller (protection seller) and the buyer (protection buyer) whereby the seller seeks to compensate the buyer in the event of a default on a loan or a bond or other defined credit event for which protection is being sought. When the default is triggered, the protection buyer receives compensation (usually the loan amount protected) and the seller takes possession of the defaulted loan or bond. It was introduced in the US market by the commercial bank, Bankers Trust, in the 1990s but was popularised in that decade by another large American commercial bank, J.P. Morgan. The global CDS market grew to more than $60 trillion by 2007 just before the financial crisis from less than a trillion in 2001. More discussion on CDS is furnished in Chapter 4.

3.15 Structured Products

3.15.1 Structured Securitised Debt Products

Structured products emerged in the form of securitised debt instruments in the capital market debt segment are based on the *pay through structure*. The PTCs under the ‘pass through structure’ were not innovative enough to promote securitisation since it could not alter the risk profile of the cash flows. The pay through structure meant that cash flows were repackaged to suit investors’ risk, return and maturity profile. In the US market, a pay through structure is known as a *collateralised debt obligation* or CDO. A CDO is a securitised instrument issued by a SPV under a pay through structure with assets as collaterals. CDOs can be further classified as collateralised mortgage obligations or CMOs (which are akin to MBS in a pass-through structure) and collateralised loan obligations or CLOs and collateralised bond obligations or CBOs (akin to ABS in a pass through structure). The differentiation in CDO structures depends on the nature of the underlying assets with the SPV. CLOs have loans as underlying collaterals while CBOs have bonds or debentures as underlying collaterals.

The first CDO was reportedly issued in 1987 by the now defunct investment bank, Drexel Burnham Lambert Inc., a firm which was made famous by Michael Milken’s junk bonds. The emergence of CDOs zoomed the volumes in the structured financial products segment of the capital market and made it a multi trillion-dollar industry. This product was tainted in 2008 as it triggered the global financial crisis by leading to excessive leveraged risks on mortgages and other financial assets.

The main objective behind a CDO structure is to make the loan market vibrant by providing an immediate source of securitising loans by lenders so as to increase the supply of loans and decrease interest costs. In this manner, a CDO converts bank loans into capital market debt and diverts money supply from the debt capital market to lenders. In other words, capital market debt is channelled through lenders to the businesses that they finance. At the same time, CDO issues become huge revenue spinners for investment banks with no risk on themselves.

CLOs have very complex structures based on several tranches of securities with different terms of issue and priority of claims. This is because CLOs combine multiple loans but don't transmit the loan payments equally to the CLO owners. Instead, the owners are divided into different classes, called *tranches*, with each class entitled to more interest payments than the next, but with them taking a higher degree of default risk. The tranching also depends on the category of loans or other debt underlying them and the seniority of the debt. In case of senior / sub-ordinate debt, cash flows from two groups of borrowers are independently used to bundle two set of securities. These two tranches of securities are issued with a pre-determined priority in their servicing. This means the senior tranche has prior claim on the cash flows from the underlying assets so that all losses will accrue first to the junior securities up to a pre-determined level. Thereby, the losses of the senior debt are borne by the holders of the sub-ordinate debt, normally the originator. The difference between yield on the assets and yield to investors is the spread which is the gain to the originator. A portion of the amount earned out of this spread is kept aside in a spread account to service investors. This amount is taken back by the originator only after the payment of principal and interest to investors. Usually, CLOs are born out of big ticket syndicated loans which are more often used for financing leveraged buy outs and are thus, known as *leveraged loans*. CLOs create a way for companies with weaker credit ratings to borrow from more institutions than just banks, thus, spreading the risk and lowering the overall cost of debt to them.

CDOs can be created either as cash flow based CDOs (known as *cash CDOs*) or as *synthetic CDOs*. A cash CDO is created when the SPV owns underlying cash generating assets such as loans, bonds and debentures and services the CDO holders with cash flow generated from such assets. Synthetic CDOs do not own cash assets like bonds or loans. Instead, synthetic CDOs gain credit exposure to a portfolio of fixed income assets without owning those assets through the use of Credit Default Swaps (CDS), which are a very often used credit derivatives instrument in global loan and debt markets. The SPV issuing a synthetic CDO buys CDS risks in return for a periodic cash premium to be paid by the CDS protection buyer, usually a lender. By doing so, the SPV assumes the risk of loss on a specific asset of the lender in the event that asset experiences a default or other specified credit event. Like cash CDOs, the risk of loss on the synthetic CDO's portfolio is divided into tranches. Losses will first affect the equity tranche, next the mezzanine tranches and finally the senior tranche. Each tranche receives a periodic payment (the swap risk premium), with the junior tranches offering higher premiums. The SPV, therefore, does not buy cash collaterals but instead buys credit risk from lenders for a return. Synthetic CDOs are extremely popular in Europe where over 90% of the CDO market is synthetic. In USA, they account for about one-third of the total issuances. Prior to the global financial crisis in 2008, the global CDS market had crossed the $50 trillion mark from less than $1 trillion in 2001 driven by demand from synthetic CDO issuances.

CDOs can get even more complicated through successive securitisations. For example, a SPV may buy MBS or ABS as underlying assets and issue CDOs thereon. Such CDOs may be termed as *structured finance CDOs*. Depending on the level of the structuring in consideration, investors have different motivations for purchasing CDO securities. At the more senior levels of debt, investors are able to obtain better yields than those that are available on more traditional securities (example, corporate bonds) of a similar rating or credit profile. At the most subordinated levels, the investor achieves a leveraged, non-recourse investment in the underlying diversified collateral portfolio. Where the CDO's portfolio is permitted to be actively managed, the investors are also able to take advantage of the expertise of a third-party asset manager. A cash CLO is represented in the following Exhibit 3.6.

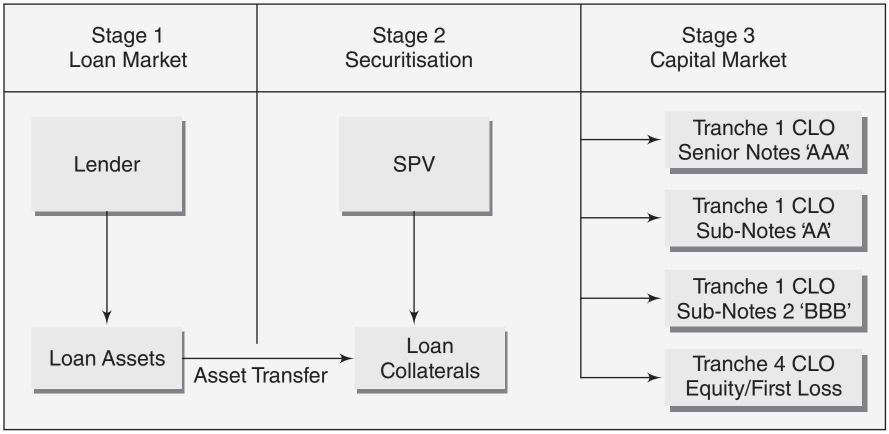


Exhibit 3.6 Cash CLO Structure

Note: The equity/ first loss tranche is frequently retained by the originator as a risk mitigation to CLO investors.

The securities issued by the CDO are split into rated and unrated classes of bonds and equity, where the rating of each bond class is determined by its position in the priority of payments and other rating criteria. Payments of interest and principal to the various bond classes (or liabilities) issued by a CDO are generally made sequentially, such that payment is first made to the most senior class and then to other classes, in the order of their subordination. These payments are made solely from the cash flows received from the underlying assets.

The senior bonds are usually rated AAA to A and have first claim on cash flows. The mezzanine and subordinated bonds are usually rated BBB to B and have a subordinate claim on cash flows. The equity tranche, which occupies a first-loss position as shown in the exhibit above, is generally unrated and receives all or most of the residual interest proceeds of the collateral. The CDO equity represents a leveraged investment in the collateral; it has both a higher expected return through coupon payments that are expected to exceed the expected losses and a higher volatility of return than the underlying assets.

The SPV formation document, the documents relating to a particular transaction and the associated legal opinions are key documents for an analyst in assessing the extent of the separation of the assets from the bankruptcy risk of the originator, the benefits to any particular structure in using an SPV and consequently and whether a particular transaction can be classified as a structured finance transaction. Typically, a SPV in a structured product transaction is a limited liability company, a trust, limited liability partnership or other form of body corporate based on the provisions of the local corporate, taxation and bankruptcy law. In general, the SPV has no credit standing by itself. Its credit standing derives from the assets held and the various contractual clauses securing the notes issued to investors and rated by agencies when sold in the market.

3.15.2 Indian Scenario in Structured Products

Under extant law and regulation in India, structured products as they have been shaped in developed markets have a limited role to play. As these products are designed to disintermediate the banking function and delink financing from credit risk. By doing so, they blur the underlying risks in credit risk based products and are perceived to be a systemic hazard, especially after the global financial crisis of 2008. Secondly, India has traditionally been a bank financing driven economy and disintermediation of banks in a systemic way is difficult considering the structure of the banking system and the requirement for traditional financing in the

SME sector. The Indian regulations do allow certain amount of structuring with regard to securitisation, as discussed in the previous sections of this chapter. However, the main constraint for structured finance products in the capital market is the restriction on the issue of *pay through structure* securities such as CDOs under the SARFAESI Act by securitisation companies. These are heavily regulated by the RBI including the issuance of CDS on corporate bonds and securitised debt instruments. The SEBI (Public Offer and Listing of Securitised Debt Instruments) Regulations, 2008, do permit the issue of structured products under a *pay through structure* subject to conditions. Therefore, transactions that repackage cash flows are permitted to offer structured products subject to the stipulations under the respective framework of law.

Case Study

ICICI Bank

In the first offer of structured product transactions in India, ICICI Bank made a CDO issue in 2004 to QIB investors using its own SPV. In this issue, a pool of 19 corporate loans was used as underlying collateral. Their cash flows were repackaged and issued as CLOs in two tranches as shown.

	Tranche A	*Tranche B*
Interest Rate	5.90%	7.50%
Credit Enhancement ₹	168,900,000	95,300,000
Outstanding Principal ₹	754,100,000	221,200,000

Tranche A consisted of superior notes with priority of interest payments while Tranche B with a higher rate consisted of sub-ordinated notes. The residual interest was retained by the originator.

There have also been securitisation deals involving issue of MBS and ABS using hire-purchase receivables, telecom receivables and mortgage receivables as underlying assets. In the inter-bank market, some of the Indian banks such as SBI and ICICI Bank have successfully executed securitisation of their loan portfolios with other banks such as Standard Chartered Bank.

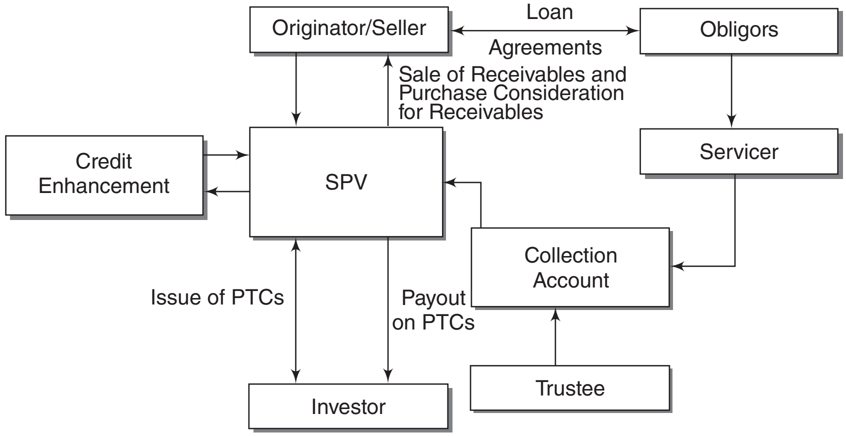
Case Study

Two-tier Securitisation 2010

Under this structure, a leading investment bank's DCM team invested in PTCs with 48-months maturity issued by NBFC and subsequently securitised the receivables under PTCs to another SPV which in turn issued PTCs (with maturity of 24 months) to investors to pay off the investment bank. While securitising receivables under PTCs, the investment bank also issued an underwriting in favour of the SPV under which investment bank would subscribe to new PTCs, if the SPV is unable to find new investors to pay off existing PTC holders.

First Tier Securitisation: NBFC granted auto/vehicles/construction loans to its various customers. It assigned/sold select pool of loan receivables to pass through SPV. NBFC also acted as service provider to collect the receivables. It also gave credit enhancement in the form of bank guarantee in respect of certain portion of loan receivables sold to the SPV. NBFC got rated for these receivables from credit rating agencies. Investment bank purchased these PTCs (48 months) from the SPV.

Second Tier Securitisation: After purchase of PTCs, the investment bank's DCM team securitised the first 24-months receivables under the PTC to another SPV which in turn issued PTCs (Initial PTCs) to mutual fund investors. These PTCs were rated by external rating agencies. The funds raised from



these PTCs were used to pay off the investment bank's claims on the first 24 months of receivables. At the end of the first 24 months, the SPV issued another tranche of PTCs (New PTCs) for the next 24 months to redeem the initial PTCs. The investment bank also underwrote the New PTCs to be issued for the balance 24 months. Under this commitment, if new investors were not found, the investment bank was obligated to subscribe to the New PTCs.

Though the market for structured securitised debt products is still nascent in India, it has growth potential due to the increasing role of the capital markets in complementing the banking system in corporate financing.

3.15.3 Structured Debt Products

Apart from structured securitised debt products, structuring of bonds and debentures floated in the capital market is also an area of structured debt products. In the Indian context, this category of structured products is more feasible than securitised debt products. In the past, several issuers used innovative structures such as deep discount bonds (IDBI), floating rate notes (Tata Steel), step-up bonds with wait periods (ICICI), triple option debentures (Reliance Petroleum) and so on. Bonds may be structured with several features for risk mitigation such as call and put options, floating rates pegged to a base rate, coupon resets, detachable coupons, *Separate Trading of Registered Interest and Principal Securities'* (STRIPS) etc. STRIPS were introduced for the first time in the US market by the US Treasury for government securities in the mid-1980s. These innovations are also coupled with *structured obligations* wherein the bond features are combined with external credit enhancements such as guarantees or cash flow escrow and tranching so as to achieve a superior risk rating than that of the issuer. In essence, there is a de-linking of the risk profile of the issuer with that of the instrument which is one of the hallmarks of structured product obligations. In the infrastructure financing area, several bond issues from developers have been tried out using structured obligations.

Case Study

Reliance Petroleum TOCD issue in 1993

Reliance Petroleum (now merged with Reliance Industries Ltd.) made a public issue of Triple Option Convertible Debentures (TOCDs) in 1993. Each TOCD had a face value of ₹60 split into three components: (i) an equity share, (ii) another equity share and (iii) a debenture. The split-up in face value was two equity shares of ₹10 each and a debenture of ₹40. Out of the three parts, the first equity share would entitle the investor for one equity share at par on payment of the allotment money on the TOCD of ₹20. The balance amount of ₹40 to be paid by the investor was also split into instalments spread over 36 months. If the investor chose to exercise the right for the second equity share at par, an amount of ₹10 had to be paid on it along with the balance amount due on the non-convertible third part. The investor was given a staggered payment schedule spread over 36 months to pay the balance amount of ₹40. After the receipt of the full amount, the company allotted two tradable equity warrants to the investor which could be exchanged for shares at par after the expiry of five years. The non-convertible part of the TOCD was not entitled to any interest for the first five years but it was possible to surrender it with the warrants while exchanging them for shares. If the non-convertible part was opted for continuation, it carried interest for the period after five years. The non-convertible part of the TOCD was to be redeemed in three instalments in the 6^{th}, 7^{th} and 8^{th} years. Thus, in this case, the option to subscribe and take equity at par was optional upon the investor for which there was a sacrifice of interest on the non-convertible portion for five years.

It may be observed from the above that in the TOCD, the investor had an option both on the equity portion and the debt portion. The debt portion could be retained for three years after the fifth year. It did not have a coupon rate but provided a yield in terms of the repayment amounts at the end of each year which resulted in an annualised yield of above 14%. Though the shares were being issued at par, in effect there was an in-built premium to the extent of the loss of interest on the non-convertible part for the first five years.

Case Study

Essar Oil OFCD issue in 1995

A similar instrument to the TOCD of Reliance was offered by Essar Oil. In 1995, Essar Oil came out with a simultaneous but unlinked issue of equity shares at premium with 12.5% secured redeemable Optionally Fully Convertible Debentures (OFCDs). Each OFCD had a face value of ₹190 consisting of three parts: Part A of ₹40, Part B of ₹45 and Part C of ₹105. The payment schedule for all the three parts was divided as shown in the following table:

Terms of payment

₹	*Total*	*Part A*	*Part B*	*Part C*
On application for the OFCD	47.50	17.50	10.00	20.00
On allotment	47.50	22.50	10.00	15.00
On first call	47.50	0.00	25.00	22.50
On second call	47.50	0.00	0.00	47.50
Total	190.00	40.00	45.00	105.00

Part A of the OFCD was compulsorily convertible to one share of ₹10/- at a premium of ₹30 on the date of allotment of the OFCD without any further act or application by the OFCD holder and the face value of the OFCD stands reduced to ₹150. On such conversion, there would be a constructive receipt of ₹40 by the company from the OFCD holder and constructive payment of the same amount by the OFCD holder to the company towards the cost of one equity share.

Part B would stand automatically and compulsorily converted into one equity share of the face value of ₹10 at a premium of ₹35 per share at the expiry of 16 months from the date of allotment of the OFCD without any further act or application by the investor and the face value of the OFCD stands further reduced to ₹105.

Part C has the feature of optional conversion, if so chosen by the investor. At the option of the investor, Part C gets converted into two equity shares of ₹10/- each at a premium of ₹42.50 per share at the end of the 32nd month from the date of allotment. For this purpose, a record date was proposed to be fixed to ascertain the entitlement of the investors and a letter of option was proposed to be sent by the company seeking the option from the investors. Part C carried interest at 12.5% from the date of allotment till the date of exercising the conversion option. If the investor did not propose the conversion, it carried interest thereafter at 14% till its redemption at the end of the 8th year as a bullet repayment.

Unlike the TOCD of Reliance, the OFCD of Essar did not offer optional equity to the investor in the first two parts. Therefore, an investor got two equity shares at a premium for the first two parts at fixed price. In order to compensate the investor partly, the non-convertible part carried interest from the date of allotment at 12.5%. This interest was enhanced to 14%, if the conversion option was not exercised on Part C. In terms of structuring, the TOCD had better features since it apparently offered equity at par to the investor but the premium was extracted through the back door. Similarly, Reliance did not have to service any interest on the non-convertible part as it did not carry any interest till the date of conversion and thereafter, it was in the nature of a cumulative deposit.

Case Study

Noida Toll Bridge Company DDB issue in 1999

The Noida Toll Bridge Company came up with a simultaneous but unlinked issue of secured redeemable Deep Discount Bonds (DDBs) and secured FCDs in 1999. The DDBs issued at a face value of ₹45,000 per bond at a price of ₹5000 to be redeemable at par after 16 years. This works out to an annualised yield of 14.72% to maturity. The DDBs were also proposed to be listed and traded on stock exchanges and transferable only by the execution of a transfer deed. In addition, the investor in the DDBs could exercise a call option at the end of the 5th year at a price of ₹9500 and at the end of the 9th year at a price of ₹16500. The FCDs, which had a face value of ₹1000, were to be fully and compulsorily converted into 100 equity shares at par at the expiry of 36 months from the date of allotment. Till the date of conversion, the FCDs carried a coupon rate of 14%. The FCDs were also proposed to be listed from the initial stage itself and upon conversion into equity, the resultant shares would continue to be listed and no separate listing application was proposed for such equity. The FCDs as was the case with the DDBs, were transferable only through an instrument of transfer.

In the case of this offer, the investor had the following options:

- In investing in either the DDB or the FCD or in both.
- In retaining both till the date of maturity or conversion, as the case may be, or in trading either one or both on the stock exchange.
- To offer the DDB by exercising the call option at the end of the fifth or the ninth year at the agreed exercise price.
- To enjoy interest at 14% on the FCD and sell it before conversion at a profit.
- To get the FCDs converted into shares and trade them at a profit.

3.16 Other Aspects of Fixed Income Securities

3.16.1 Investors' Perspective of Debt Securities

As far as an investor is concerned, a debt security offers a stable and assured return, if the debt security has a fixed coupon rate. Even if the coupon rate is variable, the indicative interest in the short-term is predictable, though the investor undertakes an interest rate risk. In addition, if the security is adequately rated by a rating agency, it offers predictable safety on the principal amount as well. Therefore, debt securities are ideally suited for investors with less appetite for risk. In addition, if the investors have no risk appetite at all, they can choose to invest in risk-free government debt securities and refrain from considering corporate debt securities.

As far as the decision to invest in a pure debt instrument vis-à-vis a convertible is concerned, the evaluation can be based on a Net Present Value approach. The present value of the investment in the convertible should be compared to the present value of the exercise price / market price of the share as on the proposed date of conversion and the interest earned till the date of conversion. This would result in the NPV of the convertible. Similarly, the NPV of the pure debt instrument can be measured taking into account the present value of the initial investment and the present value of future interest flows. The two NPVs can then be compared to provide an indication to the investor about the better investment alternative. This can be stated as follows:

- If $NPV_c > NPV_d$, wherein NPV_c represents the net present value of the convertible and NPV_d represents the net present value of the pure debt security, investment in the convertible is a better option.
- If $NPV_d > NPV_c$, wherein NPV_c represents the net present value of the convertible and NPV_d represents the net present value of the pure debt security, investment in the pure debt security is a better option.

Securitised paper such as *Pass Through Securities* (PTCs) is the latest entrant in the primary debt market. Since PTCs are often credit enhanced, they are relatively a safe and good investment option for investors such as mutual funds and other institutions. Securitised paper has, thus, far been outside the purview of retail investors primarily because public offerings of PTCs are not yet in vogue since the regulatory framework is not in place.

3.16.2 Issuer's Perspective of Debt Capital and Debt Securities

For an issuer, a debt security represents a lesser cost of capital as the debt capital is cheaper than equity capital due to its limited risk profile. In the case of fixed rate debt, the cost is also capped based on the coupon rate. Due to the fixed nature of the cost of debt capital, it provides disproportionate earnings to equity shareholders. This phenomenon is known as *trading on equity*. Most corporates prefer leveraging their capital to enable trading on equity.

Apart from cheaper cost of debt, what makes debt more attractive is the tax break enjoyed on the interest paid on debt securities. While equity dividend is not tax deductible, it has an additional cost of distribution tax for the company paying the dividend. However, interest on debt being tax deductible, the post-tax cost of a debt security is much lower than the post-tax cost of equity capital. This has already been explained earlier in this chapter.

Perhaps, the biggest advantage to an issuer of debt securities is in terms of the alternative of borrowing through a loan obligation. A loan contract is a private agreement whereby the lender and the borrower are tied down to each other by the loan covenants. Therefore, if the lending agency wishes to spread its risk, it cannot do so unless the loan receivables are either assigned to a third party or securitised. However, if the borrower issues debt securities to start with, the risk is spread across several investors and therefore, the pricing can be finer. Therefore, in general terms, debt securities have to be cheaper than loan obligations. However, in the Indian capital market, a pure corporate debt security has not found much favour due to its limited marketability. Therefore, issuers are obliged to offer higher coupon rates or other sweeteners. A ZCB is better than a NCD, since it does not have a servicing obligation and the return to the investor is factored into the redemption price though the tax shield on interest can be availed on accrual basis depending upon the method of accounting adopted by the company and its fairness from the tax point of view. This would entail significant saving of cash flow in terms of periodical interest payments. The company gets enough time to earn a return on the funds raised and pool them up for meeting redemption requirements.

The mechanism of a debt convertible offers the advantages of both debt and equity instruments from an issuer's perspective. A PCD or a FCD can be used as a source of cheaper debt capital till such time that the company has created enough additional profits in the bottom line to absorb the expansion in equity base on conversion. Therefore, while the company enjoys additional capital with minimal cost, it also absorbs the equity expansion with a milder impact on its EPS. This factor makes a convertible superior to pure equity or pure debt securities. A ZCB with a conversion option is even better considering that during the pre-conversion period, the company does not suffer any cash outgo towards interest payments. The return to the investor is factored into the conversion price on the underlying share. In this way, the company is able to offset a revenue cash cost (interest) with a reduction in a capital receipt (securities premium) that could have been charged on the share. Obviously, a ZCB that is fully convertible does not offer any tax shield to the issuer.

Issue of securitised instruments such as PTCs is advantageous to an issuer to raise capital on existing or future receivables at effectively fine rates. However, this is possible only if suitable structure has been created through good credit enhancements and a good rating has been obtained for the structure. The biggest advantage of securitising existing receivables is in unlocking liquidity, which is what makes it attractive to banks and other lending institutions.

3.17 Securities Issuances in Primary Market

An issue of equity involves the increase of the equity share capital by issue of fresh shares. The consideration for such shares can be received either in cash or in kind or through capitalisation of reserves. The Indian company law recognises all the three modes of consideration. However, shares issued for consideration other than cash and by capitalisation of reserves need specific disclosures in the financial statements. The various methods by which a company may issue shares are depicted in Exhibit 3.7.

In a public offer, shares are offered for public subscription through advertisement and issue of a public offer document. The final allotment of shares is made to the successful applicants based on established criteria. One of the essential features of a public issue is that the shares are listed on a stock exchange through the issue. As can be seen from the above diagram, broadly speaking, there are two types of public offers: Initial Public Offers (IPOs) and Follow on Public Offers (FPOs). A public offer whether an IPO or a FPO could be made by an issue of new shares by the issuer company (public issue) or through a sale of secondary shares by existing shareholders known as *sellers* (Offer for Sale). On the other hand, a preferential offer is not a general offer and is, therefore, made through a private placement of shares to select investors. A mid-way offer between a public offer and a preferential offer is a right offer that is made existing shareholders only. A rights offer is not available for subscription generally by the public. All these types of offers are discussed in detail in subsequent chapters.

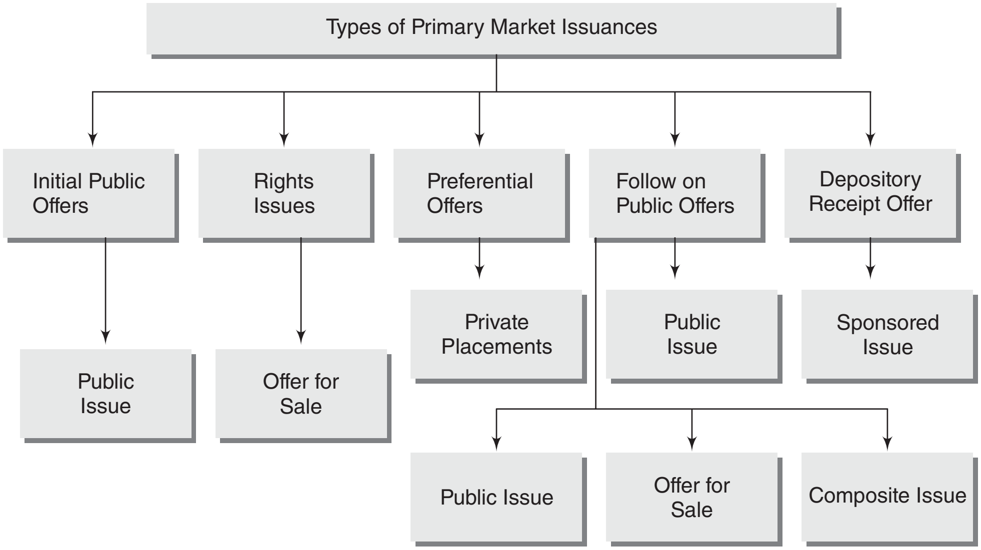


Exhibit 3.7 Methods of making Equity Offers in Primary market

3.18 General Statutory Provisions for Issuance of Securities

There are certain general requirements for issue of securities by a company that are applicable to all types of issues and issuer companies. These are discussed below:

3.18.1 Issue of Securities at Premium

As mentioned earlier, securities can be issued *at premium*. Securities can be freely priced by issuer companies based on their expectations and the comfort of investors. However, when securities are priced at a premium to their face value, such excess is termed as *securities premium*. For instance, if an equity share that has a nominal value of ₹10 is issued at a price of ₹60, it gives rise to a share premium of ₹50. After the advent of free pricing under the SEBI guidelines, companies are free to price their shares according to their judgement of the market either at par or at a premium when such shares are offered to the public. In the case of unlisted companies too, such companies are free to price their shares at a price they find appropriate, if these shares are issued privately. However, the Companies Act prescribes certain restrictions on the utilisation of such securities premium. It has to be used strictly in accordance with the provisions of Section 52 of the Companies Act. Under these provisions, the premium shall be credited to a separate *securities premium account* which can be utilised only for the following purposes:

- In paying up unissued securities of the company to be issued to the members as fully paid bonus securities.
- In writing off the preliminary expenses of the company.
- In writing off the expenses of or the commission paid or discount allowed on any issue of securities or debentures of the company.
- In providing for the premium payable on the redemption of any redeemable preference securities or of any debentures of the company.

From the above requirements, it is evident that share premium collected on issue of shares shall be used only to meet certain specialised expenditures or being capitalised as bonus shares. It is not available to meet normal expenditure or for being paid out as dividend to shareholders.

ILLUSTRATION 11

Let us consider a company that issues 1000 shares of ₹10/- each at a premium of ₹20/- per share. In this case, the issue price of the share is ₹30/- and the total amount collected from the issue is ₹30,000.The company has to account ₹10,000/- as share capital and ₹20,000/- as share premium in its books. Now, let us assume that the company wishes to redeem 1000 existing preference shares of ₹100/- each at a price of ₹110/- per share. The company can utilise the share premium collected on the equity shares for the purpose of writing off the premium payable on redemption of the preference shares amounting to ₹10,000/-. Therefore, upon such redemption, the company would reduce its preference capital by ₹100,000 and its share premium account by ₹10,000. That would leave the company with ₹10,000 (20,000–10,000) in the share premium account. Let us now assume the company wishes to capitalise it as bonus shares to the equity shareholders. It could issue another 1000 fresh equity shares as fully paid bonus shares at par amounting to ₹10,000/-to its existing shareholders. The company would, therefore, exhaust the share premium collected earlier and transferring it to equity share capital. It may be noted that bonus shares are normally issued only at par and not at a premium. In other words, though the Companies Act or the SEBI Regulations do not specifically talk about pricing of bonus shares, the accepted practice is for a company is that it should not create share premium out of a bonus issue of shares.

3.18.2 Issue of Securities at Discount

Under Section 53 of the Companies Act, there are restrictive provisions that prohibit an issuer company from issuing shares at a discount. As per these provisions, a company cannot issue shares at a discount (at less than the nominal value). It may be noted that the provisions relating to prohibition of issue at a discount apply only to shares. Other types of securities can be issued at a discount without complying with the above provisions. Similarly, sweat equity shares issued under Section 54 may be issued free of cost or at a discount without complying with the requirements of Section 53.

3.18.3 Further Issue of Shares

Under Section 62(1) of the Companies Act, if a company proposes to issue further shares after a year from the date of the first allotment of shares since its inception or after two years of its incorporation, whichever being earlier, such further issue of shares shall be offered to the persons who are shareholders of the company at the time of such offer in proportion to their holdings. In other words, all further issues of capital shall only be rights issues to the existing shareholders. Therefore, a company is obliged to make rights issues for all further equity financing requirements under this provision. Rights issues are made exercising the provisions of Section 62(1).

However, under Section 62(1)(c), if the company in general meeting passes a special resolution approving further issue of shares other than through a rights issue, the company can then make such issue in any manner, as may be approved in the resolution. Under this provision, a special resolution passed by a company under Section 62(1)(c), enables a company to make an IPO, FPO and preferential offers.

In view of the above provisions, all issuances of shares made by a company either through a public issue or private placement after the above stated time frames has to be approved by a special resolution passed under Section 62(1)(c) of the Companies Act except a rights issue which is approved through a resolution passed under Section 62(1).

3.19 Future Directions

The Indian primary market promises a good future for issuers and the investors in the years to come. The maturing of the primary market has ensured that quality of issues is not compromised for volume and activity. Though this could mean decreased business for issue managers and intermediaries as well as support service providers, the market cannot be expected to grow at the expense of quality unlike in the past. Stiffer disclosure norms, adherence requirements to objectives of the issue and continuing compliance by companies would deter issuers with low corporate governance standards from entering the market for fund raising. The primary market can no longer be perceived as a source of finance for every company in search of funds. Due to qualitative improvements by SEBI in primary market, investors would see better returns on primary investments over a longer term.

With the integration of India with the global market, setting up of International Financial Centres, liberalisation of company law, IDR regulations and so on, one could see global companies listing in Indian capital market. Based on emerging trends, the corporate bond could emerge from the shadow of government securities and could become a dependable platform of capital market fund raising for corporates. This would require investment banks tapping retail investors along with HNIs and institutional investors. For a sustained primary bond market, large and successful public offers are the key rather than institutionally placed private placements. Similarly, healthy secondary market trading in corporate bonds would become a reality if there is enough liquidity along with the availability of derivative products based on corporate bonds. For a vibrant bond market, there is a requirement of market investors and not merely long-term investors holding till maturity. However, going by global trends, the corporate bond market could emerge larger than the equity capital market in India in the years to come.

This would depend *inter alia* on the government making the secondary bond market more vibrant both in the government bond segment and the corporate bond segment. As far as the government bond segment is concerned, it still dominates the overall bond market with more than 90% share, thereby, crowding out corporate bonds. An integration of the two market segments by allowing corporate bond traders and brokers to perform intermediary function in the government bond market can make the market vibrant. As of now, the two segments are in water tight compartments with separate set of intermediaries: primary dealers in the government bond market regulated by the RBI and stock brokers in the corporate bond market regulated by the SEBI. If the regulatory framework paves the way for integration of these two intermediaries in future, it would allow for larger brokerage houses to be formed providing institutional depth in the market. The government securities market was made water tight by RBI in the wake of the Harshad Mehta scam which involved diversion of funds from the government securities market into the capital market by Harshad Mehta and his connected entities. However, with the development of adequate checks and balances in the system backed by sophisticated trading platforms and settlement systems, the time has come to bring in the era of an integrated bond market in India.

IMPORTANT TERMINOLOGY

ABS
Bankruptcy Remoteness
Bilateral Development Financial Institutions
CCPS
CDO
CDS
CLO
Collateralisation
Convertible Preference Shares
Corporate Bond Market
Coupon
Debt Convertibles
Deep Discount Bonds
DFIs
DII
Dividend Payout
Dividend Yield

Domestic Venture Capital Funds
Equity Convertibles
Equity Warrant
EVA
FCD
FII
Foreign Venture Capital Funds
FPIs
Further Issue of Shares
HNIs
Institutional Investors
Issue at Discount
Issue at Par
Issue at Premium
Issuers
Issues
MBS
Multilateral Development Financial Institutions
Mutual Funds
MVA
NCD
Obligor
OFCD
Offer for Sale
Originator
Pass through Structure
Pay through Structure
PCD
PFI
Preferential Allotment
Primary Debt Market
Primary Equity Market
Private Placement
PTC
Public Financial Institutions
QIBs
Retail Investor
Retail Investors
Scheduled Commercial Banks
Securities Premium Account
Securitisation
Securitised Debt Instrument
SIDC
SPN
STRIPS
Sweeteners
Synthetic CDO
TOCD
UHNIs
YTM
ZCD
Zero Coupon Bonds

TEST YOUR UNDERSTANDING

PART – A

I. Pick the right answer(s) or the alternative that best fits the description from the alternatives provided under each question.

1. Primary Market consists of securities issuances that are offered by eligible issuers to eligible investors based on public offer mechanism.
   (a) True (b) False
2. If an equity share of a company valued at ₹82 is issued by the company to investors at ₹60, it amounts to an issue of the share at a discount and therefore amounts to capital reduction.
   (a) True (b) False
3. If the share of a company does not have any trading in the secondary market due to lack of interest from investors, it is called an unlisted share.
   (a) True (b) False
4. A company introduces an offer that whoever buys its car gets 25 shares free of cost from the promoters of the company. This amounts to:
   (a) Primary market issue (b) Secondary sale
   (c) HNI issue (d) Tied in sale
   (e) Bonus Issue (f) Bogus issue.
5. A company issued a Zero Coupon Fully Convertible Note with a face value of ₹1000. Each note would be converted into 8 equity shares of ₹2 each at a premium of ₹98 per share. Each note also has 2 detachable warrants that can be converted into 2 shares at no extra cost to the investor. Assuming the cost of funds to be 10% p.a., how much of the amount collected can be allocated to interest cost by the company if the total conversion period is six months?
   (a) ₹50 (b) ₹80 (c) ₹0 (d) ₹196
   (e) ₹100 (f) ₹264

6. Which of the following instruments entails cash flow servicing for interest payments?
   (a) Zero Coupon Fully Convertible Debenture (b) Zero Interest Convertible Loan
   (c) Fully Convertible Warrant (d) Deep Discount Bond
   (e) Partly Convertible Debenture (f) Optionally Convertible Debenture.
7. The coupon rate of a pure debt security is 12%. The face value of the instrument is ₹1000. The instrument has a life of 20 years. At the end of every 5 years, there is an option to convert it into a zero-coupon bond with an implicit rate equal to the existing coupon rate. This conversion makes sense if:
   (a) The prevailing market rate is more than 12%.
   (b) The marginal tax rate on interest is reduced.
   (c) The marginal tax rate on income is reduced.
   (d) Income tax on cash flow is increased.
   (e) The prevailing market rate falls below 12%.
   (f) The investor seeks to defer taxation.
8. An equity warrant has an 'exercise price' of ₹50, CMP is ₹75, warrant is convertible into 2 shares and there is a bonus issue (2 for every 1 held) just prior to the conversion. If ex-bonus price corrects homogenously, the economic value of the warrant is:
   (a) ₹50 (b) ₹100 (c) ₹125 (d) ₹250
   (e) ₹150 (f) ₹225.
9. Which of the following instruments has an impact on the EPS of a company?
   (a) Zero Coupon Bond (b) Floating Rate Bond
   (c) Cumulative Convertible Preference Share (d) NCD with warrant
   (e) Optionally convertible Step up Bond (f) FRN with coupon strip.
10. A company makes profit before tax of ₹250 million. The effective tax rate is 22% and the company has deferred tax liability of ₹20 million. The company wishes to write back reserves of ₹50 million and declare dividend of ₹105 million. The Dividend Payout ratio works out to:
    (a) 42% (b) 55% (c) 10.25% (d) 53.85%
    (e) 60% (f) 28.57% (g) 25.64%
11. If a Silicon Valley constituted fund wishes to invest in infant unlisted Indian companies with the approval of SEBI, it would classify as:
    (a) AIF (b) FPI (c) FDI Investor (d) FVCI
    (e) DII (f) FII.
12. Which of the following investors does not qualify as FPIin India?
    (a) SWFs (b) UNICEF
    (c) Bank of Seychelles (d) The Boston University Endowment Trust
    (e) Petroleum Corporation of Riyadh (f) Bill Gates Foundation
    (g) Richard Gere Buddhist Monastery in Lhasa
13. Sir Donald Bradman Cricket Fund of Australia plans to promote Indian cricket by investing into teams that play in the Indian Premier League. It would classify as:
    (a) AIF (b) FPI (c) FDI Investor (d) FVCI
    (e) DII (f) FII
14. If a German Engineering giant acquires controlling interest through purchase of shares of a listed Indian company, it would classify as:
    (a) AIF (b) FPI (c) FDI Investor (d) FVCI
    (e) DII (f) FII
15. A private equity fund based in Liechtenstein wishes to invest in a private equity fund constituted in India by the Royal Indian Bank. This amounts to:

(a) FPI investment (b) FDI Investment
(c) Portfolio Investment (d) Fund of Fund Investment

16. A US based investment bank raises an offshore private equity fund with a mandate to invest in other private equity funds (including Sovereign funds) in emerging markets. This amounts to:
(a) FPI investment (b) FDI Investment
(c) Portfolio Investment (d) Fund of Fund Investment

17. A French cement company floats a SPV in Bahamas to become a Joint Venture partner in an Indian cement company by acquiring the existing stakes of the promoters through a negotiated purchase. This investment would classify as:
(a) FPI investment (b) FDI Investment
(c) Secondary Market Purchase (d) Mutual Buyback
(e) FVCI investment (f) Foreign VCF investment
(g) JV investment.

18. The following market intermediaries and support service providers are not regulated by SEBI:
(a) STAs (b) Equity Analysts (c) Financial Planners (d) CRAs
(e) Custodians (f) Insurance brokers (g) Issue Bankers (h) Debenture Trustees
(i) Portfolio Managers (j) Investment Advisors

19. A company wishes to issue a step-up bond whereby the investor will be paid higher redemption amounts for increased periods of holding. This can be achieved by increasing the YTM of the bond while keeping the coupon and the terminal cash flow constant.
(a) True (b) False

20. In balancing the upside return on a fixed income security, the investment banker applies a wait period after which the investor's return is linked to an index future. This feature does not make it a convertible security.
(a) Yes (b) No

21. In a convertible structure, the conversion price is inversely related to the dilution in the EPS while the EPS is directly related to the conversion price that is linked to the Price-Earnings Multiple.
(a) True (b) False

22. In a FCD structure, if the investor refuses to agree to the conversion price to be decided on the date of conversion but agrees to the conversion per se, the company has an option to decide the conversion price.
(a) Yes (b) No

23. In a CCPS structure, if the shares are made redeemable, the investor gets to encash the redemption price along with cumulative accrued dividend thereon on redemption.
(a) True (b) False

24. In a ZOCD structure, if the investor refuses to convert the debt into equity on the appointed date, he neither gets equity nor interest and only the principal is returned.
(a) True (b) False

25. In a fixed rate bond, if the YTM is maximised by increasing the coupon and the tenor, it opens up the bond to current yield volatility when the yield curve is headed south.
(a) True (b) False

26. Jaguar Investments Pte Ltd., a stock broking entity, wishes to invest in India in a non-banking financial company so as to apply for a banking licence in future. This classifies as:
(a) Strategic FDI (b) FVCI (c) Non-banking FDI (d) FPI
(e) Investment FDI (f) Capital market FDI (g) None of the above

27. The shareholding from a ZOCD can be structured identical to that from a share warrant provided their coupon rate remains constant.
    (a) Yes (b) No
28. A pay through securitisation structure ensures that the credit rating of a securitised instrument is different from that of the originator since the cash flows are not mapped one on one.
    (a) True (b) False
29. Credit enhancement on a structured debt product is a way of ensuring that in the event of a default on the underlying cash flow, the SPV does not become bankrupt and default to the investors.
    (a) True (b) False

PART – B

30. What are the main features of equity shares and why should an investor look at them as an investment option.
31. What are the advantages to the issuer of equity shares as compared to raising finance through issue of debt instruments? How do offers of convertibles score over those of pure equity?
32. What are the main features of debt instruments? What are the distinguishing features of convertible debentures and zero interest debentures?
33. What are the types of debt instruments that can be issued by a company incorporated under the Companies Act? Are there any limitations to issue unsecured debt instruments?
34. What are floating rate instruments and how do these score over fixed rate instruments?
35. What are the implications of discounted debt instruments vis-à-vis interest bearing debt instruments for issuers and investors? Examine from the financial and regulatory angles.
36. What are the segments of the primary market?
37. What have been the trends in the primary equity and debt markets in India? How do you see the future?

For answers to Part A, refer to Appendix B at the end of the book.

4 Secondary Markets—Systems and Regulations

LEARNING OUTCOMES

- Secondary market segments—ECM, DCM and F&O Markets.
- ECM—normal trades, bulk deals, block deals, DCM, WDM and RDM.
- Derivative markets and contracts—forwards, futures, options and swaps, Offshore Derivative Market and Participatory Notes.
- Domestic Interest Rate derivatives—FRA, IRS, Credit Derivatives—CDS and Synthetic CDOs, Currency Swaps and Forward contracts, Currency F&O.
- Significant developments in secondary markets—demutualisation, dematerialisation, corporatisation and algorithmic trading.
- Trading, settlement, risk management systems in secondary markets with NSEL case discussion.
- Secondary market law and regulation—Insider Trading Regulations, Unfair Trade Practices Regulations with cases.

4.1 Introduction[1]

Secondary market (also known as the *aftermarket* in USA) is a segment of the capital market wherein already existing securities are traded after their issue in the primary market. It may be reiterated for the purpose of clarity that the initial issuance and purchase of a security is called the *primary market* and all purchases and sales thereafter of the said security are called the *secondary market*. Therefore, the most important distinction is that while the primary market consists of *issuers* and *investors*, the secondary market consists of *buyers* and *sellers*. Apart from buyers and sellers, the secondary market comprises of stock exchange trading platforms and intermediaries such as brokers and market makers, and infrastructure providers namely depositories and clearing houses. The main advantage of an exchange traded secondary market is the elimination of

[1]This chapter discusses the broad overview of the secondary market for the purpose of providing a complete perspective on capital market discussions. Since investment banks have large allied business portfolio in secondary markets, the business of most conglomerate investment banks is inseparable from the secondary markets. Nevertheless, as mentioned elsewhere, the focus of this book is on Core Investment Banking that deals with primary markets. Therefore, an exhaustive discussion on secondary markets is outside the scope of this book.

counter-party risk as all trades are guaranteed by the stock exchange. This is the most significant value addition of exchange trading over OTC trading. As the system needs to be insulated from systemic risks, the entire operations of the secondary market are subject to surveillance by the stock exchanges and regulatory oversight of market regulator SEBI.

4.2 Secondary Market Segments

The secondary market is divided into segments based on the type of securities and trades conducted therein. Readers may refer to Exhibit 2.1 in Chapter 2 wherein the division of the capital market is illustrated. The same segmentation is carried into the secondary market as well. Accordingly, the segments in the secondary market are shown in Exhibit 4.1.

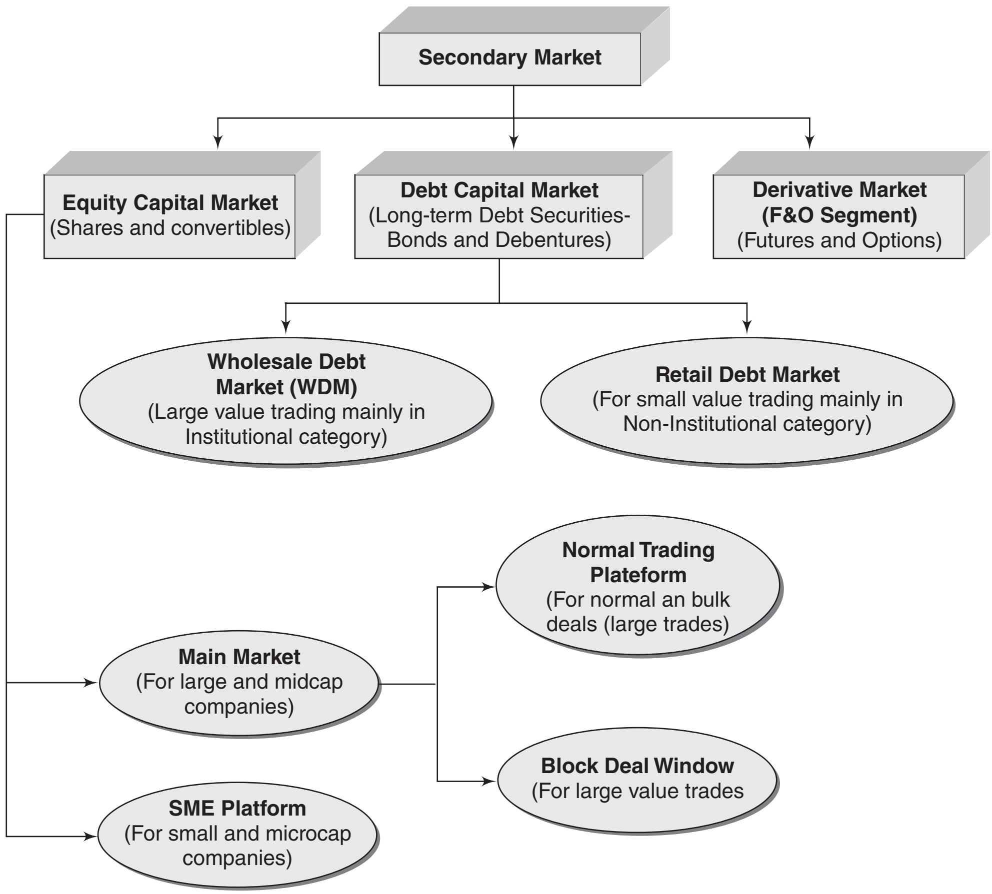


Exhibit 4.1 Segments of Secondary Market in India

4.3 Equity Capital Market—Secondary Segment

The equity segment of the secondary market is also known as the *cash market* as it is a delivery based market. Each trade has to be settled in actual delivery of securities for cash. Trades are carried out by registered brokers of the stock exchange on behalf of their clients. In order to recognise market movements from time-to-time, all stock exchanges use their respective *stock index* or several such indices including those that relate to particular sectors. In India, the indices used by the NSE and BSE have been discussed in Chapter 2. The main segment refers to the trading platform wherein large and midcap stocks are traded based on the size of their floating stock and market capitalisation.

4.3.1 Bulk Deals

There are two ways in which shares can be bought and sold on the main equity trading platform of the stock exchange, i.e. *retail trades* and *bulk deals.* Bulk deals are done on the regular trading platform but their sizes could be large. Bulk deals are defined as *"all transactions in a scrip (on an exchange) where total quantity of shares bought/sold is more than 0.5% of the number of equity shares of the company listed on the exchange."* Therefore, the stock exchange would require disclosures with regard to all such bulk deals in scrip. As per the SEBI circular[2] on bulk deals, with a view to imparting transparency in bulk deals so as to prevent rumours/speculation about such deals causing volatility in the scrip price, SEBI prescribed the following disclosure norms:

- The disclosure shall be made with respect to all transactions in scrip where total quantity of shares bought/sold is more than 0.5% of the number of equity shares of the company listed on the stock exchange.
- The brokers shall disclose to the stock exchange the name of the scrip, name of the client, quantity of shares bought/sold and the traded price.
- The disclosure shall be made by the brokers immediately upon execution of the trade.
- The stock exchanges shall disseminate the aforesaid information on the same day after market hours to the general public.

Under current practices, the broker has to make a disclosure on a daily basis up to 5.00 p.m., through the Data Upload Software within one hour of the close of trading hours, the cumulative details of all bulk deals in a scrip for a client where total quantity bought or sold is more than 0.5% of total number of issued shares of the company. However, if a single bulk deal is itself more than 0.5% as stated above, the deal should be uploaded immediately upon the execution of the order. Conceptually, bulk deals can be executed at any price, since the deal is executed on the trading system and there is no direct interface between the buyer and the seller. However, the drawback is, in case the transaction has to take place at lower than the ruling market price, all the pre-existing orders at a higher price need to be exhausted first. Bulk deals at ruling market prices are quite common among institutional investors and usually on a day when the market sentiment is strong. There would be several bulk deals in every scrips, since they can be executed at any time throughout the daily trading hours of the stock exchange. Bulk deals are also used, sometimes, in transactions relating to acquisitions in listed companies wherein the sellers may seek to avoid capital gain tax.

4.3.2 Block Deal Window

In 2005, SEBI introduced another concept of a *block deal*[3] for large transactions to be executed through the stock exchange platform. A block deal is defined as *"a trade, with a minimum quantity of 500,000*

[2]SEBI Circular No. SEBI/MRD/SE/Cir-7 /2004 dated January 14, 2004

[3]SEBI Circular No. MRD/DoP/SE/Cir- 19 /05 dated September 2, 2005.

shares or minimum value of ₹5 crore executed through a single transaction on the separate window of the stock exchange." Therefore, an individual block deal is quite large in size and therefore, there is a separate block deal window on the stock exchange to facilitate such deals. The SEBI circular (*supra*) deals with the requirements of block deals which are as follows:

- The block deal trading window may be kept open for a limited period of 35 minutes from the beginning of trading hours.
- The orders may be placed in this window at a price not exceeding +1% from the ruling market price/ previous day closing price, as applicable on the normal trading system.
- An order may be placed for a minimum quantity of 500,000 shares or minimum value of ₹5 crore.
- Every trade executed in this window must result in delivery and shall not be squared off or reversed.
- The stock exchanges shall disseminate the information on block deals such as the name of the scrip, name of the client, quantity of shares bought/sold, traded price etc. to the general public on the same day, after the market hours.
- The stock exchanges shall ensure that all appropriate trading and settlement practices as well as surveillance and risk containment measures etc., as presently applicable to the normal trading segment are made applicable and implemented in respect of the block deal window as well.

Since block deals happen on a separate trading window, they are not visible on the normal trading screen. Block deals are usually direct deals necessitated between large buyers and sellers who negotiate directly. In other words, block deals are direct deals routed through a stock exchange trading platform unlike off-market deals that are executed directly without stock exchange intervention. However, the moot point to be noted herein is that since block deals are conducted on the stock exchange, they are executed at market-driven prices with a maximum band of +/- 1% from the ruling market price/previous day closing price as stipulated by SEBI. Therefore, if two parties wish to conduct a direct deal at a price that is outside the price band permitted for a block deal, it can only be executed as an off-market deal. The other alternative would be to wait till the ruling market price comes within the permissible band of +/- 1% of the negotiated price and then execute it as a block deal.

Case Study

Ranbaxy Ltd.

According to published reports, the above issue had come up in the stake sale by the promoters of Ranbaxy Laboratories Ltd. to the Japanese drug manufacturer Daiichi Sankyo. The acquisition price was agreed at ₹737 per share (nominal value of ₹5) when the ruling market price was about ₹566 per share. Had the promoters sold through the stock exchange (bulk and block deals), the tax liability would have been 0.125% of STT, service tax and other transaction costs which would have amounted to around ₹12.5 crore. If they had sold in an off-market deal, the capital gain liability would have been 20% without indexation benefit and 10% with indexation along with surcharge. Considering that most of the shares held by the promoters were historical, the capital gain tax payable would have been quite steep at around ₹1,000 crore. However, since the negotiated price was nowhere near the ruling market price, such option could have been exercised only if the market price went up as a reaction to the news of the acquisition. Thus, both the options of a bulk deal and a block deal looked difficult in this case.

Case Study

Hero-Honda

Hero Motors, Japan was a joint venture partners with Hero Group in India for the manufacture of motorcycles in their JV company known as Hero Honda Motors. They decided to terminate the JV in 2010 with Honda selling its entire 26% stake in the company to the Hero Group who purchased it through their group investment company. For the purpose of the stake sale, both the parties entered into a binding agreement in 2011. As per the terms of the agreement, the exit price was fixed at a discount of around 52% to the CMP.

Since the JV company was listed, the sale of shares by Honda could be executed either as an off-market spot transaction or an on-market transaction. The tax implication for an off-market transaction would be considerable due to the incidence of capital gains tax while an on-market transaction was exempt from capital gains tax. However, since the agreed price was at a steep discount to CMP, in order to execute the transaction through the block deal window, it would have been impossible due to the price restrictions on that window. The other on-market option would have been the bulk deal route which would have required the transaction to be put through the system at a steep discount. In order that the transaction order is executed, the price would have had to come down in the market. This would have created volatility and price collapse. In addition, it would have opened up the possibility of a regulatory scrutiny by SEBI. Therefore, the best option in this case was an off-market spot transaction.

4.3.3 SME Platform

Both the NSE and BSE have a separate SME trading platform for the small and microcap companies that are not eligible to be listed on the main exchange. In order to address the special requirements of SME scrips in the secondary market, the NSE proposed to allow firms the option of either having continuous trading or settling for a call auction method to determine the stock price and allot shares. Unlike in regular trade which is order driven in India, in a call auction method, investors place buy and sell orders which are then matched to arrive at a price that allows the highest number of trades. Call auctions would be conducted during specified hours and not during the entire trading period in a day in order to improve liquidity in SME stocks that could, otherwise, remain illiquid during normal trading hours.

4.4 Debt Capital Market—Secondary Segment

The DCM secondary segment consists of both the G-sec market and the corporate bond market. The G-sec secondary market has already been discussed in Chapter 2. As shown in Exhibit 4.1, the corporate bond secondary segment consists of both the *Wholesale Debt Market* (WDM) and the *Retail Debt Market' (RDM)*. Large institutional trades are called the WDM segment which is the main component of the DCM secondary segment. The first WDM screen based trading was introduced by the NSE in 1994. Presently, both the NSE and the BSE offer the WDM segment for a wide range of debt securities and money market instruments such as floating rate bonds, zero coupon bonds, index bonds, CPs, CDs, corporate debentures, state government development loans, SLR and non-SLR bonds issued by financial institutions, units of mutual funds and securitised debt instruments. Similarly, the ₹RDM segment also offers apart from government securities, the facility to trade several other debt instruments such as corporate bonds and units of mutual funds.

For the healthy development of the secondary debt market, it is important to have a reliable *yield curve* that could help in the pricing of debt instruments of various coupons and maturities. The NSE also developed a *zero coupon yield curve* to assist in the pricing of zero coupon bonds. The yield curve depicts the relationship between interest rates in the economy and the associated term to maturity of the bond. Since yield is based on the value of the bond, its computation requires daily estimates of the term structure of interest rates using information on secondary market trades. The term structure forms the basis for the valuation of all fixed income instruments. By modelling the series of cash flows due at different points of time in the future for a particular bond, its underlying price is calculated as the net present value of the stream of cash flows. The development of the yield curve is critical to the growth of the secondary debt market.

In addition to the yield curve, it is also necessary to develop a market based inter-bank rate that helps in pricing term instruments. The MIBID and MIBOR developed jointly by FIMMDA and the NSE provides the guidance on short-term rates ranging from overnight call rates to 6 monthly rates. As the market grows and provides guidance on longer terms, the secondary market would benefit in being able to price longer-term debt. This development in the primary debt market is necessary to provide the secondary market with depth in trading of longer-term debt.

4.5 Derivative Market and Segments

Derivatives are speculative contracts based on other underlying assets such as stocks, loans (credit), interest rates, currencies, real estate, commodities, precious metals, weather and other variables. Section 2(a)(aa) of the SCRA defines a derivative as "*(A) a security derived from a debt instrument, share, loan, whether secured or unsecured, risk instrument or contract for differences or any other form of security; and (B) a contract which derives its value from the prices, or index of prices, of underlying securities.*"

Though the SCRA definition includes derivatives based on 'securities' as defined under the Act, depending upon the underlying 'asset' and type of contract, derivatives form a segment of the respective component of financial markets. Stock derivatives, therefore, form part of the capital market while currency derivatives form part of the foreign exchange market. Interest rate derivatives can be entered into bilaterally or on a stock exchange and commodity derivatives are a part of commodity markets. Other exotic types of derivatives are weather and energy derivatives, real estate derivatives, freight derivatives and so on. In India, all foreign exchange derivatives including forward contracts, foreign currency swaps and options, freight derivatives and commodity derivatives are regulated by the RBI under the Foreign Exchange Management (Foreign Exchange Derivative Contracts) Regulations, 2000 read with the AP DIR Notifications issued from time to time. Credit derivatives and interest rate derivatives in the OTC market are also regulated by the RBI. Capital market derivatives are mostly exchange traded equity derivatives which are regulated by the SEBI and concerned stock exchanges. Commodity derivatives designated in ₹ are regulated by the SEBI which was made the unified regulator for securities market and commodity market derivatives in 2015.

In India, due to the specific provisions under the SCRA, futures and options contracts in securities and commodities are allowed only on recognised stock exchanges but not on the OTC market in notified areas. Due to these provisions, futures and options are traded only on stock exchanges. However, in the international markets, OTC futures and options are prevalent (albeit to a much lesser extent as compared to their exchange traded counterparts). Credit derivatives, interest rate derivatives and foreign exchange derivatives are outside the purview of the SCRA and as mentioned above, these are regulated by the RBI. As per prevalent RBI regulations, derivative contracts regulated by the RBI may be entered into both on OTC market as well as on stock exchanges regulated by SEBI depending upon where a particular derivative product is traded. Similarly, commodity derivatives are allowed only as approved by SEBI. As a general principle, derivatives in Indian markets are meant for hedging purposes and not for speculative purposes unlike in overseas markets.

As depicted in Exhibit 4.2, the fundamental classification of derivative contracts irrespective of the underlying asset is into the following categories: (i) Forward Contract, (ii) Futures Contract, (iii) Option Contract and (iv) Swap. These are also termed by the RBI as generic derivative contracts. Depending upon the market segment in which they are used, generic derivatives derive their names accordingly as equity derivatives, interest rate and credit derivatives, currency derivatives and commodity derivatives.

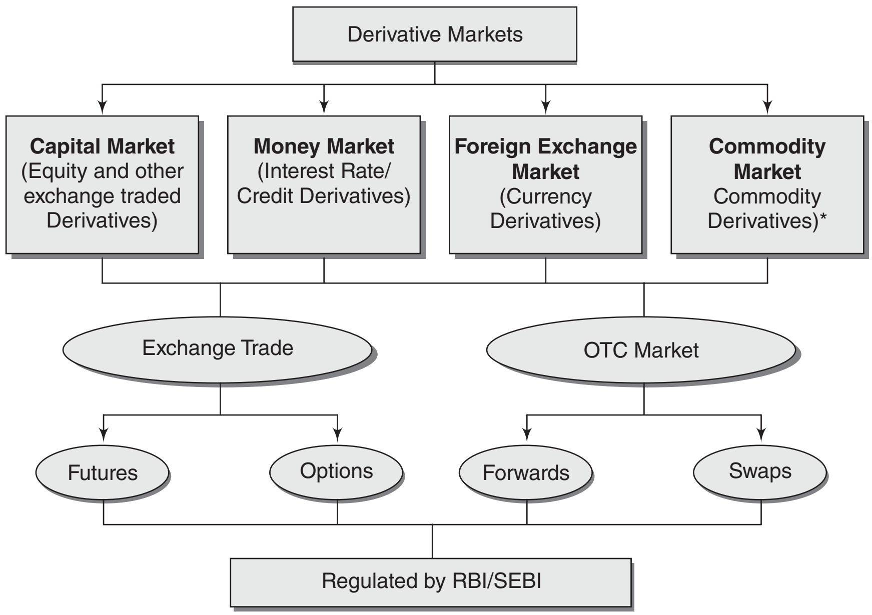


Exhibit 4.2 Overview of Derivative Market Architecture in India
**Note: Commodity derivatives are regulated by SEBI though there arealso separate commodity exchanges to deal with commodity futures.*

4.5.1 Capital Market Derivative Segment

The third segment of the capital market which has been of recent origin in the Indian context is the derivative segment that deals mainly with exchange traded equity derivatives. The genesis of capital market derivative segment is of recent origin due to statutory restrictions. In terms of Section 16 of the SCRA, the central government had issued Notification No.S.O.2561 dated 27th June 1969, under which all forward contracts in securities had been banned excepting ready forward transactions specifically exempted by the Government. In addition, Section 20 of the SCRA specifically banned option trading in securities. Regulatory consent for the introduction of derivatives in Indian capital markets happened in the 1990s by omission of Section 20 of the SCRA and insertion of Section 18A. Section 18A now provides for making contracts in derivatives legal and valid if such contracts are: (i) traded on a recognised stock exchange and (ii) settled on the clearing house of the recognised stock exchange in accordance with the rules and bye-laws of such stock exchange. Over the years, the SCRA has been amended several times to broad base the definition of 'security' under

Section 2(h) of the SCRA[4] so that many types of capital market derivative securities are now covered by it. In the preceding discussions, it has already been pointed out that certain types of derivatives fall outside the ambit of the SCRA and are regulated by the RBI/SEBI under other statutes. It may also be reiterated that in the case of derivatives that are prevalent both on exchange traded platforms and in the OTC market, these are jointly regulated both by the RBI and SEBI.

The main categories of equity derivatives traded are futures and options. Due to this reason, the derivative market is also known as the *F&O segment*. In Indian stock market, the system of futures was not prevalent but forward contracts in shares were being practised under the name of *badla*. Though the badla system contributed to the growth of the stock markets, it was also responsible for several unhealthy practices such as excessive speculation and unfair market practices that proved to the detriment of the common investors. The SEBI on its part was working on the blueprint for a separate cash and F&O segmentation on stock exchanges. Therefore, in order to bring about global practices into Indian stock exchanges and to get rid of the prevailing unhealthy practices, the badla system was eventually abolished in the year 2001. However, there were reports in mid-2012 that the BSE was contemplating a modified version of the badla being introduced in a way that would fit the present system of separate cash and F&O segments of the stock market and provide an efficient product to the market. New exchange traded products would need to be approved by SEBI before they are introduced by a stock exchange.

Options, however, have a different history in India. As mentioned above, option contracts in securities were prohibited in India under Section 20 of the SCRA and therefore, such contracts in securities could not be entered into. However, by an amendment to the SCRA in 1995, this section was omitted and the concept of options was allowed in the stock market. Thus, was born the F&O segment, which is currently being offered on the NSE and the BSE.

In the exchange-traded market, the biggest success story in India has been the capital market derivative segment dealing in equity derivatives. Index futures were introduced in June 2000, followed by index options in June 2001, and options and futures on individual securities in July 2001 and November 2001 respectively. Derivatives on stock indexes and individual stocks have grown rapidly since inception and in particular, index futures and single stock futures have been extremely popular. Due to this, the equity derivative market in India ranks among the top 15 derivative markets across the globe. It may, however, be noted that India does not have an OTC equity derivative segment, as prevalent in other countries, due to the reluctance of Indian regulators. One of the concerns could be large-scale malpractices which would escape regulatory scrutiny, thereby giving birth to systemic risks. It could also jeopardise the exchange traded derivative segment that has robust regulation and risk management system.

With the advent of the derivative segment on the stock exchanges, the secondary markets were classified into distinct trading platforms. The equity segment in the market deals with shares strictly on cash basis for delivery at the end of each settlement and no carry forwards are allowed. All speculative trading was shifted to the derivative segment which deals only with F&O contracts in shares and stock indices and debt derivatives. Commodity derivatives can be traded on a stock exchange (if allowed by SEBI) or in commodity exchanges which are also presently regulated by SEBI after the unification of the FMC with SEBI in 2015. According to SEBI, the merger was effected to bring about convergence in regulations and to harness the economies of scope and scale for the Government, exchanges, financial firms and other stakeholders at large. Post-merger, SEBI's immediate priority was to ensure the orderly conduct of commodities derivatives market devoid of any disruptions.

As capital markets evolve, all types of exchange traded derivative contracts (including interest rate, credit and currency derivatives) may eventually be exchange traded on all stock exchanges in their respective F&O segments, thus, unifying stock exchanges with mercantile exchanges.

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[4]The amendments were carried out by the Securities Laws (Amendment) Act, 1999, the SARFAESI Act 2002 and the Securities Laws (Amendment) Act, 2004.

4.5.2 Offshore Derivative Market

The SEBI Regulations in India on foreign investors stipulate that those foreign institutional investors registered with SEBI are governed by the FPI Regulations.[5] However, there are several investors that either do not qualify to be registered as foreign investors with SEBI or more importantly, do not wish to register with SEBI even if they are qualified to do so. It is for this precise reason that the *Offshore Derivative Instrument* segment, popularly known as *Participatory Notesor P-Notes* (PNs) was born. Such foreign investors usually operate through this instrument or an *Equity Linked Note* which is a derivative instrument based on underlying Indian equities floated in the offshore OTC markets by FIIs registered in India. Under the FPI Regulations, as amended from time to time, *offshore derivative instrument* means "*any instrument, by whatever name called, which is issued overseas by a foreign portfolio investor against securities held by it that are listed or proposed to be listed on any recognised stock exchange in India, as it is underlying*".

Investors in PNs are not registered or regulated by SEBI as they do not invest directly in India but invest in PNs issued by registered FPIs and their sub-accounts. PNs were thriving prior to SEBI clamping down on them in 2004. In 2004, SEBI amended the erstwhile FII Regulations by the insertion of Regulation 15A which imposed stringent restrictions on the issue of PNs by FIIs and their sub-accounts to their overseas clients. Due to this reason, the offshore derivative segment for Indian stock derivatives was vastly curbed. The rationale put forward by the SEBI was that there was serious concern on Indian capital getting round tripped through the PN mechanism which was outside the regulatory purview of SEBI.

During the next three years, the offshore derivative segment found an alternative on the Singapore Stock Exchange wherein index futures offered on Indian stocks were introduced. In 2007, when the Indian government moved to ban PNs altogether, the offshore derivative product in Singapore became extremely popular. In addition, Singapore also provided a time advantage for such investors. In order to pacify foreign investors and bring them back to the Indian market, in 2008 SEBI amended Regulation 15A to withdraw the restrictions imposed on issue of offshore PNs by FPIs. Though PNs continued to exist thereafter, the share of PNs in FPI investments in India (which was estimated to have touched a high of 55% in 2007) fell to a low of 7.1%.[6] One of the reasons attributed to this fall was the introduction of stringent KYC norms and transfer restrictions by SEBI in 2016 on foreign investors PNs. The second reason was the introduction of General Anti-Avoidance Rules (GAAR) from 2017. The apprehension was that if FPIs get taxed on their income in India under GAAR, the tax burden would be passed on and would consequently reduce returns from PNs. Hedge funds which were the biggest participants in the offshore derivative segment under the PN route found it less attractive to invest through PNs in India due to the impending GAAR regime in India. There is another reason why the use of PNs for investing in Indian markets could remain at minimal levels in future. The government relaxed the regulations for foreign investors and brought in direct access to non-institutional investors through the FPI Regulations (discussed in Chapter 2) since 2012. This was hitherto available only to registered FIIs.

4.6 Introduction to Derivative Contracts

Depending upon the application, derivative contracts are used in stocks, commodities, foreign exchange, credit, interest rate hedging and others. Many derivative products abroad (known as '*exotic derivatives'*) have a share of feature from generic derivatives along with other features such as '*caps*' and '*collars*'. According to the RBI, these are known as '*structured derivative products'*. The main generic types of derivatives are

[5]For details refer to Chapter 3

[6]According to Business Standard data reported in early 2017

briefly discussed below. Insofar as their application is concerned, interest rate derivatives, credit derivatives and commodity derivatives are discussed in this section while foreign exchange derivatives are discussed under foreign exchange markets. Stock derivatives are covered under the discussion on capital market derivative segment in subsequent sections of this chapter.

4.6.1 Forward Contract

A *forward contract* is the most basic and early form of a derivative contract under which two parties agrees to buy and sell with reference to a future date a financial instrument at a pre-determined price or rate. Under this arrangement, the buyer agrees to buy and the seller agrees to deliver a financial instrument at a future date at a specified price agreed to on the date of entering into the transaction (known as the *delivery price*). A forward contract is a bilateral non-standardised transaction that is traded on the OTC market the terms for which can be customised to the agreement of both parties. The difference between the spot and the forward price (delivery price) is the *forward premium* or *forward discount* as the case may be, which would constitute the profit or loss incurred by the purchasing party.

Since a forward contract is an OTC product, in the normal case, there would be no settlement procedure through a clearing house and there would be no further secondary market sales of such instruments. On the due date, the onus of delivery and payment is on both parties and each of them undertakes counterparty risk. However, in India, forward contracts in foreign exchange and interest rates are settled through the CCIL clearing system (just as in the case of G-secs), thereby eliminating counterparty risk. Moreover, due to the presence of the CCIL, forward contracts are more or less standardised ending on the 30th day of every month. Therefore, currency and interest rate forwards in India are a hybrid of OTC and exchange traded financial instruments. Normally, a forward contract would not have any interim payouts during the currency of the instrument since it is not *marked-to-market*. The settlement is made only on the delivery date. However, a forward contract may also be marked-to-market depending upon the negotiation between both parties in which case, there would be interim payout or pay-in as the case may be, or collateralisation at the end of each time period (typically a month) based on price movement in the spot market. However, such forward contracts are quite rare.

The key concepts associated with a forward contract are:

- ***The delivery price:*** It is the agreed price to be paid on the future date.
- ***The settlement date:*** The future date on which the transaction is settled between the parties.
- ***Spot price:*** The market price that prevails on a particular day.
- ***Long position:*** The buyer of a forward contract is said to be in a long position.
- ***Short position:*** The seller of a forward contract is said to be in a short position.
- ***Pay-off for the buyer:*** The positive difference between the spot price and the delivery price.
- ***Pay-off for the seller:*** The positive difference between the delivery price and the spot price.

Forward contracts are found most commonly in the foreign exchange derivative market across the world and in India, the ₹-USD forward contract is the most traded OTC product.

4.6.2 Futures Contract

Futures contracts are standardised exchange traded forward contracts for buying or selling a particular underlying asset (usually a share or other financial interest, commodity or currency) at an agreed price on a particular date. The purpose and substance of a futures contract are identical with that of a forward contract except that the former is exchange traded and the latter is an OTC product. Futures are standardised as to the delivery date (usually every month) and the deliverable. The features and specifications are exchange driven unlike in a forward contract which is mutually agreed to between the parties. Since futures are exchange traded products, these are settled through the clearing house of the exchange / clearing corporation which assumes the counterparty risk. Due to the fact that futures are exchange traded and standardised, there is an active secondary market for futures on stock exchanges. In addition, while forward contracts are delivery based and settled in cash, futures are generally settled by the payment of the difference amount between the spot price and the futures price. Since the counter party risk is with the clearing house, futures contracts are traded by members with the payment of a stipulated *margin*. Futures are generally marked-to-market on a daily basis, i.e. at the end of each trading day. Consequently, they are subject to a daily cash flow depending upon the price movement or additional margining as per the rules of the stock exchange. If there is a daily cash flow, it would amount to a series of one-day forward contracts for the entire tenure of the futures contract. For example, if the futures has been entered into for a price of ₹500 and on the next trading day, the futures price has risen to ₹525, the buyer gets a positive cash flow of ₹25 for that day and the futures gets carried forward at ₹525 as a fresh contract. This would amount to having settled the previous transaction as a one-day forward contract.

Futures contracts are very popular in the capital market derivative segment as well as in commodity derivatives market.

4.6.3 Option Contract

Simply put, an option is *a right to buy or sell an underlying asset on or before a specified date at an agreed price*. Therefore, the option owner has the right to buy or sell depending on the type of option purchased without having the obligation to do so. Section 2(d) of the SCRA defines *option in securities* as "*a contract for the purchase or sale of a right to buy or sell, or a right to buy and sell securities in future, and includes a teji, a mandi, a teji mandi, a galli, a put, a call or a put and call in securities.*" A similar definition is provided under Section 2(g) of the FCRA as well with respect to contracts in goods. The specified price at which the option is entered into with reference to a future date is known as the *strike price* or *exercise price* and the specified future date is known as the expiration date. The option seller (also known as the *option writer*) sells the right in consideration for a charge known as the *option premium* or *option price*. Though an option is usually written with an underlying security, sometimes, the underlying asset could be a futures contract which would be known as a *futures option*. Futures options are not yet operational in India. The option seller can provide the buyer with two kinds of rights: (i) either the right to buy the underlying which is known as a c*all option* and (ii) the right to sell the underlying which is known as the *put option*.

Options are further distinguished based on the type of exercise or exercise style. If an option contract can be exercised only on the exercise day, it would be known as a *European option*. On the other hand, an option that may be exercised at any time on or before the exercise date is known as an *American option*. As in the case of futures, options can also be traded after they are entered into in the secondary market through a stock exchange.

4.6.4 Swap

A swap is a generic derivative which involves exchange of cash flows between the counterparties. The cash flows exchanged would relate to an existing contract in the books of each party. By virtue of the swap, the first party gets the cash flows accruing to the second party and vice-versa. For example, if A is entitled to a cash flow of ₹100 on an existing contract and B has another contract on which he is entitled to a cash flow of ₹110, by entering into a swap, the cash flow entitlements are reversed. The moot point is as to why B would give up a higher cash flow in return for a lower cash flow. The main reason would be that these are future cash flows subject to risk and swaps are entered into to hedge future risk by counterparties having opposite calls on future movements. Each stream of cash flow that is exchanged is known as a *leg*. The swap agreement defines the dates when the cash flows are to be paid and the way they are calculated with reference to an underlying asset or variable such as interest rate, currency etc. Unlike forwards, futures or options, swaps do not entail any principal settlements. The difference in the cash flow is settled usually in cash. Usually, there would be multiple settlements during the currency of a swap contract which in effect means that a swap is like a series of forward contracts. Swaps are effectively used as hedging instruments for a separate set of obligations on a balance sheet.

There are two ways in which a swap can be interpreted: (i) as a package of forward/ futures contracts and (ii) as a package of cash flows arising from buying and selling financial instruments in the spot market. In the international market, an option is permitted on a swap which is known as a *swaption*. Similarly, there can also be a futures contract with a swap as the underlying asset. Though swaps are of recent origin (having begun around 1981), presently swaps are among the highest traded derivative instruments across the world in the interest rate and currency categories running into more than $500 trillion annually. Unlike futures and options that are predominantly exchange traded across the world, swaps are essentially OTC products that are designed for a given set of counterparties. The main varieties of swaps are currency swaps, interest rate swaps, commodity swaps (mostly used in crude oil trades) and credit default swaps though interest rate swaps outnumber the other categories. These are discussed in subsequent paragraphs.

4.7 Domestic Interest Rate Derivatives

As the term suggests, interest rate derivatives use interest rate as the underlying variable or *asset*. With reference to India, domestic interest rate derivatives imply rupee denominated instruments that are used to hedge interest commitments payable in ₹. A forward contract in the context of an interest rate derivative is known as the *Forward Rate Agreement* (FRA). The other OTC product in this market is the *interest rate swap.* The exchange traded interest rate derivative is the *interest rate futures.*

4.7.1 Forward Rate Agreement

The FRA is an OTC contract between the buyer and the counterparty (typically a bank) under which a notional principal amount is used with an agreed reference rate as the benchmark. In the international markets, the reference rate is typically the LIBOR. The working mechanism of a TRA is as follows:

ILLUSTRATION 1

ABC Ltd. enters into an interest rate FRA with Loan Bank for a notional principal of ₹1,000,000. The contract rate is 10%, the reference rate is the six months MIBOR and the FRA has a tenor of six months. On the settlement date, if the MIBOR is say 11%, ABC gains since it entitles the company to avail the notional amount at a rate of 10% when the market rate is 11%. So, Loan Bank has to settle the transaction on the settlement date by making a payment of 1% (11% – 10%) on the notional principal to ABC Ltd. However, the amount that is paid at the settlement date is not the interest differential but the present value of the interest differential discounted at the reference rate on the settlement date. In the above illustration, the present value of the interest differential of 1% discounted at 11% would be paid by the bank. The situation would be the opposite on the settlement date, if the reference rate is say 8%. ABC Ltd. would end up making the differential interest payment to the bank.

The benefit for ABC Ltd. by booking a FRA is that it hedges any rise in interest costs at a time when the interest curve is headed north. Assuming that ABC has loan liabilities in its books amounting to ₹1,000,000 carrying a floating interest rate of 10%, it makes sense for the company to enter into a FRA for a like amount with 10% as the contract rate. Since the expectation is that interest rate is set to increase, ABC can continue to lock in its borrowing cost at 10% by virtue of the FRA. In effect, the FRA enables a floating rate loan to have a fixed rate impact on the P&L of ABC Ltd.

According to the RBI, a FRA is defined as *"a financial contract between two parties to exchange interest payments for a 'notional principal' amount on settlement date, for a specified period from start date tomaturity date. Accordingly, on the settlement date, cash payments based on contract (fixed) and the settlement rate, are made by the parties to one another. The settlement rate is the agreed bench-mark/ reference rate prevailing on the settlement date."* The RBI introduced FRAs as a market product in 1999[7] to enable commercial banks, primary dealers and financial institutions to manage their interest rate risks as well as to offer FRAs to their corporate clients as an interest rate risk management OTC product. FRAs are permitted to be entered into without any restriction on maximum tenor or permissible notional amount. However, one of the main restrictions in a FRA is that one of the counterparties has to be a bank. Since then, the FRA has grown to be one of the main products in the domestic interest rate derivative market in India. With the establishment of the CCIL, all OTC trades in FRAs with a maximum maturity of 10 years are settled through the CCIL platform. CCIL extends post-trade processing services like interest rate reset, tracking payment obligation of members on their outstanding contracts etc. and settlements on a non-guaranteed basis.

4.7.2 Interest Rate Swap

An Interest Rate Swap (IRS) is "*a financial contract between two parties exchanging or swapping a stream of interest payments for a 'notional principal' amount on multiple occasions during a specified period. Such contracts generally involve exchange of a 'fixed to floating' or 'floating to floating' rates of interest. Accordingly, on each payment date—that occurs during the swap period—cash payments based on fixed/ floating and floating rates, are made by the parties to one another.*" Therefore, interest rate swap is used to lock interest rate and hedge against rising interest rates. Unlike a FRA wherein the settlement is made on the settlement date, in an IRS, the settlements are made periodically during the currency of the contract.

ILLUSTRATION 2

Let's assume that Company Alpha enters into an IRS with Bank Beta to hedge a fixed rate interest bearing loan of ₹1,000,000 on its books. Alpha pays interest at fixed rate to Beta while Beta pays floating rate interest to Alpha. At the periodic settlement date, the net amount of interest payment is settled between both parties in cash. The notional amount of ₹1,000,000 is never exchanged but is only used to calculate the interest flows from both sides. For the purpose of computing the floating rate flows, an agreed reference rate is used. Through this arrangement, Alpha can get the advantage of a floating rate interest even through the underlying loan contract on its books is a fixed rate one. The fixed rate being exchanged is known as the *swap rate*. The IRS would benefit a company when interest rates are expected to fall and vice versa.

IRS was introduced for the first time in 1981 by the investment bank Salomon Brothers. IRS is an OTC derivative and in the USA, it can be entered into bilaterally by any two participants. The US market also

[7]According to statistics released by the Bank for International Settlements, www.bis.org

allows IRS to be used both for hedging and for speculation (i.e. without an underlying interest exposure). The IRS is reportedly the largest OTC derivative market in the world crossing $300 trillion in notional amount value (known as *face value*) in 2016. The outstanding interest payments (known as the *gross value*) of this market were around $14 trillion at that time. The London Stock Exchange introduced an exchange traded product based on an index of IRS called the FTSE MTIRS index.

In India, in terms of RBI regulations, the participants allowed for IRS are the same as those for FRAs. In other words, one of the counterparties in the OTC market shall be a bank. In addition, the RBI allowed only plain vanilla swaps to be conducted. Swaps having explicit/implicit option features such as caps/ floors/ collars are not permitted.

4.7.3 Interest Rate Futures

Interest rate future is defined as "*a standardised interest rate derivative contract traded on a recognised stock exchange to buy or sell a notional security or any other interest bearing instrument or an index of such instruments or interest rates at a specified future date, at a price determined at the time of the contract.*" Interest rate futures in India do not have an impressive start. The RBI accorded permission to primary dealers, banks and All India financial institutions in 2003 to commence operations in exchange traded interest rate futures on the anonymous order driven system of the NSE and the BSE. However, the RBI guidelines initially restricted the interest rate futures to notional bonds and T-Bills for the limited purpose of hedging the risk in their underlying investment portfolio of the participants. The guidelines also specified heavy margin requirements for exchange traded interest rate futures due to which the market did not take off in a big way. Subsequently, a committee was appointed by the RBI to suggest steps to deepen the market. The committee recommended that interest rate futures should be integrated with the F&O segment of the respective stock exchange and should be broad based to other market participants as well. Similarly, the committee also recommended that interest rate futures should be allowed for all portfolios of banks and not just their trading portfolio. The third recommendation was to introduce interest rate futures on 10-year bonds. Based on these recommendations, in 2009[8], the RBI introduced interest rate futures on a notional coupon bearing 10-year GoI security. Subsequently, the RBI permitted 91-day treasury bills also into this market. In 2011, the RBI introduced interest rate futures on notional 2-year and 5-year coupon bearing Government of India securities. The conditions stipulated by the RBI for interest rate futures traded on stock exchanges are:

- These should be actual physical deliveries of securities for the longer term interest rate futures based on 10 year, 5 year and 2 year G-secs using the electronic book entry system of depositories. The contracts shall be cash-settled by the stock exchanges offering the contracts.
- Contracts for 91-day T-bills shall be cash settled in ₹.

SEBI had earlier prescribed a framework for stock exchanges to launch cash settled interest rate futures on G-secs having a residual maturity between 9 and 11 years as on the day of the expiry of the IRFcontract. In order to provide hedging instrumentsfor managing the interest rate exposure acrossdifferent maturities and to further enhance thedepth and the liquidity in the underlying bondmarket, SEBI permitted stock exchanges tointroduce cash settled IRFs on 6-year (residualmaturity between four and nine years) and 13-year(residual maturity between 11 and 15 years) G-secs. Effectively, the stock exchanges are presently permitted to launch IRF contracts on G-secs with a residual maturity between four and fifteen years as on the day of the expiry of the IRF contract.

[8]Interest Rate Futures (Reserve Bank) Directions, 2009

4.8 Credit Derivatives Market

Credit derivatives have their origin in debt products originating as loans from the banking system and as debt securities from the capital markets. Every debt obligation, whether a loan or a debt security, entails the risk of default, that is, also known as *credit risk*. Credit derivatives are instruments that were originally introduced to enable banks and financial institutions to hedge against credit risk. Credit risk consists of two components: (i) *default risk* and (ii) pre-*payment risk*. Credit derivatives are financial contracts which are designed to mitigate or eliminate credit risk by providing insurance against losses suffered due to credit defaults. Over the years, they have been extended to hedge investors in debt securities as well. Credit derivatives are widely used in international markets by portfolio managers to hedge credit risk, enhance returns and trade credit for speculative purposes.

4.8.1 Credit Default Swaps

The most widely known and used credit derivative globally is the *Credit Default Swap* (CDS). It was introduced in the US market by the commercial bank Bankers Trust in the 1990s but was popularised in that decade by another large American commercial bank, J.P. Morgan. The global CDS market grew to more than $60 trillion by 2007 but fell sharply due to the global financial crisis in 2008 and is reported to be around $12 trillion in 2016.

A CDS is a financial contract between the seller (protection seller) and the buyer (protection buyer) whereby the seller seeks to compensate the buyer in the event of a default on a loan or a bond or other defined credit event for which protection is being sought. When the default is triggered, the protection buyer receives compensation (usually the loan amount protected) and the seller takes possession of the defaulted loan or bond. It is true that CDS contracts have extremely complex documentation whereby it would be difficult to comprehend the extent of hedging actually available under the contract. Though some of the documentation forms are standardised under the International Swaps and Derivatives Association (ISDA) guidelines, complex CDS structures require customised documentation. Moreover, being an OTC product, CDS carries counterparty risk for the protection buyer and if the protection seller does not perform, there is no risk protection. Therefore, if the CDS contracts fail, the protection buying banks are exposed to losses on the underlying credit risk. In order to minimise performance risk from the seller, margins are insisted upon by cash and collaterals.

In the context of market intelligence, CDS plays a role in determining market perception on the credit worthiness of each entity. These include sovereign governments of countries, companies and other corporate entities, financial institutions, commercial banks and investment banks. The CDS premium indicates the level of risk associated with the balance sheet of an entity as perceived in the market at any given time. It also becomes a pointer to provide an implied credit rating ahead of formal credit ratings issued by the rating agencies or an impending bankruptcy of an entity. In the US market, the CDS pricing is used as a benchmark by financial analysts and financial market participants to assess the creditworthiness of corporate and sovereign borrowers.

Notwithstanding its contribution to the development of the derivative markets worldwide, CDS has its share of potent dangers. The systemic risk of contagion triggered by default from protection sellers can be devastating. This is because the CDS becomes a chain of derivative contracts in the market and may lead to unknown concentration of risks among participants. CDSs are not traded on an exchange and there is also no requirement of reporting the transactions to a government agency in developed countries. It is also argued that CDS can be misused to force bankruptcy of entities within a system for windfall gains to a few speculators. This inherent risk of enforced bankruptcy coupled with the lack of transparency that is characteristic of an

OTC product makes the CDS a sure recipe for systemic disaster. The exponential growth in the global CDS market led to a huge systemic risk to the extent that the CDS became the single biggest contributor to the toxic assets carried by banks and financial institutions during the financial crisis of 2008. Therefore, experts such as Satyajit Das[9] are of the opinion that CDS contracts may not actually improve the overall stability and security of the financial system but create additional risks.

In the Indian context, CDS were officially introduced by the RBI[10] as OTC products in October 2011. To begin with OTC plain vanilla, CDS on corporate bonds was introduced. In the preamble, the RBI states the objectives for CDS introduction in India in the following words, "*The objective of introducing Credit Default Swaps (CDS) on corporate bonds is to provide market participants a tool to transfer and manage credit risk in an effective manner through redistribution of risk. CDS as a risk management product offers the participants the opportunity to hive off credit risk and also to assume credit risk which otherwise may not be possible. Since CDS have benefits like enhancing investment, borrowing opportunities and reducing transaction costs while allowing risk-transfers, such products would increase investors' interest in corporate bonds and would be beneficial to the development of the corporate bond market in India.*"

Following are the important highlights of the CDS guidelines of RBI:

- Actual user participants are permitted to buy credit protection (buy CDS contracts) only to hedge their underlying credit risk on corporate bonds. Such entities are not permitted to hold credit protection without having eligible underlying asset as a hedged item. Users are also not permitted to sell protection and hold short positions in the CDS contracts. However, they are permitted to exit their bought CDS positions by unwinding them with the original counterparty or by assigning them in favour of buyer of the underlying bond. Permitted categories of users are commercial banks, PDs, NBFCs, mutual funds, insurance companies, housing finance companies, provident funds, listed corporates, FIIs and any other institution specifically permitted by the RBI.
- Market makers permitted to quote both buy and/or sell CDS spreads. They would be permitted to buy protection without having the underlying bond. Permitted categories of market makers are commercial banks, standalone primary dealers and NBFCs having sound financials and good track record in providing credit facilities and any other institution specifically permitted by the RBI.
- All CDS trades shall have RBI regulated entity at least on one side of the transaction. The user (except FPIs) and market-maker shall be resident entities.
- CDS will be allowed only on listed corporate bonds (except infrastructure bonds) as reference obligations (underlying assets). Besides, unlisted/unrated bonds issued by the SPVs set up by infrastructure companies are also eligible as reference obligation. The reference obligations are required to be in dematerialised form only.
- Obligations such as asset-backed securities/mortgage-backed securities, convertible bonds and bonds with call/put options shall not be permitted as reference and deliverable obligations. In addition, CDS shall not be written on securities with original maturity up to one year, example, commercial paper, Certificate of Deposits (CDs) and NCDs.
- Dealing in any structured financial product with CDS as one of the components shall not be permitted. On the same lines, dealing in any derivative product where the CDS itself is an underlying shall not be permissible.
- In the case of banks, the net credit exposure on account of such CDS should be within the limit of 10% of investment portfolio prescribed for unlisted/unrated bonds as per extant guidelines issued by RBI.

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[9]Satyajit Das is a risk consultant and author of Traders, Guns & Money: Knowns and Unknowns in the Dazzling World of Derivatives (2006, FT-Prentice Hall).

[10]IDMD.PCD.No. 5053 /14.03.04/2010-11 dated May 23, 2011. The notification under the Reserve Bank of India Act 1935 specifying CDS as a derivative for the purposes of Chapter IIID of the said Act was issued on October 19, 2011.

- The users cannot buy CDS for amounts higher than the face value of corporate bonds held by them and for periods longer than the tenor of corporate bonds held by them. Users shall not, at any point of time, maintain naked CDS protection, i.e. CDS purchase position without having an eligible underlying asset.
- The CDS contracts shall be standardised. The standardisation of CDS contracts shall be achieved in terms of coupon, coupon payment dates, etc. as put in place by FIMMDA in consultation with the market participants.
- The parties to the CDS transaction shall determine upfront, the procedure and method of settlement (cash/physical/auction) to be followed in the event of occurrence of a credit event and document the same in the CDS documentation. For transactions involving users, physical settlement is mandatory. For other transactions, market-makerscan opt for any of the three settlement methods (physical, cash and auction), provided the CDS documentation envisages such settlement.
- Users cannot exit their bought positions by entering into an offsetting sale contract. They can exit their bought position by either unwinding the contract with the original counterparty or in the event of sale of the underlying bond, by assigning (novating) the CDS protection, to the purchaser of the underlying bond subject to consent of the original protection seller. After assigning the contract, the original buyer of protection will end his involvement in the transaction and credit risk will continue to lie with the original protection seller.
- In case of sale of the underlying, every effort should be made to unwind the CDS position immediately on sale of the underlying. The *users* would be given a maximum grace period of ten business days from the date of sale of the underlying bond to unwind the CDS position.
- In the case of unwinding of the CDS contract, the original counterparty (protection seller) is required to ensure that the protection buyer has the underlying at the time of unwinding. The protection seller may also ensure that the transaction is done at a transparent market price. For this purpose, market participants shall use FIMMDA published daily CDS curve to value their CDS positions.
- It needs to be ensured that CDS are not used to build up excessive leveraged exposures. The market participants need to take various risks associated with CDS into account and build robust risk management architecture to manage the same.

It may be noted from the above prescriptions of RBI that CDS evolution in India would be in a controlled and limited manner unlike its global counterpart which escaped regulation by being an OTC product in the capital market. The unregulated growth of CDSs created unbridled systemic risk which was exposed by the credit crisis. On the other hand, in the Indian context, creation and trading of synthetic CDOs is expressly prohibited by the RBI as per the guidelines (supra) due to which the CDS market would not grow in value beyond that of its underlying reference obligations. It is expected that over time, the RBI would permit bank loans and other long-term debt obligations (other than corporate bonds) to be used as reference obligations to enlarge and grow the CDS market in India.

4.8.2 Other Credit Derivatives

To a lesser extent as compared to CDS, the global financial markets also have other types of credit derivatives as OTC products. These are *credit options*, *credit-linked notes* and the *Total Return Swap* (TRS). A credit option is a contract to provide specific call or put option which gives the right but not the obligation to buy or sell with reference to an underlying credit asset. Used mostly by banks and financial institutions, a credit option helps them to manage their credit spreads within the constraints of their lending and borrowing market.

Credit-linked notes are essentially hybrids that combine the features of plain vanilla bonds with that of a credit derivative. Therefore, though the instrument has a financial obligation of interest and repayment similar to that of a bond, the actual debt servicing would be determined by the performance of a specified underlying asset and the health of the issuer. It makes sense for investors to invest in such notes as they generally carry a higher coupon than plain vanilla bonds.

TRS is an agreement designed to transfer credit risk between two counterparties. Like an IRS, it works to substitute the future cash flow of a credit asset in the books of a lender with some other cash flow often linked to a floating rate (such as LIBOR) instrument or other credit obligation. In the process, there may or may not be a legal transfer of title of the underlying asset. The swapped cash flows are usually settled on a quarterly basis with reference to both the coupon as well as the market value of the underlying asset on a marked-to-market basis. The swap may be terminated at any time by settling the net cash flow, especially when there is a default by the obligor. As is the case with an IRS, the TRS works for the principal amount as well so that the buyer can remove exposure to a credit asset from its books without actually having to transfer the asset from its books. To this extent, the TRS is a synthetic product. Used by banks and portfolio managers, the TRS is issued in several types depending upon individual features of each contract.

4.9 Commodity Derivatives Market

Derivatives markets in India have been in existence since the early days of cotton and other agricultural commodity trading in the mid-nineteenth century. The Bombay Cotton Trade Association started futures trading in 1875 which is by far the first recorded history of commodity derivatives in India. It was operated as a primitive version of a stock exchange with open outcry system by traders and middlemen. By the early 1900s, India had one of the world's largest commodity markets for futures and options contracts in agricultural crops. However, due to unhealthy practices creeping into the system, post-independence the Government decided to abolish cash settlements in commodity derivatives and option trading. After the passage of the FCRA in 1952, the Act voided bilateral forward contracts and options trading other than non-transferable specific delivery contracts for the sale or purchase of any goods through recognised associations. The traders quickly moved to doing contracts on unauthorised OTC forward markets. With amendments to the FCRA, the ban on futures trading of many commodities was lifted starting in the early 2000s, when the national electronic commodity exchanges were created. These exchanges created exchange traded futures in several commodities both agricultural and non-agricultural. Though commodity derivative exchanges gained momentum, the practice of unauthorised OTC market in commodities still plagues the commodity derivative markets in India.

As far as the legal framework is concerned, beginning from September 28, 2015 the regulatory functions of the commodity derivatives market was passed on to SEBI by the merger of the erstwhile regulator *Forward Markets Commission* (FMC) with SEBI. As a consequence, the Security Contracts (Regulation) Act 1956 was amended to include commodity derivatives within the definition of 'security' and the prevailing law, the FCRA was repealed. This unification of regulation of stock markets with commodity markets under SEBI is in line with the practice in countries such as USA and UK wherein stock and commodity markets are often brought under combined regulation. In India, the practice of separate regulation persisted due to a perception that commodity futures could spiral inflation and cause speculative shortages unless they were regulated directly under a government ministry. It is for this very reason that the Government used its powers under the FCRA to ban futures in notified commodities from time to time depending upon their inflationary trends in the market. However, it may be understood that the jurisdiction of the derivative markets alone is vested with SEBI under the new dispensation from 2015. Commodity spot markets are regulated by the respective State Government and not by SEBI.

After taking over the regulatory supervision of the commodity derivatives markets, SEBI worked to streamline their working, introduce risk management systems, improve surveillance mechanisms and provide capacity building to the stakeholders. SEBI conducted presentations, workshops and consultations with the erstwhile FMC officials, commodity derivatives exchanges, commodity derivatives brokers, market experts and consultants for understanding the nuances ofcommodity derivatives market and its ecosystem. Based on these developments, the guidelines on a comprehensive risk management framework were issued to streamline the risk management framework across the national commodity derivatives exchanges in India. This framework was operationalised from January 01, 2016. The risk management norms for regional commodity derivatives exchanges were also prescribed so as to be implemented from April 01, 2016.

4.10 Foreign Exchange Derivatives Market

The economic liberalisation initiated in 1991 facilitated the introduction of derivatives based on interest rates and foreign exchange in India. India gradually moved to a market based system of currency management starting with the Liberalised Exchange Rate Management System (LERMS) in 1992 and by 1994, the rupee was made fully convertible on current account. On the capital account, the ₹ is still partially convertible as per RBI regulations under the FEMA. Therefore, the ₹ do not rank as an international currency such as the USD, GBP, Yen or the Euro. However, the financial reforms agenda allowed increased integration between domestic and international markets and created a need to manage currency risk.

The country presently has an active derivative segment in the foreign exchange market known as the *currency derivative* market. It consists of both OTC and exchange traded products. The OTC products are more popular and have been around for a longer time than their exchange traded counterparts. In the OTC category are *FOREX forwards* and *currency swaps*. The RBI is the regulator for the OTC foreign exchange derivative market. Importers, exporters and banks use the ₹ FOREX forward to hedge their foreign currency exposure. However, it may be noted that in the OTC segment, one of the counterparties has to be a bank as per the prescriptions of RBI. Secondly, under the FEMA (Foreign Exchange Derivative Contracts) Regulations, 2000 which regulate derivative contracts in foreign exchange, a resident in India may enter into a foreign exchange derivative contract only to hedge an exposure to risk in respect of a permitted transaction. Likewise, a person resident outside India may enter into a foreign exchange derivative contract with a person resident in India to hedge an exposure to risk in respect of a permitted transaction. Therefore, it is clear that foreign exchange derivatives are allowed for hedging purposes only. Turnover and liquidity in this market has been increasing, although trading is mainly in shorter maturity contracts of one year or less as per some researchers. In currency swaps**,** banks and corporates swap their ₹ denominated debt into another currency (typically the US dollar or Japanese yen) or vice versa. However, currency swaps are still in their infancy in India as compared to FOREX forwards.

Exchange traded FOREX derivatives were introduced in India after the RBI permitted their introduction in 2008. The regulation of exchange traded FOREX derivative products is under the statutory powers of SEBI. Such products are the *currency futures* and *currency options* which unlike their OTC counterparts grew by leaps and bounds in few years after their introduction and by 2010, their volumes were comparable to the capital market derivative segment.

4.10.1 FOREX Forwards Market

Under the FEMA (Foreign Exchange Derivative Contracts) Regulations, 2000 a forward contract has been defined as *"a transaction involving delivery, other than Cash or Tom or Spot delivery, of foreign exchange"*.

ILLUSTRATION 3

Ankit enters into a forward contract with National Bank for purchase of 100,000 USD at ₹50 to a dollar after 6 months. The expectation of Ankit in this case is obviously that the ₹ is expectedto quote at a lower rate of more than ₹50 to a dollar after six months and he does not wish to be exposed to such depreciation risk of the rupee against the dollar. At the end of six months, the possibilities are: (i) the dollar is more than ₹50 and Ankit buys the agreed number of dollars at ₹50 to a dollar, (ii) Ankit does not buy any dollars but pays or receives the difference between the spot price and the delivery price of ₹50 to a dollar. The former situation would be applicable when Ankit has an actual requirement of dollars. The second situation would apply when Ankit is speculating on the spot movement of the dollar.

The FOREX forward market is an OTC market all over the world. However, with respect to the Indian market, there are some distinctive features. Firstly, since trades are settled through the CCIL platform, FOREX forwards do not entail counterparty risk. In addition, contracts are pretty standardised with expiration day fixed as the last business day of the month. The CCIL clears all ₹-USD forward deals as well as spot contracts on a net settlement basis. Secondly, as per prevalent RBI regulations on foreign exchange forward contracts for residents in India, these contracts can be used to hedge against foreign currency risk only if they are backed either by a permitted capital or current account transaction in foreign currency. Hence, forward contracts in foreign exchange for speculative purposes are prohibited. The other main condition is that the maturity of the hedge should not exceed the maturity of the underlying transaction.

In addition to the domestic ₹-USD forward market, there is also an active market for such forwards in the international market. Such markets prevalent in London, Dubai, Hongkong and Singapore work on a cash settlement basis and are known as Non-deliverable Forwards (NDF). These are mainly used by FIIs who find the domestic forward market restrictive.

4.10.2 Currency Swaps

A currency swap is a derivative contract that involves an exchange of principal and / or interest on loans designated in different currencies. Generally, currency swaps involve the home currency on one side, for example, the USD-₹ swap or the Euro-₹ swap. It is also known as the *cross currency swap* in some situations when both the legs of the swap involve currencies other than the home currency, for example, USD-Euro swap contract by a resident Indian. It is common for counterparties in different currencies to enter into a currency swap so as to hedge their foreign currency exposures and to keep financing costs equivalent to their domestic currencies. A currency swap not only hedges exchange risk but also facilitates borrowing in any currency that is most suited to the borrower and swapping it later for a currency of its requirement. Therefore, if a company in USA borrows in Euro and a company in Europe requires a borrowing in USD, they can enter into a currency swap to exchange the respective cash flows through a currency swap. Similarly, they could even swap the principal obligations and service interest payments on the notional principal in their home currency. Swaps come in different variations such as *fixed-floating swaps* wherein one leg is on a fixed rate while the other is floating, *floating-to-floating swap* wherein both the legs are on floating rates and *marked-to-market swaps* wherein the principal amounts are marked to-market periodically instead of remaining fixed as in conventional swaps.

Under the FEMA (Foreign Exchange Derivative Contracts) Regulations, 2000 a person resident in India who has borrowed foreign exchange in accordance with the provisions of Foreign Exchange Management (Borrowing and Lending in Foreign Exchange) Regulations, 2000, may enter into an *interest rate swap* or *currency swap* or *coupon swap* or *foreign Currency Option* or *interest rate cap or collar* (purchases) or

Forward Rate Agreement (FRA) contract with an authorised dealer in India or with a branch outside India of an authorised dealer for hedging his loan exposure and unwinding from such hedges. Provided that:

- The contract does not involve ₹ currency.
- The RBI has accorded final approval for borrowing in foreign currency.
- The notional principal amount of the hedge does not exceed the outstanding amount of the foreign currency loan.
- The maturity of the hedge does not exceed the un-expired maturity of the underlying loan.

Persons resident outside India namely FPIs, FDI investors and NRIs are allowed to hedge their foreign currency exposures through FOREX forwards and foreign currency-₹ options. With respect to swaps involving the ₹, a person resident in India, who owes a foreign exchange or rupee liability, may enter into a contract for foreign currency-rupee swap with an authorised dealer in India to hedge long-term exposure.

It is apparent from the above regulations that currency swaps in India, as in the case of FOREX forwards require an authorised dealer as one of the counterparties and the purpose of the transactions shall be to hedge a foreign currency liability. Most important requirement under the RBI regulations is that in any derivative contract, the notional amount should not exceed the actual underlying exposure at any point of time.

In similar fashion to FOREX forwards and currency swaps, the RBI under the FEMA (Foreign Exchange Derivative Contracts) Regulations, 2000 also allows hedging for commodity price risk in foreign currency on any commodity including gold imports but excluding oil and petroleum products which are allowed only for canalising agents. Domestic oil refining companies and shipping companies are permitted to use OTC and exchange-traded freight derivatives in international markets for hedging their exposures to freight risk, subject to specified conditions.

4.10.3 Currency Futures and Options Market

A *currency futures* or *FOREXfutures* contract is essentially an exchange traded futures contract with foreign currency as the underlying asset. In other words, it is a futures contract for the exchange of one currency for another at an agreed rate. As in any other futures contract, a currency futures contract can also be terminated anytime before the agreed date. Since these are exchange traded, they are standardised in terms of their features and dates. Currency futures were first introduced on 1970 though they became prominent in 1972 after the dismantling of fixed exchange rates under the Bretton Woods system (which happened in 1971). Usually, these are entered into for the same underlying purpose of hedging foreign exchange risk and serve the same economic purpose as a FOREX forward with the added efficiency of an exchange traded product. In the overseas markets, *currency futures* and *currency options* are also used for speculative purposes.

The introduction of currency futures on Indian exchanges was triggered due to the demand for liberalisation and reform of the FOREX derivative market as being a key driver for the internationalisation of Mumbai as a financial centre.[11]Thereafter, the RBI permitted trading of currency futures and options in India. In its preamble[12] to introduce currency futures, the RBI stated, thus, "*International experiences have also established that the exchange traded currency futures contracts facilitate efficient price discovery, enable better counterparty credit risk management, wider participation, trading of standardised product, reduce transaction costs, etc.*" As defined by the RBI, currency futures shall mean, "*a standardised foreign exchange derivative contract traded on a recognised stock exchange to buy or sell one currency against another on a specified future date, at a price specified on the date of contract, but does not include a forward contract.*" The main stipulations of RBI on currency futures are as follows:

- Currency futures are permitted in US Dollar-₹ or any other currency pairs, as may be approved by the RBI from time to time.

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[11]The MIFC Report published in 2007 under the auspices of the Ministry of Finance.

[12]Currency Futures (Reserve Bank) Directions, 2008

- Only residents may purchase or sell currency futures to hedge an exposure to foreign exchange rate risk or otherwise.
- Only USD-₹ contracts are allowed to be traded. The size of each contract shall be US$ 1000.
- The contracts shall be quoted and settled in ₹.
- The maturity of the contracts shall not exceed 12 months.
- The settlement price shall be the Reserve Bank's Reference Rate on the last trading day.
- Banks may participate in currency options only after requisite approvals from the RBI. Similarly, for participation by other regulated entities, concurrence from their respective regulators should be obtained.

After the RBI permitted the introduction of currency futures, they were introduced on Indian exchanges by SEBI in 2008. The RBI and the SEBI jointly regulate these products. RBI approves the products and SEBI decides on the trading platforms. Initially, the currency futures were limited to ₹-USD only. But in January 2010, it was extended by RBI to three more currencies: Euro, GBP and Japanese Yen, pairing with the ₹. Basically, these trading platforms are identical to that of the capital market derivative platform on a stock exchange. Futures market is more amenable to non-bank participants such as corporate, brokerages and even households and these are not bound by the restrictions of RBI that apply to OTC products.

As is the case with other option contracts, *currency option* is a derivative instrument that gives the owner the right, but not the obligation, to exchange money denominated in one currency into another currency at a pre-agreed exchange rate on a specified date. In 2010, SEBI allowed the introduction of currency options on US dollar-₹ spot rates for residents,[13] providing another alternative to domestic corporates for hedging against currency fluctuations. Banks may participate in currency options only after requisite approvals from the RBI. Similarly, for participation by other regulated entities, concurrence from their respective regulators should be obtained.

Initially, the following conditions were prescribed for currency options in 2010:

- The underlying for the currency option shall be US Dollar ₹(USD-₹) spot rate.
- The options shall be premium styled European call and put options.
- The size of each contract shall be USD 1000.
- The premium shall be quoted in ₹ terms. The outstanding position shall be in USD.
- The maturity of the contracts shall not exceed 12 months.
- The contracts shall be settled in cash in ₹.
- The settlement price shall be the RBI's Reference Rate on the date of expiry of the contracts.

With time, based on consultations with RBI, with a view to maintaining orderly conditions in the domestic foreign exchange market, SEBI decided to enhance the gross open position limits for bank stock brokers to $1 billion or 15% of the total open interest in the currency derivative market.

4.11 Significant Developments in Secondary Market

Under the regulatory supervision of SEBI, the secondary markets in India went through landmark evolutionary changes so as to bring them on par with global practices and standards. Some of these are mentioned in the following paragraphs:

4.11.1 Demutualisation of Stock Exchanges

Under the initiative of SEBI, all stock exchanges were required to go through a process of corporatisation and demutualisation whereby they were converted into companies incorporated under the Companies Act,

[13]Exchange Traded Currency Options (Reserve Bank) Directions, 2010

1956 (or 2013) and the ownership thereof was de-linked from membership in the respective stock exchange. The SCRA was amended to enable the process of such transformation. The NSE, BSE and OTCEI were notified as demutualised exchanges in 2005. Under Section 4B(8) of the SCRA, the demutualisation process is stipulated to be fully completed when each stock exchange is owned to the extent of atleast 51% by public shareholders who do not have trading rights on such exchange. These changes in the constitution of stock exchanges were brought about through the powers vested with SEBI under the SEBI Act and the Regulations passed by SEBI in this regard.[14]

4.11.2 Dematerialisation

For several decades, the Indian market was dependent on holding of securities and dealing in them through the physical form wherein certificates were printed and issued to investors evidencing their title to such securities. Whenever these were traded, they were sent to the issuing company for transfer in the name of the transferee along with a share transfer deed signed by the transferor. This system depended heavily on physical handling and transportation of securities through postal department and other means. This resulted in several bottlenecks such as delay in transit, bad deliveries due to non-matching of signatures or other technical errors, loss in transit and issue of duplicate certificates, additional paper work in verification of signatures and other details and more importantly, the menace of duplicate share certificates floating in the market leading to loss of investors' confidence in the system. The duplicate share problem that rocked the stock market in the mid-nineties is a fall out of the physical handling system.

The securities markets in the developed countries had migrated to the dematerialised mode for quite some time prior to the Indian authorities realising that the lack of it in Indian market was a major infrastructural bottleneck for the future development of the market. Depository system was introduced in India with the passing of the Depositories Ordinance in 1995 which was later replaced with a full-fledged Depositories Act in 1996.This law provided the statutory framework under which depositories and de-materialised trading could take place. The two types of depository models that are in existence are the de-materialisation model and the immobilisation model. While in the former method, physical certificates are completely destroyed and securities are held electronically, in the latter case, the physical securities are held in safe custody by the depository and the records of holdings and trades are maintained electronically. The de-materialisation system being the more cost efficient and convenient system is what was adopted in India.

The process of de-materialisation and re-materialisation of securities and electronic dealing therein happens entirely through system connectivity in electronic medium between the market participants in the depository system such as the Depository, the DPs, the clearing corporation of the stock exchanges, the registrars to new issues and the share transfer agents or the share transfer departments of respective issuers.While de-materialisation is initiated through a De-materialisation Request Form (DRF) by the beneficial owner, re-materialisation happens in much the same way with the beneficial owner initiating the re-materialisation request form. Similarly, transfers resulting from buy or sell transactions or otherwise are initiated by the sellers by issuing a *delivery instruction* which is an instruction to the DP to reduce the stated number of shares from the seller's account. The delivery instruction, thus, becomes the basis on which the securities get transferred from the seller's demat account to the buyer's demat account (either with the same DP or another DP) by routing the transaction through the clearing corporation and the depository.

Under the depository system, all types of securities such as shares, bonds, stock, debentures or any other marketable security, units of mutual funds, collective investment schemes, venture capital funds, commercial paper, certificates of deposits, securitised instruments, money market instruments, government securities and unlisted securities can be dematerialised.

[14]These regulations are currently known as Securities Contracts (Regulation) (Stock Exchanges and Clearing Corporations) Regulations, 2012

4.11.3 Corporatisation of Brokers

Just as stock exchanges were required to be reformed and corporatised, SEBI introduced a process of corporatising stock brokers since they are trading members of a stock exchange. The IT Act was also amended to provide tax neutrality to sole proprietorship and partnership broking firms to convert themselves into corporate entities. The Limited Liability Partnership Act 2008 also brought in a new corporate entity into existence. As of 2015, about 70% of broking members in the cash segment of Indian stock exchanges were corporatised according to SEBI statistics.

4.12 Secondary Market Trading Systems

4.12.1 Electronic Trading System

Secondary market trading and settlement system is fundamental to its orderly conduct of business and growth. Over the years, several path-breaking reforms were implemented to make them on par with global standards. Indian secondary markets have come a long way, since the days of the open outcry and the 'badla' system prevalent in the BSE. Though the NSE was the first to introduce screen based electronic trading facility across the country, the BSE quickly introduced its BOLT system as well. The screen based trading system is an *order driven* system wherein a member can introduce an order into the system specifying the quantity of securities and the price at which he likes to transact. The order will search for matches and the transactionsare executed as soon as it finds a matching sale or buy order from a counter party.

The electronic trading system scores over the traditional open outcry system in many ways:

- Since orders are matched by the system, it adheres to strict price and time priority thereby preventing loss of orders, errors and malpractices.If an order does not find a matching counter order, it remains in the system and is displayed to the whole market until a new order comes in or the earlier order is cancelled or modified.
- Since orders are matched and prices are recorded simultaneously, the system enables real time price updation, thereby reducing information asymmetry in the market.
- By networking the whole country, it enables seamless trades across geographies, thereby improving depth andliquidity in the market.
- Since the trading is faceless, the counterparties are anonymous. This mechanism creates an equal opportunity market for all trading members.
- It provides a perfect audit trail of trades which helps SEBI in its oversight function and in resolution of defaults and disputes arising from trades by capturing in the trade executionprocess in entirety.

In order to help in order placement, the system incorporates facility to build in several terms in an order and also displays complete market information on real time orders and their details. Orders may also be entered as *limit orders* specifying quantity and price. If the order conditions are not matched, the limit order does not get executed. The order matching happens in the following manner:

- Eligible limit orders are matched with matching limit orders.
- Residual eligible limit orders are matched with market orders wherein the system determines the price.
- *Market orders* (those that do not have a price specification) are matched with market orders.

The trading system in the debt and equity markets is almost identical. Trading in all instruments is allowed during normal trading hours unless there are securities or specified scrips that have been prohibited for trading by the stock exchange. Whenever a trade takes place through the order matching process, the system sends a trade confirmation message to each of the counterparties. The information on executed trades is also disseminated across the market through a ticker window displaying the details of the trade. Limited facility is also available for trade cancellations subject to confirmation by the exchange.

With the introduction of internet trading by clients, an additional facility is available to investors. Under this system, investors are provided with web-based access or through a mobile application the facility to trade directly on the exchange. The orders originating from the devices of the investors are routed to the trading terminals of the designated brokers with whom they are connected and further to the exchange for trade execution. Soon after these orders get matched and result into trades, the investors get confirmation about them on their devices. Only SEBI registered members are allowed to provide these facilities to their clients with the permission of the stock exchange.

4.12.2 Algorithmic or High Frequency Trading

Algorithmic trading or *high-frequency trading* is an automated way of securities trading whereby pre-set computer programmes ensure that trades are put through by computers trading with each other instead of human intervention by dealers and traders. According to the NSE, *Automated Trading* "*shall mean and include any software or facility by the use of which, upon the fulfilment of certain specified parameters, without the necessity of manual entry of orders, buy/sell orders are automatically generated and pushed into the trading system of the exchange for the purpose of matching.*" SEBI allowed stock exchanges to extend algorithmic trading facility to members involving usage of various decision support tools / algorithms / strategies. Based on an examination of the proposed algorithms and the risk management strategies, the stock exchange will examine the proposal based on SEBI directions and accord approval.

The main advantage of algorithmic trading is the speed at which trades are executed for generating profits that are impossible in the human domain. It also rules out human elements in trading decisions such as gut feel, stock tips, grapevine and emotion, thereby making markets more scientific and liquid. Over time, in international markets, algo-trading has moved on to becoming high frequency trades which are executed at lightning speed. However, algo-trading does have its downsides.System failure risks, network connectivity errors, time-lags between trade orders and execution, and most of all, imperfect algorithms can cause havoc with trading and trades can multiply erroneously in no time. The crash of the NASDAQ market in 2010 was perpetrated by the use of algorithmic trading in the derivatives market which exacerbated the sudden crash in stock indices across the system. After subsequent investigations, use of spoofing algorithms, layering, front running and other such dubious mechanisms are banned in the US market.

In spite of its apparent risks, algo-trading caught on to monopolise stock trading across geographies and constitutes nearly 90% of all trading in developed markets. Though largely an institutional trading system, algo-trading constitutes about 40-50% of the volumes in the Indian market and is slated to increase in coming years.

4.12.3 Settlement System

The settlement system in a stock exchange was quite primitive till the early 1990s when market reforms stated to get introduced and with the advent of SEBI and the NSE, several transformational developments took place in subsequent years such as electronic transfer of securities, narrowing down of settlement cycles and finally, the *rolling settlement* system. The periodic settlement cycles were disbanded and all securities were put on compulsory rolling settlement system based on T+2.

A further improvement to settlement systems came about when SEBI insisted on stock exchanges establishing separate subsidiary companies to act as *clearing corporations* to settle trades and assume counterparty risk. The trading obligations of members are downloaded to their systems by the clearing corporation. The members or custodians acting on behalf of FPI clients make available the required securities in their pool accounts with depository participants by the prescribed pay-in time for securities. The depository transfers the securities fromthe pool accounts to the settlement account of the clearing corporation. On similar lines, all members or custodians have to maintain trading bank accounts with designated clearing banks that are tied up with the clearing corporation. Based on advices sent to members about their pay-in obligations, the clearing corporation generates debit instructions to designated banks which will carry out the instructions and transfer funds electronically to the settlement account of the clearing corporation. Under the T+2 rolling settlements, both the processes relating to pay-in and pay-out of funds and securities, take place within two working days after the trade date.

With the advent of clearing corporations, trades are settled by the exchange irrespective of default by a counterparty and the risk is assumed by the clearing corporation. This provides hassle free trading experience to members and reliability that trades will be honoured irrespective of the financial status of the counterparty. The reason why clearing corporations are kept apart from the stock exchange as limited liability subsidiaries is to ensure *bankruptcy remoteness* for possible risks arising from the guarantee function that they undertake. In order to meet the requirements of any eventuality, the clearing corporation also maintains a *settlement guarantee fund*.

4.12.4 Risk Management and Surveillance System

Since electronic trading and settlement systems function on real time basis, they not only provide efficient and transparent conduct of business but also come with zero tolerance to defaults or any sort of disruption. Therefore, it is extremely important that the exchange enforces efficient surveillance and risk management system that provides suitable checks and balances to counter any sort of rouge trading or excessive risk raking by members. In recognition of this necessity, the exchanges and their clearing corporations employ risk management practices to ensure timely settlement of trades. SEBI has also prescribed elaborate margining and capital adequacy standards for members to secure market integrity and protect the interests of investors. These measures ensure there is no domino effect in the event of a default by some members.

Firstly, the clearing corporation ensures that trades by each member entity are commensurate with its net worth. The capital adequacy and net worth are monitored depending upon trading on a daily basis. Suitable cash margin requirements are stipulated and in the event of an over-stretch by the member leading to funds shortage in clearing bank account, trading in its account will be suspended temporarily. In addition, the track record of a member is monitored continuously and position limits are revised based on net worth and other parameters.

In addition to risk management arising from member defaults and counterparty risk, the stock exchange also has in place efficient market surveillance system that generates timely and real time intelligence on trades and market trends. The exchange seeks to curb excessive volatility, detect and prevent price manipulation and follows a system of imposition of price bands. Further, the exchange maintains strict surveillance over market activities in liquid and volatile securities.

For all scrips that do not have any derivatives on them, price bands are fixed by the exchange within the range of 2% to 20%. In order to prevent excess price volatility, SEBI also prescribed system wide circuit breakers that would bring the entire market to a coordinated halt, if the index breaches the specified band of 10, 15 or 20%. The exchange does not prescribe any trading price band for securities on which derivative products are available or securities included in indices on which derivative products are available. In such cases, in order to prevent members from entering bogus trades, the exchange imposes a price band of 20%. Any order that falls above or below 20% over the base price, causes an alert to the exchange as a *price freeze*. Similarly, system alerts are provided when there is a very large order (the size of a block deal) in value or quantity that could lead to a *quantity freeze*.

Case Study

National Spot Exchange Ltd.

The case of NSEL is a classic example of regulatory gap in the Indian commodity market insofar as it concerned spot contracts. Since spot contracts (T+2) were outside the regulatory purview of the erstwhile commodity market regulator (FMC), these were unregulated OTC trades. Since commodities were not part of the financial market, they were not regulated by the SEBI or RBI. It is in this regulatory vacuum that a company was set up called the NSEL by Financial Technologies Ltd., a company promoted by Jignesh Shah. FTIL was also the promoter of Multi Commodity Exchange (MCX), MCX Stock Exchange (now Metropolitan Exchange) and other associated entities.

NSEL commenced its operations pursuant to Gazette notification by the Ministry of Consumer Affairs on June 5, 2007 to trade in commodity spot contracts by virtue of an exemption provided by the ministry. This exemption took it outside the purview of the FMC. NSEL was allowed to conduct T+2 contracts that complete both delivery of goods and transfer of money within two days. Under the erstwhile FCRA, such contracts had to be settled in a T+11 cycle. NSEL's promoter FTIL provided technologically advanced solutions to market participants. NSEL also introduced for the firs-time commodity based demat investment products.

Due to lack of regulatory oversight, NSEL started to do pairing contracts, i.e. a T+2 buy would be paired with a T+25 or T+35 sell order.This amounted to a forward contract which was illegal. By pairing the contracts, NSEL was able to offer 15% return on each pair to an investor. Gradually, brokers started to hawk this product to investors and it became a financing game. Even the illegal forward contracts kept getting rolled over. All the contracts were supposed to be backed by commodity stocks but eventually, they started to trade on warehouse receipts. Investors assumed guaranteed return as they thought that all trades were guaranteed by the exchange. The exchange continued these illegal operations in blatant violation of its mandate until the FMC issued a directive in 2012.

Under pressure from FMC, NSEL issued a circular on July 31 2013 stating that all forward contracts were to be stopped. This led to pandemonium and investors in outstanding contracts demanded their settlements. It was then that NSEL began to default. Subsequent forensic audit revealed fictitious stocks, unavailable settlement guarantee fund, dubious books and records, collusion between promoters, NSEL and related parties and connivance of the management of NSEL with fraudulent operators and the FMC.The failure of FMC to curb illegal forward trades between 2007 and 2012 paved the way for the NSEL to become a systemic risk. Criminal investigation agencies stepped in and proceedings began on multiple fronts on what became evident as a ₹5600 crore scam in the commodity spot market.

The NSEL episode shook the regulatory bodies and the government alike and ultimately paved the way for the repeal of the FCRA, scrapping of the FMC and vesting of regulatory oversight of commodity derivative markets with SEBI in 2015.

4.13 Regulatory Framework for Secondary Markets[15]

The regulator for the capital market in India is the SEBI and the department that works on regulation of secondary markets and stock exchanges is the Market Regulation Department in SEBI. The statutory

[15]The regulatory framework for Primary Markets is discussed in the appropriate chapters of the book with respect to various facets of investment banking. The regulatory framework for Secondary Markets insofar as it has direct relevance to investment banking is discussed herein. The other aspects of secondary market regulation such as stock exchange membership criteria, trading rules and regulations and administration of stock exchanges are outside the scope of this book.

power of SEBI to administer the secondary markets and stock exchanges is provided for specifically under Section 11(2) of the SEBI Act. This provision inter alia empowers SEBI to regulate stock exchanges, stock brokers, sub-brokers, share transfer agents and other intermediaries associated with secondary markets. It also empowers SEBI to prohibit fraudulent and unfair trade practices relating to securities markets and prohibiting insider trading in securities. Based on these powers, SEBI administers the working of the stock exchanges and secondary markets through issue of regulations and circulars from time to time. Section 12 of the SEBI Act provides that all intermediaries and persons associated with securities market shall buy, sell or deal in securities only after obtaining a certificate of registration from SEBI. Accordingly, as far as the secondary market is concerned, stock brokers, sub-brokers, share transfer agents, portfolio managers, investment advisers, custodians, depositories and participants, FPIs, mutual funds and collective investment schemes are subject to registration with SEBI. SEBI issued regulations for registration and governance of each of these intermediaries and investors in the secondary markets.

In addition to the SEBI Act, the SCRA also imposes the responsibility on SEBI to administer the securities markets. Under Section 30 of SCRA, the powers for carrying out the purposes of the Act are vested with SEBI. Similarly, the Securities Contracts (Regulation) Rules, 1957 are exercisable by SEBI.

With regard to market practices, SEBI issued the SEBI (Prohibition of Insider Trading) Regulations, 1992 and the SEBI (Prohibition of Fraudulent and Unfair Trade Practices relating to Securities Markets) Regulations, 2003.[16]

4.13.1 Insider Trading Regulations

India did not have any formal anti-insider trading regulations until 1992 when SEBI formulated them. Prior to it, the first reference was made by the Sachar Committee that was appointed to suggest amendments to the Companies Act. A second committee (Patel Committee) made recommendations on incorporating insider trading regulations in the SCRA. In 1989, the Abid Hussain Committee made recommendations on insider trading regulations being brought under the SEBI domain. However, SEBI was at that time an advisory body until the SEBI Act was passed in 1992. Subsequently, SEBI issued the Regulations for prohibition of insider trading. These Regulations provide for restrictions and prohibitions on certain activities pertaining to securities markets by persons who are considered *insiders*. According to the Regulations, an *Insider*means "*any person who, is or was connected with the company or is deemed to have been connected with the company and who is reasonably expected to have access to unpublished price sensitive information in respect of securities of a company or who has received or has had access to such unpublished price sensitive information.*" The Regulations provide that a *connected person* shall mean a director of a company or an officer or an employee of the company or holds a position involving a professional or business relationship between himself and the company such that he may have access to unpublished price sensitive information. In addition to such direct connection, several intermediaries such as bankers, merchant bankers, share transfer agents, brokers, portfolio managers, investment advisors, trustees of a mutual fund etc. are deemed to be connected. *Price sensitive information* is defined as "*any information which relates directly or indirectly to a company and which if published is likely to materially affect the price of securities of that company.*" Specifically, the following shall be deemed to be price sensitive information:

- Periodical financial results of the company
- Intended declaration of dividends (both interim and final)
- Issue of securities or buyback of securities
- Any major expansion plans or execution of new projects

[16]These Regulations replaced the earlier version of SEBI (Prohibition of Fraudulent and Unfair Trade Practices relating to Securities Markets) Regulations, 1995

- Amalgamation, mergers or takeovers
- Disposal of the whole or substantial part of the undertaking
- Any significant changes in policies, plans or operations of the company

Regulation 3 specifically prohibits an insider from dealing in securities of a company listed on any stock exchange when in possession of any unpublished price sensitive information either on own or other account. Similarly, no company shall do so in the securities of another company or associate of that other company. Restrictions also apply in procuring or passing on price sensitive information from an insider to another person. The SEBI has wide powers of inquiry and investigation under the Regulations to investigate matters relating to violation of the Regulations. In cases, where there are violations under these Regulations, SEBI may pass appropriate orders of restraint, declaring the inside transactions as null and void, return of securities dealt with or for deposit of the gratification in an investor protection fund of a stock exchange. Proceedings for such orders are conducted under the SEBI (Procedure for Holding Inquiry and Imposing Penalties by Adjudicating Officer) Rules, 1995. Penalties prescribed for violation of the Regulations under Section 15G could amount to ₹25 crores or three times the amount of profits made out of insider trading, whichever is higher. Orders issued by the adjudicating officer are appealable to the Securities Appellate Tribunal (SAT). In cases, where the offender is willing for compounding, SEBI may also issue consent orders specifying the mutually agreeable fine to be paid by the offender though in recent times, SEBI indicated that insider trading cases would no longer be disposed-off through consent orders. In grave cases of insider trading, SEBI may initiate prosecution under Section 24 of the Act which provides for a maximum imprisonment of 10 years or a fine of ₹25 crore (250 million) or both.

So far, the enforcement of insider trading law in India has not been punitive enough but the few cases that were investigated by SEBI were mostly settled through adjudicating orders or consent orders. The only case that went to criminal trial was that of Hindustan Lever Ltd. (now Hindustan Unilever Ltd.).

Case Study

Hindustan Lever[17]

The well-known case in insider trading proceedings was that against Hindustan Lever Ltd. and its directors. The crux of the matter was the purchase of 8 lakh shares of Brooke Bond Lipton India Ltd. (BBLIL) by HUL from UTI at a price of ₹350.35 per share (which was at a premium of 9% to the CMP of ₹320 per share) days before there was a formal announcement of the merger of the two companies. Suspecting foul play, SEBI conducted enquiries, issued a show cause notice to the then chairman, all executive directors and the company secretary of HLL. In March 1998, SEBI found it fit to pass an order against HLL and its directors for use of unpublished information and found them guilty of charges on insider trading. Under the order, SEBI also directed HUL to pay UTI compensation of ₹3.4 crore and also initiated criminal proceedings against the five common directors of HLL and BBLIL. Later HUL filed an appeal with the Securities Appellate Tribunal (SAT). At the appellate stage, HUL prayed that the impending merger was already known generally to the market due to which the market price of BBLIL had steadily climbed to its CMP. It stated that being the initiator and primary party to the deal, it could not be considered an *insider* and that the merger swap ratio was not yet determined at the time of the purchase. In addition, HUL also proved that acquisition of additional shares was a part of the agreed deal structure to enable controlling stake of 51% to HUL shareholders. The SAT overruled SEBI's order and exonerated the company and its officials from the charges. Thereafter, SEBI filed a complaint for criminal prosecution of the offenders with the Metropolitan magistrate for

[17]Hindustan Lever Limited vs SEBI (1998) 18 SCL 311 (AA)

offence under Regulation 3 of the Insider Trading Regulations. However, the criminal proceedings filed by SEBI were being obstructed by HUL due to which SEBI filed a criminal writ petition in the Supreme Court. The Honourable Supreme Court took strong exception to the delaying tactics adopted by the accused and directed the trial court to complete the proceedings of the trial expeditiously.

Case Study

Tata Finance/Dilip Pendse and Others[18]

This case involved proceedings against Mr. Dilip Pendse, the then managing director of Tata Finance Limited (TFL), his wife Ms. Anuradha Pendse and Nalini Properties Limited for the alleged violation of the provisions of SEBI (Insider Trading) Regulations, 1992 in respect of their dealings in the shares of TFL. Against the adjudicating order of SEBI, an appeal was filed with the SAT which redirected the matter to the adjudicating authority. The allegation pertained to the sale of TFL shares by the accused on 28th March 2001 on the basis of a unpublished price sensitive information relating to the financial position of TFL which was not in public domain. The unpublished price sensitive information was alleged to have been provided to them by Pendse who at the relevant point of time, was the managing director of TFL. The price sensitive information was pertaining to the loss of ₹79.37 crore suffered by Nishkalp Investment and Trading Co. Ltd., (Nishkalp) a wholly owned subsidiary of TFL. Pendse, besides being MD of TFL was also the Director of Nishkalp at the relevant time. It was alleged that Pendse was aware of the poor financial position of TFL on account of the losses incurred by Nishkalp before the information was made public on 30.04.2001 as part of the letter of offer filed for a rights issue. The charge was that on account of the sale, unjust profit accrued to the accused through insider trading. The accused denied the allegations and sought to show that Pendse and the others were not insiders and that the sale was not on the basis of any unpublished information. They also stated that the sale was a principal-to-principal transaction and not a *spot delivery* trade and that it took place much earlier in September 2000. They produced evidence that the trade was reported to the BSE through its broker which was corroborated by BSE records.

In the proceedings, it was held that Pendse was an insider within the ambit of Regulation 2(e) of the Insider Trading Regulations and so were the others. The adjudicator also established discrepancies in the documents filed with him and held that the trade happened in March 2001 and not in September 2000 as was sought to be shown by the accused.Further, no reasonable explanation had been provided for effecting delivery of shares and payment few days prior to the date on which the price sensitive information became public. Selling of shares through off market deals few days prior to the date on which the price sensitive information made public strongly indicated that the shares were sold on the basis of the unpublished price sensitive information. The preponderance of probabilities and the fact that the impugned transactions were executed few days prior to the date on which the unpublished price sensitive information was made available to public clearly indicated that noticees indulged in insider trading. The standard of proof required in a proceeding of this nature is not necessarily that of the strict standard of proof required in criminal cases. It is sufficient, if the preponderance of probabilities suggests towards the involvement of the delinquent in the misconduct. The strict rules of standardof proof to the exclusion of all reasonable doubt required in a criminal case may not be applicable to a proceeding of this nature. Reliance was placed on the observation of the SAT[19] as follows,“We are of the considered opinion that if an insider trades or deals in securities of a listed company, it would be

[18] SEBI ADJUDICATION ORDER NO- AO/BS/03/2009

[19] In Appeal No. 50 of 2007 (Rajiv B. Gandhi & Ors. Vs SEBI)

presumed that he traded on the basis of the unpublished price sensitive information in his possession unless he establishes to the contrary. Facts necessary to establish the contrary being especially within the knowledge of the insider, the burden of proving those facts is upon him. The presumption that arises is rebuttable and the onus would be on the insider to show that he did not trade on the basis of the unpublished price sensitive information and that he traded on some other basis."

On the basis of the above, it was concluded in this case that the accused parties had violated Regulation 3 of Insider Trading Regulations and were guilty of insider trading liable to the penalty prescribed under Section 15G of the SEBI Act. In December 2012, SEBI passed an order prohibiting Mr. Pendse from associating with the capital market for a period of 2 years.

Case Study

Other Interesting Cases on Insider Trading

There were other well-known cases under the Insider Trading Regulations which went either in favour of the accused or resulted in fines on adjudication. One such case was with regard to Samir Arora who was then the CIO of Alliance Capital Mutual Fund. It was alleged that he had used unpublished price sensitive information to sell shares in Digital GlobalSoft Ltd., a 100% subsidiary of Hewlett Packard US. He was also found to have indulged in misconduct making him liable for action under Sections 11 and 11B of the SEBI Act. In April 2004, SEBI passed an order debarring Arora from capital market trading activity for 5 years. Subsequently, the SAT set the order aside stating grounds of insufficient evidence against Arora.

In another well-known case, the managing director of ABS Industries Ltd., Rakesh Agarwal was charged with insider trading. Since he was negotiating an acquisition of his company by Bayer A.G., he was in possession of unpublished price sensitive information. It was alleged that he acquired shares of his company through a relative and surrendered them in the open offer made by the acquirer subsequently. The accused defended his action stating that it was a part of the deal structure negotiated with Bayer who insisted on acquiring a minimum of 51%. Rakesh maintained that he had to acquire shares from the open market in order to fulfil the 51% condition and that in doing so, he had acted in the best interests of the company and its shareholders. On appeal, the SAT found merit in his argument and reversed the order of SEBI directing him to pay a penalty.

In another case[20], the wife of an independent director on the board of Ranbaxy Laboratories Ltd. was charged with insider trading based on unpublished price sensitive information obtained from her husband. The information related to the acquisition of Orchid Chemicals and Pharmaceuticals Ltd. by a subsidiary of Ranbaxy. SEBI alleged that a substantial chunk of Orchid's shares were picked by the accused just days before the open offer by the acquirer and were surrendered in the open offer to make a huge profit. SEBI's investigation sought to prove that Mr. Kaul was a connected person to Ranbaxy and trading on behalf of his wife, based on his access to the unpublished price sensitive information about the impending open offer by the acquirer. The proceedings by the adjudicating officer recorded that certain key executives of Ranbaxy were clearly aware of the deal on the dates the shares were acquired and that there were several telephonic calls between at least two senior officers and Mr.Kaul. The respondent tried to show that there was no conclusive evidence, whether direct or circumstantial to establish that there was insider trading based on knowledge of the impending acquisition. However, the principle enunciated by SAT in the Rajiv B. Gandhi case (supra) holds good in insider trading cases

[20]Featured in the Business Standard dated June 16, 2012 - Insider trading: Presumptions & defences by Kumkum Sen

and the onus is on the defence to rebut the case of the prosecution. The adjudicating order imposed a fine of ₹50 lakh on Mr. Kaul under Section 15G of the SEBI Act.

In other case, market operator Sanjay Dangi and his related entities were indicted by SEBI for insider trading.According to SEBI, the IT Department had found during their survey at the offices of the company, prima facie evidence of a well laid down strategy planned by promoters of the company who had floated 10 dummy entities, who along with Mr.Sanjay Dangi manipulated the share price of the company before the issuance of the FCCBs. Further investigation by SEBI revealed that the Dangi group was actively trading in the shares of many companies where there was capital raising through FCCB issue, ADR/GDR issue, QIB/QIP placement, preferential allotment or loans or pledge/ revocation of pledge of promoter shares. In view of the large-scale violations of the provisions of SEBI Act including the insider trading regulations, SEBI passed an ex-parte interim order in December 2010.

Similarly, in 2012, Manoj Gaur and others of Jaiprakash Associates were fined ₹70 lakh for insider trading in the company's shares. In this case, reliance was placed on the Supreme Court's view in SEBI vs. Shri Ram Mutual Fund wherein it was held that a violation of any provision of the SEBI Act attracts a penalty under Section 15G irrespective of the intentions of the parties.

In recent times, SEBI reinforced the surveillance of trades for possible insider trading and increased coordination with investigative agencies attached to the income tax department, the Enforcement Directorate, CBI etc. to prosecute offenders for insider trading. It also set up an Integrated Market Surveillance System (IMSS) and a data warehousing and business intelligence system which are capable of generating and recognising trading patterns from stock prices and trading volumes to detect possible insider trading. The IMSS system is used for detecting aberrations, analysing them and identifying the cases for investigation and for taking further action, wherever warranted. The SEBI also pursued with the government for powers to obtain call logs and other methods to establish circumstantial evidence in insider trading proceedings. SEBI publishes the details of proceedings initiated in insider trading cases in its annual report .

4.13.2 Insider Trading Laws and Cases in Other Markets

Anti-insider trading law has a long history in US capital markets and the US authorities have always been the forerunners in enforcing this law. In 1909, long before the Securities Exchange Act was passed, the US Supreme Court ruled that a corporate director who bought that company's shares with the information that its price would go up committed fraud by buying without proper disclosures. Subsequently, both the Securities Act of 1933 and the Securities Exchange Act of 1934 brought in substantive provisions on anti-insider law. The Insider Trading Sanctions Act of 1984 and the Insider Trading and Securities Fraud Enforcement Act of 1988 further fortified the legal framework against insider trading. Similar anti-insider trading laws exist in the UK under the Financial Services and Markets Act 2000. The EU also has directives prescribing each member state to have such laws in place to check insider trading. Japan also has an anti-insider trading law in place since 1988.

Case Study

Michael Milken, Ivan Boesky, Dennis Levine and Martin Siegel

One of the most notable set of insider trading investigations and convictions happened during the LBO era of the 1980s in USA which saw the conviction of 'Junk Bond King' Michael Milken, Dennis Levine, Martin Siegel and Ivan Boesky. Milken was the head of high-yield bonds department at Drexel Burnham Lambert which was an investment bank that resulted from the merger of Drexel with

Burnham Lambert in 1973. What started off as a corporate finance activity by Milken soon became a takeover financing route for big ticket buy-out transactions by specialised buy-out firms such as Kohlberg Kravis and Roberts. Ivan Boesky, who was an arbitrage trader, had a modus operandi that included spotting potential takeover targets even before there was an unsolicited bid and picking up their shares, sometimes, even days before a bid was made. He would then book profits by selling them to the acquirers. It later turned out that he was obtaining insider information from investment bankers Dennis Levine and Martin Siegel who were handling M&A deals. As Milken and Boesky grew in stature and power in Wall Street, they came under a cloud of suspicion of the SEC. The investigations commenced in 1986 and after a few years, a tip off from investment bank Merrill Lynch resulted in the SEC investigators trapping Levine, Siegel and Boesky and eventually Milken. Federal prosecutors finally indicted Milken on 98 counts of securities fraud, insider trading and other offences. He pleaded guilty to six charges including illegal dealings with Boesky. Milken and Boesky bore the brunt of the fines and jail sentences. Though Milken was sentenced to ten years in prison, he was let off after 2 years due to good conduct and co-operation with the authorities. Drexel was eventually liquidated in bankruptcy in 1990.

Case Study

Raj Rajaratnam and Rajat Gupta

In the biggest insider trading case in more than a generation, US prosecutors fought an exclusive insider trading trial on hedge fund investor, Sri Lankan born Raj Rajaratnam, co-founder of the Galleon Group LLC, a hedge fund. For the first time ever, prosecutors were allowed to use audio transcripts of telephone calls of Rajaratnam that were tapped to prove evidence. Jurors examined more than 45 such transcripts. The charges pertained to illegal profits amounting to $45 million through insider stock tips, some of which originated from Rajat Gupta, former chief executive of consulting firm McKinsey and independent director on the boards of investment bank Goldman Sachs and Procter & Gamble. Gupta was charged in separate proceedings for passing on inside information about the two companies in which he was director including a tip off about a $5 billion investment in Goldman Sachs by Warren Buffett's Berkshire Hathaway minutes before it was announced to the market in September 2008. Federal prosecution led by Indian born US Attorney Preet Bharara termed the Rajaratnam case as "the largest hedge fund insider trading case in history and the biggest insider trading case since the 1980s." Among the other companies that Rajaratnam had indulged in insider trading were IBM, eBay and Intel. Rajaratnam was found guilty and was convicted on five counts of conspiracy and nine counts of securities fraud in May 2012. A month later, Rajat Gupta was pronounced guilty by a federal jury and was convicted on three counts of securities fraud and one count of conspiracy for passing along confidential boardroom information about Goldman to Rajaratnam's a hedge fund that earned millions of dollars trading on his tips. The trial of Rajaratnam and Rajat Gupta brought to focus once again the law on the subject of insider trading. The US Courts ruled that there cannot be an absolute proof of insider trading knowledge and activity. In a different case, the US Courts also observed, "you cannot expect a tipper or tippee to voluntarily confess to passing or receiving insider information."

4.13.3 Fraudulent and Unfair Trade Practices Regulations

The SEBI Regulations on unfair trade practices define such practices broadly so as to capture a wide variety of transactions in the securities markets that are intended to deceive or accrue unfair gains. Such practices are also extended to the activities of intermediaries and providers of information. Similarly, circular transactions and mis-selling of financial securities or mutual fund schemes are also considered unfair practices. Unregistered collective investment schemes are also prohibited under the regulations. SEBI exercises its investigative powers under the regulations to act against parties perpetrating such practices and takes necessary punitive action.

Post-IPO Fraudulent Manipulations

From a sample study of post-IPO secondary market manipulations concerning small IPOsin the Indian capital market in yesteryears, the following practiceswere found to be used:

- In many of such issues, there were no QIB subscriptions. Only retail and HNI quotas were filled. All such issues were of sizes ranging between ₹30–100 crore.
- For getting issues subscribed, promoters were willing to discount the offer price substantially to capital market operators. These operators would pump up the grey market and post-listing aftermarket trading by indulging in circular trading wherein the trading volumes will be far higher than the floating stock.
- Many small issues like Gremach, Orbit Corp, Atlanta were manipulated by operators. The trading volumes in post-IPO trading were several times higher than the number of shares issued by the respective companies. In many cases, benami accounts were used with names of office boys and domestic servants. The menace of dummy investing was also noted to be widely prevalent in the IPO market.
- Regulating IPO grey market poses a big challenge for SEBI. The grey market is used by operators to hype up the demand prior to listing.

Case Study

Atlanta Ltd. 2006–07

In this case, SEBI investigation showed IPO price manipulators, hand-in-glove with the promoters of the company. It was alleged that IPO funds were diverted to promoter group entities and used by the promoters and operators to hike their stake in the company at a price much lower than the market price. SEBI also alleged that the promoters-managers of Atlanta had showed IPO money as revenue to the company to report a huge jump in net profit and jack up the stock price. SEBI launched the investigation after the stock price of Atlanta recorded a 10-fold jump in less than four months from listing. Its IPO closed in mid-September 2006 at ₹150 per share and the shares were listed on September 25 at ₹170. The stock started its ascent in early October and peaked at ₹1,446 on January 17 2007, an 864% rise. In early 2006, the firm placed about 5 lakh shares with four entities, which it termed as strategic investors in the IPO prospectus. Of these four firms, three were discovered to be connected to notorious IPO manipulators.

Case Study

Pyramid Saimira Theatre Ltd. 2009

The company's IPO in 2006 had gross irregularities including illegal employee quota allotments. Thereafter. the price was rigged in the market. SEBI investigation showed that the main promoter and co-promoter (a well known stock broker) indulged in forgery, siphoning of funds, falsification of records, bribery and dissemination of false information to the market and price manipulation. SEBI passed an order prohibiting the promoter and four others from the securities market. The order also barred the stock broker, a journalist with a leading financial daily, an executive of a PR agency and two government officials from the stock market. The government officials were also suspended. Besides these, 16 individuals and 232 other entities were also banned from participating in any form of share transactions. The forgery related to a letter purported to be written by SEBI directing the promoter to make an open offer which was circulated to the media. The stock broker was also found to be using a large number of front accounts including his related persons/entities to manipulate the securities market and to route the funds through several layers and this prima facie appears to be a money laundering activity. The order was appealed against and the Honorable Supreme Court confirmed the order dismissing the petition in 2010.

IMPORTANT TERMINOLOGY

Aftermarket
Algorithmic Trading
Block Deals
Bulk Deals
Capital Market Derivative Segment
Cash Market
CDS
Clearing Corporation
Dematerialisation
Demutualisation
Exchange Traded
F&O Segment
Foreign Exchange Market
Forwards
FRA
Futures
High Frequency Trading
Insider Trading
IRS
MIBID
MIBOR
Offshore Derivatives Instruments
Options
OTC Traded
Participatory Notes
Secondary Market
Settlement Guarantee Fund
Swaps
Unfair Trade Practices
Yield Curve

TEST YOUR UNDERSTANDING

I. Pick the right answer(s) or the alternative that best fits the description from the alternatives provided with each question.

1. One of the significant improvements of exchange traded system over the OTC trading system is the elimination of counterparties.
   (a) Yes (b) No
2. The derivative segment is also a market of origination of securities of a non-capital raising nature while the ECM and the DCM originate securities of a capital raising nature.
   (a) True (b) False
3. The F&O market homogenises forward trades of the OTC market with futures and options while the OTC market homogenises swap transactions.
   (a) True (b) False
4. A large institutional investor is approached by the controlling shareholders of a listed company to purchase upto 2% of the outstanding shares at a negotiated price which is 20% higher than CMP. Under the SCRA, such a transaction constitutes a:
   (a) Block deal (b) Bulk deal (c) OTC deal (d) Spot transaction
5. A large PE fund negotiates to purchase from an existing VC investor in a company a 15% stake through a secondary transaction. Such a transaction constitutes a:
   (a) Block deal (b) Bulk deal (c) OTC deal (d) Spot transaction

6. A large institutional investor is approached by the controlling shareholders of a listed company to purchase upto 2% of the outstanding shares at a negotiated price which is 20% higher than CMP. Under SEBI regulations, such a transaction constitutes a:
   (a) Block deal (b) Bulk deal (c) OTC deal (d) Spot transaction
7. A large domestic mutual fund floats a new scheme of unit capital which proposes to invest in secondary purchases through bulk deals and block deals thereby gaining substantial advantage over investing in the secondary retail market. This scheme amounts to issue of domestic participatory notes.
   (a) Yes (b) No
8. An institutional FPI invites subscriptions to participatory notes issued through private placement in Singapore, London and Luxembourg to other large institutional investors. These PNs will have no exchange risk as all trades will be hedged with ₹-USD swaps. Such an issue of PNs is prohibited under FEMA.
   (a) Yes (b) No
9. In an order-driven trading system, if market order is placed for a scrip for ₹85, the order gets executed only when the market price falls to ₹85 or below.
   (a) True (b) False
10. The SEBI LODR Regulations:
    (a) Provide a regulatory framework under the SCRA for regulation of stock exchanges.
    (b) Provide a regulatory framework for stock exchanges and securities traded on them under the SCRA.
    (c) Provide for regulation of securities that are listed or proposed to be listed on a stock exchange and governs the terms of such listed status for the issuer.
    (d) Is a branch of securities law dealing with listing of securities on a stock exchange?
11. Derivatives in India:
    (a) Can be traded both on the OTC and exchange driven markets except that there is more than one regulator for stock derivatives and other derivatives.
    (b) Cannot be traded on OTC market due to the express provisions of the SCRA.
    (c) Can be traded on OTC market only in the stock future segment while option contracts can only be traded on an exchange.
    (d) Can be traded only on stock exchanges if the underlying asset is a security or a commodity due to the provisions of the SCRA.
12. In a CDS transaction, the protection buying bank will have the following option:
    (a) If the protection seller defaults, the bank can enforce performance of the contract on the obligor (borrower) of the underlying debt.
    (b) If it is a naked CDS, in the event of a default by the protection seller, the bank can enforce performance of the contract only on the seller and not on the obligor.
    (c) Since the bank assumes counterparty risk, in the event of a default by the protection seller, the bank has no other recourse but to seek recovery and damages through legal action.
    (d) In the event of a default by the protection seller, the bank can sell the CDS in the secondary market and transfer the risk for a consideration to the new buyer.
13. In a securitisation structure, the future receivables of an issuer emerging from a long-term supply contractare securitised to provide cash flows for servicing the proposed issue of securities. Such securitised instruments would be Asset Backed Securities.
    (a) True (b) False
14. In a securitisation structure, the future receivables of an issuer emerging from aircraft rentals are securitised to provide cash flows for servicing the proposed issue of securities. Such securitised instruments would be classified as:

(a) Aviation derivatives (b) ATF bonds (c) Aircraft futures
(d) MBS (e) Pay through bonds (f) Pass through derivatives
(g) ABS

15. The following amounts to insider trading under the appropriate regulations in India:
 (a) A stock broker receives an order of sale of the shares of a company from his client who is a director on the board of the company.
 (b) An employee of an investment bank has not disclosed to the management that his brother is also an employee in the bank in the securities trading division.
 (c) The managing director of a company has not disclosed to the board that he has an interest in another company that is proposed to be acquired by the first company.
 (d) The CEO of a company acquires shares of the company a day prior to the board meeting in which the proposal to pay a handsome interim dividend was considered. The CEO did not participate in the board meeting though he had knowledge of the agenda.
 (e) The auditor of a company acquires shares in the company in violation of law.
16. Insider trading regulations prohibit the dissemination of UPSI by making it a punishable offence.
 (a) True (b) False
17. If a bulk deal does not get reported on the stock exchange system due to the lapse of a broker but the information of such a trade is used by another broker to trade in the same scrip and make substantial gains, it amounts to insider trading.
 (a) Yes (b) No
18. A spot transaction is entered into for sale of 20% stake in a company at a significant premium to CMP. As soon as the deal is signed off between the parties, the company's management is informed about it. However, the stock exchange is not notified due to a communication gap. In the meantime, an institutional broker places a large buy order from his FPI client for the same scrip at the CMP and the deal is executed. In a subsequent proceeding, it is alleged that the FPI indulged in insider trading. The allegation is correct.
 (a) Yes (b) No
19. Insider trading is a capital market offence under which an investor uses UPSI obtained through private means for trading in the stock of the company in question provided he makes gains in the process. Losses do not constitute an offence.
 (a) Yes (b) No
20. In an insider trading prosecution, it is necessary to show that the accused is an insider possessing price sensitive information that was used for enhancing the profits of the company unfairly.
 (a) Yes (b) No
21. In the capital market, any exchange of UPSI is considered a punishable offence under Insider Trading Regulations if it pertains to a listed company.
 (a) Yes (b) No
22. An Indian investment bank proposes to introduce an IRS product to its HNI clients which is based on the movement of the floating interest rate curve. The client can swap a fixed rate contract to a floating rate contract and the net settlement is made periodically in shares of listed companies as per an approved basket. SEBI issues a show cause notice to the i-bank for initiating prosecution for having violated the SEBI law. The RBI sends another notice to the company stating that the derivative product is violative of RBI law. Decide.
 (a) Violative of SEBI law (b) Violative of RBI law
 (c) Violation under both laws (d) Permissible under both laws

For answers refer to Appendix B at the end of the book.

5 Evolution of Investment Banking

LEARNING OUTCOMES

- The world of global and Indian investment banking industry. The historical growth and evolution of this industry into a diversified global financial service.
- The era of the Glass Steagall Act in the US and the subsequent blurring of commercial banking and investment banking as separate businesses.
- Growth of universal banks and financial conglomerates globally and in India and the various models for integration.
- Detailed analysis of the Global Financial Crisis 2008 and the role attributable to investment banks therein.
- Regulatory changes in USA post 2008 pertaining to the investment banking industry.
- Conglomerate structure of Indian investment banking.

5.1 Concept and Definitions

In a very broad perspective, *Investment Banking* as the term suggests, is concerned with the primary function of assisting the capital market in its function of capital intermediation, i.e. the movement of financial resources from those who have them (the Investors) to those who need to make use of them for generating GDP (the Issuers). At the macro level, banks and financial institutions on one hand, and the capital market on the other, are the two broad platforms of institutional intermediation for capital flows in the economy. Therefore, it can be inferred that investment banks are the counterparts of banks in the capital market in discharging the critical function of pooling and allocation of capital. Nevertheless, it would be unfair to conclude so, as that would confine investment banking to a very narrow sphere of its activities in the contemporary world of global finance. Over the decades, backed by evolution and fuelled by technological developments, investment banking has transformed time and again to suit the needs of the finance community to become the most vibrant and exciting segment of financial services. Investment bankers have always enjoyed celebrity status, but at times, have paid the price for excessive flamboyance as well.

The Dictionary of Banking and Finance[1] defines *investment bank* as a term used in the US to mean *a bank which deals with the underwriting of new issues and advises corporations on their financial affairs*. The equivalent term in UK for such function is *Issue House*. This definition obviously captures the core activity of an investment bank pertaining to capital market floatations and financial advisory service to corporations. It does not, however, throw a pointer towards the evolution of investment banks as global one-stop financial shops. A broader definition is provided by *Bloomberg* which defines an investment bank as a *financial intermediary that performs a variety of services, including aiding in the sale of securities, facilitating mergers and other corporate re-organisations, acting as brokers to both individual and institutional clients and trading for its own account.* This definition captures several functions of an investment bank though it still does not capture all of them.

In keeping with the ever-expanding trend of the investment banking industry, in the words of John F. Marshall and M.E. Ellis, "*Investment banking is what investment banks do.*"[2] This definition can be explained in the context of how investment banks have evolved in their functionality and how history and regulatory interventions have shaped such evolution. Much of investment banking in its present form owes its origins to the financial markets in USA, due to which, American investment banks have been leaders in the American and Euro markets as well. Therefore, the term *investment banking* can arguably be said to be of American origin.

5.1.1 Merchant Banking

At this stage, it would be necessary, for the purpose of a conceptual discussion on the subject, to draw a fine line of distinction between the two terms *investment banking* and *merchant banking*.

The Dictionary of Banking and Finance defines a merchant bank as "*a bank which arranges loans to companies, deals in international finance, buys and sells shares and launches new companies on the stock exchange, but does not provide normal banking services to the general public.*" This definition connotes that merchant banking is a service-oriented activity consisting of arranging finance and trading in shares and helps to launch new stock issuances. There is also another important connotation in the above definition that merchant banking does not include commercial banking, i.e. accepting demand deposits and making loans and advances. This is because, historically, USA always maintained a compartmental approach between commercial banking and investment banking. This aspect has been dealt with in subsequent paragraphs of this chapter.

The second definition of merchant banking is again of US origin that emanates from the fund-based activity of US investment banks. "*Merchant banking is the activity of making direct investments of the investment bank's own funds in some asset not directly related to the investment bank's traditional business*". Thus, when an investment bank takes own exposure to securities (in addition to its underwriting obligations), it constitutes merchant banking. Included in merchant banking would also be investments adjunct to transactions such as buy-outs and acquisitions wherein the investment bank is primarily an advisor. These investments go beyond the realm of core investment banking and are as such described as merchant banking. Therefore, it can be said that merchant banking is an umbrella term that describes investment of its own funds by an investment bank in outside businesses and the monitoring and sale of such investments. However, this connotation of merchant banking has to be differentiated from proprietary trading, i.e. trading in securities in the secondary market by the investment bank on its own account. The US connotation of *merchant banking* is, therefore, that of a fund-based risk oriented business which is an integral part of the wider term *investment banking*.

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[1]The Dictionary of Banking and Finance, P.H. Collin, Bloomsbury Publishing, London.

[2]Investment Banking and Brokerage by John F. Marshall and M.E. Ellis, Probus Publishing.

According to Bloomberg, the term ‘merchant banking’ is “*a British term for a bank that specialises not in lending out of its own funds but in providing various financial services such as accepting bills arising out of trade, underwriting new issues and providing advice on acquisitions, mergers, foreign exchange, portfolio management etc.”* This service connotation of merchant banking in the UK is based on the historic evolution capital market activity in that region. Investment banking in the UK was referred to as *merchant banking* since it had confined itself largely to securities marketing and capital market intermediation until the US investment banks entered UK and the European markets and extended the scope of such businesses.

The fourth definition of the term *merchant banking* can be drawn from the law and regulation concerning investment banking in India. In India, as per the SEBI (Merchant Bankers) Rules, 1992 a merchant banker is defined as “*any person who is engaged in the business of issue management either by making arrangements regarding selling, buying or subscribing to securities or acting as manager, consultant, adviser or rendering corporate advisory service in relation to such issue management.”*Therefore, in India, the term *merchant banking* connotes *issue management* of various types provided under law and activities connected therewith. Hence, this connotation is more in the lines of the UK connotation of *issue house*. It consists of assisting issuers to raise capital by placement of securities issued by them with investors. However, merchant banking is not merely about marketing of securities in an agency capacity. The merchant banker has onerous responsibility towards the investors who invest in such securities. The regulatory authorities require the merchant banking firms to promote quality issues, maintain integrity and ensure compliance with the law on own account and on behalf of the issuers as well. In India, the merchant banker leading a public offer is called the *Lead Manager*.

From the above discussion, it has to be understood that the term *merchant banking* has different connotations in the US and other markets. In the US market, it is a fund-based activity. In UK and in India, it predominantly connotes intermediation and advisory activity in connection with public floatations of securities. However, it is clear that *investment banking* is a term of wider import describing a range of fund-based and fee-based capital market activities performed by investment banks. *Merchant banking* is a term of much narrower import defining either a fund-based activity (as in the US Market) or a predominantly fee-based service concerning largely with issue management and activities connected therewith (as in the UK and Indian markets).

In conclusion, in the present globalised era, the term *investment banking* is understood to mean both fund based and fee based activity and the term *merchant banking* is understood as its British equivalent. In India, investment banking is well understood to mean its global connotation and merchant banking is understood to mean the statutory role of an investment bank under SEBI regulations.

5.2 Evolution of American Investment Banks

The earliest events that are relevant for this discussion can be traced to the end of World War I, by which time, commercial banks in the USA were preparing for an economic recovery and consequently, to the significant demand for corporate finance. It was expected that American companies would shift their dependence from commercial banks to the stock and bond markets wherein funds were available at lower cost and for longer periods of time. In preparation for a boom in the capital markets in the 1920s, commercial banks started to acquire stock broking businesses in a bid to have a presence in such markets. The first such acquisition happened when the National City Bank of New York acquired Halsey Stuart and Company in 1916. As in the past, in the entire 1920s, investment banking meant underwriting and distribution of securities.

The stock and bond market boom of the 1920s was an opportunity that banks could not miss. But since they could not underwrite and sell securities directly, they owned security affiliates through holding companies. However, the compartments were not maintained in a water-tight fashion. The affiliates were thinly capitalised and were financed by the parent banks for their underwriting and other business obligations. While the boom lasted, investment banking affiliates made huge profits as underwriting fees, especially in the segment called *Yankee Bonds*, issued by overseas issuers in US market. In the stock market, the banks mainly conducted broking operations through their subsidiaries and lent margin money to customers. But with the passage of the McFadden Act in 1927, bank subsidiaries began underwriting stock issues as well. National City Bank, Chase Bank, Morgan and Bank of America were the most aggressive banks at that time.

The stock market got over-heated with investment banks borrowing money from the parent banks in order to speculate in the bank's stocks, mostly for short selling. Once the general public joined the frenzy, the price-earnings ratios reached absurd limits and the bubble eventually burst in October 1929, wiping out millions of dollars of bank depositors' funds and bringing down with it banks such as the Bank of United States.

5.2.1 Regulation of the Industry

In order to restore confidence in the banking and financial system, several legislative measures were proposed, which eventually led to the passage of the Banking Act 1933 (popularly known as the *Glass-Steagall Act*) that restricted commercial banks from engaging in securities underwriting and taking positions or acting as agents for others in securities transactions. These activities were segregated as the exclusive domain of investment banks. On the other hand, investment banks were barred from deposit taking and corporate lending, which were considered the exclusive business of commercial banks. The Act, thus, provided water-tight compartments that were non-existent earlier. Since the passage of this Act, investment banking became narrowly defined as the basket of financial services associated with the floatation of corporate securities, i.e. the creation of primary market for securities. It was also extended to mean at a second level, secondary market making through securities dealing. The only exception was with respect to the issue of commercial paper by corporations to finance their working capital requirements. Although such paper competes directly with short-term loans from banks, investment banks had the freedom to facilitate the issuance of such securities and to subscribe to such issues as well. The main concern of the regulators at that time was the inherent risk of capital market investments and exposure of investment banks to such risk. Therefore, the regulators perceived a conflict of interest between commercial banking that raised deposits from risk-averse depositors and investment banking that operated on a medium to high-risk model. It was also perceived that breaking up large universal banks such as J.P. Morgan would eventually lead to specialised institutions in the respective areas of the loan and securities markets.

By 1935, investment banking became one of the most heavily regulated industries in USA. The Securities Act, 1933 provided for the first time the preparation of offer documents and registration of new securities with the federal government. The Securities Exchange Act, 1934 led to the establishment of the Securities Exchange Commission. The Maloney Act of 1938 led to the formation of the NASDAQ, the Investment Company Act, 1940, brought mutual funds within the regulatory ambit and the Investment Advisers Act, 1940, regulated the business of investment advisers and wealth managers. Due to the strict regulation against universal banking, there were break-ups in large banks such as J.P. Morgan. Subsequent to the passage of the Glass-Steagall Act, a splinter group from J.P. Morgan set up Morgan Stanley investment bank while J.P. Morgan itself continued as a commercial bank.

In the post-Glass Steagall scheme of things, companies mostly raised short-term debt from commercial banks and looked for long-term financing from the capital market. Commercial banks had explicit federal deposit insurance, i.e. a government guarantee on their deposits for the safety of the deposit holders. Due to this reason, commercial banks were very tightly regulated by the US Federal Reserve. On the contrary, investment banks in that era were intermediaries for bond and equity floatations in the capital market. Therefore, there was very little need for large investment banks until after 1981. To that extent, the affairs of investment banks were less regulated though they had to licence themselves with the SEC.

Until the beginning of the 1970s, almost all investment banking firms were private partnerships, generally with a limited capital base. When there was a need to underwrite large securities issuances, these partnerships almost always formed underwriting syndicates, in order to meet regulatory capital requirements, distribute the securities and share the risk. In that era, investment banking was based on *relationship banking* with clients of which one of the architects was Sidney Weinberg of Goldman Sachs. In the late 1970s, the investment banking industry began to change to tilt towards *transactional banking* a la Morgan Stanley, where companies started to use different investment bankers for different services, on a need-to-know basis. Due to this reason, investment banks began to grow in size and scope, largely through mergers and most of the larger firms converted to listed corporations. A reason for the increase in size of investment banking firms was also the increased importance of information technology, with large investments and fixed costs. With their new-found large capital bases and distribution channels, the historical rationale for forming syndicates to distribute securities largely disappeared. Consistent with this, the number of investment banking firms participating in a given syndicate also shrunk noticeably in the subsequent decades.

5.3 Birth of American Universal Banks

5.3.1 Historical Reasons

In the post-Glass-Steagall Act era beginning from the 1930s, until the beginning of the 21st century, investment banking had been through several phases of transformation, which had broken down the water-tight compartments to a great extent. According to an estimate, the American economy grew at an average inflation adjusted rate of 4% per annum between 1947 and 1973. In order to support this prosperous phase of growth, initially, large banks used *bank holding companies* to skirt the regulations and ensure inter-state banking and buy savings and loan companies (a separate category catering to households). The Bank Holding Company Act, 1956 increased regulation of bank holding companies and inter-state banking. Other legislations followed such as the Truth in Lending Act, 1968 and Fair Credit Reporting Act,1970 by which the government ensured that banks were tightly controlled until 1973 and did not enter investment banking.

Due to the 1973 Arab oil embargo, world economies were under pressure and inflation and interest rate volatility became disturbing. It was at this time that institutional investors made their advent into securities markets. It was also the time when the industrial and financial service sectors were beginning to expand and globalise. The venture capital industry and the hedge fund industry also started taking definitive shape by this time. Due to these developments, investment banking and commercial banking once again became constrained by the very legislation that was meant to clean up the system in the 1930s. This led to several relaxations over the years such as the Securities Acts Amendments, 1975 that permitted commercial banks to have subsidiaries (called Section 20 subsidiaries) that were allowed to underwrite and trade in securities. In 1990, J.P. Morgan was the first bank to open a Section-20 subsidiary. Since the Glass-Steagall Act did not apply to foreign subsidiaries of US banks, they continued to underwrite in the Eurobond market and by 1984, they had a 52% market share in that business. But there was stiff competition from Japanese banks in this market and by 1987; they underwrote only 25% of the Eurobond issuances.

5.3.2 Consolidation Era

During the economic growth and globalisation of the late 1970s and 1980s successive governments promoted de-regulation of financial services. The first major de-regulation was in the area of fixed commissions on Wall Street. The emergence of large institutional investors such as mutual and pension funds gave rise to demands for lower commissions on their large trades. Responding to this call, the SEC directed and the NYSE obliged to eliminate fixed commissions on Wall Street in 1975. This led to a shake-out in the industry and the smaller partnership firms either folded up or got acquired by the larger investment banks. On the banking front, winds of change were sweeping the commercial banks and the Savings and Loan companies (S&Ls) due to high inflationary pressures in the 1970s. The government, thus, allowed free interest rate regime allowing banks to compete with the S&Ls. The S&Ls were also allowed to expand from home loan mortgage business into other riskier sectors of financial businesses such as investments.

5.3.3 Financial Engineering

The changes happening in the financial sector also coincided with the arrival of academic finance professionals into investment banking who were trained in quantitative finance. Academic finance and research pioneered by economists such as Franco Modigliani, Merton Miller, Fischer Black, Myron Scholes, Robert Merton, Harry Markowitz and others brought sophisticated mathematical and statistical tools to the theory of finance and risk pricing and evaluation. While the Modigliani and Miller theory on capital structure stimulated thought on leveraging and increased the appetite of American companies for debt, the Black-Scholes model enabled risk pricing and gave birth to several structured products in financial markets. New methods to evaluate product pricing based on associated risk led to the growth of arbitrage trading and derivatives. The Efficient Market Hypothesis of the 1970s led the regulators to believe that markets should be allowed to function largely on their own and that asset prices would be taken care of through market mechanisms. The international financial institutions were also advocating the doctrine of free capital flows across economies (especially for those in the developing countries) and increased deregulation of markets. This shift in political and regulatory thinking resulted in deregulation of markets, disinvestment of several public sector undertakings and opening up of the financial sector. Similar trends were seen in UK and Europe at that time under various political regimes. In the USA, the advocates of de-regulation in financial sector also started to occupy important positions in the government, the Federal Reserve and as heads of the big commercial and investment banks such as Donald Regan, the then CEO of Merrill Lynch who was later on the treasury secretary in the government. The first major de-regulation of the financial sector happened in 1982 by de-regulating the S&L sector and allowed inter-state banking more freely. Later on, came the mortgage backed securities. Many years prior to it in 1968, Ginnie Mae, a federal agency had initiated the process of securitising mortgages which were guaranteed by it. The Secondary Market Enhancement Act, 1984, facilitated easier tax and inter-state provisions on securitisation deals which was carried forward by the Tax Reform Act, 1986, which led to the introduction of *Real Estate Mortgage Investment Conduit (REMIC)* that fostered the growth of mortgage backed securities. The spread of mortgage backed securities brought the commercial banks and the S&Ls closer to investment banks and capital markets. However, efforts to break down the Glass Steagall Act in the 1980s did not materialise. The S&L crisis in the 1980s and the stock market crash of 1987 once again brought the focus back to core areas of specialisation. Similarly, the ambitious expansion of investment banks on a global scale was also halted to some extent till the 1990s. The crisis in the banking and S&L sectors saw thousands of them shutting down between 1985 and 1992.

5.3.4 Expansion of Business

Investment banks were quick to cash in on the transformation sweeping the financial sector. In later part of the 1970s and 1980s, investment banks started to grow in size and product diversity and transformed from mere financial intermediaries into fund houses with enormous risk taking capabilities. It was in the mid 80s that the new breed of investment bankers pioneered by Salomon Brothers entered Wall Street. These were swashbuckling, risk-taking bond traders and financial engineers with a background in quantitative finance who designed new products for sophisticated derivative trading. The entry of these newly qualified quantitative financial brains into investment banking resulted in its expansion into several new areas and services which included derivatives, securitisation and structured products. The strategy was to take large risks on proprietary account rather than merely providing fee-based services or executing deals for clients.

5.3.5 Deregulation and Globalisation

The collapse of the Soviet Union in 1989 once again provided the momentum for free market policy making in the US and by then the winds of liberalisation were blowing heavily in favour of financial sector deregulation. The important technological advancement and information and communication technology revolution in the 1990s fuelled once again the global growth of financial sector in general and investment banks in particular.

By late 1990s, the shift in the investment banking industry was towards providing expertise in new products and sophisticated techniques for structured financial deal making and managing risks. Apart from these activities, investment banking extended considerable spectrum of advisory services in the areas of corporate restructuring, mergers and acquisitions and LBOs[3], fund raising and private equity. On the dealing and trading side, investment banks emerged with significant presence in derivatives market, arbitrage and speculation in which they held large positions themselves; often financed through leverage. In structured finance, investment banks also provided financial engineering through securitisation deals and derivative instruments.[4] By the turn of the century, investment banking had grown much beyond the traditional areas of underwriting new issuances and security dealing, thus, giving birth to the huge behemoths of the investment banking industry. Earning huge fee and investment income, these banks became formidable forces in the financial sector and the economy as a whole with the result that Wall Street wielded considerable influence on policy makers by the 1990s.

Considering the archaic objectives of the Glass Steagall Act and its subsequent dilution over the decades, it was finally repealed and replaced by the Financial Modernisation (Gramm-Leach-Bliley) Act of 1999 on November 12, 1999. This Act removed the anti-affiliation restrictions among commercial banks, investment banks and insurance companies including the restriction that bank holding companies cannot own other financial businesses. Therefore, it was now possible to create financial conglomerates having banking and other financial businesses under the common ownership of a bank and financial holding company.

5.3.6 Conglomerisation

One of the first mega institution created after the de-regulation was Salomon Smith Barney, formed by the merger of two investment banks, Salomon Brothers and Smith Barney. Similarly, Citibank which was the largest commercial bank and Travelers, an insurance company, merged to form Citigroup. Travelers was a part of the Sandy Weill group consisting of Commercial Credit, Primerica and Salomon Smith Barney. All these were brought together in Citigroup to form the globally largest universal bank. Though the Citigroup merger happened in 1998 when the Glass Steagall Act was still in existence, its subsequent repeal ensured that Citigroup was not broken up thereafter. J.P. Morgan Chase was the product of mergers between Chemical Bank, Manufacturers Hanover, Chase Manhattan, J.P. Morgan, Bank One and First Chicago with all these mergers happening after 1991. J.P. Morgan also acquired Jardine Fleming, a Hong Kong based global investment bank in 2000. Large banking groups like Citigroup and J.P. Morgan expanded the influence of the universal banking system and by 2007, the commercial banking segment held $11.8 trillion in assets which amounted to 84% of the US GDP at that time. On the investment banking side, by 2007, investment banking industry accounted for 22% of US GDP overall and held $3.1 trillion in assets. The growing influence was

[3]LBOs are discussed in Chapter 16.

[4]Securitisation and Structured Products are discussed in Chapter 3.

also helped by the growth in the financial economy as compared to the real economy, i.e. for every dollar financing the real economy, there were many dollars of financial transactions generated by investment banks in the securities markets. J.P. Morgan was the biggest US bank by latest estimates.

The prominent US based investment banks and universal banks prior to the global financial crisis of 2008 are listed in Table 5.1.

Table 5.1 Prominent US based Investment Banks in 2007

Goldman Sachs#
Morgan Stanley Dean Witter#
Merrill Lynch & Company#
Lehman Brothers#
Bear, Sterns & Company#
Salomon Smith Barney (Citigroup)**
J.P. Morgan Chase**
Bank of America**
Wells Fargo**
Washington Mutual Bank**
Wachovia (First Union– Wachovia)**
Pure Investment Banks ** Universal Banks which were the largest commercial banks in US at that time that had significant investment banking presence as well.

5.4 The US Investment Bank Crisis in 2008

The investment banking crisis in the US in 2008 triggered a global financial crisis which led to closure and bail out of several banks, *quantitative easing* of trillions of dollars by the US Federal Reserve, the Bank of England and the ECB and led to a global recessionary phase for several years, thereafter, resulting in lower employment generation and GDP growth across nations. The genesis of the crisis was unarguably in the US financial system. As explained in the previous discussion, the 1980s and 90s saw the emergence of a powerful Wall Street with tremendous influence on US regulators and policy makers. The de-regulation and subsequent repeal of the Glass Steagall Act meant a free regime both for investment banks and commercial banks. This phase coincided with the introduction and growth of complex structured products in the market that blurred the applicability of regulatory controls and capital adequacy norms for several leading investment banks. On their part, commercial banks turned universal banks with significant presence in origination and dealing in securitisation and mortgage backed securities. The increasing influence of bankers also meant that the financial sector saw tremendous growth driven by fat pay packets and astronomical bonuses in millions of dollars to investment bankers which further fuelled the Wall Street culture of leveraging and risk taking. A career on Wall Street became synonymous with cowboy adventurism that provided the thrill of being rich, famous, flamboyant and arrogant. Despite the fall of rogue bankers and traders like Michael Milken and Ivan Boesky, there was little restraint imposed by the government, SEC or the Federal Reserve that could have prevented bankers from excessive risk-taking and leveraging. On the contrary, from 2003 onwards until the collapse in 2008, the financial economy headed by the big universal banks and Wall Street investment banks led the real economy. This can be measured from the fact that in 2002 the global market cap was $22.83 trillion which rose almost three-fold to $60.84 trillion by 2007. During this phase, the global GDP rose from $33.1 trillion to $61.1 trillion, a growth of about 85%. Global market cap had almost equalled global GDP by 2007. This phenomenon is largely attributed to excessive credit creation by banks and mindless manufacture of derivative products by the investment banks therefrom.

5.4.1 The Origins

Through the late 1980s and 1990s, the US Federal Reserve followed an easy money policy which began with injecting liquidity to pull the stock market out of its 23 percent fall on the black Monday, October 19, 1987 due to the South-east Asian crisis. The decade, thereafter, saw interest rate cuts and market friendly policies which was justified by high GDP growth and falling unemployment. This economic environment prompted the belief that market mechanisms were sacrosanct and that regulatory intervention would be required only when there were asset bubbles or high inflation. It was perceived at that time even by the government that a sophisticated and unrestrained financial sector would be in the overall good of economic growth. Since the Federal Reserve was the most important financial regulatory authority in the US, a hands-off regulatory policy by it meant that Wall Street could put the easy economic liquidity to work to produce astronomical growth in financial markets. The derivative market which originated and prospered during this era provided one of the key growth engines for this phenomenon. Financial product innovation, thus, became the growth mantra of Wall Street and the new chapter in America's march towards global leadership. Central bankers led by Alan Greenspan, the then Chairman of the US Federal Reserve and Tim Geithner, the then President of the Federal Reserve Bank of New York endorsed product innovation and derivatives as products of risk dissipation in the financial markets and therefore, healthy for their growth and well-being.

The above said climate of Wall Street at that time coincided with a parallel phenomenon that had its beginnings in the liberal housing policy pursued by US administrators in the preceding decades. The government had a favourable fiscal policy to promote home ownership as well by way of tax deductions and providing home loans through government owned mortgage lenders, i.e. Government National Mortgage Association (Ginnie Mae), Federal National Mortgage Association (Fannie Mae) and Federal Home Loan Mortgage Corporation (Freddie Mac). Since 1934, the US government floated these national agencies for promoting the home ownerships in the US. These state agencies and the other players in the S&L industry helped the home loans and mortgage sector to grow significantly in the 1970s. The sector suffered an implosion and severe setbacks in 1980s but began to grow strongly, thereafter, due to the sub-prime lending boom that was to happen in the 1990s and 2000s.

5.4.2 Sub-Prime Lending

Sub-prime lending was a market practice that began in the 1990s in the home loan market largely to propel the growth of mortgage lenders. Prior to it, mortgages were long-term, fixed rate *prime mortgages* in which the lender's due diligence standards, the borrower's credit-worthiness and security for the loan in terms of asset mortgage were sacrosanct. In contrast, sub-prime loans were those in which one or more of these criteria are diluted. Therefore, either the loan will either have a higher *loan-to-value (LTV)* ratio (of more than 75-80%), lesser servicing capacity than normally acceptable or poor track record of the borrower. Sometimes, proper documentary evidence to establish proof of income is also dispensed with (known as *Alt-A loans*). In 1993, there were only 24,000 sub-prime mortgages as compared to 2.2 million prime mortgage loans. In addition, sub-prime loans had to conform to underwriting standards and were used primarily to refinance prime mortgages for borrowers who were in default but had the capacity to repay. Sub-prime loans in those days were made mainly by non-bank mortgage lending companies who did not have recourse to public deposits.

Sub-Prime Mortgages and Securitisation

Though securitisation existed for several decades prior to 1990s and as mentioned earlier, the first mortgage backed securitisation was done by Ginnie Mae in 1968, it was only in the 1990s and 2000s that the process of securitisation became all pervasive in mortgage loans with the introduction of Collateralised *Debt Obligation (CDO)*.[5] Through this process, the lender could package mortgage backed securities (CDOs) with sub-prime loans as the underlying assets and sell them to capital market investors such as mutual funds, hedge funds, pension funds and insurance companies by using investment banks as the intermediaries. Since risk was now getting dissipated by reselling sub-prime loans to Wall Street, mortgage lending became a fee driven business where volume was key to profits. The original *mortgage backed securities* created by Ginnie Mae were *pass-through securities* while the CDOs in 1990s and 2000s were *pay through securities* which were often provided credit enhancements credit guarantee mechanisms that ensured that they would get prime structured credit rating.[6]

In later years, especially from 2003, sub-prime loans became increasingly being used to push credit into the market due to the close linkages developed by mortgage lenders with investment banks through the process of securitisation. In order to make mortgage loans attractive, their sub-prime versions required no down payment by borrowers, ballooning repayment structure (instead of an EMI) and ballooning rates of interest. When these loans had principal defaults, these were funded by the banks to show repayments. Such funded components known as *negative amortisation income* was credited to the income statements and accordingly, the principal defaults were covered up. By 2006, it was estimated that sub-prime and Alt-A mortgages accounted for about 40% of the mortgage loan market. This was a twenty-fold increase from 1993. It no longer mattered to the lender whether a borrower would repay a mortgage or not. Lenders were making their fee income originating mortgage loans and earned more fee through refinancing and ever-greening such loans or by parcelling them into CDOs with the help of investment bankers. On their part, investment bankers made their fee income originating securitisation deals and wanted the lenders to keep feeding them with mortgage loans continuously so as to keep their securitisation business working.

The healthy growth of the economy in the 1990s and 2000s held housing prices high and kept the ball rolling for sub-prime loans and CDOs due to the high value of the underlying collaterals. Coupled with it, sub-prime borrowers paid higher interest rates than prime borrowers; due to which CDOs of sub-primes had higher yields as compared to CDOs of prime mortgages. When they were repackaged with credit enhancements, the sub-prime CDOs managed AAA ratings due to which investors picked them up for their higher yields not worried about the underlying risk of low quality mortgages they carried.

Credit Default Swaps and Synthetic CDOs[7]

As mentioned in Chapter 4, the global CDS market grew to more than $60 trillion by 2007 just before the financial crisis from less than a trillion in 2001. With increased sophistication, the US market started trading in *synthetic CDO*, i.e. CDOs that are unrepresented by underlying bonds or loans but are based on underlying CDS contracts. A synthetic CDO results when the buyer of a CDO invests not in the cash flow of an underlying debt security but in a CDS which results in cash flow only when there is an event of default. Therefore, such investor has no *locus standi* in the debt contract in question but is merely taking a bet on a borrower defaulting on its repayment obligations. With the result, the amount outstanding on CDS contracts on a particular loan or bond could far exceed the actual loan or bond amount outstanding since there is no limit to how many CDSs can be issued against a particular debt obligation to create synthetic CDOs. This

[5]Refer to Chapter 3
[6]ibid for conceptual discussion
[7]These derivative structures are discussed at length in Chapter 3

phenomenon explains the explosive growth of the CDS market in the years running upto the financial crisis. When the outstanding CDS on a particular loan exceeds the loan defaulted, the market uses an auction system (known as *protocols*) under which the CDS holders receive far less than the face value of the CDS. After 2005, the demand from investors in Wall Street and the investment banks for sub-prime loans far outstripped supply and the gap was filled predominantly through synthetic CDOs.

5.4.3 The Contagion Risk

As enumerated in the discussion above, the tremendous growth witnessed in the US financial sector in the 2000s was largely due to the explosion of sub-prime mortgages, securitisation of such mortgages into CDOs and the rampant use of synthetic CDSs. These products working in tandem closely knit the commercial banks and S&L sector with investment banking in the post Glass Steagall era. A further integration with the insurance industry became a reality as well when the American International Group (AIG) began to insure AAA rated structured products for negligible premia. Most of the AAA rated CDO issues of J.P. Morgan were insured by AIG which was perceived as insulation of risks for J.P. Morgan and free premium income for AIG. On the regulatory front, most of the CDO deals were privately placed with institutional investors including hedge funds. Therefore, these products had limited oversight from the SEC. Sub-prime loans were not regulated adequately by the Federal Reserve even though their existence had crossed reasonable proportions. CDS transactions were OTC products and therefore, received very less attention from both the regulators. CDSs are not traded on an exchange and there is also no requirement reporting of transactions to a government agency in developed countries. However, the systemic risk of contagion triggered by default from protection seller in a CDS can be devastating. This is because the CDS becomes a chain of derivative contracts in the market and may lead to unknown concentration of risks among participants. It is also argued that CDS can be misused to force bankruptcy of entities within a system for windfall gains to a few speculators. This inherent risk of enforced bankruptcy coupled with the lack of transparency that is characteristic of an OTC product makes the CDS a sure recipe for systemic disaster.

Since the Federal Reserve followed an easy money policy with low interest rates, leveraging became a very attractive option to finance investments into sub-prime derivatives. Most of the institutional investors were borrowing funds within US and from cheap markets such as Japan and Switzerland and investing them in the sub-prime securitised products. Investment banks such as Bear Sterns, Lehman and other market leaders not only originated securitisation and CDS products but also heavily invested in them through the market. They borrowed short-term funds through commercial paper and repo deals on a daily basis. Since the housing prices remained buoyant during 1997-2004 due to low interest rates, the asset bubble helped to perceive no risk at all from investing in this business. As a result, the risk was not fully priced and the yields from securitised instruments backed up by CDSs were very attractive. The asset bubble in the housing sector was accompanied by bubbles in the commercial real estate space, due to which other structured products such as REITs became extremely prominent as well.

Gradually, the financial market had integrated to such an extent that the same products that bore a credit risk for the commercial banking and lending industry were being redistributed in the financial markets with a manifold increase in volume terms, i.e. for every loan transacted, there were financial securities and structured derivatives being generated many times over. During the frenzy in the markets after 2001, since most of these products were based on sub-prime loans, the contagion risk became all pervasive across all sectors of the financial economy.

The maximum risk in the system at that point of time was being borne by investment banks. In the US, investment banks are particularly vulnerable to any credit-market turmoil, because they rely on funding not from depositors but from the capital and money markets, much of it through short-term debt. A major part of the short-term financing happens through the repo trade market in which dealers sell securities to investors then buy them back the next day for slightly more, with the difference being the interest. Globally, the repo market was at $4.5 trillion in 2008. The other significant source of short-term financing for investment banks is commercial paper. Therefore, among all financial sector participants, the biggest potential casualties of a crisis were the investment banks with the highest degree of *liquidity risk* on their balance sheets.

5.4.4 The Sub-Prime Default Crisis

As explained above, the financial sector in the US had reached a precipice of systemic risk that would spread across the system when disaster would strike. The trigger for such a catastrophe began to become visible when the macroeconomic fundamentals of the US economy began to change. The dotcom bubble and 9/11 tragedy prompted the Federal Reserve to pump liquidity to stimulate the economy. But later events such as the Iraq War started to put strain on the economy with inflationary trends rising after 2002. Due to persistent inflation, the Federal Reserve had to abandon its easy money policy under which the Fed rate was at 1% until 2003. Interest rates were gradually increased to curb inflation and by 2006, the Fed rate crossed the benchmark of 5%. This increased the servicing cost of housing loans which in turn had an effect on new home loans and purchases. The housing bubble began to show a correction and asset prices began to fall. The increased servicing cost also meant that sub-prime borrowers found it difficult to service their mortgage loans and began to default.

So, on one hand, while defaults began to spread, the asset securities backing the mortgages began to depreciate in value leaving many mortgages uncovered for default risk. The entire spectrum of securitised instruments and credit derivatives built upon such mortgages began to become 'toxic' (unrepresented in value terms). The contagion risk as explained above ensured that the toxicity spread to the entire financial sector including commercial banks, investment banks, insurance firms and institutional investors. As the news of the spreading default crisis broke out, it led to a seizure in the system and funds began to dry up. As liquidity in the system got choked, investment banks that were heavily leveraged on a short-term basis and holding toxic assets against them were the first hit. When the asset prices fell, the leverage ratio of the investment banks increased overnight leading to a loss of confidence in the bank's balance sheet.

Furthermore, the contagion effect spread into the banking system as well. In addition, since most US market investors are spread across the globe, several banks and other institutional investors across the globe were affected by the crisis in the US financial system. Banks in Iceland, UK, Germany, Switzerland and Japan were most severely affected due to their exposures to US sub-prime mortgages and derivatives. This led to the coining of the term *global financial crisis of 2008*. The exponential growth in the global CDS market led to a huge systemic risk to the extent that the CDS became the single biggest contributor to the toxic assets carried by banks and financial institutions during the financial crisis of 2008. The most affected US institutions were Bear Sterns, Lehman Brothers, Merrill Lynch, Goldman Sachs, Citigroup, AIG, Washington Mutual, Wachovia, Freddie Mac and Fannie Mae.

5.4.5 US Regulatory Response to the Crisis

By September 2008, the US financial system had entered a vicious circle of falling asset prices, increased leverage of banks, drying up liquidity and loss of confidence. Only a government intervention could have helped the banks escape the death trap. As a regulatory response to the crisis, the US Federal Housing Finance Agency (FHFA) on September 7, 2008 announced the decision to place Fannie Mae and Freddie Mac into conservatorship run by the FHFA. Washington Mutual, which was the largest S&L lender at the time, was placed under receivership of the Federal Deposit Insurance Corporation, after it had a run on its deposits. It was the largest bank collapse in US history until then. Its banking assets were sold to J.P. Morgan.

The Federal Reserve Bank of New York forced a merger of Bear Sterns with J.P. Morgan Chase Bank (read case study below) and the US Federal Reserve forced a similar merger of Merrill Lynch with Bank of America (BoA). Merrill Lynch had to suffer severe write-downs on its toxic assets due to its exposure to the mortgage CDO business. Merrill Lynch got a better valuation from BoA at around 38% premium over its book value as compared to what Bear Stearns received from J.P. Morgan. Goldman Sachs had a bail out investment from Berkshire Hathaway, the investment firm of Warren Buffet. Morgan Stanley was the biggest recipient of emergency loans from the US Federal Reserve and the US Treasury. It also benefitted from capital provided by Tokyo based Mitsubishi UFJ Financial Group which, subsequently, became its biggest shareholder. Wachovia, the fourth largest bank holding company in US at that time and a universal bank, was bought over by Wells Fargo—universal bank and the fourth largest bank in USA.

AIG which was the largest US insurance company at thetime suffered a downgrade in its credit rating in September 2008 due to its insurance exposure to structured CDOs that were toxic. Its consequent liquidity crisis forced the Federal Reserve Bank of New York and the US Treasury (Government) to intervene and provide life support in exchange for a potential 79% stake for the Government in the form of convertible warrants. Effectively, AIG was nationalised at that time though it remains to be seen if that status would continue in future. The total bailout package for AIG consisted of loan and investment support as well as purchase of toxic assets and guarantees issued by AIG aggregating to around $182 billion. The bail out of AIG helped Merrill Lynch to recover some of its dues from AIG on its CDO portfolio.

Apart from individual bail outs of the large institutions, at the systemic level, the US Fed cut interest rates and extended lending through its discount window (usually reserved for commercial banks) for the first time to all bond dealers, thus, becoming a lender of last resort to investment banks. In addition, the Federal Reserve provided financial stimulus (which is known as *Quantitative Easing or QE*) by injecting liquidity into the banking system through direct purchase of their toxic assets which is different from normal open market purchases. The government on its part used tax payers' funds to purchase toxic assets from banks under the *Troubled Assets Relief Program (TARP)*. The QE purchases continued well after 2008 and in subsequent years, further doses of liquidity injection (known as QE2, QE3 etc.) were administered. The TARP programme originally estimated at $800b and subsequently, reduced to $475b due to regulatory reform ended more or less successfully and by the end of 2016, was very much in its last phase of winding down.

The biggest casualty of the US financial crisis was the collapse and eventual liquidation of Lehman Brothers, the fourth largest investment bank in the US at the time. Lehman's bankruptcy was the largest in US corporate history (read case analysis below). The week beginning September 14, 2008 was historic and unprecedented in US financial history. Lehman Brothers, Merrill Lynch and AIG were all declared troubled in those few days and a market catastrophe was averted only because the US Fed resorted to QE measures on September 18th. The large-scale bail outs notwithstanding, the financial crisis of 2008 claimed the existence of four top investment banks–Bear Sterns, Lehman Brothers, Merrill Lynch and Wachovia. The large-scale bail outs by the US Fed and the US Government led to the uprising among the common people against the use of tax payers' funds to protect the *Too-Big-To-Fail (TBTF)* institutions. While the government and the Fed argued that leaving the TBTF institutions to collapse would have triggered a larger global collapse of endemic proportions, several disenchanted critics and commoners blamed the excesses of Wall Street as reasons for the crisis and hence, demanded that tax payers' money should not be used to protect the guilty. These voices got organised in later years into a movement known as *Occupy Wall Street*. Demonstrations by these protestors were witnesses not only in the US but in UK and EU as well.

5.4.6 The Dodd-Frank Wall Street Reform and Consumer Protection Act 2010

In order to prevent another systemic crisis, the US law makers steered away from the pre-2008 regime of excessive reliance on the belief that market mechanisms are self-regulatory. The Dodd-Frank Wall Street

Reform and Consumer Protection Act 2010 which was passed in response to the US financial and investment bank crisis of 2008, provided for new or heightened regulation of a number of different areas of the financial services industry so as to promote the overall financial stability of the US economy. The Act identified and addressed the regulatory deficiencies that were noted in the U.S. financial regulatory framework following the 2008 financial crisis.

Broadly, the Dodd-Frank Act addressed the following areas of the financial system of the US:

- *Registration and Regulation of Private Fund Advisers:* The Act provided for compulsory registration of systemically important funds with the SEC with a threshold of $100 million of AUM. Such fund managers were prescribed periodic reporting requirements under the Act to the SEC/Commodities Futures Trading Commission.
- *New Regulatory Regime for the Derivatives Markets:* Prior to 2008, OTC derivatives were a largely unregulated area as already described in previous discussions. Under the Dodd-Frank Act, counterparties in a OTC derivative trading product such as banks, investment banks and insurance companies may be deemed a *swap dealer*, *security-based swap dealer*, *major swap participant* or *major security-based swap participant* and thus, be subject to registration with and comprehensive derivatives regulation by, the Commodity Futures Trading Commission (CFTC) for *swaps* and by the SEC for *security-based swaps*. For this purpose, commodity derivatives were called swaps and capital market derivatives were termed as *security-based swaps*. The Act imposed requirements both on dealers and participants in the OTC derivative markets.
  - The new regulatory regime under the Dodd-Frank Act also prescribed that most OTC derivative contracts which were settled bilaterally earlier, would be subject to *central clearing* mechanisms. A central clearing agency would be established to act as a central counterparty to remove individual counterparty credit risk and distribute risk among the clearing agency's participants that must satisfy the clearing agency's capital and margin requirements. By migrating most privately negotiated, bilateral contracts in the OTC market to central clearing and requiring real-time trade reporting, the Act aimed to allow the regulators to see the volume of contracts trading in the market, to assess the asset classes in play, to monitor derivatives trading data and thus, to oversee risk exposures and reduce systemic risk in the derivatives markets. These new requirements were also meant to provide market participants access to timely information on price and other derivatives trading data.
- *Addressing Systemic Stability:* Under the provisions of the Act, the Financial Stability Oversight Council (FSOC) was set up to monitor and maintain the stability of the US financial system and to facilitate coordination and information sharing among regulatory agencies. All systemically significant financial companies would be subject to monitoring by FSOC under the provisions of the Act.
- *Oversight of Credit Rating Agencies:* The Dodd-Frank Act established the Office of Credit Rating Agencies (OCRA), a new office housed within the Securities Exchange Commission (SEC). The objectives of OCRA included ensuring that credit ratings are not unduly influenced by conflicts of interest and promoting accuracy in credit ratings.
- *Regulation of TBTF Financial Conglomerates:* The Act added a new Section 13 to the Bank Holding Company Act of 1956 (BHC Act) that gave legislative effect to the proposals put forward by Paul Volcker, the former Federal Reserve Chairman (known as *Volcker's Rule*[8]). This section generally prohibits any banking entity from engaging in proprietary trading or from acquiring or retaining an ownership interest in, sponsoring, or having certain relationships with a hedge fund or private equity fund, subject to

[8]The Donald Trump administration announced reform of the Dodd Frank Act regime and the operation of the Volcker's Rule in order to provide more flexibility in the operations of investment banks whose profitability in some businesses diminished significantly after 2010. These reforms may provide scope for investment banks to reintroduce some of the market practices prevailing before 2008. Readers may keep abreast of these changes.

certain exemptions. It also provides for non-bank financial companies supervised by the Federal Reserve that engage in such activities or have such interests or relationships to be subject to additional capital requirements, quantitative limits, or other restrictions.

- The Act also requires large, complex financial companies to periodically submit their own *funeral plans* detailing their procedures for a rapid and orderly shutdown should the company undergo. Companies that fail to submit such plans will be penalised with higher capital requirements as well as restrictions on growth and activity. In order to address the public concerns on use of tax payer's money for bail outs of TBTF institutions, the Act makes clear that most large financial company failures are expected to be resolved through the bankruptcy process and not through bailouts using U.S. taxpayers' funds.

- *Reforms in Mortgage Lending:* The Act implemented a series of measures designed to reform and improve the laws regarding protection of mortgage borrowers and the mortgage lending system. Several curbs on sub-prime lending were introduced such as prohibition of a variety of financial incentives for sub-prime loans, pre-payment penalties on mortgage loans, balloon payments, negative amortisation, interest-only payments and other features.

Case Study

Bear Sterns

Bear Sterns at the time of its collapse in 2008 was the fifth largest investment bank in the US based in New York. Founded in 1923 by Joseph Bear, Robert Stearns and Harold Mayer, it was a full service pure investment bank engaged in all facets of capital market operations including derivatives and proprietary trading. It was also into associated areas such as asset management, risk advisory, foreign exchange trading and derivatives. It was listed in 1985. It was one of the most respected investment banks in the US for which it won recognition in 2005. Bear Sterns had extensive presence in the sub-prime derivatives market both on its investment banking balance sheet and its derivative hedge funds which were part of its asset management portfolio. The bank built up heavy leverage of 35:1 by 2007, most of it in short-term borrowings for its CDS and CDO exposures. Unlike its peers, Bear's mix of businesses was less diverse and it relied more heavily on overnight funding in repurchase or repo markets.

Bear's problems began in 2007 when it had to rescue one of its CDO hedge funds with a bailout of $3.2 billion. Two of its sub-prime hedge funds had lost all their value with exposures in subprime toxic assets. Gradually, its reputation and credit rating climbed down and by March 2008, rumours of its impending bankruptcy surfaced on Wall Street. Bear Sterns reached a crisis point on March 10 when its short-term financing through repo trades for overnight funds was also abruptly declined by lending commercial and investment banks leading to a complete dry up of its liquidity. At the time of its bankruptcy, Bear Sterns had outstanding positions in CDS and interest rate swaps exceeding $10 trillion making it a TBTF institution. TBTF institutions were perceived by the regulators and the government as vital to preserve public confidence in the financial system. Though Bear was the smallest of the largest five investment banks in the US, it had the maximum exposure to toxic mortgage assets and its collapse would have meant a domino effect on the financial system.

Upon its rescue appeal to the Federal Reserve Bank of New York on March 14, 2008, the Fed agreed to a rescue package subject to a merger of Bear Sterns with J.P. Morgan Chase through a *fire sale*at a price of $2 per share against its market price of around $93 per share in February 2008. After a class action suit was filed by Bear's shareholders, J.P. Morgan finally accepted to a negotiated price of $10 per share which was approved by them. This merger was a pre-condition by the Fed to finance a bail out non-recourse loan of $ 30 billion to J.P. Morgan against security of toxic assets of Bear Sterns. The Fed decided to have the deal structured this way rather than to bailout Bear Sterns directly, in which case, the Fed apprehended that the bailout could have been much higher. J.P. Morgan Chase completed its acquisition of Bear Stearns on May 30, 2008 at the renegotiated price. The merger kept out of its purview the associated funds managed by Bear Sterns which got rebranded as Irving Place capital and is presently an independent entity. This forced deal on J.P. Morgan and Bear Sterns remains highly controversial to this day and is widely perceived as a transgression of its own powers by the Federal Reserve Bank of New York.

However, the deal worked favourably for J.P. Morgan which was spearheaded by Jamie Dimon, its charismatic CEO who was the most influential banker in US at the time. J.P. Morgan's shares rose sharply the day after the takeover, even as other shares tumbled. According to analysts, the $14 billion added to its market cap was actually Bear Sterns's true worth. They valued Bear Sterns at a breakup value of $7.7 billion while the deal cost J.P. Morgan around $1.2 billion. However, J.P. Morgan claimed that the estimated hidden costs of the merger including outstanding law suits were around $6 billion.

Case Study

Lehman Brothers[9]

Lehman Brothers began as a general store set up by Henry Lehman, a German-Jewish immigrant in Montgomery, Alabama in 1844. In 1950, he was joined by brothers Emanuel and Mayer and they named the business Lehman Brothers. In the early days, the firm traded cotton for cash or merchandise becoming a broker for buying and selling of cotton. In 1858, Lehman opened an office in New York as it was the centre for commodity trading. The post-Civil War period witnessed the rapid growth of railways, thus,triggering the transformation of the nation from an agrarian to an industrial economy. Railroad bonds represented a significant advancement in the development of capital markets and attracted a great number of individual investors. Lehman Brothers responded by expanding its business to include securities. The firm also moved into the area of financial advisory, which provided the foundation for underwriting business in future.

During the rapid economic growth of the 19th century, Lehman Brothers entered merchant banking. Building the securities trading business further, the firm became a member of the New York Stock Exchange in 1887 and underwrote its first stock offering in 1889. In the 1920s, Lehman was a major partner to the consumer industries of the US helping them to raise finance and grow. Triggered by the stock market crash of 1929, Lehman was one of the pioneers of innovative financing techniques such as private placements, arranging loans between blue-chip borrowers and private lenders. When the US government forced financial institutions to choose between commercial banking and investment banking in the wake of the Glass Steagall Act, Lehman opted to remain a pure investment bank.

The end of World War II spelt an unprecedented era of growth for the US economy and Lehman Brothers once again became an important financial advisor and underwriter for many growing companies. By the 1960s and 1970s, many of Lehman Brothers' clients were expanding overseas. To meet their financial requirements, Lehman opened an office in Paris in 1960, followed by London in 1972 and Tokyo in 1973. Its international presence was also helped through inorganic growth by the merger with Kuhn, Loeb and other firms with itself. During the M&A wave of the 1980s, Lehman was advisor to several leading companies such as Chrysler, American Motors, General Foods, Philip Morris and Hoffman-La Roche.

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[9]This case analysis partly includes some of the observations made about Lehman Brothers by the Financial Times, London.

In 1984, following a bitter internal power struggle in Lehman, it was acquired by American Express Bank which merged the firm with its own brokerage firm Shearson. When American Express divested Shearson in 1993, the independent firm came to be known once again as Lehman Brothers. The new Lehman made its IPO in 1994 and since then was known as Lehman Brothers Holding Inc. The old hands at Lehman, Peterson and Glucksman left the firm and it was in the hands of Richard Fuld who spearheaded the investment bank after its IPO and its eventual spin-off from the American Express group in 1994. Mr Fuld was a shrewd and aggressive operator, leveraging his bank's prowess in the fixed-income markets and its small capital base to take big risks and earn returns higher than those of larger investment banking peers.

Post 2001, when the US Fed followed a low interest regime to spur growth and stave off a recession, Lehman grew rapidly, playing a major part in the securitisation market and the leveraged lending businesses recording record earnings from 2005 to 2007. It also acted as financial advisor for the largest ever M&A transaction in the financial sector involving the $98 billion acquisition of ABN AMRO by a consortium of the Royal Bank of Scotland, Santander and Fortis. Lehman's assets under management also grew to a record $175 billion and it was named the 'Best Investment Bank' by Euro money in its 2005 and by Fortune in 2007.

Lehman's slow collapse began following the mortgage market crisis that unfolded in 2007 as mentioned in a previous discussion. Lehman's debt burden had mounted after the $22 billion takeover of Archstone, a property development giant which was acquired at the height of the property boom at peak valuation. Lehman, a bank with a little more than $20 billion in equity at the time, joined Tishman Speyer, a developer and Bank of America to spend $15 billion for Archstone-Smith Trust. Archstone became its Achilles Heel, with a crippling $30 billion-plus of property assets that the bank could not sell and investors could no longer tolerate. Lehman's stock price began a steady fall from a peak of $82 as investors feared the fact that the firm was a major player in the market for subprime and prime mortgages and being smaller than its peers such as Goldman and Morgan, it had lesser tenacity to face significant losses. The distress sale of Bear Sterns in March 2008 loomed large in the minds of investors. Lehman and Bear Stearns had a number of similarities. Both had relatively small balance sheets, they were heavily dependent on the mortgage market and they relied heavily on the repo or repurchase market, most often used as a short-term financing tool. Lehman was one of the ten largest players in the CDS market. In its latest filing prior to its bankruptcy, Lehman reported a total derivatives business of $729 billion with a net fair value of $16.6 billion.

However, the exposure to the crisis ridden mortgages and CDS market started to take a toll on Lehman's financials. On June 9, 2008, Lehman announced a second-quarter loss of $2.8 billion, far higher than analysts had expected. On its part, Lehman sought to raise $6 billion in fresh capital from domestic investors. Before this move, Lehman sought an investment from Korea Development Bank and China's Citic Securities. However, the negotiations were protracted and unsuccessful providing very little time for Lehman to seek other alternatives. In late June, Fuld also began discussing the possibility of a management buy-out and initiated talks with several private equity firms which proved unfruitful as well. By August, analysts were anticipating grave losses and the share price decline began to accelerate.

On September 8, the government placed Fannie Mae and Freddie Mac under administration which dimmed the prospects of a government financed bailout for Lehman. However, on September 10, the investment bank said that it would spin off the majority of its remaining commercial real estate holdings into a new public company. It also confirmed plans to sell a majority of its investment management division in a move that it expected would generate $3 billion. There were no takers for any of these proposals. It also initiated talks for sale of its asset management business but a deal with Carlyle fund could not go through due to higher valuation expectation by Lehman. In the meantime, Lehman announced massive losses for the subsequent quarter at $3.9 billion resulting from write-off of $5.6 billion on account of write downs in toxic mortgage assets.

Though in the subsequent few days, there were hectic deliberations among Wall Street frontliners such as Lloyd Blankfein of Goldman Sachs, Morgan Stanley's John Mack and Merrill Lynch's John Thain, in an attempt to devise a plan to buy $33 billion of commercial assets from Lehman, the hitch was that without a government guarantee, there was no possibility of allowing the bank to continue trading until a takeover was completed. Lehman expected to stave off the situation either through sale of its business to Barclays or Bank of America or through a government funded bail out. When the government made it clear that a Bear Sterns type of bailout was impossible, it was the last straw for Lehman. Bank of America quickly announced it had entered into merger discussions with Merrill Lynch, while Barclays withdrew from the race to acquire Lehman. Critics point out that Fuld's failure to recognise the risks of the credit bubble and the slowness of response was Lehman's undoing. The bank's market cap crumbled to the point where it stood at $2 billion on the last Friday of its existence.

Lehman Brothers Holdings filed for bankruptcy in USA under Chapter 11 of the US Bankruptcy Code on September 15, 2008. It was the biggest corporate bankruptcy proceeding in US history with assets of $639 billion and liabilities of $613 billion. The petition for bankruptcy protection did not include Lehman's broker-dealer operations and other divisions, including Neuberger Berman, the asset management division. On 16th September, Barclays bought Lehman's North American investment banking business for $1.75 billion. Its core investment banking operations were sold in the bankruptcy proceedings to Barclays Capital. Meanwhile, a worldwide battle began over the remains of Lehman Brothers. Lawyers for global companies like J.P. Morgan Chase, the General Electric Capital Corporation and Credit Suisse rushed into court, along with small investors. The lack of clarity on determining the realisable value of Lehman's assets in derivatives when they were wound down in liquidation contributed to the confusion.

The US Bankruptcy Code has three main chapters on bankruptcy claim settlements. Chapter 11 involves reorganisation of a debtor's business affairs and assets by which the debtor can commence its business afresh subject to the terms and conditions under its plan of re-organisation. This is similar to a rehabilitation plan under the erstwhile BIFR/CDR/Insolvency Code in India. Chapter 13, Bankruptcy Proceedings, on the other hand, allow the debtor to consolidate, prioritise, repay and in some cases, reduce or eliminate old debt while receiving court protection against creditors. In India, this happens mostly during winding up. The third, Chapter 7, allows for liquidation of assets of the debtor and the proceeds are paid to the creditors which frees the debtor from all obligations.

After almost four years of filing for bankruptcy protection under Chapter 11, Lehman Brothers emerged out of bankruptcy proceedings in March 2012 as a holding company with complete settlements arrived at with all its creditors. After the last creditor agreed to the settlement plan in 2012, the federal bankruptcy court gave its approval to the re-organisation plan of Lehman and allowed it to proceed with the settlement of its liabilities by liquidation of the available assets. At the time of writing, Lehman still had $300 billion in claims from creditors and Lehman estate was to pay them less than 50 cents to a dollar. Thus, Lehman entered the final stage of distribution to creditors. As part of the liquidation process, Lehman planned to take Archstone public instead of making a distress sale. Since Lehman filed for bankruptcy under Chapter 11 of the US Bankruptcy Code, it would eventually emerge as a debt free company to be able to pursue future business interests similar to the process adopted by General Motors Inc in its bankruptcy phase. However, that process would take several years since assets need to be liquidated and several court cases pending on various issues need to be settled. Considering that Lehman was in financial business which runs on trust, it is unlikely that it would emerge again as Lehman Brothers after sale the process is concluded.

5.5 European Investment Banks

In continental Europe (excluding UK), the concept of a *Universal Bank* had been the undercurrent since the late nineteenth century when most of these banks were established. The term *universal banking* meant the co-existence of commercial banking (lending activity) with investment banking (investment and distribution activity). Their universality was in the sense of harnessing the vast retail customer base that these banks enjoyed to market security issuances by their investment banking arms. These issues were mostly in the local markets designated in the local currencies. France's Banques d'affairs and Germany's Universalbanken are examples.

The United Kingdom, which is the largest investment banking market in the region, had its own structure evolved from history. The oldest merchant bank in London was Barings Brothers, which played a prominent role in the nineteenth century. Securities distribution was the function of stock-brokers, secondary market trading was taken up by jobbers and advisory services were provided by merchant banks. The term *merchant bank* was evolved to distinguish between commercial banks and those that provided capital market advice. However, the breaking down of such barriers in 1986 by allowing banks to own broking outfits led to consolidation and most broking firms got absorbed by bigger and diversified entities. Around the same time, US too was witnessing the disappearance of distinction between pure broking entities restricted to secondary markets and investment banking entities involved with primary markets. The US investment banks with their integrated global business model entered UK and Europe and later into Japan. The introduction of the Euro in 1999 helped the US invasion further by neutralising the local currency advantages enjoyed by European universal banks. By 2001, the US bulge group garnered 29.7% of the investment banking fee generated in Europe as compared to 16.3% by the European universal banks.

Post-1986, the merchant banks and commercial banks in UK could not match up to the US onslaught which ultimately led to the sale of SG Warburg, the leading merchant bank to Swiss Bank Corporation (which was acquired by UBS later) in 1995. In 1997, Natwest Bank and Barclays Bank exited investment banking business. Morgan Grenfell, a merchant bank was sold to Deutsche Bank in 1990. In this upheaval, niche players such as Drexel Burnham and Barings Bank also collapsed with internal failures. This led to cross border M&A between European banks inter-se and their American counterparts to create bigger investment banks. UBS Warburg was born out of the merger of UBS and Swiss Bank Corporation, which had earlier acquired SG Warburg. The Swiss Bank Corporation was also merged with UBS. It is presently known as UBS Investment Banking but was formerly known as UBS Warburg and Warburg Dillion Read and UBS Paine Webber. All these divisions were rebranded and are presently known under the group name of UBS. Deutsche Bank acquired Bankers Trust, Morgan Grenfell and Alex Brown and rose to be one of the most prominent universal banking groups in Europe. The European bank that suffered the most in the global financial crisis was UBS due to its exposure to US sub-prime mortgages. It received liberal equity financing from the sovereign fund of the Singapore government as well as from the Swiss government to tide over its crisis. Similarly, other banks that faced the heat were the Royal Bank of Scotland, Santander and Fortis after their acquisition of ABN AMRO bank in 2007. Presently, Fortis does not exist anymore while RBS was restructured and the erstwhile ABN AMRO bank was restored partly under the ownership of the Dutch government for its operations in the Netherlands. The other well-known Dutch financial services groups are ING and Rabobank. ING formed out of a merger of a Dutch insurance company and a Dutch bank in 1991 after the legal restrictions on mergers between insurers and banks were lifted in the Netherlands. ING is primarily a commercial bank, insurance and investment management combined and does not offer core investment banking solutions. Rabobank group is into commercial banking, insurance advisory and asset management and operates a division for investment banking advisory services. Both these names, therefore, do not reckon as prime investment banks.

The German bank Dresdner based in Frankfurt, was also a universal bank with significant presence in commercial and investment banking. In 2002, Dresdner Bank became a wholly owned subsidiary of the insurance corporation Allianz. In 2006, Dresdner went through a re-organisation of its commercial and investment banking activities. It was sold by Allianz to Commerzbank in 2009 and ceased to exist as an independent entity thereafter. Commerzbank, another prominent German bank based in Hamburg, is a privately owned universal bank with international presence in corporate banking and investment banking and is quite strong in the European institutional segment. The third prominent German financial services group based in Munich and one of the largest in the world is the Allianz group. It is primarily an insurance and asset management group and after the sale of Dresdner Bank in 2009, it does not have any direct presence in investment banking but has a minority ownership in Commerzbank.

After the collapse of Barings Bank in 1995, the prominent global British names in financial services are HSBC, Standard Chartered and Rothschild. Originally, the Hong Kong and Shanghai Banking Corporation (HSBC) was established as a British bank in Hong Kong. HSBC Holdings Plc was established in 1991 as the parent holding company for HSBC and based itself in London. In 2011, it was the second largest financial conglomerate in the world and a universal bank with a full-service investment banking division. It is listed on London as its main exchange with subsidiary listings on Hong Kong, Paris, New York and Bermuda. HSBC grew in Europe and UK as a result of several acquisitions, including the Midland Bank. It also extended its presence in South America and USA through acquisitions and moved to establish branches in mainland China and Australia through subsidiaries.

Standard Chartered Plc, an amalgam of the Standard Bank of British South Africa and the Chartered Bank of India, Australia and China in 1969, is a British universal bank and one of the world's largest financial services groups. In 2000, it acquired Grindlays Bank from the ANZ group to increase its presence in South and South-east Asia. It has significant presence in investment banking advisory services and private banking apart from commercial banking.

N.M. Rothschild (Rothschild) is a 200-year-old independent family owned investment banking and financial services group based in London and operates in about 40 countries worldwide. It was the foremost name in Britain in the 19th century in financial services and the world's biggest bond trader. It has extensive presence in investment banking advisory services in M&A, merchant banking, corporate finance, investment advisory, wealth management and asset management businesses. It ranks consistently among the top investment banks in the world for M&A advisory services.

Outside of the US, UK, Europe and Japan, the Australia and New Zealand Banking Group (ANZ) based in Australia is its fourth largest commercial bank. It is more than 175 years old and has grown globally through strategic acquisitions including that of Grindlays Bank in 1984 and has strong presence in Asia Pacific and the Middle East. Apart from commercial banking, ANZ offers wealth management, investment banking and capital market services, structured products and derivatives and foreign exchange services.

The prominent investment banks outside of US are listed in Table 5.2.

Table 5.2 Prominent Non-US Investment Banks

HSBC
Credit Suisse (Formerly CSFB)
Deutsche Bank
UBS AG
Barclays Capital
Nomura Holdings
BNP Paribas
Barclays Capital
HSBC Holdings
Societe Generale
Commerzbank
Rothschild*
Daiwa Securities*
ANZ
* These are pure investment banking entities. The rest are universal banks.

Case Study

Barings Bank Collapse

Barings Bank was born around 1776 and was the oldest merchant bank of UK dating back to the trading days of 18th century Britain. In 1803, it became Barings Brothers & Co. (BB Co.) and the traditional rivalry between Barings and Rothschild in British merchant banking is akin to the rivalry between Goldman Sachs and Morgan Stanley in USA. In 1890, Barings suffered a near collapse due to excessive underwriting risks taken in Argentine bonds. Its growth never realised its full potential thereafter and it remained a mid-market merchant bank in UK and USA markets. However, by then, Barings Plc was the holding company and BB Co. was the merchant banking entity. It also had a separate entity called Barings Securities for conducting securities business (which had separate geographical subsidiaries in UK, Japan and Singapore) and Barings Asset Management. Thus, Barings Bank was a universal bank having commercial banking, merchant banking, asset management and securities business as its business verticals until it met with its fatal destiny in 1995.

The collapse and liquidation of Barings Bank in 1995 was triggered through its Singapore office by rogue trader Nick Leeson but the Board of Banking Supervision of the Bank of England which launched an investigation into the collapse held that lack of adequate supervision by the head office and absence of internal control systems precipitated the crisis. Nick Leeson was working in the back office of Barings Securities in Jakarta until he was posted to head the Singapore subsidiary to start the trading desk on Singapore stock exchange. While he was the head of Singapore office, he continued to handle the Jakarta back office which gave him complete control on trading and settlements of his own trades. As Leeson began to take arbitrage bets from his Singapore entity, it is reported that he came across a mistaken trade made by his deputy that cost the company GBP 20,000. In order to conceal the loss, he operated a coded account called ‘88888’. As arbitrage trading generally involves wafer thin margins and huge volumes with apparently no risk (since trades are settled immediately), there was not much of supervision from the London office. This period also coincided with an internal re-organisation within the group wherein the securities firm and the merchant banking firm were being combined which kept the head office pre-occupied.

Leeson gradually started to hold open positions in his arbitrage trades between Singapore and Japan markets rather than to settle them. His calls on the NIKKEI went wrong and his losses mounted. He started using the coded account to make artificial trades and book profits for clients on Barings books and conceal the actual losses. He funded additional margin calls imposed by the Singapore exchange on his loss trades with capital from the group securities firms by fraudulent misrepresentation to the management. The artificial gains being booked by the Singapore office were quite substantial and resulted in handsome bonuses to Leeson and his staff. No one questioned the making of such high profits from arbitrage trading which is essentially a riskless low margin trading activity. Gradually, Leeson's open positions mounted and by 1995 he held almost 50% of the open positions on NIKKEI futures.

Barings was just starting to form a risk management department and risk controllers were appointed in London, Tokyo and Hong Kong during 1994, but not in Singapore. In Barings Securities Singapore, Leeson was the general manager and effectively controlled every operation. Furthermore, there was no single person within Brings responsible for supervising Leeson. The lack of oversight continued until the losses became so large that the continuance of the bank itself was at risk. Finally, Leeson fled from his office with the losses staggering at GBP 827 million. He was extradited to Singapore and was sentenced to prison. He served the sentence and was released in 1999. However, the collapse of the Barings bank was inevitable. The investigation by Bank of England stated in these words the reasons for the collapse – "Barings's collapse was due to the unauthorised and ultimately catastrophic activities of, it appears, one individual (Leeson) that went undetected as a consequence of a failure of management and other internal controls of the most basic kind."

In the consequent liquidation of Barings Bank, ING absorbed all the commercial banking business of Barings becoming ING Barings in the process. However, it later divested its American business and went back to original name of ING. The asset management business was sold to Mass Mutual which continued to use the name of Barings Asset Management. The investment banking advisory and financial services business was sold by ING to Northern Trust. Barings Private Equity was taken over by the general partners of respective regions and exists under different names. The corporate existence of Barings Bank, the oldest investment bank of Britain was, thus, ended.

5.6 Global Industry Structure

The investment banking industry on a global scale is oligopolistic in nature ranging from the global leaders (known as the *Global Bulge Group*) to stand alone *pure* investment banks. The Bulge group usually consists investment banking as a business vertical in a universal banking or a *conglomerate* structure. The smaller banks are either standalone pure investment banks or boutique banks. Depending upon the spectrum of services they offer, investment banks can range from *full service investment banks* to *boutique investment banks* offering a few specialised services. The Bulge group consisting of the large US and European investment banks has global presence and these firms dominate the *league tables* in key business segments.

Investment banks take industry league tables quite seriously since they define their position in the industry and send a strong message to their clients about their performance and capabilities. Though the rankings in the league tables keep changing with time, generally the top firms are more or less the same. A listing of the top global investment banks based on their fee earnings in 2016 is provided in Table 5.3 so as to provide a general idea of how the global investment banking industry is structured.

Table 5.3 Major Global Investment Banks

	Fee Income US$ Million
J.P. Morgan	5727.97
Goldman Sachs	5040.39
Bank of America Merrill Lynch	4498.11
Morgan Stanley	4453.97
Citigroup	3843.40
Barclays Capital	3161.33
Credit Suisse	2864.58
Deutsche Bank	2701.96
Wells Fargo	2093.97
RBC Capital Markets	1779.95

Source: Financial Times League Tables 2016

In the post Glass Steagall era, both pure investment banks and universal banks with significant presence in investment banking occupied the top positions in the global industry rankings till 2008. In the aftermath of the financial crisis in 2008, regulatory intervention caused the leading pure investment banks of Wall Street to convert to the universal banking model and subject themselves to regulatory oversight by the Federal Reserve. However, the *pure investment bank* model, i.e. banks that do not have commercial banking affiliation still persists with other banks in USA and outside. In the above list, all the banks except the last name are universal banks. RBC Capital Markets is a leading 152-year old pure investment bank based in Minnesota. However, it may also be noted that the global investment banking industry ranges from the acknowledged global leaders listed in Table 5.3 to a larger number of mid-sized competitors, national or regional level players and the rear end of the industry is supported by boutique firms or advisory and sectoral specialists.

5.6.1 Factors Responsible for Growth of Universal Banks and Financial Conglomerates

Globally, a large number of corporations prefer to deal with one-stop financial shops rather than look for separate entities to serve their commercial banking and investment banking needs. The technological advancement in the 1990s and the availability of global access through the revolution in communication technologies fuelled global growth for corporate looking to establish their business in various countries. Since corporate businesses were getting conglomerated, international experience indicates that there has been a progressive de-regulation financial business as well to meet the varied financial requirements of their clients. Therefore, combining commercial banking and investment banking into a universal banking model was encouraged and has been extensively detailed in earlier discussions. However, the combination of banking and insurance business has been somewhat limited, at least until the late 1990s. In 1997, the US Federal Reserve Board (the country's central bank) raised the amount of revenue that a commercial bank's Section 20 subsidiary can earn from underwriting and dealing in securities to 25% of its total revenue. This led to further marriages between commercial banks, investment banks, insurance companies and their allied businesses such as asset management. On the aspect of banks taking up insurance activities, in most European countries banks are allowed to set up insurance subsidiaries (*downstream linkages*) but in some others such as the US and Japan, restrictions do exist. The cross-country pattern of restrictions on the ownership of banks by insurance companies (*upstream linkages*) is more or less like that of downward linkages. Most countries that do not set in principle any limits on downstream linkages do not set them on upstream ones either. Insurance companies in many countries have also acquired stakes in some banks.

The second factor that contributes to the rising influence of global universal banks has been the advent of globalisation of capital flows which brought along with it increasing integration of global financial markets, liberalisation of inbound and outbound investments and the emergence of sophisticated technologies and trading mechanisms. Global transactions such as cross border mergers and acquisitions, international capital raising through global security floatation and syndicated loans have given rise to the criticality of having global financial conglomerates. To serve their clients better, many investment banks and universal banks have gone global either singly or in joint ventures and have become large financial conglomerates.

All the industry leaders listed in Table 5.3 as well as other top global financial groups have operations in almost all major financial centres of the world. Many other Wall Street firms and pure investment banks pursued the globalisation strategy. Major US banks earn more than a quarter of their revenues from global securities businesses. Similarly, several non-US banks and securities firms set up their presence in the US such as Deutsche Bank, UBS AG, HSBC, Credit Suisse, Daiwa and Nomura Securities.

The emergence and growth of financial conglomerates was largely driven by the potential of such entitles to benefit from the economies of scale and scope and to capture synergies across complementary financial services/business lines. These economies result in improved operational efficiency and effectiveness due to lower costs, reduced prices and improved innovation in products and services. Some thinkers and policy makers feel that regulatory authorities in developed economies have encouraged consolidation in the financial services industry in order to facilitate enhanced diversification, capitalisation, investments in banking information technology and to lessen the supervisory burden where banking organisations are larger and more visible and thus, open to increased public scrutiny. Consequently, there has been an increasing trend of financial conglomeration across countries including India.

5.7 Structure of a Financial Conglomerate

The corporate structure of financial conglomerates varies in different countries based on the regulatory framework and business climate. However, there are broadly four business verticals: (i) commercial banking and allied activities, (ii) investment banking and securities business, (iii) asset management and investment services and (iv) insurance and allied areas. Keeping these verticals in mind, a financial conglomerate may be characterised primarily as banking or securities or an insurance structure. The character would be determined by the sector represented at the holding company level and / or by the type of activity that constitutes the major business of the conglomerate. Alternatively, a financial conglomerate may be comprised of businesses such that none of the primary businesses determines the character of the conglomerate. There are several financial conglomerates engaged primarily in securities in the United States such as Goldman Sachs and Morgan Stanley, where major securities firms are owned by holding companies. A financial conglomerate in which no one sector dominates would typically be one formed on the basis of a holding company with subsidiaries in the banking and / or insurance and / or securities business.

The most common conglomerate model in a global perspective is presented in Exhibit 5.1.

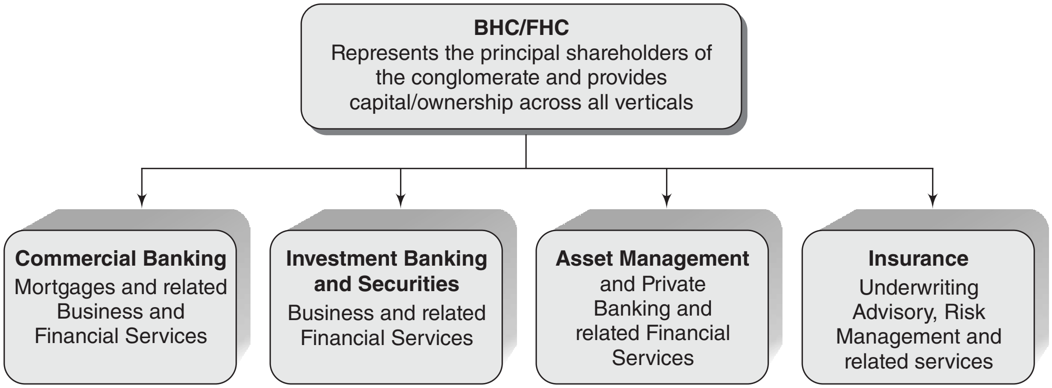

Exhibit 5.1 Common Template of a Financial Conglomerate[10]

5.7.1 Systemic Risks from Financial Conglomerates

Due to the enormous size and complexities in business and corporate structure, especially with regard to multi-jurisdictional operation, financial conglomerates carry a systemic risk and therefore, pose enormous regulatory challenges across the world. Through the holding company and its subsidiaries, the conglomerate conducts regulated and unregulated financial and even non-financial activities. Typically, conglomerates undertake a range of financial activities, including commercial banking, investment banking and insurance, both within their home economy and abroad. They will also be major players in wholesale financial markets such as being market makers in foreign exchange and OTC derivatives. As a market maker, they provide liquidity to other market participants and at the same time absorb significant funds from the market. They may also be an important part of the local payment and settlement infrastructure. As such, in stable markets they are an important resource for market activity and depth and as a channel or counterparty for mitigating risk. But in turbulent times, through their linkages with domestic financial institutions and their prominent role in markets, they also have the potential to be a source of financial instability in domestic markets and across jurisdictions as well.

The World Bank in its policy research working paper published in 1994[11], identified the following risks due to the operation of financial conglomerates:

- *Contagion Risk:* Refers to the situation where one entity in the group affected by financial problems such as insolvency or illiquidity, arising in another regulated or unregulated group member entity. It is the potential consequence of the various tangible and intangible linkages to other group companies. One key concern is the potential transfer of capital from a regulated entity, as might occur when it attempts to rescue another group member from financial difficulties. Such transfers may be evident, as in the case of loans, investments and guarantees, or may be obscured, most often through devises such as the off-market pricing of intra-group transactions. Another key concern is the potential for negative events involving another group member to triggering a liquidity crisis or substantially diminished flow of business for a regulated entity. A similar but distinct issue is *systemic risk,* where problems in an

[10]BHC – Bank Holding Company, which is generally used for housing ownership structure of a banking company with all its associated subsidiaries.
FHC – Financial Holding Company, which is a common holding company for all verticals in financial business along with associated subsidiaries.

[11]The Regulation and Supervision of Domestic Financial Conglomerates – David H. Scott, Policy Research Working Paper 1329, Financial Sector Development Department, The World Bank, August 1994.

institution spread to unrelated entities and result in difficulties of systemic proportion. Systemic risk is a concern with respect to individual financial institutions as well as financial conglomerates. However, a financial conglomerate's involvement in a broader range of financial markets can increase the possibility of simultaneous crises in several markets, thus, exacerbating systemic risk as was the scenario in 2008.

- *Lack of transparency:* Transparency is a concern in relation to the financial condition of individual group members and the combined group and to the group's corporate and managerial structure. A potential consequence of transactions between various legal entities that comprise the group is an overstatement of the reported profits and capital of a regulated entity, as well as the likelihood that net group capital is less than the sum of the capital of all group members. Consequently, the effectiveness of prudential requirements and supervisory indicators applicable to individual institutions may be diminished. The increased complexity often inherent in the group context raises concerns regarding the capacity of supervisors to identify and gauge the risks to which a regulated entity is exposed. An unclear corporate or managerial structure can raise concerns regarding the supervisor's ability to identify connected parties, lines of authority and financial and managerial responsibility within the group.
- *Autonomy:* Where a regulated entity is a component of a larger business organisation, a supervisory concern is the autonomy of those individuals responsible for the sound operation of the regulated entity. Supervisors need to be assured that directors and managers can be held accountable for ensuring the sound operation of the institution, responding to supervisory mandates and ensuring compliance with law and regulatory requirements. The concern is that directors and managers of the regulated entity may lack the necessary authority *vis-a-vis* other individuals within the group.

The RBI Report[12] on financial conglomerates identified the following systemic risks arising from their operations both domestically and globally:

- *Sheer size and complexity of the conglomerates*: First, there is the moral hazard associated with the *Too-Big-To-Fail* position of many financial conglomerates. In addition, it becomes more difficult to manage and understand the operation of a firm as the organisation grows. While both these issues are not unique to financial conglomerates, these issues tend to come to sharp focus because financial conglomerates tend to be large.
- *Holding-out* phenomenon: The second aspect of financial conglomerates is that financial difficulties in one subsidiary in a segment could have contagion or reputation effects on another subsidiary in a different segment on account of the *holding out* phenomenon, especially when using the same brand name. If these entities can expect support when needed, a moral hazard problem arises, as they could be tempted to take on more risk than they would otherwise have done. These possible contagion and cross segment moral hazard risks form an argument for supervisory intervention at the level of a financial conglomerate.
- The third set of issues prompting supervisory focus relates to the concerns about regulatory arbitrage, non-arm's length dealings, etc. arising out of Intra-group Transactions and Exposures (ITEs), both financial and non-financial that may further get accentuated by the non-transparency of such intra-group channels. In general, supervisory concerns arise when the ITEs:
  - result in capital or income being inappropriately transferred from the regulated entity to a non-regulated entity;
  - are on terms or under circumstances which parties operating at arm's length would not allow and may be disadvantageous to a regulated entity;
  - can adversely affect the solvency, the liquidity and the profitability of individual entities within a group;

[12]RBI Discussion Paper on Holding Companies in Banking Groups, August 27, 2007.

- are used as a means of supervisory arbitrage, thereby evading capital or other regulatory requirements altogether.

ITEs between group entities within a financial conglomerate may significantly impact the financial performance and capital adequacy position of the individual entities involved. Internal lending may also increase the risk of contagion. Intra-group transactions may involve conflicts of interest between the parties concerned.

5.7.2 Regulatory Approach

International integration of financial markets with large conglomerates as players therein has direct consequences for the global financial system as was evidenced in the collapse of Lehman Brothers and others in the wake of the global financial crisis in 2008. Therefore, in the context of inter-jurisdictional systemic risk due to international financial conglomerates, in instances where domestic financial conglomerates wished to expand internationally, the thinking emerged that such domestic authorities should be asked to adhere to international supervisory standards. This was partially in response to the failure of Bank of Credit and Commerce International. Such standards were adopted in 1992 by the Basel Committee on Banking Supervision, with the endorsement of the governors of the central banks of the G10 countries. These standards for the supervision of international banking groups apply to bank supervisors in countries whose domestic banks wish to establish operations in the Basel Committee member countries. The Basel Committee consists of bank supervisory authorities from Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, Netherlands, Sweden, Switzerland, the UK and the USA. The standards provide that member countries may impose restrictive measures, including the denial of entry, on banks which are not subject to supervision that meets the established standards. The standards include provisions relating to group-wide supervision. The initial standards established a framework applicable to conglomerates in which a deposit-taking bank was a member. That framework was enhanced in 1993 by agreements that dealt with investment firms, i.e. securities companies and investment management firms. In addition to this, since financial conglomerates are often made up of entities coming under various jurisdictions and subject to differing supervisory regimes, it has also been recognised that cooperation among regulatory authorities internationally will clearly be an important prerequisite of any effort to improve the prudential supervision of global financial conglomerates.

As far as intra-jurisdictional systemic risk due to financial conglomerates is concerned, a basic regulatory response to the emergence of financial conglomerates is increased integration and cooperation among the different authorities responsible for the various types of financial businesses operating as a group. In 1996, The Joint Forum on Financial Conglomerates (Joint Forum) was established under the auspices of the Basel Committee, the International Organisation of Securities Commissions (IOSCO) and the International Association of Insurance Supervisors (IAIA) to take forward the work of the Tripartite Group of Securities, Insurance and Banking Regulators (formed in 1993) whose report was released in July 1995. In considering the problems of supervising conglomerates, the Tripartite Group had drawn a distinction between financial conglomerates whose interests were exclusively, or predominantly, in financial activities and mixed conglomerates which were predominantly commercially or industrially oriented, but contain at least one regulated financial entity in some part of their corporate structure. However, the report focused mainly on financial conglomerates and noted that they combine businesses which are subject to different schemes of supervision and might also include financial activities which, in many countries, are not conducted in an entity which is subject to a single regulatory supervision such as mortgages, credit derivatives and other debt structures.

The regulatory options from an intra-jurisdictional perspective are: (i) consolidated regulation and (ii) separate regulation. Consolidated regulation would require the presence of a single regulator across the financial sector or a super-regulator in a system of multiple financial regulators as in India. Germany put in place a super securities regulator in 1994. In simple terms, consolidated regulation is a response to the fact that financial conglomerates very frequently carry on part of their business—in some cases the major part—through subsidiaries and affiliates. Moreover, a bank or insurer may belong to a group headed by a holding company and in such case supervisors need to take account of the activities of the holding company and fellow subsidiaries of the bank or insurer. Consolidated supervision is, therefore, a comprehensive approach to supervision which seeks to evaluate the strength of an entire group, taking into account all the risks which may affect an examined institution regardless of whether these risks are carried in the books of the examined institution or in related entities.

In a separate regulation system, there could be the hazard of regulatory arbitrage by the conglomerate, though in reality, neither system has been found more effective than the other. Hence, several countries follow a combination of the two systems. The Netherlands has a coordinating agency at the apex level while the USA follows a system of focussed supervision of financial conglomerates within the sectoral regulatory framework through enhanced inter-regulatory coordination. In the UK, the erstwhile Financial Services Authority (FSA) performed the role of a super regulator. However, the UK moved away from a unified regulator model in 2013 to introduce the Prudential Regulatory Authority (PRA) and the Financial Conduct Authority (FCA) in place of the FSA. The PRA is the banking and insurance regulator structured as a subsidiary of the Bank of England. The FCA is the financial market regulator. A coordinating agency called the Financial Policy Committee was put in place to ensure inter-regulatory coordination and facilitating financial stability.

In 2010, the US passed the Dodd-Frank Act (*supra*) that added a new Section 13 to the Bank Holding Company Act of 1956 (BHC Act), that gives legislative effect to the proposals put forward by Paul Volcker, (*Volcker's Rule*). This Act also amended the Financial Holding Company Act of 1956 to provide for similar provisions with respect to TBTF financial companies restricting their proprietary trading exposures and floating their own private equity and hedge funds.

In 2012, it was reported that a FHC model for public sector banks in India was under the consideration of RBI as it was proposed in the Budget. The formation of a single FHC for all 24 public sector banks was also announced in Budget 2012. The operational issues to be considered before operationalising the proposal were: (i) availability or otherwise of sovereign guarantee for funds to be raised by the FHC, (ii) cost of borrowing of the FHC as compared to cost of sovereign borrowings, (iii) listing of the FHC, (iv) availability of funds with the FHC to service its market borrowings, (v) concentration of systemic risk, if any. However, the proposal for a FHC in the banking sector was long standing considering the future requirements of public sector banks to meet the Basel III norms as well as to meet the requirements of a growing economy. Recognising the fact that India needed larger banks, the SBI and its subsidiaries were merged and were expected to be operational as a merged entity in 2017-18. However, allowing FHCs to be formed by private banking groups and financial conglomerates could take more time and legislative reforms.

India presently has a Financial Stability Development Council (FSDC) headed by the Finance Minister that was conceived primarily to ensure financial stability and inter-regulator coordination agency so as to smoothen regulatory conflicts and overlapping jurisdiction to regulate the financial sector. As India follows a multiple regulator system, these conflicts can be common. The FSDC is an apex regulatory body which was created in response to the recommendations of the Raghuram Rajan Committee in 1998. The FSDC can be seen as India's initiative to set up a regulatory mechanism to promote and protect financial stability in the wake of the global financial crisis of 2008. The FSDC has an institutional structure for the oversight and monitoring of Financial Conglomerates in the form of an Inter Regulatory Forum (IRF) which was set up in 2012 modelled around the *lead regulator* principle.

5.8 Evolution of Indian Investment Banking

5.8.1 Origin

In India, though the existence of this branch of financial services can be traced to over three decades, investment banking was largely confined to merchant banking services. The forerunners of merchant banking in India were the foreign banks. Grindlays Bank (since merged with Standard Chartered Bank in India) began merchant banking operations in 1967 with a licence from the RBI followed by the Citibank in 1970. These two banks were providing services for syndication of loans and raising of equity apart from other advisory services.

It was in 1972 that the Banking Commission Report asserted the need for merchant banking services in India by the public-sector banks. Based on the American experience, which led to the passage of the Glass Steagall Act, the Commission recommended a separate structure for merchant banks distinct from commercial banks and financial institutions. Merchant banks were meant to manage investments and provide advisory services.

Following the recommendations of the Report, the SBI set up its merchant banking division in 1972. Other banks such as the Bank of India, Central Bank of India, Bank of Baroda, Syndicate Bank, Punjab National Bank, Canara Bank followed suit to set up their merchant banking outfits. ICICI was the first financial institution to set up its merchant banking division in 1973. The later entrants were IFCI and IDBI with the latter setting up its merchant banking division in 1992. However, by the mid-eighties and early nineties, most of the merchants banking divisions of public sector banks were spun off as separate subsidiaries. SBI set up SBI Capital Markets Ltd. in 1986. Other such as Canara Bank, BOB, PNB, Indian Bank and ICICI created separate merchant banking entities. IDBI created IDBI Capital markets much later since merchant banking was initially formed as a division of IDBI in 1992.

5.8.2 Growth

Merchant banking in India was given a shot in the arm with the advent of SEBI in 1988 and the subsequent introduction of free pricing of primary market equity issues in 1992. However, post-1992, the merchant banking industry was largely driven by issue management activity which fluctuated with the trends in the primary market. There have been phases of hectic activity followed by severe downturn in business. SEBI started to regulate the merchant banking activity in 1992 and majority of the merchant bankers registered with SEBI were either in issue management or associated activity such as underwriting or advisorship. SEBI had four categories of merchant bankers with varying eligibility criteria based on their net worth. The highest number of registered merchant bankers with SEBI was seen in the mid-nineties but the numbers have dwindled since due to the inactivity in the primary market. The number of registered merchant bankers with SEBI as at the end of March 2011 was 192 from a high of almost a thousand in the nineties.

5.8.3 Constraints to Investment Banking

Due to the over-dependence on issue management activity in the initial years, most merchant banks perished in the primary market downturn that followed later. In order to stabilise their businesses, several merchant banks diversified to offer a broader spectrum of capital market services. However, other than a few industry leaders, the others merchant banks could not transform themselves into full service investment banks. Going by the service portfolio of the leading full service investment banks in India, it may be said that the industry in India has seen more or less similar development as its western counterparts, though the breadth available in the overseas capital market is still not present in the Indian capital market. Secondly, due to the lower availability of institutional financing to fund capital market activity, it is only the bigger industry players, especially those backed by commercial banks and financial institutions that are in full service investment banking. The third major deterrent has been the inadequate breadth in the secondary market, especially in the corporate debt segment. Though there are around 5000 listed companies on the BSE and about 2000 companies listed on the NSE, the actively traded scrips are far below these numbers, if we take into account compulsory and voluntary de-listings and dormant scrips.

5.9 Characteristics and Structure of Indian Investment Banking Industry

Investment banking in India has evolved in its own characteristic structure over the years both due to business realities and the regulatory regime.

On the regulatory front, the Indian regulatory regime does not allow all investment banking functions to be performed under one legal entity for two reasons: (i) to prevent excessive exposure to business risk under one entity and (ii) to prescribe and monitor capital adequacy and risk mitigation mechanisms. Regulation 13 of the SEBI (Merchant Bankers) Regulations 1992 provides that no merchant banker other than a bank of a PFI shall carry on any business other than that in the securities market. Therefore, bankruptcy remoteness is a key feature in structuring the business lines of an investment bank so that the risks and rewards are defined for the investors who provide resources to the investment banks. In addition, the capital adequacy requirements and leveraging capability for each business line have been prescribed differently under relevant provisions of law. On the same analogy, commercial banks in India have to follow the provisions of the Banking Regulation Act and the RBI regulations, which prohibit them from exposing themselves to stock market investments and lending against stocks beyond specified limits.

Therefore, Indian investment banks follow a conglomerate structure by keeping their business segments in different corporate entities to meet regulatory norms. For example, merchant banking business has to be in a separate company as it requires a separate merchant banking licence from the Securities and Exchange Board of India (SEBI). Merchant bankers other than banks and financial institutions are also prohibited from undertaking any business other than that in the securities market. However, since banks are subject to the Banking Regulation Act, they cannot perform investment banking to a large extent on the same balance sheet. Asset management business in the form of a mutual fund requires a three-tier structure under the SEBI regulations. Equity research should be independent of the merchant banking business to avoid the kind of conflict of interest as faced by American investment banks. Securities business has to be separated into a different company as it requires a stock exchange membership apart from SEBI registration.

Investment banking in India has also been influenced by business realities to a large extent. The financial services industry in India till the early 1980s was driven largely by debt services in the form of term financing from financial institutions and working capital financing by commercial banks and Non-Banking Financial Companies (NBFCs). Capital market services were mostly restricted to stock broking activity which was driven by a non-corporate unorganised industry. Merchant banking and asset management services came up in a big way only with the opening up of the capital markets in the early 1990s. Due to the primary market boom during that period, many financial business houses such as financial institutions, banks and NBFCs entered the merchant banking, underwriting and advisory business. While most institutions and commercial banks floated merchant banking divisions and subsidiaries, NBFCs combined their existing business with that of merchant banking.

Over the years, two developments took place. First, with the downturn in the capital markets in the later phase, the merchant banking industry saw a tremendous shake out and only about 10% of the larger firms remained in serious business. As mentioned earlier, the number of merchant bankers in business in 2016 is about 200 from a high of more than a 1000 in the 1990s. Even out of the 200, those catering to the big-ticket deals are about 15-20. The rest address the SME segment which is sizeable in India and growing. The other development is that due to the gradual regulatory developments in the capital markets, investment banking activities came under regulations which required separate registration, licensing and capital controls. SEBI is quite active in penalising erring bankers for failure to live up to their statutory duties and responsibilities from time to time.

Due to the reasons explained above, Indian investment banking industry has a heterogeneous structure. The bigger investment banks have several group entities in which the core and non-core business segments are distributed. Others have either one or more entities depending upon the activity profile.

5.9.1 Heterogeneous Structure

The heterogeneous and fragmented structure of the industry in India is evident even if Indian investment banks are classified on the basis of their activity profile. Some of them such as SBI, ICICI, Kotak Mahindra Capital, HDFC, Axis, IDBI, PNB and BOB offer almost the entire gamut of investment banking services permitted in India. Among these, the long-term financial institutions (IDBI and ICICI) converted themselves into full service commercial banks. They also have full service investment banking subsidiaries under their fold (IDBI Capital Markets and ICICI Securities). Those such as SBI, PNB and BOB are also universal banks.

In addition to the above large universal banks, the foreign universal and commercial banks operating in India such as Citibank, BoA Merrill Lynch, J.P. Morgan, Deutsche Bank, HSBC, Standard Chartered, Barclays, Credit Suisse etc. offer capital market services and M&A advisory as part of their investment banking portfolio. J.P. Morgan operates a full-service investment bank in India as do the other investment banks, i.e. Morgan Stanley and Goldman Sachs. Morgan Stanley also runs asset management business in India. At the middle level are several niche players including the merchant banking subsidiaries of some public-sector banks. Some of such subsidiaries have been shut down or sold off in the wake of the two securities scams in 1993 and in 2000. However, certain banks such as Canara Bank, Punjab National Bank and Bank of Baroda have had successful merchant banking activities. Among the middle level players are smaller universal banks such as HDFC Bank, Axis Bank, Kotak Mahindra Bank, Yes Bank and IDFC Bank. There are also investment banks structured as non-banking financial services companies such as Tata Capital, Reliance Capital, IIFL Securities, Rabo India Finance Ltd., SREI, L&T Finance, IL&FS and others. These entities offer mainly merchant banking and corporate advisory services.

There are also several home grown pure investment banks in India. DSP, JM Financial and the erstwhile Enam Securities (presently part of Axis group), Ambit Corp, Edelweiss, Religare Capital, Avendus, Centrum, Karvy, Anand Rathi are examples of mid-size investment banks in India. Most of these are full service investment banks. There are also the large accounting firms that have floated investment banking advisory services in India through affiliate firms that cater to some medium and large advisory mandates along with the big banks. At the lower end are several boutique investment banks in India that are into specialised corporate advisory services but may also prefer to hold merchant banking or underwriting registrations. These boutique banks like in the US, concentrate on the smaller mandates and to regional companies with or without pan-India presence. MAPE Advisory, Brescon, Spark Capital, Veda Advisors, Cogence, Equirus, Ripple Wave Equity, O3 are some of the recent generation boutique investment banks in India.

Table 5.4 Major Indian Investment Banks

SBI Capital Markets Ltd.
ICICI Securities Ltd.
Axis Bank
Kotak Mahindra Capital Company
Morgan Stanley India
J.P. Morgan India
HSBC India
Standard Chartered India
IDBI Capital Markets
PNB Investment Services
HDFC Bank
BOB Capital Markets
Edelweiss Financial Services
IIFL Securities
IDFC Bank
BoA Merrill Lynch
JM Financial
Note: It may be observed from the above list that like in Europe and hitherto in USA, there is a dominance of universal banks in India in investment banking space as compared to pure investment banks.

5.9.2 Growth and Consolidation Phase

The Indian investment banking industry which grew aggressively from 1993 till 1996 riding on the first IPO wave extended its presence thereafter into other areas of investment banking such as corporate finance and M&A. It was also during the second phase that home grown Indian investment banks such as ICICI, DSP and JM felt the need for cross border alliances to forge their entry into international finance. ICICI—J.P. Morgan, DSP-Merrill Lynch and JM-Morgan Stanley were the successful joint ventures among the leading banks. Post 2000, in all the three joint ventures, the partners parted ways and decided to go separately with their respective ventures. While both ICICI Securities and J.P. Morgan India operate separately, so do JM Financial and Morgan Stanley. In the case of DSP Merrill Lynch, the US partner bought out the Indian shareholder Mr. Hemendra Kothari and acquired ownership of the joint venture. The company was delisted from the stock exchanges thereafter, thus, becoming a subsidiary of Merrill Lynch USA (which is a subsidiary of Bank of America). The only other frontline Indian pure investment bank, Enam Financial Consultants was acquired by Axis bank, which is detailed below. Therefore, the investment banking industry in India showed the following trends in its growth and structure in a twenty-year span between 1992 and 2012.

- From a proliferation of small and medium sized banks numbering about 1000 which were mainly merchant banks registered with SEBI for various issue management functions, the industry started to diversify into non-merchant banking areas which involved broking, proprietary trading, derivatives, bond placements, corporate advisory services in M&A, restructuring and private equity. Thus, merchant banking became only a part of their business portfolio over the years through it was the only business for many bankers' way back in 1992–93.

From an industry with firms having small balance sheets with standalone merchant banking, the industry went through a transformation and consolidation phase after 2000. Most of the small banks either got acquired or closed down for lack of merchant banking business. Those that survived, graduated to higher levels with bigger balance sheets and better capital adequacy. The bigger banks consolidated to become universal banks and financial conglomerates with both domestic and cross border capabilities for financial solutions. Presently, the industry is characterised by more investment banks and less of pure fee based merchant banking outfits.

The Indian investment banking industry caught global attention as fallout of some of the big-ticket transactions concluded in outbound acquisition space in 2005-07, notably the Tata-Corus, Birla-Novelis and Tata-JLR deals. Several global banks such as J.P. Morgan, Goldman and Morgan Stanley decided to set up their own offices in India. India also became the back-office support for several global banks for their transaction businesses the world over. As a result, the Indian scene transformed from having pure merchant banks and fringe underwriters to having larger universal banks and global investment banks, on one hand and home grown pure investment banks, on the other. By 2016, Indian investment banks were observed to outperform foreign investment banks operating in India in terms of the league tables.

Case Study

Axis Bank's Acquisition of Enam Financial Consultants

Axis Bank, one of the new generation private sector banks in India initiated a deal to acquire Enam Financial Services, a stand-alone pure investment bank from the private sector in late 2010. The strategy was to provide investment banking presence for Axis Bank which was otherwise a commercial bank. However, the transaction was restricted to the investment banking part of Enam (equity distribution, investment banking and corporate advisory services) and did not include its asset management company and insurance broking business. The deal consideration was fixed at ₹2,067 crore which was to be paid in an all-stock deal to Enam shareholders. Enam was closely held among the promoters Vallabh Bhansali, Nemish Shah and Jagdish Master with Mr. Bhansali, a respected investment banker as its Chairman. As per the original deal structure under the merger agreement between both the companies, Enam Securities was to demerge its investment banking related businesses to a wholly owned subsidiary of Axis Bank [Axis Securities and Sales Ltd. (ASSL)]. Axis Bank would have likewise demerged its investment banking operations (which were not significant at that time) into the wholly-owned subsidiary which would then have become the internet-banking entity of the Axis group. In consideration for the transfer, Axis proposed to issue 5.7 shares of itself to Enam shareholders for everyone share held by them in Enam. This would have translated into a stake offering of 3.3% to Enam shareholders in Axis Bank on its expanded equity capital.

The deal was referred to the RBI for prior approval under the provisions of the Banking Regulation Act, 1949. RBI raised doubts on the structuring of the deal and questioned as to why the deal consideration was payable by Axis Bank through issue of its shares while the transfer was proposed to be made to its subsidiary. RBI also stipulated that the investment banking business being bought from Enam could not be integrated into the balance sheet of Axis Bank due to regulatory restrictions of RBI and SEBI. RBI also turned down the proposal to induct Mr. Bhansali on the board of Axis Bank since he would also be a shareholder as per the scheme. The RBI also raised questions on the issue of new equity shares by Axis and the valuation done for the deal.

Reacting to RBI's directives, the deal structure was changed such that the transfer of undertaking by Enam would be directly to Axis Bank for an all stock consideration payable to Enam shareholders. Simultaneously, the undertaking would be transferred by Axis Bank to ASSL for a cash consideration of ₹274 crore payable by ASSL to Axis which represented the book value of Enam's investment banking undertaking as of date. In addition, to satisfy RBI, ASSL did not propose to seek any financing from Axis of the amounts payable under the deal but proposed to raise outside borrowings. The cash component, which did not figure in the original deal structure, had to be introduced as the business was going to be ultimately being transferred to the books of the subsidiary. The revised structure had to also address the tax concerns of both parties. Under the revised scheme, since there was a demerger and then a transfer of business undertaking by the holding company (Axis) to its subsidiary (ASSL) it was tax neutral though Enam shareholders would be swapping unlisted shares for listed shares. However, the incidence of stamp duties might have been higher on the transfer.

The revised structure was approved by the Boards of both companies after a delay of around 10 months. RBI gave its final seal of approval for the revised structure in April 2012. However, very shortly thereafter Axis announced that though the deal structure would remain the same, the deal consideration was being slashed by about one-third to ₹1,396 crore. Accordingly, the number of new shares to be issued by Axis was brought down to 12 million from 13.8 million proposed earlier. Though both companies were agreeable to the revised downward valuation citing change in market conditions in the intervening period, they did not agree to the suggestion that the valuation was brought down due to the concerns of RBI. Mr. Bhansali was proposed to be appointed as advisor to ASSL under the revised scheme.

The proposed transaction received further regulatory approvals from SEBI and the High Court thereafter for the proposed scheme. It created one of India's leading financial services groups combining the investment banking and equities franchise of Enam Securities with the dominant debt capital markets and commercial banking franchise of Axis Bank making it a full-fledged financial conglomerate with formidable strength in both equity and debt capital markets, commercial banking and asset management.

IMPORTANT TERMINOLOGY

Bank Holding Company
Boutique Investment Bank
CDO
CDS
Contagion Risk
Core Investment Banking
Financial Conglomerate
Financial Engineering
Financial Holding Company
Frank-Dodd Act
Full Service Investment Bank
Global Bulge Group
Investment Banking
Lead Manager
League Tables
Merchant Banking
Pass Through Securities
Pay Through Securities
Pure Investment Bank
S&L Institution
Section 20 Subsidiary
Sub-prime Mortgages
TBTF Institutions
Synthetic CDO
Universal Bank

TEST YOUR UNDERSTANDING

I. Pick the right answer(s) or the alternative that best fits the description from the alternatives provided under each question.

1. The following activity constitutes merchant banking under the Indian regulatory framework:
   (a) Preparation of an offer document for fund raising through a public issue of securities.
   (b) Taking a public limited company private.

(c) Providing advice on capital restructuring that includes reduction of capital.
(d) De-listing a company as a part of corporate restructuring.
(e) Demerging a listed company and creating a listed subsidiary.
(f) Syndication of bank loans for an infrastructure project.

2. The Glass-Steagall legislation in the USA provided for the combination of commercial banking and investment banking in the financial sector to prevent collapse of standalone investment banks.
   (a) True (b) False
3. One of the main unintended fallouts of the Gramm-Leach-Bliley Act of 1999 was that investment banks could access enormous funds across markets thereby taking excessive risks which caused a systemic collapse in 2008.
   (a) True (b) False
4. Sub-prime mortgages were repackaged as CDOs and sold to Wall Street investors by investment banks with AAA ratings secured through credit enhancements and further protected by CDS obligations.
   (a) True (b) False
5. The Dodd-Frank Wall Street Reform and Consumer Protection Act 2010 introduced for the first time a way to regulate OTC derivatives by stipulating that they should be cleared through a central clearing mechanism which shall provide counterparty guarantee.
   (a) True (b) False
6. Financial Engineering by an investment banks includes the structuring of a derivative contract de-linking the obligations of such contract with the underlying cash flows or by innovating on such obligations.
   (a) True (b) False
7. Under the Volcker's Rule, investment banks shall not have any affiliations with hedge fund or private equity fund business if such funds invest in companies that compete with the clients of the banks.
   (a) True (b) False
8. In a financial conglomerate structure, the insolvency of one business entity will result in the insolvency of the other business entities of the group since they belong to the same ownership structure.
   (a) True (b) False
9. One of the failures of the system that precipitated the financial crisis of 2008 was the mispricing of mortgage loans and the consequent asset bubble in the housing industry.
   (a) True (b) False
10. The CDS mechanism ensured that low quality CDOs were given default protection by insurance companies.
   (a) True (b) False

For answers refer to Appendix B at the end of the book.

6 The Business of Investment Banking

LEARNING OUTCOMES

- Context of modern investment banking and various business verticals that comprise contemporary global investment banking.
- Implications of global regulatory changes post 2008 on the business of investment banking.
- Regulatory environment in India for the operation of investment banking business.
- Scope of core investment banking and allied businesses to investment banking—asset management and securities business, careers in investment banking.
- Conflict of interest issue and its impact on the re-organisation of the industry, case studies.
- The future of investment banking and financial conglomerates.
- Business profiles of the largest American financial conglomerates and investment banks.

6.1 Nature of Contemporary Investment Banking

Investment banking metamorphosed from a pure intermediation and service activity of the early era into a global fund and non-fund business in securities and capital markets. This evolutionary process has already been described in the previous Chapter. Contemporary global investment banks handle significant fund-based business of their own in the capital market along with their non-fund service portfolio, which is offered to clients. However, these distinct segments are handled either on the same balance sheet or through a conglomerate structure using subsidiaries and affiliates depending upon the regulatory requirements in the operating environment of each country.

As mentioned in Chapter 5, the requirement of a strong and huge balance sheet has become imperative in contemporary investment banking to bag prestigious and *big-ticket* mandates so as to be on the top of the league tables. This was not the case prior to the 1980s wherein *relationship banking* prevailed over size and profile of the financial intermediary. The universal banks with investment banking parentage such as Goldman Sachs ($900 billion in 2016), Morgan Stanley ($800 billion in 2016) and universal banks with commercial banking parentage such as J.P. Morgan ($2.4 trillion 2016), Citigroup ($1.8 trillion 2016), Wells Fargo

(($2.0 trillion 2016) and Bank of America Merrill Lynch ($2.18 trillion 2016), HSBC Holdings Plc ($1.0 trillion in 2016) provide an idea of how big the balance sheets for investment banking business have grown with time. In contemporary terms, investment banking is as much a capital driven industry like commercial banking. Therefore, regulators in the USA preferred to bring even the TBTF pure investment banks such as Goldman Sachs and Morgan Stanley under central bank regulation by mandating their conversion into universal banks in the wake of the financial crisis in 2008.

Over the past seven to eight decades of evolution, the size of the balance sheet of an investment bank has had increasing influence on its fee earnings. In 2007, while the banks with the five biggest balance sheets earned 26% of global investment banking income, the banks with the next five biggest balance sheets earned 24% of such income. This trend prevailed even after the financial crisis of 2008 and the gap widened to 27% and 20% respectively in later years. While the bulge bracket investment banks and universal banks garner a larger share of the big-ticket transactions and fee income, the host of smaller full service and boutique i-banks share the rest of the global earnings in investment banking annually.

This goes on to show that the importance of having large balance sheets is fundamental to financial businesses in general and to investment banking in particular. This is the primary reason why most financial groups transformed into either universal banks or financial conglomerates to drive their business verticals better. However, due to the systemic risk that TBTF banks bring, there is higher regulation on capital adequacy and risk capital allocation for such banks which impacts their profitability to some extent. So, the ROE of the big universal banks is bound to be lower than mid-sized and standalone investment banks. For example, the ROE of J.P.Morgan and HSBC was around 11% in 2017 which is lower than some of the smaller banks.

6.2 Full Service Investment Banking

Investment banking has two facets to it, known in the industry as the *buy-side* and the *sell-side*. In its core business (known as *Core Investment Banking)*, the investment bank is an intermediary and may work from either of the sides depending upon the client it represents. In its allied businesses, it works from the buy side or the sell side based on the nature of the business. Simply put, the buy side is about purchasing a security or a service while the sell side represents the sale of a security or a service. For example, when the investment bank is an issue manager, it is on the sell side. But as a private equity fund manager, it is on the buy side. Equity research or stock recommendations are the sell side while an LBO banker is on the buy side and so on.

The entire business portfolio of *full service investment banking* can be segregated across three broad platforms:

- ***Equity Capital Markets:*** Raising equity capital for companies through public offers, underwriting support, market making, private equity placements, equity broking, proprietary trading, equity derivatives trading, equity research and support services.
- ***Debt Capital Markets:*** Raising debt capital through bond issues and placements, bond underwriting, proprietary bond trading, market making, debt market derivatives, debt broking, debt market research and support services.
- ***Mergers and Acquisitions (M&A):*** M&A advisory, arranging acquisition finance, merchant banking (as per US terminology), co-investing, white knighting, LBOs and buy-outs, due diligence, valuation and support services.

Full service investment banks are engaged in all the business segments listed above. They work on larger deals and among them the bulge bracket banks work on multi-billion dollar deals. Full service banks are characterised by their geographical spread across various financial markets and segments and usually offer varied solutions to clients. In contemporary conglomerate banking, they become a one-stop-shop for all investment banking and other financial solutions. Full service banks can be both universal banks and pure investment banks. J.P. Morgan, BoA Merrill Lynch, Citigroup, Wells Fargo, Barclays, HSBC, UBS and Deutsche Bank are universal banks which offer full service investment banking. Goldman Sachs, Morgan Stanley and the erstwhile Lehman Brothers, Bear Sterns and Salomon Brothers are examples of pure investment banks offering full service investment banking.

On the other hand, *boutique investment banks* are those that specialise in one or more segments in the overall business portfolio but do not offer all the services. Boutique banks are smaller in size and usually restricted to a region, few industries or segments. Usually, they work on smaller deals, typically less than a billion dollars in size and usually assist on the *sell-side* in M&A transactions. They have lesser number of offices and geographical presence. Boutique banks are more localised and one would encounter several such banks in each country, region or city.

Between the bulge bracket full service investment banks and the small boutique banks there are a host of mid-sized investment banks (also known as *i-banks*) that are either smaller full service banks or larger boutique banks. There are several such banks in the mid-size segment and lower end of the i-banking industry proliferating across each country. Examples of some mid-sized banks are Lazard Group (formerly Lazard Freres), Greenhill & Co., Houlihan Lokey, Raymond James Financial, N.M. Rothschild, Evercore, Lincoln International (Chicago), Investec (UK), Mizuho International (Japan) and Espirito Santo (Portugal). Lazard is a very old investment bank dating back to 1848. Lazard is one of the foremost international *i*-banks in M&A advisory services much like the erstwhile Salomon Brothers. Lazard also provides investment management and asset management services and runs several funds. Raymond James is primarily a full-service wealth and asset management company but runs a significant investment banking business as well. It is one of the largest financial services group in USA. Raymond James Bank is a significant S&L institution in USA. It was ranked the foremost real estate investment bank in 2012.

The above business portfolio discussion of full service investment banks is depicted in Exhibit 6.1.

BUSINESS PORTFOLIO

NON-FUND BASED

Equity portfolio: Stand by underwriting, private placements, securities business for equity and equity derivatives (broking, marketing, distribution & research).

Debt portfolio: Fixed income underwriting and placement, structured financing, securitisation, high yield bonds, CDOs and debt finance advisory, prime brokerage services.

M&A portfolio: Corporate Restructuring, M&A transaction services, merchant banking, corporate finance advisory.

FUND BASED

Equity portfolio: Underwriting, bought deals, secondary market making and proprietary trading, equity derivatives and arbitrage trading.

Debt portfolio: Underwriting, secondary market making, proprietary trading, debt derivatives and structured products.

M&A portfolio: Participation as lead or co-investor in buy-outs. LBOs/MBOs (principal investments business), mezzanine financing (sub-debt, convertibles and preferred shares).

Exhibit 6.1 Contemporary Full Service Global Investment Banking

6.3 Core Investment Banking[1]

Investment banking evolved from its humble beginnings in financial intermediation to a gamut of services and businesses across geographies to become a global trillion-dollar industry. Therefore, considering that it has spread far beyond its original mandate of capital market intermediation, there is a further differentiation of its business portfolio into what is termed as *core investment banking* and *allied businesses*. While *core investment banking* refers to the principal and traditional function of raising capital for clients across debt and equity markets and M&A advisory services, *allied businesses* refer to the various services, products and activities spread across (i) secondary markets, (ii) derivative markets, (iii) other financial markets and (iv) fund management across all financial markets. This differentiation is depicted in Exhibit 6.2.

BUSINESS PORTFOLIO

CORE INVESTMENT BANKING

- *Public Offers* in Equities and Bonds – Domestic offers, foreign listings on domestic markets such as Wall Street, Sponsored ADR/GDR programs, underwriting, sales and distribution
- *Private Placements* – Bond and equity institutional placements, global bond underwriting and placements.
- *Private Equity Advisory*
- *M&A transaction advisory*, tender offers, M&A financing, leveraged loans, co-investing, buy-outs and LBOs, high yield Bond placements
- *Structured Products* origination and sales
- *Mezzanine Financing* - Sub-debt, convertibles and preferred shares

ALLIED BUSINESSES

- *Asset Management* – Mutual Funds, Hedge Funds, Private Equity and Venture Capital, Buy-out Funds, Fund of Funds
- *Securities Business* – Broking, investment advisory, derivative trading, structured products trading, arbitrage trading, prime brokerage.
- *Proprietary Trading* and Investments in secondary markets
- *FOREX and commodity* derivatives trading
- *Risk advisory* and management
- *Settlement and custodial* services
- Lending and allied services
- *Wealth Management*
- Other capital market services

Exhibit 6.2 Core Investment Banking and Allied Business Portfolio

As far as the US investment banks are concerned, core investment banking, securities business, prime brokerage, asset management and advisory services are the main contributors to their revenue. The erstwhile Merrill Lynch being a pure investment bank derived a higher proportion of its income from secondary market brokerage. Its highest revenue earner was, however, proprietary trading and investment. Morgan Stanley

[1]This chapter provides an introduction to the various facets of the business portfolio of investment banking and its allied businesses. However, as mentioned in Chapter 1, readers may appreciate that this book is focused on Core Investment Banking and therefore, Section II of the book is dedicated to detailed perspectives on each facet thereof.

earns almost equal revenues from investment banking and asset management though its highest revenue is again from proprietary trading and investment. In general, it is found that proprietary trading and investment contribute the largest revenue to US investment banks. The top underwriters and new issue managers are Goldman Sachs, Morgan Stanley, Bank of America Merrill Lynch, J.P. Morgan and Credit Suisse. The leading investment banks in fixed income underwriting (issuances of pure debt securities) are Morgan Stanley, Bank of America Merrill Lynch and Credit Suisse.

The global mergers & acquisitions business is large and measures up to trillions of dollars annually. Investment banks play a lead advisory role in this booming segment of financial advisory business. Besides, they come in as investors in management buy-outs and management buy-in transactions (discussed in Chapter 5). On other occasions, wherein investment banks manage private equity funds, they also represent their investors in such buy-out deals.

In the case of universal banks such as the Citigroup or UBS AG, loan products form a significant part of the debt market business portfolio. Pure investment banks such as Goldman Sachs and Morgan Stanley do not have commercial banking in their portfolio and therefore, do not offer loan products. However, several leading investment banks have a large presence in structured finance and securitisation products such as Asset-Backed Securities (ABS), Mortgage Backed Securities (MBS) and Credit Derivative Products (CDOs). Structured financing involves origination of loan transactions that are structured to meet desired pricing of borrowers and rating requirements of lenders. Many investments banks such as J.P. Morgan, Deutsche Bank, Citigroup and Wells Fargo that have a strong commercial banking presence are extremely active in structured financing deals. As far as ABS, MBS and CDO structures are concerned, investment banks dealing in them originate and float issuances of such securities and many, a time invest in them. This line of business activity is also known as *financial engineering*. Besides, as explained above there are a host of mid-sized investment banks domestic players in each country which either specialise in local markets or in certain product segments. Some investment banks in the overseas markets also specialise in niche segments such as management of hedge funds, bullion trade, commodity hedges, real estate, metals and minerals and other exotic products. In 2012, J.P. Morgan and Barclays were the top global participants in commodity derivatives matching the strengths of Goldman Sachs and Morgan Stanley in OTC energy derivatives. J.P. Morgan was the leader in metal derivatives after it acquired RBS Sempra in 2010, which was a joint venture between RBS and Sempra Energy. All these four banks were also the top players in the energy derivative markets.

From the above discussion, it may be appreciated that investment banking encompasses a wide area of fund based and non-fund capital market businesses and services and has a significant financial risk exposure to the capital market. Though investment banks earn a significant component of their income from non-fund based activity, it is their capacity to support clients with fund-based services, which distinguishes them from pure merchant banks. In the US capital market, investment banks underwrite issues to buy them outright and sell them to investors, thereby taking upon themselves significant financial exposure to client companies. Besides, being large financial power houses themselves, the global investment banks play a major role as institutional investors in trading and having large holdings of capital market securities. As dealers, they take positions and make a market for many securities both in the equity and derivative segments. They hold large inventories and therefore, influence the direction of the market. Goldman Sachs, Morgan Stanley, J.P. Morgan, erstwhile Salomon, Merrill, Lehman and Bear, Schroders, Rothschild and others are significant market investors both on their own account and on behalf of the billions of dollars of funds under their management.

The business profiles of the largest US based Full Service Investment Banks are furnished in the Annexure to this Chapter.

6.4 Service Portfolio of Indian Investment Banks

The core services provided by Indian investment banks are in the areas of equity market, debt market and corporate finance advisory services. In addition, in the lines of their global peers, Indian investment banks also have their presence in allied businesses in asset management and securities business. These are introduced below.

6.4.1 Core Investment Banking

Merchant Banking, Underwriting and Book Running

As mentioned in previous chapters, the primary market was revitalised with the abolition of the Capital Issues (Control) Act, 1947 and the passing of the Securities and Exchange Board of India Act, 1992. The SEBI functions as the regulator for the capital markets in India which is comparable to the roles of other capital market regulators such as the SEC in USA. SEBI vide its guidelines dated June 11, 1992 introduced free pricing of securities in public offers for the first time in India. When the primary markets are buoyant, issue management, book building and syndicated underwriting form a very dominant segment of activity for most Indian investment banks. A segment of the primary market is also the private placement market for corporate debt securities and qualified institutional placements of equity by listed companies. Investment banks manage public offers and also perform the intermediation function in private placements. SEBI has gradually been increasing its regulations of the private placement market as well, thereby making merchant bankers play a significant role therein.

Mergers and Acquisitions Advisory

The mergers and acquisitions industry which was pretty nascent in India prior to 1994 grew significantly post-2000, especially during a spate of cross border acquisitions by Indian companies. The three main factors that have given a big push to this industry are:

- The liberalisation of the FDI policy in several sectors in India which has enabled a significant inbound M&A market to flourish in India.
- The forces of globalisation which forced Indian industry to consolidate in size in the domestic market and to look beyond national boundaries for new opportunities of growth.
- The institutionalisation of corporate acquisitions by SEBI through its Regulations, popularly known as the Takeover Code. The Takeover Code 2011 provides a much more liberal acquisition structure as compared to its earlier version.

One of the prime business verticals in core investment banking has always been M&A advisory since the days of Salomon Brothers and Lazard on Wall Street. In India, M&A is a core business vertical for investment banks in all segments. While some of them provide pure advisory services in relation to M&A, others holding valid merchant banking licences from SEBI also manage the open offers arising out of such corporate events. There are also several boutique banks that specialise in M&A and buy-outs as their main activity.

Corporate Finance Advisory

Investment banks in India also have a large practice in corporate finance advisory services relating to project financing, corporate restructuring, capital restructuring through equity repurchases (including management of buyback offers under Section 68 of the Companies Act), raising venture capital and private equity, structuring joint-ventures and strategic partnerships and other value added specialised areas. Debt syndication from domestic and international lenders is a major component of corporate finance advisory for Indian investment banks. Several Indian PSU banks and their investment banking entities are active in debt syndication. SBI Capital Markets, IDFC Capital, BOB Capital Markets are active in domestic syndications while Standard Chartered, Deutsche Bank, Barclays, PNB and Bank of India are active in ECB syndications.

6.4.2 Allied Businesses

Asset Management Services

Most of the top financial groups in India which have investment banking businesses also have their presence in the asset management business through separate group entities. Mutual Fund industry grew significantly in India from the late nineties and is a force to reckon with in the capital market. Mutual funds provide the common investor the service of sophisticated fund management. Mutual funds are discussed further in subsequent paragraphs.

Several Indian investment banks have also ventured into the business of starting dedicated venture capital and private equity funds. SBI, ICICI Ventures, Kotak Mahindra Private Equity, Edelweiss, Ambit, IL&FS, IDFC, Canara Bank, Motilal Oswal, SIDBI and others have dedicated venture capital and private equity funds. SBI is reportedly in the process of setting up a venture fund. Besides, several investment banks tied up with foreign funds to set up India specific private equity funds. Venture capital and private equity transactions are discussed in Chapter 12 while the business aspects at a fund level are discussed subsequently in this Chapter.

Securities Business

Broking, Trading, Sales and Distribution The universal banks such as SBI, ICICI, IDBI, HDFC, Axis and Kotak Mahindra and specialised investment banks such as IL & FS, IDFC Securities have their broking and distribution businesses both in the equity and debt segments of the secondary market. They are quite strong in serving institutional clients. In addition, several other pure investment banks such as BoA Merrill Lynch, JM Financial, Karvy, Anand Rathi, Motilal Oswal, IIFL Securities etc. have a strong presence in this area of activity with regard to non-institutional clients (HNIs and retail investors). After the introduction of the derivative segment, it had provided an additional area of specialisation for investment banks. Derivative trading, risk management and structured product offerings are the new segments that are fast becoming the areas of future potential for Indian investment banks. The securities business also provides extensive research based products and guidance to investors. The secondary market services cater to both the institutional and non-institutional investors.

Investment Advisory, Portfolio Management and Wealth Management Many reputed investment banks nurture a separate service segment to manage the portfolio of HNIs, family offices, individuals, households, trusts and other types of non-institutional investors. Investment management has several variants such as private banking, wealth management, portfolio management and investment advisory. Private banking, essentially, refers to commercial banks handling personal financial matters of their preferred clients who are usually UHNIs and HNIs. Wealth management is a more generic term that includes management of the finances of clients across asset classes. It is mostly offered by specialised firms which could in some cases be investment banks. Portfolio Management Services (PMS) refer to managing the capital market investments of clients which is mostly offered by securities houses affiliated to investment banks. PMS may be structured either as a discretionary or non-discretionary arrangement. PMS is a licensed activity and is regulated by SEBI. Investment advisory is purely a recommendatory service to provide stock recommendations from time to time to clients. Discussions on wealth management and investment advisory services are provided in subsequent paragraphs of this chapter.

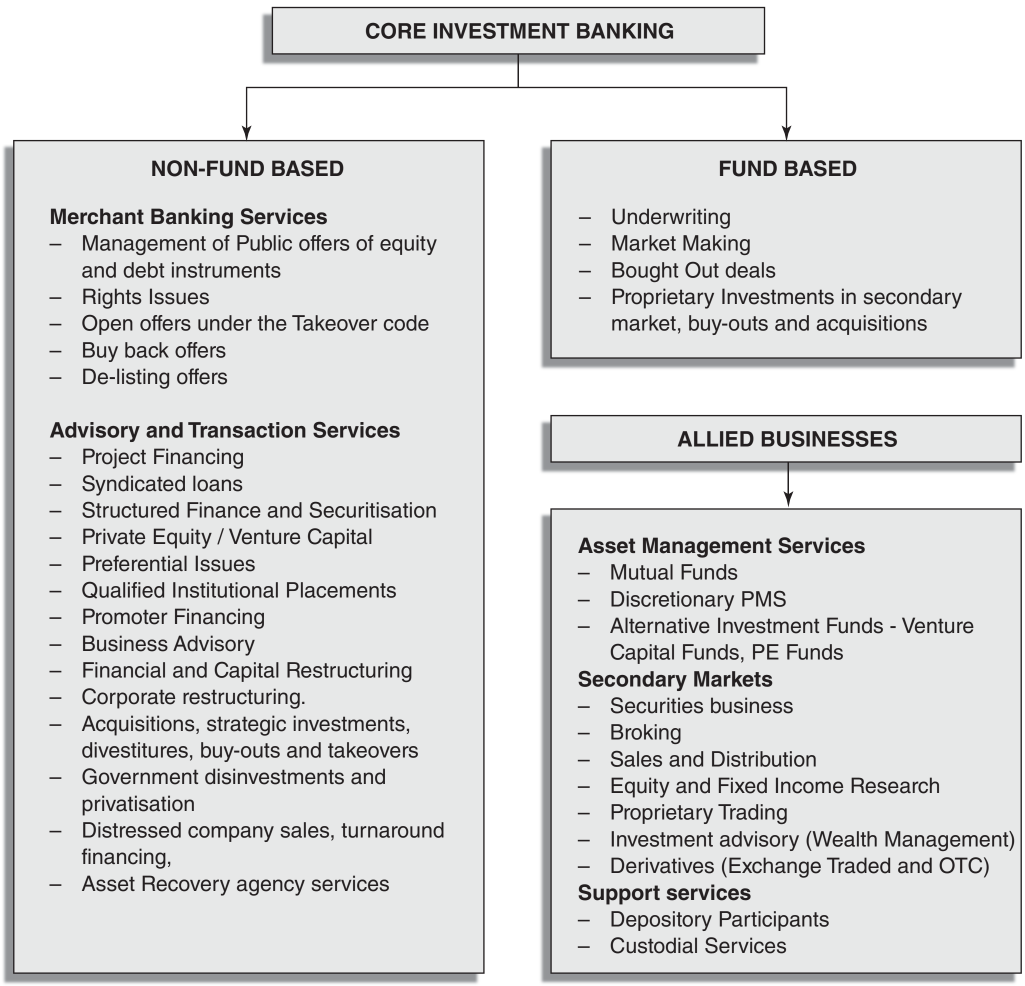

Exhibit 6.3 Business Portfolio of Indian Investment Banks

6.5 Introduction to Allied Businesses

It has been discussed earlier in this chapter that investment banking evolved as a bouquet of capital market financial services based on historical developments and regulations in various countries. Similarly, as has been discussed in Chapter 5, investment-banking industry has a heterogenous structure and not all banks do everything. Full service investment banks provide a host of services and are also present in a range of businesses that are allied to core investment banking. In this and subsequent paragraphs, an outline of these allied businesses is being discussed.

For the purpose of this discussion, we classify the allied businesses into the following two broad categories of services:

- ***Asset Management:*** The business of floating and managing pools of public funds or private funds for profits from capital market and alternative investments.

- ***Securities Business:*** Broking, trading and secondary market operations, prime brokerage services, dealing, marketing and distribution of securities, research activity and investment advisory services in equities, fixed income securities, derivatives, mutual funds and alternative investments.

6.6 Asset Management

Investment banking shares synergies with institutional investing by mutual funds and private equity funds. This is the reason why several investment banks have presence in these allied businesses. Globally, there is a convergence happening between investment banking and fund management to the extent that fund management is no longer a business of choice but a business imperative for the growth and sustenance of investment banking business. This may be gauged by the fact that in 1970, out of the top 15 global investment banks, only 7 (less than 50%) had any fund management affiliations. However, by 1998, all major investment banks such as Merrill Lynch (now a part of BoA), Goldman Sachs, Morgan Stanley, Salomon Smith Barney (now part of Citigroup), Donaldson Lufkin Jenrette (now part of Credit Suisse), Lehman Brothers (now bankrupt), BT Alex Brown (now part of Deutsche Bank), BA Robertson Stephens, J.P. Morgan and Credit Suisse among others, had fund management affiliations. Fund management has helped these banks to wield tremendous financial clout and become capital market powerhouses. It has also balanced out revenues at times when investment banking went through market cycles. More importantly, the real synergy emerges from the support that fund management can provide for underwriting and securities marketing businesses. Though fund management initially started off as a complementary activity, it evolved as an organised asset management business in later years.

Globally, investment banks paid huge considerations to enter the asset management business by acquiring existing firms in that space. In 1997, the Zurich Group paid Scudder, Stevens & Clark US$ 2 billion for the acquisition. In the same year, Merrill Lynch paid US$5.3billionand acquired Mercury Asset Management (UK). Similarly, J.P. Morgan entered the pension fund business through American Century. Goldman Sachs acquired Liberty Investment Management among several other such integrations that have happened over the years. In the Indian context, all major investment banks have their presence in asset management. SBI, ICICI, IDFC, Kotak Mahindra, JM Financial, HDFC, Axis Bank, among others, have their mutual fund businesses apart from private equity businesses managed by some of them.

6.6.1 Synergies between Institutional Investing and Investment Banking

Though asset management is an allied business to investment banking when looked at as a fee based service, the real synergy is in the garnering of investible funds which can be used for institutional investing to further the growth of investment banking business. As illustrated above, many investment banks have, therefore, considered asset management as a natural extension to core investment banking. Those who could not acquire existing asset management businesses started off their own asset management firms and floated several funds.

Institutional investing in primary markets (known as *merchant banking* in the US) and institutional investing in secondary markets (known as *proprietary trading*) are segments that combine well with the business profile in investment banking. For example, commercial banks have investment banking subsidiaries while institutional investing can be part of the core banking operations. Similarly, financial institutions invest as institutional investors while being in investment banking either directly or through group companies. Therefore, institutional investing is a core vertical that combines with investment banking both for universal banks and standalone pure investment banks.

Apart from banks and institutions, the other categories of investors that are relevant for this discussion are mutual funds, venture capital funds and foreign investors. Investment banks can have affiliate entities that are in the business of mutual funds or in venture capital / private equity funds. Mutual fund is more of a retail financial service and helps the investment bank to develop loyal retail clients and strengthen its sales and distribution network. This is the reason why most investment banks are found to be in the mutual fund business apart from *alternative investment funds* such as private equity funds. This practice is prevalent outside India as well. BoA Merrill Lynch, Goldman Sachs, Morgan Stanley and other leading investment banks have large mutual funds under management.

Apart from institutional investment banks, those that are in the category of NBFCs can be institutional investors as well. Investment banks such as Tata Capital, Reliance Capital, Edelweiss, Ambit etc. and NBFCs such as L&T, Sundaram and SREI have investment fund activity in both the primary and secondary markets. This activity helps them to manage their funds, develop investment skills and in structuring financial products for their merchant banking activity.

Venture capital is alternative investment strategy focused on making gains out of nurturing early stage businesses. Therefore, they invest in unlisted companies. Most investment banks abroad and in India floated separate venture capital and private equity funds. UBS, Citigroup, J.P. Morgan, Deutsche Bank and several others in abroad and IDBI, ICICI, Canara Bank, IL&FS, IDFC, Kotak and others in India are instances of investment banks having presence in venture capital and private equity business.

6.6.2 Types of Asset Management

There are several types of asset management businesses globally such as mutual funds, investment trusts (such as REITs), hedge funds, Fund of Funds (FoFs), private client services or private banking, buy-out funds and private equity funds. Private Equity business includes risk capital financing or venture capital business.

Mutual funds are financial pools that are invested for gains in capital markets. They are large pools of funds floated usually through public offers. The difference between a mutual fund and a portfolio fund created for private banking is that the former is a widespread fund formed through the pooling of individual or institutional contributions of several investors while the latter is a private fund of a high net worth investor. Due to the fact that they deal with public funds, the investment activity of mutual funds is highly regulated. A detailed discussion on mutual funds is provided in the following paragraphs of this chapter.

Buy-out funds invest in corporate buy-outs wherein they acquire either the whole or principally the whole of the target company. In the context of buyouts, the structure of a LBO has been dealt with in detail in Chapter 16. However, all buy-out structures are not necessarily LBOs. There are several buy-out transactions that are entirely financed by the buy-out funds either singly or through co-investment without recourse to debt financing.

Private client services, also known as *private banking* or *private wealth management* is a service offered to ultra HNIs, HNIs and other private customers to manage their funds. These funds are managed on individual basis for each client and are not pooled into a common fund. Investments of each client are managed separately and accounting is also distinct. The profit or loss from the activity accrues to the client directly and not to the fund manager. In India, capital market investments in this category are regulated under the PMS Regulations.

6.7 Mutual Funds

As stated above, a mutual fund is a corpus of money that is pooled through subscriptions received from scores of retail and non-retail investors. Since mutual funds collect money from several investors and pool them together, they are organised into distinct pools (known as *schemes*) with common investment objectives. Each scheme is managed by a professional fund manager who determines the investments that are most likely to achieve the stated objectives. The corpus of each scheme is divided into unit capital. Each unit is fungible and represents proportionate ownership of the scheme's invested assets.

Each scheme can be of two types: *open-end* and *closed-end*. Open-end schemes are intended to be perpetual (unless redeemed to the extent of more than 50% by investors) and the value of their units is determined by the *net asset value* or NAV on an on-going basis. Investors may enter or exit the scheme at the prevailing NAV from time to time subject to the standard *entry or exit load* that may be levied as per the terms of issue of the scheme. In a closed ended scheme, the scheme has a specific life and is liquidated and distributed to the then prevailing investors upon reaching the maturity date. The NAV is determined by dividing the value of the scheme's assets less its outstanding liabilities by the number of units in the unit capital. The mutual fund distributes its earnings to investors in proportion to the number of units held by each investor as of the *record date* for distribution of dividends.

6.7.1 Evolution and Mutual Fund Environment in USA

The mutual fund industry has its roots in nineteenth century Great Britain. Most of these were early forms of investment company that later spread to the US. The early structures were similar to closed-end mutual funds. In the US, the first open-end mutual fund was the Massachusetts Investors Trust, set up in 1924. The Great Depression of 1929 and the stock market crash had its impact on the growth of the mutual fund industry. It also brought the industry under the regulatory purview of the SEC as per the provisions of the Securities Exchange Act of 1934.

Apart from the above Act, mutual funds are also regulated by the SEC under the Investment Company Act of 1940 and the Investment Advisers Act of 1940. The former Act requires mutual fund unit prices to be linked to the daily NAV, prohibits transactions between the fund and its managers, limits leveraging by the fund and prescribes a minimum of 40% independent directors on the board of the fund. The latter Act regulates the asset managers and investment advisers of the fund. Mutual funds raising their unit capital from the public must register their offerings with the SEC as in the case of a stock offering and provide notice filings to states in which they intend to offer their units to the public. Funds selling to the public are also subject to regulation as broker-dealer under the Securities Exchange Act of 1934. As far as the tax treatment goes, the Internal Revenue Code of 1986 grants pass-through status to mutual funds upon their satisfying stringent operational and investment requirements.

The US mutual fund industry saw tremendous growth during the 1950s and again the 1980s. The total assets under management crossed US$ 1 trillion in 1990. Presently, there are several trillion dollars of funds under management by the mutual fund industry. American Century, Fidelity, Dreyfus, Franklin Templeton, Scudder, Principal and USAA are some of the big names in this industry.

The mutual fund industry enjoys a significant share of the global asset management industry. Many of the US funds have become global funds with increasing amount of assets being deployed in overseas and emerging markets. The growth of this industry has been fuelled to a large extent by the explosion in institutional investment in mutual funds. Over the years, the share of institutional assets in the overall mutual fund assets has been increasing. The other major contributor has been the pension and retirement fund segment.

6.7.2 Structure of a Mutual Fund in India

Though Indian mutual funds do not enjoy the same breadth as their US counterparts, the operating environment for mutual funds in India is more or less similar to that of USA. Mutual funds are usually set up under a three-pronged structure. Setting up a mutual fund is an expensive legal exercise. Each mutual fund would have a sponsoring entity, known as the sponsor of the fund. The fund itself is constituted as a trust under the Indian Trusts Act, 1881 wherein the unit holders are beneficiaries. The trust is safeguarded by a trustee company and the funds are managed by an asset management company. The share capital of the asset management company is mostly held by the sponsoring company of the mutual fund. Therefore, the three entities, i.e. the sponsor, the asset manager and the trustee are the pillars of the structure of a mutual fund.

The investors in a mutual fund are usually initiated through a public offer. In India, an offer made to launch a new scheme is called a New Fund Offer (NFO). NFOs are similar to IPOs of equity except that mutual fund units are not shares floated by a company. Mutual fund units merely represent proportionate ownership in the assets of the fund as a beneficiary. They do not give rise to any voting rights or other management rights in the affairs of the trust. Such powers are only vested with the trustees. The day-to-day management of the fund activities are looked after by the Asset Management Company or AMC. The AMC runs a complete team of fund managers and administrative officers to look after the affairs of the fund. The trustees deliver the function of overseeing the safeguarding and distribution of the assets of the fund on behalf of the beneficiaries and matters relating to investor protection. Exhibit 6.4 shows the structure and constituents of a mutual fund.

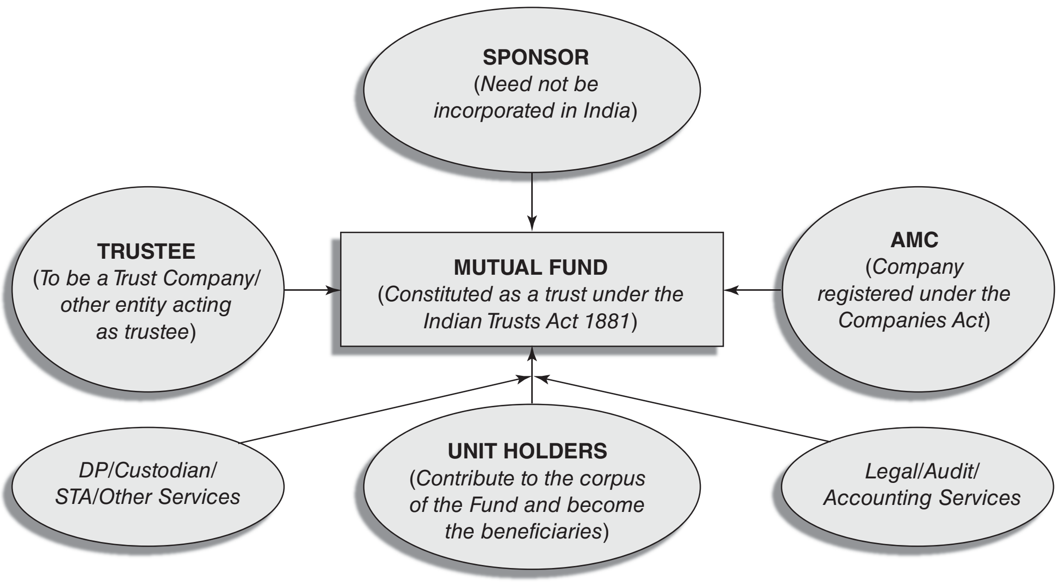

Exhibit 6.4 Structure of a Mutual Fund in India

The expenses incurred by the AMC are met out of the investment management and advisory fee paid to it by the fund. These expenses are debited to the fund on an annual basis and become a cost to the unit holder. Similarly, the trustee company or other constitution can charge a trusteeship fee to the fund. Other fees payable by the fund would be to service providers such as custodians, legal, audit and tax services.

6.7.3 Regulation of Mutual Funds

In India, mutual funds are governed by the Securities and Exchange Board of India (Mutual Funds) Regulations, 1996. As mentioned earlier in this chapter, all mutual funds constituted in India have to be compulsorily registered with SEBI. While granting registration, SEBI considers the standing and past track record of the sponsor. Some of the main provisions of the regulations are as follows:

- There are broadly two types of domestic mutual funds: (i) those that invest exclusively in the money market and (ii) those that invest exclusively in the capital market or primarily in the capital market and partly in the money market as may be found profitable. The first category of funds is called *liquid funds* as they deal with float money management. Liquid fund schemes are run by mutual funds as a part of their product offerings.

- The AMC shall not be allowed to act as the trustee of the fund. The AMC and Trustee should be two separate legal entities.
- AMC is not permitted to undertake any other business activity other than the management of the mutual fund and activities such as financial consultancy, exchange of research and analysis on commercial basis as long as there is no conflict with its primary role vis-à-vis the fund. An AMC cannot act as the asset manager for more than one mutual fund.
- The AMC has been restricted by prescribed caps on the fee it may charge for fund management services under the regulations. In addition, the AMC is eligible for reimbursement of the following expenses incurred for the fund:
  - Initial sponsoring cost of the fund and the launch expenses for each of its schemes.
  - Recurring expenses incurred for marketing, selling, agency commission, brokerage, registrar and share transfer agent etc.
- The trustee company or the Board of Trustees shall have a minimum of 50% independent outside directors who shall not have any affiliation with the sponsoring company or any of its subsidiaries.
- Every mutual fund must distribute a minimum of 90% of its profits earned in a particular year.

6.7.4 Investment Pattern

Under the Regulations, mutual funds have certain stipulations on their investment activity. Some of the main provisions on investments by mutual funds under the regulations are as follows:

- A mutual fund may invest its funds in the following assets:
  - Capital market securities as defined under the SCRA.
  - Money market instruments
  - Privately placed debentures
  - Securitised debt instruments—either asset backed or mortgage backed
  - Gold or gold related instruments
  - Real estate assets
  - Infrastructure debt instruments
- A mutual fund scheme shall not invest more than 15% of its NAV in debt instruments issued by a single issuer which are rated not below investment grade by a credit rating agency authorised to carry out such activity under the Act. Such investment limit may be extended to 20% of the NAV of the scheme with the prior approval of the Board of Trustees and the Board of the AMC. These limits do not apply to investment in government securities.
- A mutual fund scheme shall not invest more than 10% of its NAV in unrated debt instruments issued by a single issuer and the total investment in such instruments shall not exceed 25% of the NAV of the scheme. All such investments shall be made with the prior approval of the Board of Trustees and the Board of the AMC.
- No mutual fund scheme shall invest more than 30% of its NAV in money market instruments of an issuer. Provided that such limit shall not be applicable for investments in government securities, treasury bills and collateralised borrowing and lending obligations.
- A scheme (unless it is a fund of funds) may invest in another scheme under the same asset management company or any other mutual fund without charging any fees, provided that aggregate inter-scheme investment made by all schemes under the same management or in schemes under the management of any other asset management company shall not exceed 5% of the NAV of the mutual fund.

- No scheme of a mutual fund shall make any investment in any fund of funds scheme.
- Not more than 5% of the corpus as reflected by the Net Asset Value (NAV) can be invested in unlisted shares or convertibles in an open-ended scheme and not more than 10% by a closed ended scheme.
- Not more than 10% of the NAV can be invested in shares or convertibles of a single company unless it is a sector specific scheme.
- Mutual funds are not allowed to make loans.
- Mutual funds are allowed to take up underwriting activity for public offers after getting themselves registered separately under the SEBI (Underwriters) Regulations 1993.
- A fund of funds scheme shall be subject to the following investment restrictions:
  - A fund of funds scheme shall not invest in any other fund of funds scheme;
  - A fund of funds scheme shall not invest its assets other than in schemes of mutual funds, except to the extent of funds required for meeting the liquidity requirements for the purpose of repurchases or redemptions, as disclosed in the offer document of fund of funds scheme.

Subject to the above general restrictions, mutual funds can frame a variety of schemes which are either pure debt schemes or equity oriented schemes or both (known as balanced schemes). Within the broad classification, there can be different strategies such as a growth strategy or an income strategy. Similarly, there can also be sector specific funds such as IT, infrastructure, SME sector, pharmaceutical sector etc. There are also funds that are floated to offer tax advantages to investors. Under the present regulations, fund of funds is also permitted to be floated in India. These are mutual funds that invest in the units of other mutual funds.

6.8 Hedge Funds

Hedge funds are of recent origin in the Indian capital market and therefore, home grown hedge funds are yet to be heard of. The few foreign hedge funds that have found an entry have mostly been investors under the FDI or FPI route and therefore, their presence is a minor part of the overall institutional investment. However, globally hedge funds have been around for about 70 years. The first hedge fund started by Alfred W. Jones started operations on the New York Stock Exchange on January 1, 1949.

Hedge funds are typically private investment funds and like mutual funds, they pool investors' funds and invest them in pursuit of profit. However, what differentiates them from mutual funds is the fact that the objectives and the offer memorandum allow the hedge fund to invest across different classes of assets (i.e. financial assets, commodities, real estate and precious metals), across different segments (equity, debt, derivatives), to take both long and short positions and to use leverage. This breadth of investment platform given to hedge funds is what makes them speculative and highly susceptible to the risk of investment loss. It is the ability of these funds to go both long and short in various markets that has given them the name *hedge funds*. SEBI defines a hedge fund as an, "*Alternative Investment Fund which employs diverse or complex trading strategies and invests and trades in securities having diverse risks or complex products including listed and unlisted derivatives.*"

Hedge funds grew in the US markets throughout the second half of the twentieth century. Top Wall Street investment banks and brokerage houses such as Merrill Lynch, Paine Webber and Bear Stearns entered the hedge fund business and several smaller funds were floated by Wall Street's blue-eyed investment bankers. Though as an industry, hedge funds are smaller than mutual funds, they command more than a trillion dollars in assets under management. Hedge funds owe their growth and importance to the fact that they cater to the investment and speculative requirements of wealthy private investors. George Soros, Warren Buffet and other global investors gave hedge funds and their managers celebrity status. Bridgewater Associates is currently the world's largest hedge fund.

Unlike mutual funds, however, hedge funds are not required to register with the SEC. Hedge funds typically issue securities in *private offerings* that are not registered with the SEC under the Securities Act of 1933. In addition, hedge funds are not required to make period reports under the Securities Exchange Act of 1934. But hedge funds are subject to the same prohibitions against fraud as are other market participants and their managers have the same fiduciary duties as other investment advisers. One of the important issues occupying the agenda of the International Organisation of Securities Commissions (IOSCO) is the need and extent of regulation that may be required to tame hedge funds so as to prevent collapses such as that of Long-Term Capital Management in 1998 and also to prevent hedge funds from causing global economic turbulences as in the south-east Asian crisis in 1997.

Case Study

Long-Term Capital Management[2]

Long-Term Capital Management (LTCM) was a hedge fund established in 1994 by John Meriwether who was formerly the vice-chairman of Salomon Brothers and the head of its bond trading division. LTCM also had on its board of directors, Nobel laureates Myron Scholes and Robert C. Merton, who jointly won the Nobel Prize in Economics in 1997.

LTCM's main business model was to deal in high volume low margin arbitrage trade in fixed income government securities especially from Japan and Russia. They developed complex mathematical tools to aid them in this operation, which is known as *convergence trade*. The model was based on the hypothesis that though in the long-term dated bonds would converge in value, in the short-term there would be arbitrage opportunities wherein highly traded bonds would be priced higher than the less traded bonds. But in order to make large profits on this trade, LTCM had to build up sizeable inventories and therefore. leveraged itself very heavily.

In the first few years, the model worked very well and LTCM was an enormously successful hedge fund and returned annualised returns in excess of 40% to its investors. Thereafter, LTCM ventured into lesser known territories of derivative trading and merger arbitrage in which it had little expertise. By 1998, the company on an equity base of US$ 4.72 billion, had leveraged an astounding amount of US$ 124.5 billion. However, the company was solvent since it also had assets with market value of close to US$ 130 billion. But it had also in the process taken on off-balance sheet derivative positions of more than US$ 1.25 trillion.

LTCM's troubles started off when the Russian Government defaulted on its government bonds on 1998. Globally, this led to a knee jerk reaction and investors sold Japanese and European Bonds and bought back US treasury bonds. With this development, LTCM's model was upset and instead of making profits from convergence, it incurred losses on divergence of bond values. LTCM had a run on its equity and suddenly lost US$ 4.6 billion of its capital base in less than 4 months. Leading investment banks and funds such as Berkshire Hathaway, Goldman Sachs and AIG offered to buy-out the general partners, but the offer was declined. Finally, it led to intervention by the Federal Reserve Bank of New York (US central bank) which organised a bail-out package of US$ 3.625 billion through the major lenders to LTCM. This was done to prevent the triggering of a wider collapse of the financial markets. Many big commercial and investment banks such as Salomon Smith Barney, J.P.Morgan Chase, Deutsche Bank, CSFB, Morgan Stanley and Lehman Brothers were a part of the bail-out package for

[2]Interested readers could refer to the life stories of Michael Milken, Dennis Levine, Ivan Boesky, Nick Leeson and our very own Harshad Mehta and Ketan Parekh who were all victims of flamboyance beyond the borders of legality. While the first three were convicted in the USA on counts of insider trading, Nick Leeson was charged with bringing down the Barings Bank through rogue trading. Harshad Mehta and Ketan Parekh were accused of stock market scams in the Indian capital market in 1993 and 2000 respectively.

LTCM. With this, the fund was able to wind up operations in 2000 and thus, became the most well-known casualty of the hedge fund industry and an embodiment of the risk potential that this industry carries with it.

Experts and analysts felt that high leverage ultimately turned out to be the Achilles Heel for LTCM since its directional bets were still correct. Bond prices do converge ultimately but re-pricing in the market due to sudden developments on that occasion led to a run on its money and if it did not have high leverage, LTCM did not have to run up losses and wipe out its assets. If LTCM had the liquidity to hold its entire bond portfolio till maturity, the losses would not have occurred.

6.8.1 Business Structure

Hedge funds are more often than not, structured as small enterprises and rely on the skills of few key managers, mostly including the founders of the fund. The competitive edge for the fund is to market these key people and raise funds from investors. Most hedge funds are structured as *limited liability partnerships* between two types of partners; the *general partner* and the *limited partner*. The organisation of the fund as a limited partnership and not as a company or a LLP (limited liability partnership) makes it possible for the fund to avoid application of several regulations. The general partner is the one who starts the fund and the limited partners are the ones who invest in it. Contractually, the general partner has unlimited liability in case of bankruptcy and the limited partners have limited liability to the extent of their investment in the fund. However, general partners, sometimes, do not invest into the fund as individuals but they constitute themselves as a LLP and become partners in the limited partnership. Thereby, the general partners can limit their liability to the level of the LLP. The LLP of the general partners and the limited partners enter into a partnership contract that defines the investment criteria of the fund and other contractual rights and obligations. The general partners manage the day-to-day investments but they could be assisted by other managers or an investment advisory firm. Besides they are provided back office support by one-stop shop brokers (known as *prime brokers*), custodian, registrar and share transfer agent, marketing agents and other support service providers. They also use the services of accounting, audit, tax and legal firms.

The compensation structure of a hedge fund manager is usually structured as per industry practice. The standard practice is a *one-and-twenty* structure, i.e. 1% management fee and 20% incentive from profits generated by the general partners. However, sometimes the profit determination would be after netting off past losses so that investors do not pay incentive on a cumulated loss. This arrangement is called a *high-water mark*. Sometimes, incentive does not accrue unless a minimum level of return is achieved. This would be called a *preferred return* arrangement. Hedge funds have a strong rewards programme pegged to performance for the general partners who also remain heavily invested in the fund. They share their profits and risks with the limited partners.

As far as the investment strategies of a hedge fund are concerned, they usually use global investment strategies across geographical and sectoral markets and indulge in significant deal sizes. They use a significant amount of leverage as well. They also try to arbitrage across the bank market and the capital market by borrowing at cheaper rates and investing in stocks and bonds and vice versa. This type of trade is known as *carry trade* in which hedge funds indulge heavily. Prior to the global financial crisis of 2008, the yen carry trade played a significant rolein the heating up of US securities and home mortgages markets due to the low interest rates prevailing in Japan as a result of its economic slowdown.

6.8.2 Regulation of Hedge Funds

Regulation of global hedge funds continues to pose a challenge to regulators across the world, though presently, there are country specific regulations in each jurisdiction. In most countries, hedge fund advisers are required to be registered with the local securities market and / or commodity market regulators.

US Regulation

The regulation of hedge funds in general and systemically important hedge funds in particular was tightened in the US with the passage of the Dodd-Frank Act in 2010. The existing framework of securities law under the Securities Act, 1933, Securities Exchange Act, 1934 and Investment Company Act, 1940 was also amended to provide for the heightened regulation.

Presently, hedge funds are subject to the same trading reporting and record-keeping requirements as other investors in publicly traded securities. They are also subject to a number of additional restrictions and regulations, including a limit on the number and type of investors that each fund may have. Hedge funds are also prohibited by the Investment Company Act of 1940 from making public offerings. They are permitted to raise capital only from *accredited investors*. Accredited investors (including institutions such as banks, pension funds and other corporate investors) are prescribed with minimum net worth and income criteria which may be reviewed by the SEC from time to time. Hedge funds are also prohibited by the Investment Company Act of 1940 from making public offerings and are subject to the anti-fraud provisions included in the Securities Act of 1933 and Securities Exchange Act of 1934.

Besides capital market regulation under the SEC, many hedge funds operating in the U.S. are also regulated by the Commodity Futures Trading Commission (CFTC) under the provisions of the Commodity Exchange Act. Hedge funds investing in US commodity markets are to be registered separately with the CFTC and would be regulated by the provisions of the Act.

European Regulation

A similar framework of law, as introduced in the US, was also introduced in the EU in the wake of the global financial crisis of 2008. Some of these provisions provide for heightened regulation of hedge funds. In 2010, the EU approved the *Directive on Alternative Investment Fund Managers (AIFMD)*, the first ever EU regulation focused specifically on alternative investment fund managers. The AIFMD has to be adopted as law by EU member countries by passing their national respective legislation in 2013. The European Securities and Markets Authority and the European Commission were entrusted with the responsibility of framing rules and guidance to give effect to the AIFMD.

The AIFMD applies to all fund managers operating in the EU as adopted under the provisions of national legislation of each country. It would also apply to all non-EU fund managers marketing their products in EU region, once they qualify to become EU qualified fund managers. Otherwise, non-EU fund managers merely marketing their funds in the EU will be subject to reporting requirements under an enhanced national private placement regime. The AIFMD requires hedge funds to register with national regulators of respective EU countries and increases disclosure requirements and frequency for fund managers operating in the EU. Furthermore, the directive increases capital requirements for hedge funds and places further restrictions on leverage utilised by the funds.

Apart from the US and EU jurisdictions, restrictions were also contemplated by the securities markets regulators of Hong Kong and Singapore in Asia.

6.9 Private Equity Funds

SEBI defines a private equity fund as an "*Alternative Investment Fund which invests primarily in equity or equity linked instruments or partnership interests of investee companies according to the stated objective of the fund.*" Private equity is about investing directly in companies in Off-Market Transactions (OTC) as compared to on-market investing. Therefore, a private equity investor takes *unsystematic or alpha risk* while market investors take *systematic or beta risk*.

Included in this domain is a venture capital or early stage investment fund. SEBI defines a venture capital fund as an *"Alternative Investment Fund which invests primarily in unlisted securities of start-ups, emerging or early-stage venture capital undertakings mainly involved in new products, new services, technology or intellectual property right based activities or a new business model and shall include an angel fund..."*

It may be observed from the above definitions that a VCF is intended primarily to invest in unlisted securities while a private equity fund is mandated to invest primarily in equity interests. This difference is what characterises the two activities into early stage and later stage investment respectively. From a risk perspective, though both the activities involve unsystematic risk taking, venture capital investing is riskier due to the early stage of investment.

6.9.1 Evolution of Global Private Equity

It is said that private equity is at least as old as the Roman civilisation. According to Levin (1994), there was a private financing during Julius Caesar's time of a private fire department in Rome. Marcus Licinius Crassus was the investor whose fire department would reach the affected site and make an on the spot assessment of the situation. If the building on fire could be saved, Crassus's team would make a deal at a substantial discount to purchase the building. If the deal went through, they went ahead and saved the building; otherwise they would leave without further action. As a result, the business model worked and Crassus made huge profits.

In the nineteenth century, with the advent of the industrial revolution, there was substantial entrepreneurial activity to set up new industrial businesses. Though bank financing was the mainstay to finance such businesses, venture capital surfaced as a risk financing model to set up those units which banks perceived as risky or unworkable. Venture capital at this stage was not institutionalised but mostly confined to wealthy individuals. Later on, early merchant banks of UK became the first form of institutional venture capitalists with the advancement in venture capital financing. The merchant banks of England also went on to provide capital for the industrialisation of USA and therefore, paved the way for US investment banks in later years. Around the 1940-50s, US witnesses its first batch of institutional venture funds run by professional venture capitalists who identified venture capital as the early stage risk capital for small businesses. This business got further boost when the Small Business Investment Act was passed in 1998 which provided recognition and tax breaks for small business investment companies and regulation through the Small Business Administration. The Act also enabled banks to invest in such VC companies. This Act provided a conducive environment for the VC industry which then witnessed explosive growth. During the later part of the twentieth century, the VC model refined itself and positioned itself as risk capital to early stage technology companies.

In the 1980s, the flow of funds into this industry was enormous with more types of investors getting into financing this activity. The main trigger was, of course, the strong primary market for IPOs. Investors felt that nurturing good IPO candidates was a sure formula to profitable exits. This led to the explosion in both venture capital and later stage private equity financing funds. However, the industry had its share of setbacks during the late 1980s. The explosive growth of the industry meant shortage of good deals and expertise of professional private equity specialists. The industry suffered again during the dotcom bust in 2001 due to astronomical valuations and euphoria surrounding internet businesses. However, the industry gathered its feet again and both venture capital and later stage private equity hit the high growth curve after 2004. There has been renewed activity on the buy-out front as well and several large buy-out deals were seen during 2006 and 2007.

6.9.2 Business Structure

The business of private equity is a small world and usually revolves around professional managers and their trusted investor groups. Funds are usually stared by former VC and private equity fund executives by roping in some of the investors that they have worked with and who have confidence in such managers. The usual categories of investors are HNIs, investment banks, pension funds, private endowment funds and trusts, insurance companies and commercial banks.

The structure of US funds is very much in the lines of what has been discussed for hedge funds except that the remuneration patterns are not meant to incentivise speculative risk taking. The funds are structured as Limited Liability Partnerships (LLPs) or as partnerships based on the state law as also to seek federal tax pass-through status for the fund. The main advantage of a LLP structure is that it provides protection against the liabilities of the fund. In India, a pass-through status is available only for trusts set up under the Indian Trusts Act though a partnership firm has a different scheme of taxation as compared to a company. Therefore, Indian funds are usually constituted as trusts and the day-to-day operations are looked after by an AMC.

In the US structure, the partnership has general partners and limited partners, an aspect that has already been discussed earlier. Typically, in an investment bank sponsored private equity fund, the investment bank plays the role of a general partner. The profit and loss allocations are a matter of intense negotiation between the general partners and the limited partners. Generally, the limited partners share upto 80% of the profits proportionately and the general partners are given 20% as *carried interest*. Losses are normally allocated to limited partners after they are first set-off against the general partners' capital contribution. Limited partners, however, insist on third party liability indemnification from the general partners for liabilities incurred by them in the course of business. The partnership agreements specify the life of the venture which is typically 10-12 years.

ILLUSTRATION 1

ABC Capital, an investment bank sponsors a private equity fund with a contribution of 2%, i.e. US$ 2 million in a total fund corpus of US$ 100 million. The life of the fund is ten years. At the end of the tenure, the invested capital of the fund has appreciated to US$ 750 million. This translates into a CAGR of 22.3% (750/100$^{\wedge 1/10}$-1). Let us now assume that the investment bank is a general partner who is entitled to a share of 20% carried interest. Therefore, its share would amount to (750-100 X 20%), i.e. US$ 130 million. Let us consider that the investment bank has to part with 40% of its profits with its managers as performance bonus. That leaves the bank at corporate level with a profit of US$ 78 million. In addition, the bank would also get its share of the 2% profits of the limited partners, i.e. US$ 10.4 million (750-100 X 80% X 2%). Therefore, the total returns to the bank would amount to US$ 140.4 million. This translates into a CAGR of 63.7% (140.4/2$^{\wedge 1/10}$-1) on its 10-year investment of US$ 2 million.

6.9.3 Industry Structure

Globally, private equity is a multi-trillion-dollar industry with big-ticket institutional private equity players. These funds raise billions of dollars from wealthy individuals and other types of investors for equity related business investments. UBS Warburg, Newbridge, General Atlantic Partners, AIG, Citigroup, Goldman Sachs, Bank of America Merrill Lynch, Sequoia, Temasek, Barings Private Equity, Bain capital, Carlyle, Chryscapital, ING, DE Shaw, TPG Capital and several others have large private equity funds. Some of these are standalone funds while the others are affiliated to investment banks as part of their fund based business. There are also some sovereign wealth funds such as Khazanah (Malaysian Fund), Singapore Government funds etc. that operate in the private equity space. Private equity business thrives in mature capital markets that offer investor friendly market mechanisms and a pro-investor policy regime. Therefore, private equity funds have evolved across the international capital market including certain sectors of emerging markets as well.

In the context of the Indian capital market, institutional private equity is of recent origin. The Indian industry went through rapid transformation in the post-liberalisation era commencing in 1991. From 2001 onwards, Indian industry was on a consolidation drive in various sectors and companies sought to grow not only to stand up to competitive market forces in the Indian market but to attain global scale of operations to be able to have a presence in the international market. This corporate growth initiative coupled with an investor-friendly regime and good economic conditions led to a spurt in private equity activity in India. In the initial stages, though private equity was largely confined to the information technology sector, thereafter it extended to several other sectors including large-scale manufacturing such as pharmaceuticals, construction, FMCG and core sectors like cement, steel and infrastructure. The interest of private equity also extended to service sectors such as banking and financial services, e-commerce, entertainment, healthcare and wellness and education. Private equity investors showed interest even in project financing, an area dominated by large banks and specialised financial institutions. In the infrastructure sector, private equity has played a role in financing both the developer (corporate equity) as well as specific project SPVs (project equity). In addition, the Indian market also saw buy-out transactions spearheaded by funds such as Blackstone, Actis and Navis, Nutrine Confectionery, Nirulas, MTR Foods, Nilgiris Dairy Farm etc. Some of the very successful PE deals in India are that of Warburg Pincus in Bharti Airtel and Gujarat Ambuja Cement (now renamed Ambuja Cement), Chryscapital in Suzlon Energy, Actis in UTI Bank (now Axis Bank) and Punjab Tractors and IDFC Private Equity in Hotel Leela Venture.

6.9.4 Investment Strategies

As has been explained in Chapter 12, the private equity investment spectrum ranges from early stage/ later stage investments to PIPE financing, acquisition financing, turnarounds and buy-outs. Various firms position themselves in this entire spectrum depending on the skills and expertise of their general partners and their specialisation. Most of the funds floated by technocrats and former business executives position themselves as venture capital firms. In the USA, most of the venture capitalists are located either in California on the West Coast or in Boston, New York, Washington and Virginia on the East Coast. Accel Partners, Bain Capital, Canaan Partners, IDG Ventures, Norwest Venture. NEA, Sequoia and US Venture are some of the globally known venture capital funds. In India Chryscapital, Accel Partners, Nexus, IDG, Helion, Kalaari, SIDBI, Gujarat Ventures, Reliance are some well-known VC funds. VC funds are generally very sector focused, i.e. they are either in information technology or biotechnology, pharmaceuticals, healthcare etc. For example, specialist VC firms such as NEA (New Enterprise Associates) in Baltimore or Institutional Venture Partners in Menlo Park have specific sectoral focus. Venture capital funds are also floated by huge multi-national corporations as a way to nurture talent and grow complementary businesses. These funds are known as *corporate venture capitalists*. Intel capital, GE, Microsoft, Google and SAP are examples.

Those firms that have access to large investors and look for bigger deal sizes, position themselves as private equity funds. Private equity is a multi-trillion-dollar industry and names such as Carlyle, Sequoia, Newbridge, Texas Pacific, General Atlantic Partners, Greater Pacific, Westbridge Capital, Temasek, Warburg Pincus etc. being well noted among many others. In India, some of the home grown private equity funds are SBI, ICICI Ventures, Kotak, IDFC, Tata Capital, Reliance Capital, Aditya Birla Private Equity, Axis, Avendus, Edelweiss, IL&FS, Multiples etc. There are other types of private equity funds that specialise in partnering acquisitions and buyouts and position themselves as buy-out funds. Kohlberg Kravis & Roberts is the best-known buy-out firm that led LBOs in the 1980s apart from with Drexel Burnham Lambert and Blackstone. Usually, private equity firms floated by investment banks position themselves as private equity or buy-out firms rather than as venture capital firms.

6.9.5 Indian Private Equity Scenario

The VC Beginnings

In India, the private equity industry was initiated at the level of venture capital only around the 1980s and that too mostly through the initiatives of state owned banks and financial institutions. The reasons for the late emergence of the venture capital industry in India are mostly historical and linked to the state of the capital market and ownership patterns of Indian companies. The Venture Capital Guidelines notified on 25th November, 1988 went on to define the scope of venture capital to mainly include assistance provided to enterprises where the risk element is comparatively high and/or the entrepreneurs being relatively new. The investment size was restricted to ₹10 crore and the technology was relatively new, untried or very closely held or being taken from pilot to commercial scale or which incorporates significant improvement over the existing ones in India.

Pursuant to the guidelines, several institutional Venture Capital Funds (VCFs), mostly backed by financial institutions or banks were promoted to provide VC assistance as per the eligibility norms. However, the main hindrance was the definition given to the scope of VC assistance so as to mean risky and start up technologies. VC was perceived as a high-risk high-return game. Therefore, the units that were supported were mainly the technocrat-promoted variety wherein, but for the assimilation of technology, the promoters were first generation entrepreneurs with lack of business background and in particular, industrial experience.

The traditional concept of VC being risk capital was broad-banded by SEBI in 1996 notifying a new set of regulations for the VC industry called the SEBI (Venture Capital Fund) Regulations, 1996 which did away with the requirement of looking for *untried technologies*. The entire spectrum of private equity investment was, thus, put in place to include later stage and turn around companies. Though the environment for full-fledged private equity investments were put in place in 1996, the guidelines has several restrictions and even the tax law was not investor friendly. Subsequently, tax breaks were given to VCs and the SEBI guidelines were also revised following the recommendations of the K.B. Chandrashekhar Committee in 2000. In the dotcom era of 1997-2001, several technology VCs were set up in India modelled after their Silicon Valley counterparts. Thereafter, gradually with the emergence of a strong domestic capital market and the impressive growth of corporate India, many VCs such as ICICI, UTI and IL&FS evolved into full-fledged private equity players.

Evolution and Growth of Private Equity

The first characteristic private equity transaction in India is arguably the US$ 292 million investment made by Warburg Pincus in Bharti Televentures which also resulted in a successful exit for the fund when Bharti was taken public with its IPO. The transaction generated proceeds of $1.32 billion for Warburg on the share sale. Several foreign private equity funds also established their presence in India either as domestic funds or as off-shore funds operating through investment advisors in India. Deal values picked up only after 2004 during which the first $1.5 billion transaction was made. Post-2004, even acquisition financing, turnaround financing and equity buy-outs became an integral part of private equity business in India. The total private equity investments in India touched US$ 7.47 billion in 2006. It was a watershed year for private equity in

India spread over 302 transactions with even the average deal size being larger than ever before. The largest private equity investment in 2006 was in Idea Cellular amounting to $ 950 million. Similarly, the largest exit transaction was the US$ 736 million acquisition of Matrix Laboratories by Mylan which provided exit to private equity investors. Other subsequent successful exits by PE investors include the Paras Pharmaceuticals sale to Reckitt Benckiser in which the PE firm Actis made an exit. The largest buy-out in 2006 was the US$ 760 M buy-out of Flextronics by KKR.

In terms of market maturity, private equity came a long way in India from its nascent beginnings in venture capital in 1988. The deal sizes grew bigger, valuations became more robust and the investing funds became broader as compared to the sectoral bias they started with in the 1990s. At that time, most funds were from US origin and were keen to invest only in IT and related sectors. With the growing maturity of the market, funds became multi-sectoral and post-2000 investments were seen in several manufacturing and service sectors as well as in real estate and infrastructure. The third phenomenon in market development was the strong emergence of strong domestic brand names in private equity such as ICICI, IDFC, IL&FS, Kotak, New Silk Route, Canaan Partners, Motilal Oswal, Multiples and others. This coincided with the arrival of the big ticket private equity and buy-out funds from US and Europe into India. Some of the well-known global funds such as those of Singapore, Malaysia and China also made their entry into Indian private equity.

Private Equity at the Crossroads

The decade of 2011-2020 can be termed as the consolidation phase of private equity in India with some of the older funds exiting and newer funds consolidating the industry. Several funds that invested in the bullish markets prior to 2008 saw their investment values getting eroded subsequently. Weak capital market added to their exit woes due to which their follow-on fund raising efforts were also quite unsuccessful. In the years subsequent to the global financial crisis, private equity sector in India suffered due to a plethora of sectoral and macroeconomic issues including the scare of additional taxation from the introduction of GAAR in domestic taxation. The dearth of quality later stage investment opportunities and high valuation expectation of Indian promoters were also two major factors dogging the PE industry growth in India. Fund raising for new investments domestically is also a challenge the PE funds in India need to grapple with. Domestic institutions and investment banks started to become investors in PE funds set up in India. For example, Multiples asset management, a local PE fund floated in 2010 had several domestic banks such as Andhra Bank, Indian Overseas Bank, LIC, PNB and SIDBI as investors. However, more than 90% of PE fund raise for Indian investments is from overseas sources.

According to a study by KPMG[3], returns generated by PE investors from Indian markets on an invested capital of $ 5 billion between 1999 and 2010 amounted to a gross IRR of 17.9%, only a little more than the 14.4% that the market index (SENSEX) generated over like period. Net of management fee and other operational costs, the IRR fell below 14.4%. This compared unfavourably with China (20.4%), Australia (24.9%) and Japan (20%). Even PIPE investments did not generate good returns for PE funds. Mid-size firms invest on an average around $10 million in each transaction while the larger funds look for higher amounts. However, the return expectation of larger firms is around 16–18% while the mid-sized firms look for around 25% IRR. In 2012, few foreign PE funds such as Jardine Rothschild, Spinnaker Global and Eight Capital exited India citing lack of quality deal flow. A large number of mid-sized PE funds entered India around 2006 and made investments at high valuations which impacted their return and exit prospects post 2010. Therefore, the period beyond 2013 saw a consolidation within the PE industry with the smaller funds folding up and the larger funds diversifying their portfolio.

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[3]Reported in Businessworld 21st May, 2012 p 25

Growth of Venture Capital

The start-up ecosystem in India has evolved from only being a technology sector phenomenon of the late 1990s and early 2000s into a more broad-based venture capital industry. Several home-grown VC funds were set up in subsequent years such as Accel Partners, Inventus, IDG Ventures, Indo-US Ventures, Nexus, Helion and others. In addition, several global VC funds also identified India as a favourable investment destination in the VC space. Investment in start-ups and early stage companies increased considerably after 2010. Even the larger PE funds in India were attracted to early stage investments due to the lack of adequate quality deals in later stage companies and steep valuations in Indian market. Marquee PE investors such as Blackstone and Sequoia Capital made such investments in 2011 as did Goldman Sachs and IDFC PE. The angel funding space also got institutionalised in this period and institutional angel funds such as Mumbai Angels and The Indian Angel Network were initiated. In addition, non-institutional angel investors from the technology sector are also prominent investors in the Indian VC space. E-commerce, cloud computing and education proved to be the sunrise sectors for VC and angel investments. The period after 2013 was extremely good for new PE investments and exits due to the substantial uptick in capital market activity. The emergence of the e-commerce sector wrote a new chapter in private equity investments in India with the leading players such as Flipkart, Snapdeal and Paytm, Ola etc. raising billions of dollars of capital with each of them being valued in excess of a billion dollars (known as *unicorns*). The e-commerce sector also saw the convergence of venture capital, private equity and buy-out funds with some of the biggest funds in the world such as Tiger Capital and Softbank becoming early stage investors. The advent of buy-out transactions, the liberalisation of the Takeover Code and increasing corporate governance awareness among Indian corporates are the boosters to PE investments in future.

Other than the e-commerce sector, the VC investment space is not plagued by high valuation syndrome as is the PE space, since companies are small and investors are limited. Secondly, successful exits made by funds such as Nexus Ventures developed a better ecosystem for new funds to enter. According to a study conducted by IDG Ventures[4] while technology investments provided about 500% cumulative return, non-technology sectors provided about 300%. Due to these strong trends in technology, bid data, cloud computing, innovation, financial technology and other sunrise sectors, venture capital industry has a bright future in India.

6.9.6 Regulation of Private Equity in India

Regulation of Alternative Investing in India

Keeping in view the growing interest in India for venture capital and private equity, SEBI consolidated the regulation of all such funds under a new scheme of regulation which was introduced in 2012. These regulations intend to regulate funds that are not registered as mutual funds or as collective investment schemes under their respective regulations. These regulations also permit non-resident funds to get registered, if they are not registered under the FPI or the FVCI Regulations. SEBI introduced the SEBI (Alternative Investment Funds) Regulations 2012 (AIF Regulations) under which such funds are sought to be regulated. The Regulations prescribe compulsory registration of all AIFs with SEBI whether domestic or foreign. The essential requirement for a fund to be brought under these regulations is that the fund should have been pooled and constituted in India.

Under the AIF Regulations, an alternative investment fund has been defined as, " *Alternative Investment Fund means any fund established or incorporated in India in the form of a trust or a company or a limited liability partnership or a body corporate which:*

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[4]Reported in The Economic Times dated 8th February 2012

- *is a privately pooled investment vehicle which collects funds from investors, whether Indian or foreign, for investing it in accordance with a defined investment policy for the benefit of its investors; and*
- *is not covered under the Securities and Exchange Board of India (Mutual Funds) Regulations, 1996, Securities and Exchange Board of India (Collective Investment Schemes) Regulations, 1999 or any other regulations of the Board to regulate fund management activities.*"

The above definition is subject to specific exclusions as defined under the Regulations. It may be noted that SEBI seeks to migrate even all existing domestic VCFs to the AIF Regulations in due course. The AIF Regulations define a private equity fund as "*An alternative investment fund that invests primarily in equity or equity linked instruments or partnership interests of investee companies according to the stated objectives of the fund.*" The Regulations also define Category I, Category II and Category III funds based on their investment objective. While Category I definition primarily fits for VCFs, Category II fits PE funds and Category III fits hedge funds.

The investment criteria prescribed for VCFs under Category I are identical to those prescribed for domestic VCFs under the erstwhile VCF Regulations. The investment criteria prescribed for PEFunds under Category II merely state that the investments shall primarily be in unlisted companies but does not prescribe any limits. Subject to this general condition, PEFs shall invest as stipulated in their placement memorandum. The main provisions in the regulations with regard to investment are:

- The minimum corpus of an AIF is stipulated at ₹20 crore and individual subscriptions to such fund should be a minimum of ₹1 crore. No scheme is allowed to have more than 1,000 investors.
- The fund manager has to have a continuing interest in the fund to a minimum extent of 2.5% or ₹5 crore, whichever is less.
- Funds may raise subscriptions through private placement. After the fund raise is closed, a closed ended fund may also be listed.
- Category I and II AIFs shall not invest more than 25% of their corpus in one Investee Company. The same limit for a Category III fund is 10%.
- Investment by Category I and II funds in on the SME platform shall be construed as investment in unlisted securities.
- Category I funds shall invest at least 66.66% of their corpus in unlisted equity shares or equity linked instruments of a VCU or in companies listed or proposed to be listed on a SME exchange. The balance of 33.33% may be invested in any of the investment options provided below:
  - Subscription to initial public offer of a VCU whose shares are proposed to be listed.
  - Pure debt instruments only as follow on funding in a VCU wherein it already has an equity exposure.
  - Preferential allotment of equity shares of a listed company subject to a lock in period of one year.
  - Equity shares or equity linked instruments of a financially weak company or a sick industrial company whose shares are listed. A financially weak company has been defined for this purpose as a company, which has accumulated losses at the end of the previous financial year and has resulted in erosion of more than 50% but less than 100% of its net worth as at the beginning of the previous financial year.
  - Special Purpose Vehicles (SPVs) which are created by a venture capital fund for the purpose of facilitating or promoting investment in accordance with these Regulations.
  - The venture capital fund may enter into an agreement with merchant banker to subscribe to the unsubscribed portion of the issue or to receive or deliver securities in the process of market making for a SME issue in which case the restrictions mentioned above shall not apply in case of acquisition or sale of securities pursuant to such subscription or market making.

There is no regulation on the type of investee companies or VCUs in which AIFs can make investments except that they shall be domestic companies and unlisted at the time of investment. VCUs may be engaged in any type of manufacture or service activity. Therefore, under the guidelines, VCFs may invest in sick and turnaround companies as well.

Regulation of Foreign Venture Capital Funds in India

Foreign venture capital investors in India are those funds that are pooled and constituted outside India with a mandate to invest in India. These are known as FVCIs under the SEBI regulations and governed in similar fashion through a separate set of regulations. These regulations provide for these funds to get registered in India following which they can make investments in Indian companies. The FVCI or a global custodian acting on behalf of the FVCI shall enter into an agreement with the domestic custodian to act as a custodian of securities for FVCI. The domestic custodian shall be responsible for monitoring of investment of the FVCI and furnishing of periodic reports and other information to SEBI.

The general investment conditions governing FVCI investments are as follows:

- The fund shall disclose to the SEBI its investment strategy at the time of registration and subsequently at the launch of each of its funds.
- It can invest its total funds committed in one VCF.
- The corpus has to be invested in VCUs in the ratio of 66.66%: 33.33% mutatis mutandis as domestic Category I AIFs. FVCIs do not have a restriction as domestic funds with regard to maximum exposure to a single VCU. Therefore, technically, the entire corpus may be invested in a single VCU.

It may be noted that under the above regulations, registration is not compulsory though there are certain tax advantages in registering. For FVCIs, there would also be free pricing allowed for investments and exits, if they are registered with SEBI.

6.10 Securities Business

For the purpose of this discussion we shall define *securities business* as comprising of equity and fixed income broking, prime brokerage services, sales and distribution of securities, equity and fixed income, research and investment advisory services. Internationally, investment banks also conduct several other businesses such as derivatives, risk arbitrage, securitisation and money market operations under the portfolio of securities business. In the Indian context, investment banks conduct money market operations along with capital market operations by taking a separate licence from RBI as *primary dealers*. However, for the purpose of this chapter, we confine our discussion to those activities that are most closely linked to capital market activity.

As it may be appreciated, securities business has a close synergy with investment banking. The broking divisions of full service investment banks play a vital role in complementing the functions of their issue and underwriting departments. Broking divisions have several valued customers who can be of good investment potential for the securities floated in the primary market. The research division provides reports that are useful for investors in analysing the merits of such issues. The sales and distribution network provides the backbone for marketing of new security issuances which creates the required strength for underwriting business. However, it has to be ensured that in conducting these complementary businesses, there is enough supervision and no overlapping or conflict of interest. As mentioned in the case of Barings bank (in Chapter 5), it was the lack of internal controls that led to the collapse of investment banks and the emergence of conflict of interest in several US investment banks that caused millions of dollars of penalties and lawsuits on them. Most global investment banks have vast securities business (also known as *brokerages*) in their group to support their core investment banking functions. In addition, there are large security houses whose primary business is that of sales and distribution, investment advisory and related financial services. Charles Schwab is the largest independent brokerage house in USA measured by client assets. Other well-known names in securities and investment business are Wells Fargo, Fidelity, Franklin Templeton, Northern Trust and Principal.

Case Study

MF Global

MF Global Holdings, a futures broking entity run by former Goldman Sachs head Jon Corzine filed for bankruptcy under Chapter 11 of the US Bankruptcy Code in 2011 after a proposed deal for a sell-off fell through. It was already suspended from trading by the stock exchanges. The Federal Reserve of New York suspended MF Global from conducting new business with itself. The bankruptcy made MF Global the most well-known failure of a US brokerage house due to the Euro zone debt crisis. In the week prior to filing for bankruptcy, it declared a quarterly loss, its share price fell and credit rating agencies downgraded it to junk status. MF global indulged in heavy proprietary trading with calls on the course of euro zone sovereign debt. This was a transformation that Corzine had initiated so that MF Global would transform from a brokerage into an investment bank trading on own account. The bankruptcy was a result on wrong calls taken on proprietary trading positions.

In India, all the top tier investment banks have effective securities businesses, some of them within the investment banking companies and others in affiliate or subsidiary companies. ICICI Securities, HDFC Securities, Axis Securities and Sales, SBICaps Securities, IDBI Capital Markets, Kotak, JM, DSP and Edelweiss are examples. In addition, standalone brokerages such as Motilal Oswal, IIFL Securities, India Bulls Ventures and Karvy Stock Broking areeminent securities houses. Foreign investment banks present in India such as Morgan Stanley, J.P. Morgan and Goldman Sachs also have presence in this segment.

6.10.1 Broking and Dealing

The function of stock brokers is to conduct trading on behalf of clients. In earlier days, brokers and jobbers had distinct functions but in recent years, the distinction has blurred. According to Rule 8 of the Securities Contracts (Regulation) Rules, 1957, in order to become eligible to the membership of a stock exchange (and thereby be a broker), a person should fulfillcertain requirements. A company incorporated under the Companies Act is eligible to be admitted as a member if:

- A majority of the directors of such company are shareholders of such company and also the members of that stock exchange; and
- The directors of such company who are members of that stock exchange, have unlimited liability in such company.

SEBI stipulated additional requirements for corporate members to be admitted in stock exchanges. It is also possible for a member of one stock exchange to seek multiple memberships in other stock exchanges based on the relevant guidelines issued in this behalf by the Capital Market Division of the DEA, Government of India.

In addition to the requirements stated above, under Section 12 of the SEBI Act, no stock broker is permitted to buy or sell or otherwise deal in securities except under and in accordance with the conditions of a certificate of registration obtained from the SEBI. For this purpose, SEBI promulgated the SEBI (Stock-Brokers and Sub-Brokers) Regulations, 1992. These regulations inter alia cast a responsibility on the stock brokers to maintain proper books of account and other records and adhere to a code of conduct as prescribed therein. The books of stock brokers are subject to audit by the stock exchange and inspection by SEBI. Apart from these requirements, brokers should also maintain client database and have individual broker-client agreements drawn up and executed in the prescribed format. In addition to the statutory requirements enumerated above, the members of the stock exchange are bound by the bye-laws of that exchange and trading systems stipulated therein. Brokers are subject to capital adequacy norms in relation to the volume of business handled by them. Brokers have to also meet the margin requirement on trades conducted by them as per the norms of the respective stock exchange. As far as client relationships are concerned, brokers have to maintain individual accounts of their all clients and there has to be complete transparency and demarcation of trading done on behalf of clients and proprietary trading.

Apart from domestic brokers, SEBI has issued a separate set of guidelines to register foreign broking houses to operate in India for the limited purpose of trading on behalf of its registered FII clients in India. They are, however, not allowed to conduct any proprietary trading in India.

In addition to regulation of brokers of stock exchanges, sub-brokers are also under regulation by the stock exchange and SEBI. A sub-broker, unlike the main broker functions under the broker mainly for the purpose of marketing securities or soliciting broking business. Therefore, by definition, sub-brokers are not members of any stock exchange and are, therefore, not bound by its bye-laws. Since many a time, the actual investors are in contact with the sub-broker and not with the member of the exchange, it would be difficult to protect their interests. In order to bring the sub-brokers under regulation as well, the SEBI regulations referred to above now prescribe compulsory registration for sub-brokers as well. Under Section 12 of the SEBI Act, no sub-broker is permitted to buy or sell or otherwise deal in securities except under and in accordance with the conditions of a certificate of registration obtained from the SEBI. Every broker has to maintain records of sub-brokers working under him or her and an agreement with each sub-broker specifying the scope of authority and responsibilities of the stock broker and the sub-broker. Sub-brokers are also bound by a code of conduct stipulated under the above said regulations.

Sales and distribution is the activity relating to marketing and selling of securities to investors on a regular basis. It also includes supply of stationery, collection of application forms from investors, opening and operating collection centres and handling investor related requirements. This is a vital function that supports new issues launched by the investment banking department. Most broking businesses of investment banks handle broking, sales and dealing for institutional and HNI clients as these customers have the maximum potential and requirements for large volumes of securities.

6.10.2 Trading

Trading can be proprietary or for the benefit of clients. Institutional broking houses handle trading for their clients either on profit-sharing arrangement or for a management fee. The client trading services usually have the following business areas: (i) taking positions (going short or long) and providing liquidity to clients and (ii) providing trading and hedging advice, market making and risk management. Proprietary trading and institutional trading are often handled by distinct groups within the investment bank in order to avoid the issue of conflict of interest.

Trading should be distinguished from dealing. Broking and dealing generates fee-based income for the bank based on transactions conducted for the client either through brokerage earnings or through selling commissions generated from sales. It can also come from bid-ask spreads, if jobbing is also conducted along with broking. All such income is only transaction based and does not emanate from holding any positions in the market. Trading, on the other hand, involves taking positions with intent to make profits. Therefore, *traders* are different from *dealers* and *salespeople*. This is the reason why securities departments keep their dealers and traders distinct. Several investment banks, especially the pure investment banks run large businesses in trading, both for proprietary and institutional purposes.

The other characteristic of trading operations is to take risks in maintaining positions. Dealing by definition, is not about taking risks. Even if dealers sometimes indulge in risk-taking, it would be in a narrow range well defined through internal control procedures. This is because, dealers are not meant to earn profits but accrue transaction based income. Traders are meant to make trading profits either for the investment bank or for their institutional clients. The degree of risk taking by a trader depends on the constitution of the investment bank or the securities house and their operating philosophy. In the developed capital markets, the risk-taking function becomes more sophisticated and some investment banks feel pride in their star traders. Some banks specialise in particular segments such as fixed income securities or equities. For example, Salomon Brothers specialised in bond trading. Some banks have traders in sophisticated operations relating to arbitrage, risk arbitrage and creation and trading of synthetic instruments that require complex quantitative modelling. This is the reason why several investment banks recruit mathematicians, statisticians and physicists in their trading divisions.

6.10.3 Institutional Sales

Serving the institutional client base, *Institutional Sales* is a business vertical that deals with equities, fixed income, currency and commodity derivatives. Usually, the equity and fixed income sales and derivatives sales are organised in separate departments as the expertise is different. Institutional sales involve working with in-house traders, on one hand and the investment desks and treasury departments of clients, on the other. Hedge funds are the most active clients for an institutional sales team. Institutional sales in equity involve shares, convertibles and stock derivatives. Fixed Income sales includes bonds (investment grade, sub-investment grade and unrated), structured products, special situation securities such as distressed asset bonds, project finance bonds, infrastructure bonds etc., emerging market bonds, municipal bonds, commercial paper and other short-term paper. Derivative sales include currency derivatives, commodity derivatives and credit derivatives.

Apart from pure sales, Institutional Sales function includes *Prime Brokerage Services* as well. These involve securities lending to clients for the purpose of providing liquidity for the trading activity. Prime brokerage desks usually maintain an inventory of securities to perform the lending and trading activities for clients. In addition, they also provide financing by way of margin funding for trading positions and even extend credit for trade settlements based on a collateral mechanism.

6.10.4 Equity, Fixed Income and Quantitative Research

Research is considered as the backbone of the entire securities business, especially for institutional sales, dealing and trading. Most full-service investment banks have full-fledged research departments spread across all segments—equities, fixed income securities and derivatives. Research analysts generate different types of products such as sectoral reports, company reports, economic analysis and specific stock recommendations. They also provide a lot of back office support, especially for traders in looking for evidence of market imperfection in stocks, under-valuations and mispricing. Based on the investment strategy adopted by traders,there can also be specific requests to the research department to look for unique propositions such as value investing or dividend stripping. In the bulge bracket investment banks, research departments are large and divided into specific segments. Usually, they have around 50 research analysts, but big banks like BoA Merrill Lynch, Goldman Sachs and Morgan Stanley have more than 100 analysts at any given time. The usual segregation in a research division is into equity research, fixed-income and bond research and quantitative research that focuses on derivatives, arbitrage and complex modelling strategies. In India, the top tier investment banks and institutional securities houses have well developed research departments catering to all the above-mentioned segments. Many of them cater to institutional clients such as DFIs, FIIs, mutual funds and banks.

To sum up, it is often said that while trading and research are *powerful allies*, trading and dealing are *natural allies*.

6.10.5 Investment Advisory and Wealth Management Services

Investment advisory services is all about making investment recommendations to clients and helping them in making such investments. Investment advisory services are usually meant for HNI clients and arealso, therefore, known sometimes as *private banking*. One has to appreciate a fundamental difference in the manner in which wealth management through portfolio management services or other forms of asset management differ from investment advisory services. In asset management, the funds are removed from the investor's books and pooled separately into a different entity or on the books of the asset manager. In investment advisory, the funds are not removed from the books of the investors. Instead, the advisor merely makes recommendations from time to time on suitable investment options looking at the profile of the investor.

In the Indian capital market, both investment advisors and portfolio managers are regulated. Investment advisors require stipulated minimum qualification and should adhere to a code of conduct so as to prevent investors from getting misled by sub-standard advice or service quality. Investment advisory also relies heavily on the research department in order to generate good advice from time to time. The research reports generated by that department are often used by the advisory department to recommend to clients. Investment advisors also prepare financial plans for individual clients keeping in view their profile and investment requirements. Therefore, some investment advisors position themselves as *financial planners*. Investment advisory services provided by securities houses generally relate to equities, bonds, mutual funds or other capital market instruments as they mostly deal with HNI and institutional clients. Financial planners, on the other hand, deal mostly with individual and retail investors and generally provide advice on all sectors including other avenues of investment such as bank deposits, government savings and insurance products.

6.11 Interdependence Between Different Verticals in Investment Banking

As is evident from the above discussion, there are different verticals in core investment banking and allied businesses that enjoy synergies with one another. While some of the service or business segments form the core of investment banking, others provide invaluable support as allied activities. It is important to understand the inter-dependence and complementary existence of all these business segments.

While merchant banking in India largely relates to management of public floatation of securities or reverse floatation such as the buybacks and open offers, underwriting is an inherent part of merchant banking for public issues. Similarly, market making is a part of the process of floating issues on the SME platform for small companies. Market making offers liquidity and depth to the secondary market and thereby complements primary market floatation. Corporate finance advisory and transaction services have a close linkage with merchant banking as more often than not, such services culminate in a merchant banking assignment for a public issue or a reverse floatation. Such services also help in maintaining an enduring relationship with clients during times when merchant banking is not a hot activity due to depressed market conditions. The other segment of primary market activity, i.e. venture capital and private equity has equal synergies with merchant banking. Being in venture capital business enables identification of potential IPO candidates quite early, which helps not only in generating good fee income from merchant banking services, but also in good capital gain for the venture capital invested at earlier rounds of financing in such companies. Similarly, being in private equity business helps in harnessing the potential offered by later stage and listed companies, which may approach an investment bank primarily for merchant banking services. Providing exits to PE and VC investors through IPOs, strategic acquisitions and secondary sales has a close linkage with primary markets and M&A advisory services.

The allied business verticals in the secondary market operations also have synergies with those in the primary equity and debt market segment as far as investment banking is concerned. Stock broking and primary dealership in debt markets nurture institutional, corporate and retail clients who can be tapped effectively for asset management, portfolio management and private equity businesses. In addition, presence of the equity derivative and foreign exchange derivative segments can help in offering solutions in treasury management to clients. In addition, the advisory and transaction services vertical can draw expertise from such segments in providing structured financing solutions to its clients. All these verticals are driven by support services such as sales and distribution and equity research and analysis. Lastly but importantly, the capability in sales and distribution determines the success of the merchant banking vertical.

Thus, it may be seen that the growth and success of an investment bank depends on its strengths in each vertical and how well it combines them for synergies. To sum up the discussion, core investment banking and its allied businesses are closely inter-related. On the whole, investment banking is a business that is very sensitive to the economic and capital market scenario and therefore, the broader the platform of operations, the more is the likelihood of an investment bank surviving business cycles and sudden shocks from the market.

6.12 Regulatory Framework for Investment Banking Business in India

In the absence of a comprehensive piece of legislation governing financial services in India, various services are regulated through a plethora of Acts and Rules and by different regulators and investment banking is no exception. Investment banking in India is regulated in its various facets under separate legislations or guidelines issued under statute. The regulatory powers are also distributed between different regulators depending upon the constitution and status of the investment bank. Pure investment banks that do not have presence in the lending or banking business are governed primarily by the capital market regulator (SEBI). However, universal banks and NBFC investment banks are regulated primarily by the RBI in their core business of banking or lending and insofar as the investment banking segment is concerned, they are also regulated by SEBI. An overview of the regulatory framework is furnished below:

- At the constitutional level, all investment banking companies incorporated under the Companies Act are governed by the provisions of that Act.
- Universal Banks are regulated by the Reserve Bank of India under the RBI Act and the Banking Regulation Act which put restrictions on capital market exposures to be taken by banks. In terms of Section 19(2) of the BR Act, no banking company shall hold shares in any company, whether as pledgee, mortgagee or absolute owner, of an amount exceeding 30 percent of the paid-up share capital of that company or 30 percent of its own paid-up share capital and reserves, whichever is less, except as provided in sub-section (1) of Section 19 of the Act. In addition, the aggregate exposure of a bank to capital market in all forms (both fund based and non-fund based) on a standalone and consolidated basis should not exceed 40 percent of its net worth as on March 31 of the previous year. Within this overall ceiling, the bank's direct investment in shares, convertible bonds / debentures, units of equity-oriented mutual funds and all exposures to Venture Capital Funds (VCFs) (both registered and unregistered) should not exceed 20 percent of its net worth. Banks are also allowed to own 100 percent of investment banks and undertake mutual fund activity through separate entities. Within the overall limits set by the BR Act, the RBI prescribed a ceiling for a bank's investment in group businesses which is 10% of its paid-up capital and reserves in other regulated financial businesses. If such businesses are unregulated, the ceiling is 5%. The aggregate group exposure is also restricted to 10% in the case of regulated financial businesses.

Due to the above statutory framework, under the present scenario, financial conglomerates in India can exist only under the Bank Subsidiary Model, if a bank is the parent organisation. The structure would be a similar parent-subsidiary structure even if a NBFC or an investment bank is the parent organisation since there are separate registration, capital adequacy and prudential norms requirements for each sector supervised by a specific regulator.

- In the past, the restrictions relating to the exposures of merchant banking subsidiaries of commercial banks to underwriting business and other fund based commitments such as standby facilities etc. was capped at 25% of their Net Owned Funds (NOF). In recent years, these restrictions were relaxed. Therefore, these companies are now on par with other investment banks which can do so upto 20 times their *net owned funds*.
- Investment banking companies that are constituted as non-banking financial companies are regulated operationally by the RBI under Chapter IIIB (Sections 45H to 45QB) of the RBI Act. Under these sections, RBI is empowered to issue directions in the area of resource mobilisation, accounts and administrative controls. The following directions have been issued by the RBI so far:
  - Non-Banking Financial Companies Acceptance of Deposits (Reserve Bank) Directions, 1998
  - NBFCs Prudential Norms (Reserve Bank) Directions, 1998
- Functionally, different aspects of investment banking are regulated under the Securities and Exchange Board of India Act, 1992 and the guidelines and regulations issued there under. These are listed below:
  - Merchant banking business consisting of management of public offers is a licensed and regulated activity under the Securities and Exchange Board of India (Merchant Bankers) Rules, 1992 and Securities and Exchange Board of India (Merchant Bankers) Regulations, 1992.
  - Underwriting business is regulated under the SEBI (Underwriters) Rules, 1993 and the SEBI (Underwriters) Regulations, 1993.
  - The activity of secondary market operations including stock broking are regulated under the relevant bye-laws of the stock exchange and the SEBI (Stock Brokers and Sub-Brokers) Regulations,1992. Besides, for curbing unethical trading practices, SEBI has promulgated the SEBI (Prohibition of Insider Trading) Regulations, 1992 and the SEBI (Prohibition of Fraudulent and Unfair Trade Practices Relating to Securities Markets) Regulations, 1995.
  - The business of asset management as mutual funds is regulated under the SEBI (Mutual Funds) Regulations, 1996.
  - The business of portfolio management is regulated under the SEBI (Portfolio Managers) Regulations, 1993.
  - The business of venture capital by such funds that are incorporated in India is regulated by the SEBI (Alternative Investment Funds) Regulations, 2012 and by those that are incorporated outside India is regulated under the SEBI (Foreign Venture Capital Funds) Regulations, 2000.
  - The business of institutional investing by foreign investment banks and other investors in Indian secondary markets is governed by the SEBI (Foreign Portfolio Investors) Regulations, 1995.
- Investments banks that are set up in India with foreign direct investment either as joint ventures with Indian partners or as fully owned subsidiaries of the foreign entities are governed in respect of the foreign investment by the Foreign Exchange Management Act, 1999 and the Foreign Exchange Management (Transfer or issue of security by a person resident outside India) Regulations, 2000 issued there under as amended from time to time through notifications issued by the RBI.
- Apart from the above specific regulations relating to investment banking, investment banks are also governed by other laws applicable to all other businesses such as the tax law, contract law, property law, local state laws, arbitration law and the other general law applicable in India.

6.13 Careers in Investment Banking

Investment banking careers are quite gruelling both at entry and at senior level, as they require working under high pressure and demand high level of skill and expertise. Usually, entry level positions in any investment banking business desk is that of an *analyst*. Highly qualified personnel such as MBAs, CFAs, CA, CPA, CMA etc. would be considered for the next level, i.e. an *associate*. Depending upon the hierarchy structure in a particular bank, the designations thereafter could be such as *principal*, *AVP*, *Vice-President*, *Head* or *Managing Director*. All these are functional positions and do not represent the senior management such as the CEO or Director. It could take around 20 years to reach a senior management position from an entry level job.

Analysts are the number crunchers at an investment bank and need to have excellent financial modelling skills. They would also require knowing interpretation of financial statements and analysis. Familiarity with financial reporting standards, different types of valuation models for equity, debt and other securities is an advantage. Over time, analysts also develop deep insights into industry trends and how macroeconomic variables influence business outcomes.

Associates have more of a functional role to play in support of the AVPs and VPs to drive transactions. While the VP drives a transaction team with the support of AVPs and associates, the associates are primarily responsible for the preparation of *Pitch Books*. A pitch book is an investor presentation or marketing pitch prepared by the investment bank to secure a mandate from a prospective client. Client meetings are extremely important in this business and are usually driven by the Managing Directors and VPs. These positions require excellent communication, inter-personal skills, marketing abilities and leadership capabilities to motivate and lead high performance teams. The AVPs and associates require being good team members as well. Higher positions come with business development and client management responsibilities wherein revenue generation and growth are the key deliverables. Lower positions come with functional performance as the key deliverable. Remunerations are usually lucrative and go exponentially higher at senior levels since a bulk of the remuneration package is based on performance or responsibility assumed.

Investment bank hiring can be both at entry level and through lateral hiring. Analyst and associate openings are usually filled though recruitment from B-schools and other channels. Lateral hiring happens usually at VP or higher positions and is often facilitated through references, networking and executive search agencies. Lateral hiring may take place from investment banking into allied businesses and vice-versa. For example, an investment banker may move into a private equity career or a senior securities head may move into an investment banking position. Similarly, lateral hiring in a senior investment banking position may happen from industry or consulting space as well.

6.14 Conflict of Interest in Investment Banking

With the repeal of the Glass Steagall Act, regulators had to put in place systemic checks in the US (known as *firewalls*) to prevent the Section 20 subsidiaries of banks from accessing the funds of their parent commercial banks. Several firewalls were introduced both at the corporate level and at the management and employee level. Firewalls are essentially with respect to systems that would enable firms to separate those areas that routinely process confidential information considered as *inside areas* from those which deal with sales / distribution of financial products and investment advisory services or other departments providing support services that are considered *public areas*. However, the firewalls could not prevent impending disasters that rocked the US capital market at the turn of the century.

So, how does the conflict of interest really arise? Most investment banks have in-house research divisions as a support function as discussed earlier. The research divisions perform vital functions of tracking corporates and making recommendations to their clients in the secondary market operations or to their own dealing rooms. They also issue reviews and ratings to new issuances hitting the market. The conflict could arise, if the research analyst promotes a share, the public offering for which is being handled by the merchant bank. Alternatively, it could also be that the analyst is privy to insider information from the merchant banking division and there upon issues recommendations that could amount to fraudulent deceit of investors or gains for select few. While an investment bank may be advising a client on a buy-out, its private equity arm may be in the fray for its purchase. An example of this was the sale of the power storage business of Invensys in 2001 wherein Morgan Stanley was the advisor in the $505 million sale to EnerSys, a company owned by Morgan Stanley Capital Partners (Morgan Stanley's private equity arm).

Over the years, the firewalls between investment bankers and research analysts melted especially in the heat of the IPO and the internet boom. The compensation patterns of the investment bankers and the research analysts were also getting complementary to an extent, thus, undermining their independence. Therefore, the most burning global issue in the investment banking industry at the beginning of the 21st century became the conflict of interest between investment banks and their research analysis divisions. In the wake of the Enron, WorldCom and other corporate disasters, this issue gained significant importance.

A study was conducted by the SEC in 2001 on *full service investment banks* in Wall Street focusing on these conflicting relationships. The study disclosed two main areas on conflict: (i) research recommendations tending to become marketing tools for merchant banking assignments by the same bank and analysts getting paid share of such investment banking gainsand (ii) ownership of stocks by research analysts in the companies that they recommend or research. The study disclosed that analysts leveraged their position in pumping up recommendations in companies that they are interested in when they went public. The SECalso initiated investigations into instances of investment banks issuing over-optimistic research and steering shares in hot IPOs to important clients for vested interests. The regulators alleged that the firms allowed their investment bankers to pressure equity research analysts in ways that could cause them to issue misleading research to the harm of investors.

In such investigations, some of the banks were imposed fines. In 2003 and 2004, the SEC, Self-Regulatory Organisations (SROs), and others settled with 12 broker-dealers to address conflicts of interest between the firms' research and investment banking personnel. Merrill Lynch paid up fines to the extent of $100 million in regulatory proceeding in 2002 brought against its misleading research reports. Citigroup's Salomon Smith Barney was also in the dock and found it paying the heaviest of fines. CSFB was also in trouble with the regulators. Most of the other top investment banks such as Goldman Sachs, Lehman Brothers, Bear Sterns, Deutsche Bank, J.P. Morgan Chase and others also found their names in the fines list in 2002. CSFB was fined for misleading investors on offerings in technology shares. J.P. Morgan, on the other hand, was under a cloud for its role in the infamous off-balance sheet partnerships it had crafted for Enron. Besides, investment banks were also the targets of several lawsuits filed by aggrieved investors. In late 2002, the French luxury goods leader, LVMH, filed a 100 million euro suit against Morgan Stanley alleging that its research report on LVMH was biased because of the investment bank's close advisory relationship with LVMH's arch rival Gucci Group NV. Morgan Stanley was also the underwriter of Gucci's IPO in 1995.

Both the NYSE and the NASDAQ came out with *research analysts conflict of interest rules*' in May 2002 which was subsequently approved by the SEC. Under the Global Research Analyst Settlement (*Global Settlement*), the firms investigated had to undertake reforms designed to sever links between research and investment banking. The SROs also adopted equity research rules to address analyst conflicts across the industry, but these rules were not as stringent in some areas as the Global Settlement. In the revised dispensation, one of the main provisions is that analysts have to disclose their interests in their recommendations. In addition, there is sought to be a water-tight compartment in the working of the investment banking departments and the research divisions. The third area has been the regulation of compensatory structures for research analysts based on the profits of the merchant banking divisions. Market observers felt that this was a good development from the point of view of addressing conflict of interest.

6.14.1 Developments after the Financial Crisis in 2008

At the request of the broker-dealers, a court modified the Global Settlement in 2010 and eliminated settlement terms where, for the most part, comparable rules existed in the framework of the stock exchanges and SROs. However, the Financial Industry Regulatory Authority (FINRA) in the US was working to finalise a rule proposal designed to broaden the obligations of firms to identify and manage equity analyst conflicts and better balance the goals of helping ensure objective and reliable research with minimising regulatory costs and burdens. FINRA was also instrumental in working to finalise another rule proposal that would address conflicts faced by debt research analysts. FINRA would recommend to the SEC to codify the changes required to address the gaps in present regulation.

The Dodd-Frank Wall Street Reform and Consumer Protection Act, 2010 passed in response to the financial crisis of 2008 required the US Government Accountability Office (GAO) to study the conflict of interest issues once again. A report published by the GAO in 2012 discusses (i) what is known about the effectiveness of the regulatory actions taken to address analyst conflicts and (ii) what further actions, if any, could be taken to address analyst conflicts. GAO reviewed empirical studies, the SEC and SRO rules mentioned above, examination findings and enforcement actions. GAO also interviewed SEC and Financial Industry Regulatory Authority (FINRA) officials, market participants and observers. The GAO report established the following position:

- Existing research and stakeholder views suggest that the Global Settlement and other regulatory actions have helped to address conflicts faced by equity research analysts. The results of the empirical studies that GAO reviewed generally suggested that the Global Settlement and equity research rules adopted by the SROs were associated with improvements in analysts' stock recommendations.
- Independent monitors, which were required as part of the Global Settlement, also found that the 12 firms that were investigated and settled were generally complying with the Global Settlement.
- Broker-dealers, institutional investors and others told GAO that the regulatory actions helped insulate equity research from investment banking influence, although some noted that not all conflicts can be eliminated and certain restrictions can be circumvented.
- The Report noted that the current SRO research rules do not cover debt research analysts, although these analysts face conflicts of interests similar to those faced by their equity analyst counterparts. In the absence of an SRO debt research rule, the SROs had to rely on anti-fraud statutes and SRO rules requiring ethical conduct. They also encouraged firms (with limited success) to comply voluntarily with industry-developed principles designed to address debt analyst conflicts.
- The Report also noted that the Global Settlement firms continue to be subject to the requirements of the Global Settlement and the SRO research analyst rules, while other firms that provide the same services are subject only to the SRO research analyst rules. As a result, investors may not be provided the same level of protection.
- The Report comes to the conclusion that some of the Global Settlement's terms that serve to protect investors were not codified and that they should form part of SEC rules in future to provide the same level of protection to all investors and service providers.

6.14.2 Indian Scenario

Under the framework of SEBI regulations, there are certain checks and balances with regard to the functioning of investment bankers and the conflict of interest issue. Regulation 21A of the SEBI (Merchant Bankers)

Regulations 1992, provides that a merchant banker shall not lead manage any issue or be associated with any activity undertaken under any regulations made by the Board, if he is a promoter or a director or an associate of the issuer of securities or of any person making an offer to sell or purchase securities in terms of any regulations made by the Board. Regulation 26 states that, "*No merchant banker or any of its directors, partner or manager or principal officer shall either on their respective accounts or through their associates or relatives, enter into any transaction in securities of bodies corporate on the basis of unpublished price sensitive information obtained by them during the course of any professional assignment either from the clients or otherwise.*"

Under the SEBI regulations, credit rating agencies are bound by a code of conduct just as investment bankers and are obligated to treat, as confidential, information supplied to it by the client and no credit rating agency shall disclose the same to any other person.Their code of conduct stipulates that the agency shall ensure that no conflict of interest exists between any member of its rating committee participating in the rating analysis, and that of its client. SEBI also promulgated the SEBI (Prohibition of Fraudulent and Unfair Trade Practices relating to Securities Markets) Regulations, 2003 to curb malpractices of various kinds in the secondary markets. Merchant bankers are also deemed to be *persons in concert* under the Takeover Code.

The corporate scandals that surfaced in the USA also resulted in precautionary amendments to regulations in India by SEBI. There were cases involving securities frauds in the Indian capital market from time to time and in 2006, for the first time, SEBI issued a disgorgement order providing for punitive damages on investment bankers in connection with an IPO scam. In recent years, SEBI investigated several IPO related violations by investment bankers and issuers as well as secondary market trading violations based on insider information. As a result, analysts are barred from private trading in the shares they analyse.SEBI also introduced the SEBI (Research Analysts) Regulations, 2014 and the SEBI (Investment Advisors) Regulations, 2013 to rein in these service providers and ensure checks and balances in the system. The research analysts' regulations contain a separate Chapter III on *Management of Conflicts and Disclosure Requirements*.

In spite of the above steps, the conflict of interest issue is not adequately codified in India. Secondly, there are no separate regulations for equity and debt research analysts. The internal mechanisms of most investment banks in relation to firewalls are largely unregulated in India. The stock exchanges and the AIBI, an industry body that is a SRO do not provide any coded framework for mitigating conflict of interest in investment banking in India. There is clearly room for more regulation in this area of importance for the survival of the investment banking industry free from periodical controversies and violations.

6.15 The Dark Side of Investment Banking

History has shown that investment banks, however, big or small made mistakes, sometimes proving to be fatal. The cases of Bear Sterns and Lehman Brothers falling prey to excessive leverage, on one hand and pure speculation, on the other, have been discussed in Chapter 5. Furnished below is the leverage of the leading US banks at the time of the financial crisis (Table 6.1).

Table 6.1 Leverage of the leading US Banks at the time of Financial Crisis

Investment Bank	*Leverage (times)*
Bank of America	12
J.P. Morgan	14
Citigroup	19
Goldman Sachs	26

(*Contd.*)

Morgan Stanley	30
Bear Sterns	31
Lehman Brothers	34
Fannie Mae / Freddie Mac*	45
Merrill Lynch	46
I Forbes * Mortgage institutions that collapsed in the crisis.	

It may be noted that the banks that collapsed had a very high financial leverage as compared to those that managed to survive. The other aspects to the darker side of investment banking would be business failings, conflict of interest, excessive executive remunerations, facing regulatory wrath, lack of compliance etc. Some of these aspects have already been discussed under various sections in Chapter 5 and this chapter. The ones that are otherwise worth a mention but have not been discussed elsewhere are furnished below:

- Citigroup agreed to settle SEC charges that it had misled investors during the financial crisis in 2008 about a product linked to toxic mortgage assets. Citigroup agreed to pay $285 million as compensation in a compounding proceeding of the SEC. The investigation revealed that Citigroup failed to disclose that it had chosen about half the assets for short selling and was betting they would decline in value. Citi sued one of its employees while it paid the penalties. This was the third largest proceeding against an investment bank by the SEC for their role in the 2008 crisis. The biggest was the $550 million settlement with Goldman Sachs Group Inc announced in July 2010 and the second was a $300 million settlement with State Street. Overall, the SEC collected $ 2 billion in fines from investment banks for the 2008 crisis.
- In the wake of Occupy Wall Street movement showing public resentment at the obnoxious pay packets of bankers on Wall Street, leading banks such as Credit Suisse, Deutsche bank and J.P. Morgan cut back on bonus payments in 2011 and 2012. This was also true of some leading bankers such as Lloyd Blankfein, James Gorman and Jamie Dimon.
- In the aftermath of the investment banking crisis in 2008 globally, the Indian investment banking industry did not suffer as much in comparison though there was a slowdown in business and earnings. Larger banks depended on M&A activity and government mandates for survival while the boutique banks were working on private equity entry and exit deals.
- In 2011, the demand for breaking up TBTF institutions gathered momentum after the collapse of global investment banks and problems in commercial banks due to their exposure to toxic derivative products sold by investment banks to them. In UK, the Independent Commission on Banking submitted its recommendations in 2011 suggesting that major British commercial banks should ring fence their investment banking operations from commercial banking by 2019. The report became significant in the backdrop of the British Government's rescue efforts for the Lloyd's group, RBS and mortgage lenders Northern Rock and Bradford & Bingley in the aftermath of the 2008 crisis. As a result, while the mortgage banks got nationalised, RBS became 81% government owned and Lloyds to the extent of 41%. Elsewhere in the US and EU, regulators and economists still deliberate on the adverse consequences of universal banking and financial conglomerates.
- BoA's acquisition of Countrywide Financial Corp in 2008 for $2.5 billion ended up to be a liability more than a strategic advantage. By 2012, the cost of the acquisition ballooned to $40 billion in real estate losses, legal expenses and settlements with state and federal agencies. Countrywide was at that time the largest mortgage lender in the US. The acquisition converted BoA into a huge mortgage lender just at the time of the housing bubble collapse. The acquisition saddled BoA with thousands of delinquent borrowers and lawsuits losses.

Case Study

J.P. Morgan

J.P. Morgan, was the largest bank in USA by assets in 2011 surpassing Bank of America for the first time. While J.P. Morgan never suffered losses during the financial crisis and thereafter in spite of taking over Merrill Lynch, Washington Mutual and Bear Sterns, BoA had to suffer huge write downs after it took over credit card company, MBNA Corp and mortgage lender, Countrywide Financial Corp. However, J.P. Morgan received a shock a year later from an unexpected quarter. It suffered huge losses of more than $3 billion in its derivative proprietary trading division known as the Chief Investment Office in 2012. The loss was attributed to derivative losses that were tied to the credit-worthiness of bonds. The portfolio included layers of instruments used in hedging and became too complicated to work and too big to unwind quickly in depressed market conditions that prevailed in global markets in 2012. The losses marred the reputation of the bank known for its efficient risk management practices and prompted a credit rating downgrade. The bank sacked its long standing chief investment officer and the bank's CEO Jamie Dimon, the best-known banker in USA was also shown in bad light. Dimon was also a member on the board of the Federal Bank of New York. He was one of the staunch opposers to excessive regulation of the financial sector and what are known as Too-big-to-Fail banks. Such TBTF banks came under sharp criticism in the aftermath of the global financial crisis that led to the fall of mega banks in the US including Bear Sterns, Lehman Brothers and Merrill Lynch and brought immense liquidity pressures on the other two big 5 banks, Goldman and Morgan. The former chairman of the Federal Reserve, Paul Volcker, was one of the strongest advocates of stronger regulation of TBTF banks. Dimon was strongly opposed to it.

- Barclays Bank was in controversy in 2012 along with 15 other major banks over an allegation of having rigged the LIBOR, the world's most important global interest rate for several years. Barclays ended up paying GBP 290 million in fines for a settlement. This led to the German market regulator to launch an investigation into Deutsche Bank. In another proceeding in 2012, both Standard Chartered Bank and HSBC were investigated for failure of internal due diligence mechanisms which helped in abetting money laundering globally by drug traffickers and terrorists.
- In India, Deutsche Bank was sued by Unitech group, a Delhi based property development company, in 2012 accusing the bank of having sold an interest rate swap that wasn't suitable and wasn't explained properly at the time of sale. The lawsuit was filed in London for over a $150 million loan transaction. Deutsche bank was accused of being negligent in selling an unsuitable hedging instrument and Unitech sought to set aside a claim by the bank for $11 million owed by the company to the bank under the swap contract. This led to an investigation by the UK FSA on procedures deployed by banks while selling OTC derivative contracts to clients. The issue of improper sales of products by banks and investment banks affected several countries globally including India. This prompted the RBI to issue directions to commercial banks on ensuring proper sales of foreign exchange OTC derivative products. Investment banks in India are not permitted to originate foreign exchange OTC derivatives. Only authorised dealers in foreign exchange (commercial banks) are allowed to do so.
- Several prestigious investment banks were victims to insider trading allegations and prosecution, the most recent in 2012 being the case of Rajat Gupta, at the time an independent director on the board of Goldman Sachs. The case of Rajat Gupta and one of the other famous older cases, that of Michael Milken are already discussed in Chapter 4.

6.16 Will the Mistakes be Repeated?

To sum up, it can be said that the investment banking industry went through tumultuous timesin its chequered history. Every time there was a systemic crisis, on the one hand, the crash of the capital market battered their bottom lines and led to large-scale cut back in staff and operations. On the other hand, the role of investment banks in corporate scandals and their questionable business practices and ethics took a toll on their reputation and image. The confidence in larger universal banks and financial conglomerates was also shaken in 2008 which would require several decades of rebuilding. According to a BCG Report quoted by Reuters in 2017, investment banks paid a cumulative amount of $321 billion in fines since the global financial crisis for their lapses. This makes a compelling statement on their role leading to the crisis and their internal failures.

Nevertheless, going by later developments, investment banks did not seem to have learned their lessons from the 2008 crisis.By 2012, the implementation of the Dodd-Frank Act was slowed down by the government due to lobbying by Wall Street. The Donald Trump administration promised to bring reform to the working of the Act to accommodate the interests of Wall Street. The global CDS market was at $12 trillion in 2016, a steady decline from the peak of almost $60 trillion in 2007 but investment banks started to show signs of aggression again. Preet Bharara, the U.S. Attorney for the Southern District of New York who successfully tried several investment banking bigwigs for corrupt practices and financial crimes once said, "*The bigger and better question may not be whether insider trading is rampant but whether corporate corruption in general is rampant; whether ethical bankruptcy is on the rise; whether corrupt business models are becoming more common.*" Neil Barofsky, the former inspector general of TARP, said in 2011, *"It is a remarkable failure of our system that we've not addressed the fundamental problems that brought us into the financial crisis. And it is cynical or naïve to imagine it won't happen again."*

6.17 Full Service Investments Banks and Financial Conglomerates of the Future

While the meteoric growth of universal banks (especially in the USA), financial conglomerates and TBTF institutions looks suspect considering the regulatory overtone in various countries, there is no doubt about the fact that the future belongs to *full service investment banking* comprising of core investment banking (managing and underwriting security issues of all types, structured products, corporate finance and M&A advisory), allied businesses in asset management (mutual funds, wealth management and private equity) and securities business. Therefore, while the top end of the industry would consist of full service investment banks, the middle layer would constitute mid-sized banks and the lower end would be occupied by specialist boutique investment banks. Nevertheless, there is a firm recognition of the enormous costs paid by the system due to the emergence of TBTF institutions and therefore, regulatory authorities are on an overdrive to curb the indiscriminate growth of such institutions. In short, what began as the Glass Steagall Act in 1933 has come about a full circle.

6.17.1 Regulatory Challenges for Investment Banking

According to a report[5], the *Dodd-Frank Act* and the *Volcker's Rule*, *Basel III Banking Accord* which would become fully implementable from January 1, 2019, Markets in Financial Instruments Directive (MiFiD), European Banking Authority (EBA) Governance Guidelines, Financial Stability Board (FSB) Principles, European Market Infrastructure Regulation (EMIR), Foreign Account Tax Compliance Act (FATCA) and

[5]Capgemini Report on Regulatory Changes in the Investment Banking Industry published in 2013

the Financial Transaction Tax (FTT) Act in the USA are the main global regulatory developments that would impact the future working of the investment banking industry. In a similar study in 2015, Morgan Stanley outlined that regulatory impact would be felt on the following key areas of investment banking business: (i) capital, (ii) liquidity, (iii) risk management, (iv) compliance, (v) traded markets and (vi) governance.

The heightened regulatory compliance has its impact on profitability as well. In a report in 2015, it was calculated that the ROE for the top 15 investment banks had fallen to around 7% from a high of about 20% (33% in the case of Goldman Sachs) in the seven years preceding the 2008 crisis. Among all the regulatory challenges, Basel III alone would have significant impact on bottom lines. The rules of Basel III require banks to raise billions of dollars of capital in reserve, improve bank liquidity (principally through the Liquidity Coverage Ratio) and reduce the amount banks can leverage through the Leverage Ratio. In addition, Basel III requires periodical stress testing, resolutionand recovery plan for banks which will be an additional requirement for universal banks and TBTF institutions.

In terms of regulatory impact on business verticals, a significant amount of capital will be required under Basel III as a buffer to support fixed-income trading activity. This, along with restrictions on proprietary trading under Volcker's Rule, less room for leveraging and low bond yields due to continuing low interest rates in US, UK, Eurozone and Japan would make fixed income business the most challenging for investment banks. Apart from this, the other businesses that would be severely affected are proprietary trading, structured products and equity derivatives.

The Volcker's Rule prohibits US investment banks from short-term proprietary trading for the banks' own accounts, as well as prohibiting them from having general trading relationships with hedge funds and private-equity funds. To ensure trades are correctly classified as per Volcker's requirements, banks would require to significantly improve their capabilities in risk reporting, risk monitoring and compliance. This increased compliance cost and restrictions are the reasons why the Donald Trump administration announced possible roll backs on this regulation in 2017. However, there is near consensus on the negative impact of bailout of TBTF institutions in future. Therefore, heightened compliance, risk management and early warning systems, transparency and governance and Basel III adherence are the future emphasis of investment banking regulation.

6.17.2 Business Challenges for Investment Banking

Regulations would impact future business profitability in investment banking two-fold: (i) curtail revenue generating capacity and (ii) increase costs of asset holding, financing and maintaining regulatory capital under Basel III. In addition, *credit valuation adjustment* for OTC transactions to reduce counterparty risks would increase cost to customers and reduce their returns. The provisions around standardisation and centralised clearing of OTC derivatives would increase the cost of capital for firms and investors alike. It is also likely to make the process of risk management more complicated and expensive. In future, investment banks have to reassess viability of every business segment considering regulatory impact and market shifts and make necessary changes to their business models.

The second aspect that would have a profound impact on the way investment banking business is conducted in future is technology. Financial technology (or *fintech*) is disrupting banking and capital market activity in a big way. The fundamental rules of financial intermediation are being redrawn. While technology is leading to disintermediation in the distribution of capital, the cost and complexity of customer acquisition is increasing. On the market floor, many participants may see themselves getting forced out as a result of algorithmic trading and new rules for electronic trading of derivatives. This could exacerbate trading risks, have a negative impact on the liquidity of the market and result in higher capital and operating costs for market participants. The challenges on executive compensations and outsourcing back office operations outside the US would be an added cost for US based investment banks in future.

Investment banks have to come up with new business and risk diversification strategies for future sustenance and growth. Building scale, spreading operations in different geographies and finding broad-based business models are the future requirements for many large and mid-sized banks. The total share of non-US business for US investment banks have only been going up over the decades, especially from the mid-nineties. At the same time, the portfolio allocation of US investors to non-US securities has also been increasing.

In the last 25 years, the share of revenue from core investment banking activity declined steadily and was being replaced by proprietary trading, asset management and advisory services. Keeping in mind this trend, many universal banks shopped for security firms or entered into affiliations with such firms. Investment banks are also buying into asset management companies and setting up private equity funds. The merger of Morgan Stanley with leading brokerage firm Dean Witter sums up the trend. In future, however, investment banks have to tweak this strategy suitably to address the emerging regulatory and technological transformation.

The business of investment banking is at the cross roads with rapid transformation in operating environment due to growing sophistication in the financial markets, adoption of game changing financial technologies,rapidly evolving client requirements and growing concerns and increasing regulatory oversight. While market developments signal the necessity for universal banks and financial conglomerates to deliver investment banking solutions, these institutions have to rediscover their competencies and new ways of conducting the investment banking business for future growth and industry leadership in the decades to come.

IMPORTANT TERMINOLOGY

Alternative Investment Funds
AMC
Asset Management
Boutique Investment Bank
Buy Side
Carried Interest
Carry Trade
Close End
Core Investment Banking
Corporate Venture Capitalist
Dealer
Entry and Exit Load
Financial Planner
Firewalls
Full Service Investment Bank
Fund of Funds
General Partner
High Water Mark
Investment Advisor
Investment Advisory
Limited Partner
LLP
NFO
Open End
Pitch Book
Portfolio Manager
Preferred Return
Prime Broker
Private Banking
Private Offerings
Pure Investment Bank
Sales People
Securities Business
Sell Side
Strategic Sale
Takeout
Trader
Universal Bank
Wealth Management

TEST YOUR UNDERSTANDING

I. Pick the right answer(s) or the alternative that best fits the description from the alternatives provided under each question.

1. The following activity does not constitute investment banking:
   (a) Preparation of a project report for fund raising for an infrastructure project
   (b) Advising on a proposed joint venture
   (c) Advising the government on economic policy issues
   (d) Proprietary trading in derivatives and cash markets
   (e) Treasury management

2. Which of the following businesses is regarded as part of investment banking?
   (a) Energy trading
   (b) Real Estate Investment Trust
   (c) Trading in carbon credits
   (d) Investment advisory and wealth management
   (e) Microfinance credit
   (f) Financing buy-out transactions
   (g) Money changing
   (h) Currency trading
   (i) Hedge fund
3. In investment banking, the following are considered 'core investment banking':
   (a) Commodity derivatives
   (b) REITs
   (c) Corporate restructuring
   (d) Microfinance credit
   (e) Financing LBOs
   (f) Weather derivatives
   (g) Money changing
   (h) Currency trading
   (i) Fixed Income Trading
4. Which of the following combinations captures the connotation 'Full Service Investment Banking' better?
   (a) Merchant banking, mortgages, fixed annuities, pension funds and brokerages.
   (b) Merchant banking, superannuation funds, derivatives, letters of credit and guarantees.
   (c) Re-insurance, broking, wealth management and risk advisory.
   (d) Hedge Funds, currency trading, forex advisory, exchange traded real estate fund.
   (e) Asset management, portfolio management, derivatives, equity research, private equity.
   (f) Issue management, corporate advisory, sales and distribution, equity research, asset management.
5. Investment banking and merchant banking can be performed on the same balance sheet as that of a NBFC in India.
   (a) Yes
   (b) No
6. Identify which of the following relationships leads to '*conflict of interest*' for an investment bank.
   (a) The securities division enters into a futures contract for a particular stock being covered by the research division.
   (b) A research analyst recommending a particular stock is married to the son of a billionaire champion investor in the stock market.
   (c) A leading investment banker is known to be very close to the managements of several leading companies, the public floatations of which, he has handled.
   (d) A leading investment bank influences the regulator to bend the rules in its favour.
   (e) The investment bank agrees with a company to sell its stock to investors through the portfolio management scheme run by its wealth management arm.
   (f) The sales and distribution business is primarily run with the commissions earned on marketing of stock issuances by the investment banking business.
7. A limited partner in a private equity fund is promised a return in the following manner—if the fund makes a net appreciation in its stock portfolio as on the last day of the year with reference to the first day by a margin of 20% or more, the limited partner is entitled to 5% thereof subject to deduction of net losses if any, booked during the year. This arrangement can be categorised as:
   (a) Land-mark arrangement
   (b) Preference Share arrangement
   (c) Carry Trade
   (d) Stop Loss Arrangement
   (e) Prime Return Arrangement
   (f) Preferred Return Arrangement
8. In an asset management structure, if the taxation of incomes and gains is attracted at the investor level and not at the fund level, such mechanism is called a:
   (a) Transparent structure
   (b) Tax neutral structure
   (c) Go through structure
   (d) Pass through structure.

9. In a mutual fund structure, if the fund generates profits from its investment activity, the general partners are given a top up bonus in addition to their share of dividends.
   (a) True (b) False
10. An AMC structure has been formed by floating the mutual fund in Cayman Islands while the asset management will be done through several AMCs floated across world markets. This is an illegal structure since it does not fall under any particular regulator's purview.
   (a) True (b) False
11. A corporate broker-underwriter shares information about its trades on behalf of clients with another investment bank which handles stock issuances. This amounts to:
   (a) Insider Trading (b) Breach of Client Confidentiality
   (c) Conflict of Interest
12. A US underwriter enters into an understanding with its sales and distribution desk to share the underwritingspread with it for promoting the sale of the securities that it underwrites. This leads to a conflict of interest.
   (a) Yes (b) No
13. Core Investment banking in Indian context is predominantly non-fund based activity while in the US andother developed markets, it is predominantly fund based.
   (a) True (b) False
14. One of the areas in Core Investment Banking is strategic resource planning over a longer period of time for a company's growth and ensuring that fund management is as per corporate governance norms so as to protect the interests of investors.
   (a) Yes (b) No
15. Mr. India Capital, an investment bank wants to merge with Miss India Capital, a commercial bank. The combined entity will be called Mrs India Capital. Will this merger be allowed?
   (a) Yes (b) No
16. What are the core services offered by investment banks? How are the different business verticals inter-dependent?
17. Distinguish between merchant banking and investment banking. How are full service investment banks more competent to deliver better value to clients?
18. What is the regulatory framework for investment banking in India? Explain the conglomerate structure permitted in India.
19. Explain the 'conflict of interest' issue in investment banking? Why has it caught the attention of regulators worldwide? What are the measures to address it?
20. Are financial conglomerates a regulatory hazard? Explain the reasons why conglomerate banking has become the order of the day.

For answers upto Question 15, refer to Appendix B at the end of the book.

Annexure Brief Business Profile of The Largest American Universal Banks[6]

J.P. Morgan

J.P. Morgan is a universal bank and ranks among the top ten largest banks in the world and the largest bank in the USA. It also ranks as the largest US bank by market capitalisation and total assets. The conglomerate structure is represented through its apex holding company, J.P. Morgan Chase & Co., which is listed primarily on the NYSE. It is one of the largest financial conglomerates formed in the post-Glass Steagall era wherein banking and non-banking businesses can be held under a common ownership structure. J.P.Morgan Chase & Co. is a bank holding and financial holding company under the Bank Holding Company Act, 1956 and the Financial Holding Company Act, 1956.

J.P. Morgan group's retail, SME and corporate banking businesses are carried out under its subsidiary J.P. Morgan Chase Bank branded as *Chase Bank* while the investment banking, institutional asset management, private banking, wealth management, brokerage and securities business, investment management and treasury services are carried out under the subsidiary and brand name of J.P. Morgan. There are several subsidiaries that conduct the business for the financial conglomerate. The investment banking business works with a broad range of issuer clients, including corporations, institutions and governments and provides comprehensive strategic advice, capital raising and risk management expertise. It offers equity and debt market issuances of securities for capital raising, M&A advisory, arranges leveraged loans, high-yield or junk bonds and mezzanine debt for clients for several strategic requirements such as M&A, buybacks, buy-outs and large dividend payouts. It has large allied businesses in the areas of asset management, securities trading, investment management, derivatives, treasury and private banking.

The conglomerate structure emerged both from legacy mergers and through a series of mergers and acquisitions after the dismantling of the Glass Steagall regime. Chase Manhattan Bank (itself an amalgam of Chase National Bank and Bank of the Manhattan Company), Chemical Bank, J.P. Morgan & Co., Bank One Corporation and a few others were all different financial businesses that grew independently with the earliest dating back to 1799. In the current structure, they have all been merged into a conglomerate with J.P.Morgan Chase & Co. Inc being the holding company. The investment banking business originally flourished in J.P. Morgan &Co. But in the 1930s, it had to be spun off due to the provisions of the Glass Steagall Act into a separate business. The parent retained the commercial banking business which was more influential and profitable at the time. Setting up a commercial bank also had huge entry barriers in those times due to the high political patronage it had to enjoy. Thus, was born Morgan Stanley as a pure investment bank on September 16, 1935 entirely with founding capital provided by J.P. Morgan & Co.. with Henry S. Morgan (grandson of the founder Piermont Morgan) and Harold Stanley as the founding partners.

In later years, the investment banking and asset management businesses of J.P. Morgan also flourished due to the merger with Chase Manhattan Bank which had built them up through acquisitions. The group kept acquiring many other smaller financial businesses including the bank of New York Co's retail banking in 2006. In the wake of the global financial crisis in 2008, J.P. Morgan Chase had to acquire investment bank, Bear Sterns (the smallest among the five largest at the time), through an all stock merger at the behest of the US government. Similarly, in September 2008, it bought the commercial banking operations of Washington Mutual. These two acquisitions added several clients and bank branches to J.P. Morgan's business in

[6]Wells Fargo was the third largest American bank after J.P.Morgan and Bank of America with total assets of almost US$ 2 trillion in 2016. However, it has not been profiled herein as historically it was a commercial bank and built its dominant position around this business. Wells Fargo Securities was established as a subsidiary only in 2009 after its acquisition of Wachovia in the wake of the Global Financial Crisis in 2009. Therefore, it does not have any investment banking antecedents although it presently classifies as a universal bank.

commercial and investment banking. J.P. Morgan's charismatic Chairman & CEO Jamie Dimon walked into the group when it merged with Bank One Corporation. Under his leadership, the conglomerate grew by leaps and bounds and won tremendous goodwill with the Federal government and the US Federal Reserve during the financial crisis in 2008 by supporting them with the compulsory acquisitions of Bear Sterns and Washington Mutual. As of 2016, the financial conglomerate was the largest in USA with J.P. Morgan Chase & Co. having a total asset base of over US$ 2.4 trillion.

Goldman Sachs

The Goldman Sachs group converted itself into a bank holding company to be regulated by the Federal Reserve in the wake of the financial crisis in 2008. Prior to it, the business had transformed into a conglomerate structure with the incorporation of its apex holding company, The Goldman Sachs Group, Inc., on July 21, 1998. This holding company listed on the NYSE through an IPO in 1999.

Historically, Goldman Sachs had been a pure investment bank founded in 1869, as a Jewish business, by Marcus Goldman. It is credited with several landmark financial transactions in the US corporate sector raising capital for several well-known names. It is also credited for having originated path breaking financial instruments. Though it was initially focused on handling IPOs and stock trading, with the collapse of its trading entity in the stock market crash of 1929 and the arrival of Sidney Weinberg at the helm in 1930, the firm shifted its focus back to investment banking. It developed associated expertise in investment research, bond trading and merger arbitrage. By the 1980s, the firm had dominant position in investment banking, trading (equities and fixed income) and M&A advisory and financing. It was a leading originator of commercial paper, equities, bonds and REITs for its clients. It moved into asset management in 1986 spanning mutual funds, hedge funds and private equity. The firm is also credited with several of its top executives holding prime positions in other investment banks and the US government, UN and NYSE. But a major dent was created to the firm's finances by the global financial crisis due to its exposure to sub-prime mortgages. It was rescued through bail-out funds from the TARP programme of the government and a distress investment by Berkshire Hathaway. It, however, regained its eminence after the crisis and managed several big-ticket issuances such as the Twitter IPO and Apple Inc's bond sale offerings.

Under its present conglomerate structure, Goldman Sachs Group Inc. has total assets in excess of US$900 billion which made it the fifth largest financial conglomerate in USA in 2016. However, it retains its investment banking character because of its dominant position in capital market services. But it also has lending operations and other financial services allied to its core investment banking. Its main business lines are classified under four verticals[7]:

- ***Investment Banking:*** Serves public and private sector clients around the world. It provides financial advisory services to enable companies to raise capital, facilitate mergers and acquisitions, divestitures, takeover defences, restructurings, spin-offs and risk management. The Company underwrites public offerings and private placements of several security offerings such as through a range of securities such as common and preferred stock, exchangeable securities and various types of debt instruments including investment-grade and high-yield debt, bank loans and bridge loans. It advises on local and cross-border transactions and provides acquisition financing through its investing and lending vertical. In addition, the investment banking vertical originates and underwrites structured securities, which include mortgage-backed securities, asset-backed securities and their credit derivatives.
- ***Institutional Client Services:*** It is a securities trading, brokerage and service activity that makes markets and facilitates client transactions in fixed income, equity, currency and commodity products on the market. The following are some of the products marketed under this vertical:

[7]Based on disclosures made in its profile on http://www.reuters.com/

- Money market products such as commercial paper, treasury billsand repurchase agreements.
- Fixed income products such as government bonds, bank and bridge loans, municipal securities, emerging market and distressed debt, various types of MBS, ABS and credit derivatives.
- Equity trading and market making in all types of equity and equity linked securities including hybrids and convertibles and stock derivatives in both OTC and exchange traded categories. It also works with its clients to create instruments to enable investors to establish or liquidate investment positions or undertake hedging strategies. It also serves markets in derivatives on indices, industry groups, financial measures and individual company stocks across world markets. This vertical also provides its clients with access to a range of equity execution services, including electronic low-touch access and high-touch execution. It provides financing to its clients for securities trading activities through margin loans, borrowing and lending securities to cover institutional clients' short sales.
- Currencies and currency derivatives
- Commodity derivatives include crude oil and petroleum products, natural gas, base, precious and other metals, electricity, coal, agricultural and other commodity products.

The Company's clients are institutions that are professional market participants, including individual investors investing for their retirement, buying insurance or putting aside surplus cash in a deposit account. It provides prices to clients for a range of products in a range of asset classes and markets. Institutional Client Services and its other businesses are supported by the Company's Global Investment Research division, which provided fundamental research on over 3,400 companies around the world and approximately 40 national economies as well as on industries, currencies and commodities.

- ***Investing and Lending:*** This is primarily a proprietary investment and financing activity in long-term transactions which include various asset classes in primarily debt securities and loans, public and private equity, leveraged buy-outs, acquisition financings, real estate and in funds managed by other banks. It also provides credit to corporate clients through loan facilities and to individuals through secured loans.
- ***Investment Management:*** The Company's investment management segment provides investment and wealth advisory services. Its clients include institutions and highnet-worth individuals as well as retail investors who access its products through a network of third-party distributors around the world. It manages client assets across a range of asset classes and investment strategies, including equity, fixed income and alternative investments. Its alternative investments include hedge funds, credit funds, private equity, real estate, currencies, commodities and asset allocation strategies. It offers its investments in a range of structures, including separately managed accounts, mutual funds, private partnerships and other vehicles. The Company also provides investment advisory solutions designed to address its clients' investment needs. Its wealth advisory services include income and liability management, trust and estate planning, philanthropic giving and tax planning.

Morgan Stanley

Apart from Goldman Sachs, the other leading pure investment bank on Wall Street was Morgan Stanley. However, it too had to fall in line with Federal Reserve regulation after the financial crisis in 2008, thereby bringing the curtains down on pure investment banks on Wall Street. All the bulge bracket banks are presently under a conglomerate structure with their holding company being a bank and / or financial company regulated under law. Morgan Stanley is no exception.

Having started off as an offshoot of J.P.Morgan in the aftermath of the Glass Steagall Act (supra) in 1935, Morgan Stanley carved a distinct dominant identity for itself among the top tier investment banks on Wall Street. It was always focused on investment banking as its primary business and was associated in the origination of several prestigious equity and bond offers from leading companies such as General Motors, AT&T and IBM. In later years, it played a major role in taking technology companies public such as Compaq, Cisco, Netscape, Broadcom, Google, Apple, Facebook, Verisign and others. It grew its expertise in securities trading, real estate and mergers and acquisitions. Its acquisition of Dean Witter in 1996 created scale and catapulted it into the league of bulge bracket investment banks. Morgan Stanley had its share of troubles during the global financial crisis in 2008 and with bail out from the US government under the TARP and with investment from Mitsubishi Bank of Japan, it survived to see another day. However, with the collapse of Lehmann Brothers, the forced acquisitions of Merrill Lynch and Bear Sterns and the conversion of Goldman Sachs and Morgan Stanley into a universal banking structure, the era of bulge bracket pure investment banks on Wall Street was over in 2008. However, Morgan Stanley continues to be regulated as a financial holding company as it has no presence in commercial banking business. As of 2016, it had total assets in excess of US$800 billion.

In terms of business portfolio, Morgan Stanley is a global financial services firm operating through its subsidiaries and affiliates. However, like Goldman Sachs, Morgan Stanley retains its character as an investment bank with affiliated capital market businesses. It advises, originates, trades, manages and distributes capital for governments, institutions and individuals. The conglomerate business segments are Institutional Securities, Wealth Management and Investment Management.

Institutional Securities

The Company's Institutional Securities business segment provides investment banking, sales and trading, and other services to corporations, governments, financial institutions and high-to-ultra high net worth clients. Investment banking services comprise capital raising and financial advisory services, including services relating to the underwriting of debt, equity and other securities as well as advice on mergers and acquisitions, restructurings, real estate and project finance. Sales and trading services include sales, financing and market-making activities in equity securities and fixed income products, including foreign exchange and commodities as well as prime brokerage services. The Company's prime brokerage services to clients include consolidated clearance, settlement, custody, financing and portfolio reporting. The Company trades, invests and makes markets in listed futures, Over-The-Counter (OTC) swaps, forwards, options and other derivatives referencing, interest rates, currencies, investment grade and non-investment grade corporate credits, loans, bonds, the United States and other sovereign securities, credit indices, asset-backed security indices, property indices, mortgage-related and other asset-backed securities, and real estate loan products. The Company uses these instruments for market-making, foreign currency exposure management, and asset and liability management. Other services include corporate lending activities and credit products, investments and research.

In connection with the commodities activities in its Institutional Securities business segment, the Company engages in the production, storage, transportation, marketing and execution of transactions in several commodities, including metals, natural gas, electric power, emission credits and other commodity products. In addition, the Company is an electricity power marketer in the United States and owns electricity generating facilities in the United States.

Wealth Management

The Company's Wealth Management business segment provides brokerage and investment advisory services, market-making activities in fixed income securities, financial and wealth planning services, annuity and insurance products, credit and other lending products, banking and retirement plan services to individual investors and small-to-medium sized businesses and institutions. The principal Wealth Management lending activities include securities-based lending and residential real estate loans. Securities-based lending provided to the Company's retail clients is primarily conducted through its Portfolio Loan Account (PLA) and Liquidity Access Line (LAL) platforms. The Wealth Management business segment also provides margin lending to clients.

Investment Management

The Company's Investment Management business segment provides a range of investment strategies and products across geographies, asset classes, public and private markets, to institutional clients. Institutional clients include defined benefit/defined contribution pensions, foundations, endowments, government entities, sovereign wealth funds, insurance companies, third-party fund sponsors and corporations. Individual clients are serviced through intermediaries, including affiliated and non-affiliated distributors. Strategies and products comprise asset management, including equity, fixed income, liquidity, alternatives and managed futures products, as well as merchant banking and real estate investing.

Bank of America

Unlike J.P.Morgan Chase whose banking affiliations originated from its acquisition of Chase Manhattan Bank, Bank of America was originally established as a commercial bank and by 1930, it became the largest banking institution in the country. Though its growth and expansion outside of California was halted by the regulatory and anti-trust laws, prevailing at that time including the Bank Holding Company Act, 1956, it continued to growth with acquisitions of other banks as soon as the laws became more favourable through a holding company structure coined as Bank of America Corporation in 1998. Its acquisition spree continues to this day including names such as Security Pacific National Bank, Continental Illinois National Bank and Trust Co. and its subsequent absorption by Nations Bank. The merged company was renamed Bank of America which is the main commercial banking subsidiary of the conglomerate. The group also acquired FleetBoston Financial, MBNA, the United States Trust Company, LaSalle Bank Corporation and others. This gave the group considerable presence in credit card business and asset management apart from widening its footprint in commercial banking. It acquired Countrywide Financial in 2008 giving it a substantial presence in mortgage business. It was subsequently renamed as Bank of America Home Loans.

The group also had its affiliations with the capital market through acquisitions, notably Robertson Stephens and Continental Illinois which had a large leveraged loan portfolio. The securities business was structured under a subsidiary called Bank of America Securities. However, the decisive moment came when it acquired investment bank and asset manager, Merrill Lynch, in a bail out acquisition in the aftermath of the global financial crisis in September 2008. Merrill Lynch was then said to be within days of a collapse. On a conglomerate basis, this acquisition made it the largest financial services group in the world at that time. In 2016, Bank of America Corporation had total assets of US$ 2.18 trillion making it the second largest financial conglomerate after J.P. Morgan.

Presently, the group's conglomerate structure serves individual consumers, small and middle-market businesses, institutional investors, corporations and governments with a range of banking, investing, asset management and other financial and risk management products and services. The group's service segments are comprised of Consumer Banking, Global Wealth & Investment Management (GWIM), Global Banking, Global Markets, Legacy Assets & Servicing (LAS) and all other.[8] Its corporate and investment banking business divisions were rebranded as Bank of America Merrill Lynch in 2009 while consumer banking retained the name BofA.

Consumer Banking

The group's Consumer Banking segment offers a range of credit, banking and investment products and services to consumers and small businesses. Consumer Banking product offerings include traditional savings accounts, money market savings accounts, Certificate of Deposits (CDs) and Individual Retirement

[8]ibid

Accounts (IRAs), non-interest and interest-bearing checking accounts, investment accounts and products as well as credit and debit cards, residential mortgages and home equity loans and direct and indirect loans to consumers and small businesses in the United States.

Global Wealth & Investment Management

The Company's GWIM segment provides tailored solutions for clients through a set of investment management, brokerage, banking and retirement products. GWIM also provides wealth management solutions as well as customised solutions for clients' wealth structuring, investment management, trust and banking needs, including specialty asset management services.

Global Banking

The Company's Global Banking segment provides a range of lending-related products and services, integrated working capital management and treasury solutions to clients and underwriting and advisory services. Global Banking's lending products and services include commercial loans, leases, commitment facilities, trade finance, real estate lending and asset-based lending. Its treasury solutions business includes treasury management, foreign exchange and short-term investing options. Global Banking also provides investment banking products to clients, such as debt and equity underwriting and distribution and merger-related and other advisory services.

Global Markets

The Company's Global Markets segment offers sales and trading services, including research, to institutional clients across fixed-income, credit, currency, commodity and equity businesses. Global Markets product coverage includes securities and derivative products in both the primary and secondary markets. It provides market-making, financing, securities clearing, settlement and custody services across the globe to institutional investor clients in support of their investing and trading activities. Global Markets also works with commercial and corporate clients to provide risk management products using interest rate, equity, credit, currency and commodity derivatives, foreign exchange, fixed-income and mortgage-related products. It also manages risk in a range of financial products, including government securities, equity and equity-linked securities, high-grade and high-yield corporate debt securities, syndicated loans, Mortgage-Backed Securities (MBS), commodities and Asset-Backed Securities (ABS).

Legacy Assets & Servicing

The conglomerate's LAS segment is engaged in providing mortgage servicing activities related to residential first mortgage and home equity loans serviced for others and loans held by it and manage certain legacy exposures related to mortgage origination, sales and servicing activities.

All Other

The Company's All Other operations consists of Asset and Liability Management (ALM) activities, equity investments, the international consumer card business, liquidating businesses, residual expense allocations and other. ALM activities encompass certain residential mortgages, debt securities, interest rate and foreign currency risk management activities. Additionally, certain residential mortgage loans that are managed by LAS are held in this segment.

Citigroup

Citibank as it was known then, started off like J.P. Morgan as a commercial bank by the name of City Bank of New York in 1812. By the end of the 19th century, it became the largest bank in USA. It was also the first American bank to cross US$1 billion in assets and went on to become the largest global bank by the time of the Great Depression in 1929. It was rechristened as First National City Bank of New York in the mid- 1950s. A bank holding company was formed to provide the conglomerate structure to its fledgling operations after the passage of the Bank Holding Company Act, 1956. In the mid-1970s, the banking company was renamed Citibank and the holding company was renamed Citicorp. Citibank was a pioneer in consumer banking products such as the credit card and the Mastercard was originated from its fold. It was also the pioneer in ATM banking. In 1988, Citigroup was incorporated as the apex bank and financial holding company. Its banking subsidiary continues to be known as Citicorp.

The advent of the universal banking model happened when the merger of the Traveler's Group with Citicorp in 1998 is one of the largest financial mergers of all time. Travelers, at the time, was a conglomerate with life insurance (through its buy-out of Primerica) and investment banking (through its buy-out of Smith Barney) in its fold. It had also acquired capabilities in asset management and brokerage though other acquisitions. However, the landmark acquisition of Salomon Brothers, a bulge bracket investment bank at the time catapulted it into mainstream investment banking. Salomon Brothers was a pioneer in M&A banking. Besides, it was very strong in fixed income business while Smith Barney was strong in equities and retail investment services. Together, they complemented Travelers' skills across investment banking, brokerage and institutional sales. The creation of Citigroup culminated the process of conglomerisation across all the verticals of banking and non-banking financial business.

The conglomerate went through heavy turbulence in the global financial crisis in 2008 due to its exposure to sub-prime mortgage CDOs and despite desperate measures to cut losses, it faced a threat of existence in 2008 in the lines of pure investment banks such as Lehman Brothers and Merrill Lynch. Its stock started to trade below $1 on the NYSE. It received a rescue package from the Federal Government through its TARP programme in late 2008 to rescue it from bankruptcy. In return, Citigroup, the apex holding company, had to accommodate government holding of 36% along with other stiff conditions on executive compensation and other matters. It also had to separate its non-core businesses in brokerage and asset management into a separate subsidiary called Citi Holdings. In subsequent years, Citigroup bounced back with strong performance and the government exited Citigroup in 2010 through the market. In 2016, Citigroup was the fourth largest financial conglomerate in USA with total assets in excess of US$1.8 trillion.

Presently, the Citigroup conglomerate businesses provide consumers, corporations, governments and institutions with a range of financial products and services, including consumer banking and credit, corporate and investment banking, securities brokerage, trade and securities services and wealth management through its two main subsidiaries: Citicorp and Citi Holdings.

Citicorp[9]

As mentioned above, Citicorp is the Company's global universal bank for consumers and businesses and represents its core franchises. Its operating businesses are: (i) Global Consumer Banking, that represents its traditional commercial banking services across 160 jurisdictions and (ii) Institutional Clients Group, which includes capital market services and wholesale banking for large institutional clients. It provides corporate, institutional, public sector and highnet-worth clients across the world with a range of wholesale banking products and services, including fixed income and equity sales and trading, foreign exchange, prime

[9]ibid

brokerage, derivative services, equity and fixed income research, corporate lending, investment banking and advisory services, private banking, cash management, trade finance and securities services.

Citi Holdings[10]

Citi Holdings contains businesses and portfolios of assets that Citi has determined are not central to its core Citicorp businesses under its restructuring plan in 2009. Citi's consumer businesses in Argentina, Brazil and Colombia will be reported as part of Citi Holdings. Smith Barney's business portfolio was also housed under this company until its divestiture in 2009 to Morgan Stanley. The main assets of Citi Holdings are the mortgage assets emanating from the crisis of 2008 which will be fully wound down and liquidated in time.

[10]ibid

7 Investment Banking and Business Valuation

LEARNING OUTCOMES

- Context of value, value creation and business valuation
- Business valuation in the context of corporate valuation using different approaches
- Financial forecasting
- Drivers for value creation
- DCF methodology using the Dividend Discount Model, the Enterprise Free Cash Flow Model and the Free Cash Flow to Equity Model
- Other approaches such as Asset-based Valuation, Relative Valuation and Economic Profit Model
- Valuation of goodwill
- Adjustments and additional dimensions in valuation
- Applicability of valuation approaches
- Arriving at fair value
- Valuation in special cases
- Valuation and investment banking
- Judicial review and regulatory oversight on valuation

7.1 Introduction

The term *corporate valuation* suggests valuation of corporate form of business to derive the underlying value of its share. Investment bankers often grapple with the task of corporate business valuation for the purpose of a transaction therein. Business valuation is indeed an intricate exercise considering the complexities of present day businesses and corporate structures. In this chapter, we discuss the approaches to business valuation of a corporate enterprise based on the available methodologies. Readers may appreciate that several eminent authors have written extensively on this subject and books on valuation abound. Nevertheless, it is felt that a book on investment banking is incomplete without a discussion on business valuation. The objective of this chapter, therefore, is not to explore the realm of valuation in its entirety. On the contrary, the idea herein is to introduce the reader to a working knowledge of this subject as it has a very pertinent relevance to investment banking. For extensive readings on valuation, interested readers may refer to any of the books specialised in the subject.

Valuation is both a science and an art. It is often said that *value lies in the eyes of the beholder*. In this sense, valuation is very subjective but over the years, several methodologies have been developed and fine-tuned so as to give the whole subject a sense of objectivity. Nonetheless, valuation continues to have certain amount of scope for subjectivity as the models that are used may be quantitative but leave some room for the valuer to introduce bias. According to *Aswath Damodaran,* whose opinion author endorses, *in far too many cases, the decision on whether a firm is under or over-valued precedes the actual valuation.* This kind of pre-conceived notions could make the valuation far too biased for acceptability. Therefore, there is a need on the part of the valuer to be free from any bias to reduce the subjectivity in the use of valuation models.

7.2 Value and Valuation

For the purpose of this discussion, value can be defined as *the worth of a company expressed in terms of the value of its share*. However, a company will have no value if it just matches to earn as much as it should. Value is attributed to a company when it generates returns that are in excess of the shareholders' expected return. Such value can be attributed to value created by the operations of the company as well as from strategic initiatives. A company has to ensure that both these activities are aligned and reflected in its share price. Simply put, this should be equal to the market price of all the shares of the company, which is known as *market capitalisation*. The market values a company on the basis of its expected future performance. This is usually denoted as the price-earnings multiple which is discussed in a subsequent paragraph of this chapter. The most valuable corporations of the world are those with the highest market capitalisation.

However, one has to realise that the market price at any given point of time may not represent an unbiased expectation of the future performance of the company. This is because markets are not perfect and are driven by the forces of demand and supply. Market asymmetry can result in a company being over or under-valued at a particular time. Herein arises the need for valuation. While value of a company can be represented by its market capitalisation, there is a need to examine value through a process of valuation. Valuation looks at alternative approaches to measure the intrinsic value that may or may not coincide with the market value at that time. Therefore, when there is an impending transaction, valuation becomes imperative. In addition, since not every company is listed, valuation becomes the only way of measuring the value of unlisted companies.

7.3 Corporate Value versus Investment Value

The measurement of shareholder value may be looked at from two perspectives, value of the business of the company and the value to its shareholders, i.e., (i) *corporate value* and (ii) *investment value*. Corporate value is the present value of the expected returns from the business measured in terms of various approaches used for such *valuation*. This is also known as the intrinsic or fundamental value of a company. Investment value is the present value of the return expected by the capital market and is reflected by the market price of the share of the company from time to time. Depending upon the information available with the market and other market dynamics, investment value of a company could diverge from its corporate value. The mandate for a corporate management is to ensure that the market price of the share reflects its corporate value. In other words, enhancing the value of a company denotes not only enhancement of the corporate value, but the reflection of such enhancement in its investment value as well.

As indicated above, the main philosophy that underlies most valuation methods (discussed in succeeding paragraphs) is that *valuation is the process to arrive at the present value of an asset or firm that has a future earning potential, viewed either as profits or cash flows*. Under this postulate, the value would be equal to the present value of such future profits or cash flow discounted at an appropriate rate. It is, therefore, called the discounting approach and when used on cash flow, it is known as the *Discounted Cash Flow (DCF)* or *DCF methodology*. DCF is represented as:

$$\text{Value of Asset} = \frac{\text{Future Cash Flow}}{(1+r)^n}$$

where, $(1 + r)^n$ represents the applicable discounting factor

The biggest advantage of using the DCF approach is that it breaks down time barriers and equates all cash flows into the present time period which can then be used for valuation or any other type of decision-making.

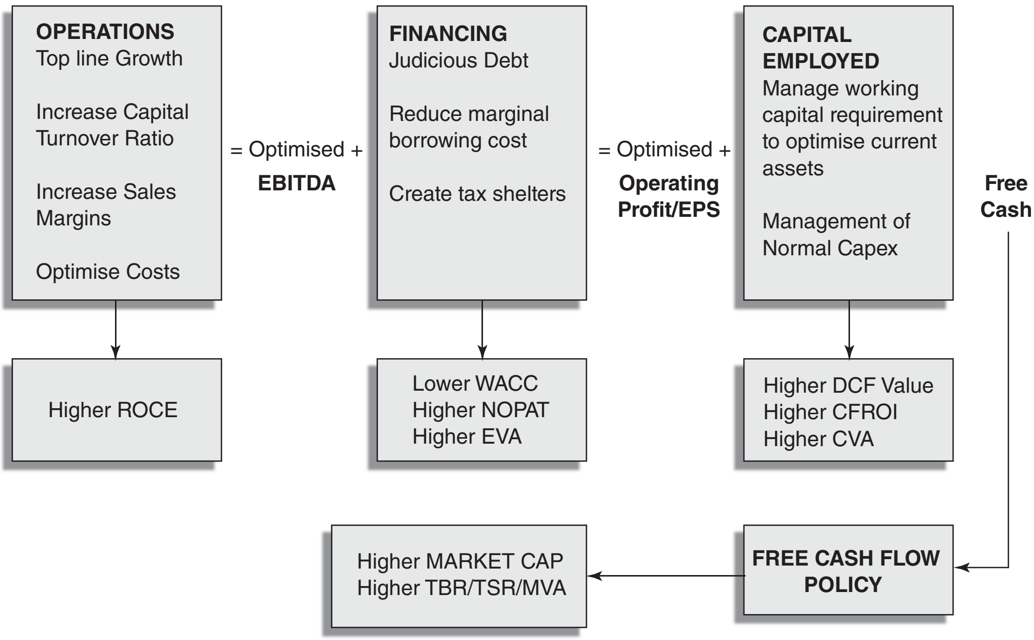
7.4 Business Valuation

At the outset, one has to draw a subtle difference between security valuation and business valuation. Valuation of a security such as a bond/debenture or a share of a company may be done purely from an investor's perspective by looking at the variables that measure such value. One can obviously conclude that the value of a share obtained from such valuation when multiplied by the total number of shares issued by the company would result in the value of the enterprise. However, such an approach is more ideal from an investor's perspective. When we measure the value of an equity share from a shareholder's perspective, it is possible to use dividends and price-earnings multiple to arrive at value. The *dividend discount model* uses the DCF approach which tries to discount future expected dividends to arrive at the value of share. The P/E ratio arrives at value using the current earnings (EPS). These methods are discussed briefly in upcoming sections.

Though the above-mentioned methods are arguably methods to value equity, the scope of this chapter is to explore valuation methodologies that are available to value a company as an enterprise and derive the value of the underlying equity share there from. In this sense, corporate valuation is about measuring the continuing value of a company's business in today's terms. Understandably, business valuation methodologies assume a *going-concern* concept for the company. These methods are discussed in detail in this chapter.

7.5 Drivers for Value Creation

At the broadest level, the value of a company is derived from the value of its assets and the expected future earning potential by the exploitation of such assets. Therefore, a company creates value if it can earn an economic return, i.e. a *rate of Return On Capital Employed* (ROCE) that is higher than the opportunity cost of such capital. Extending this concept, higher the rate of growth of such a company, higher is its value generation. Growth is a function of the ROCE and the reinvestment rate of capital back in the business. While the ROCE and reinvestment rate are the drivers to growth, value creation happens when the returns from the growth are in excess of the cost of capital. To summarise, the ROCE, reinvestment rate and the cost of capital are the key determinants of value creation by a company. Value can be achieved only when growth happens at the optimum cost.



*TBR = Total Business Return, TSR = Total Shareholder Return, MVA = Market Value Added

Exhibit 7.1 Connecting the Value Drivers

The value that a company generates has to get reflected in its market capitalisation. If the market expectations are different from the intrinsic value of the company, the company is either under or over-valued by the market. Though the market tends to correct pricing inefficiencies in the long-term, the value that shareholders realise from the market is based on current market expectations rather than on fundamental factors. This is the reason why the role of a company's top management is also to ensure that information asymmetry in the market is reduced as much as possible so as to enable a fair valuation.

7.6 Corporate Valuation using Business Valuation Models

7.6.1 Overview

As discussed above, an equity share represents the right to receive a future stream of cash flow by way of dividends, which are not determinable in the present. However, one can take an approach to forecast expected dividends. At the same time, an equity share is not just about receiving dividend. It represents proportionate ownership of a company due to which the financial interest extends even to profits that have been earned by the company but have not been distributed as dividends. These are known as *retained earnings*. Therefore, an alternative way of looking at the value of an equity share could be to consider the future earning potential of the company. A third way of approaching the issue is to consider the worth of a company as the value of its present assets. This would mean that an equity share represents a proportionate part of the assets of a company either considered at their book value or their market value. A different dimension that is often not quantifiable in the valuation of an equity share is its right of vote in corporate decisions. Therefore, the strategic value of a share, though not exactly quantifiable could be distinct from its economic value measured in terms of any of the considerations specified above.

From the above discussion, it is clear that there are alternative approaches to the valuation of an equity share based on the approach of corporate valuation. Based on the facts of a given case, valuers adopt different approaches and methods for corporate valuation to make the methodology appropriate to the given situation. In this chapter, we discuss the broad approaches to valuation and the methods adopted under each approach. As has been mentioned above, the valuation aspect would be revisited in subsequent chapters at appropriate places to discuss the suitability of an approach to a particular type of transaction.

7.6.2 Approaches to Corporate Valuation

The alternative approaches to valuation for deriving the valuing of an equity share using enterprise valuation as the basis are shown in Exhibit 7.2.

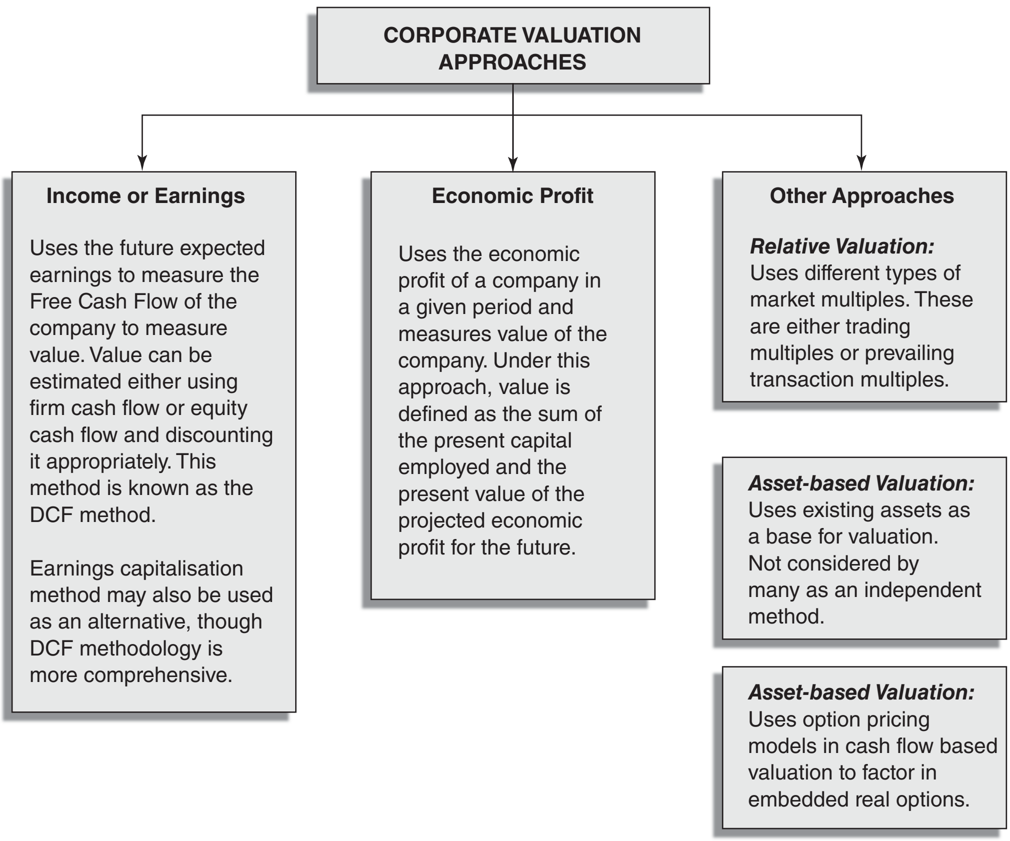


Exhibit 7.2 Corporate Valuation Overview

7.6.3 Assessment of Alternative Approaches to Value Measurement

Though several approaches to valuation are available as shown above, the ones that are mainly used are the earnings approach based on *Discounted Cash Flow* (DCF) analysis, relative valuation based on earnings multiples or market multiples and the asset-based approach. Each of these approaches has its own characteristics which need to be well understood since they determine the appropriateness of a particular method in a given case. The income or earnings-based approach often scores over the other methods such as asset-based methods (cost approach) and relative valuation based on market multiples. This is because the cost approach does not consider some critical drivers of value as the income approach. However, the income approach has several judgemental factors and assumptions to be made which make it quite subjective. The use of relative valuation is tricky since it requires comparing *an apple to an apple*. Therefore, the valuation could be misleading, if comparable data is not available for a particular business.

Therefore, when business models are unique or comparable data is not available, the relative valuation approach would not be appropriate.

Generally speaking, economic measures such as the EVA are better measures of value creation for a given time period while DCF methods are more ideal from a valuation perspective, i.e. to arrive at intrinsic enterprise value in absolute terms at a given point of time. In the short-term, cash flow can be erratic and even meaningless providing anomalous results, especially in growth oriented companies. DCF makes sense only when projected over a period of time to arrive at the present value in the context of valuation or a forecast-based capital budgeting decision. EVA relies on accounting profit for a given year and is, therefore, an effective short-term assessment tool from a VBM perspective. In view of this, DCF and EVA are not to be used as alternatives to each other but as complementary methods to assess value creation from a long-term and short-term perspective.

EVA is very effective as a performance evaluation tool for value management and for structuring compensation for the managers of a company. This is because, EVA brings in discipline among the top managers by making them realise the cost of equity funds being used in the business. Often, it is found that promoters and management are used to consider equity as cost free funds, especially if it has been raised from the public market at high premium. They are happy to show accounting profit and a rate of growth in EPS. Accounting profit treats the cost of debt above the line as a charge on profits and the cost of equity as a below the line item. This approach confuses the true picture of value creation. As opposed to accounting profit, economic profit is the excess return generated by the company after deducting the WACC. Therefore, it instils the culture of treating equity as cost bearing funds. *Value is created only when the company earns in excess of the WACC.* Extending the EVA concept further, it will also make managers responsible for the excess capital retained in the business and the necessity to either re-invest it or return it to shareholders.

7.7 Asset-based Valuation Models

Asset-based valuation is simple but is not considered an independent method in enterprise valuation since it does not capture the going-concern concept at all. As has been mentioned earlier, the value of a company is derived from the value of the assets it possesses and the expected future earning potential thereof. The value of the assets is captured in the current cash flows and the future potential is captured by the expected growth rate assumed in valuation. On both counts, the asset-based valuation methodology falls short of desirability. However, according to *Aswath Damodaran*, asset-based valuation is not in conflict with other methods since even in cash flow-based methods, the value of assets is included in the valuation. This is because cash flow is depended upon the existence of assets in the business and therefore, if one were to assume no growth in assets, the expected cash flow assessment may be equal to the value of assets.[1] However, based on the selection of assets and expected future growth of investments, the valuation could be significantly different under each approach.

Asset-based valuation can be done either on the *book value* of assets or their current market value. The latter approach gives rise to the liquidation value or *break-up value* of the equity share as it assumes that the company would be liquidated to realise the value. A third variation of the asset-based approach is the *replacement value* which tries to estimate how much it would cost to establish a company with similar assets at current prices. It is generally felt that asset-based valuation provides the bare minimum valuation for a company if it is used on existing assets at their book values or break up values. Therefore, these are to be applied in sick or financially distressed companies that do not promise any future business model but have a significant underlying value of assets. It follows that such a valuation is relevant for companies that are capital intensive and are driven by assets. Many core industries such as cement, steel, other metals, fertilisers, weaving, utility companies and infrastructure companies are asset heavy. They do not have any major intangible assets since they are in commodity business. Such companies are valued for their production capacities and strategic locations. In such cases, where the business model fails and a company goes into distress, asset-based valuations could provide a good platform for valuing the company's present worth. In turn-around cases, where the business model looks good but the company is presently financially distressed, alternative methods such as option pricing could provide a better insight into valuation.

Asset-based valuation is not considered an independent method and when it is employed, it would more often than not be used in conjunction with other methods assigning appropriate weightage based on its overall importance in the given valuation context. As mentioned above, it is most appropriate for asset heavy businesses and distressed companies facing liquidation. It is also ideal for financial businesses such as banks and financial or investment companies. These aspects have been further elaborated in a subsequent paragraph.

Asset-based methods are discussed below with illustrations.

7.7.1 Net Asset Value and Break-up Value

Under this method, the share is valued at its Book Value (also known as *Net asset Value*) as per the values of assets and liabilities appearing in the balance sheet. Therefore,

$$\textit{Book Value per Share} = \frac{\text{Equity Shareholders' funds as per balance sheet}}{\text{Number of equity shares issued and paid up}}$$

The limitation of this method is in the fact that it considers only the historical value of the assets while the liabilities are considered at present value.

A modification of this method is the break-up value method, under which both the assets and liabilities are considered at their liquidation value. In such a case,

Break-up value per share = Liquidation value of assets – outstanding debt

ILLUSTRATION 1

ABC Ltd. has the following information as at the end of the current financial year.

Equity Capital 10,000 shares of ₹10 each	
Reserves and Surplus	
General Reserve	₹50,00,000
Revaluation Reserve	₹15,00,000

[1]Investment Valuation–Aswath Damodaran, John Wiley & Sons Inc. Second Edition page 21.

Capital Redemption Reserve	₹25,00,000
Debenture Redemption Reserve	₹20,00,000
Surplus in P&L Account	₹5,00,000
Miscellaneous Expenditure not w/o	₹10,00,000

Land and buildings and stock have been valued at ₹5 lakh more and ₹2 lakh less respectively to their book values.

Table 7.1 Computation of Book Value

	₹	₹
Equity Capital	100,000	
Cash reserves General reserve CRR DRR Surplus in P&L account	10,000,000	
Total Cash net worth	11,000,000	
Less Misc. Exp not W/o	1,000,000	
Tangible net worth		10,000,000
No. of shares (nos.)		10,000
NAV per share (₹)		**1,000**

Table 7.2 Computation of Break-up Value

	₹	₹
Equity Capital	100,000	
Cash reserves General reserve CRR DRR Surplus in P&L account Revaluation reserve	11,500,000	
Less Misc. Exp not W/o	1,000,000	
Tangible net worth	10,500,000	
Add appreciation in land and buildings	500,000	
Less depreciation in stocks	200,000	
Break-up value		10,300,000
No. of shares (nos.)		10,000
Break-up value per share (₹)		**1,030**

7.7.2 Principles to Arrive at Realisable Value of Assets

The following general principles may be adopted in this regard:

- Current assets such as inventories and debtors are considered at their net realisable value after providing for wastages and irrecoverable debtors. The net realisable value may be reckoned for inventories on the following basis:
  - Raw materials are valued based on their condition and the most recent purchase price.
    Work-in-progress is considered at the manufacturing cost of finished goods as reduced by the amount of conversion cost to be incurred.
  - Finished goods may be valued at their factory cost.
- Other current assets such as prepaid expenses, deposits, loans and advances are valued on the basis of the amounts appearing in the balance sheet or the actual realisable value, whichever is less.
- Operating fixed assets such as land and buildings are valued at the current replacement cost less depreciation and deterioration in value of the structures. To a large extent, such value depends upon the level of maintenance and upkeep of the property.
- Non-operating fixed assets such as surplus land and buildings are considered at their fair market value. Investments are considered at cost, if they are meant for long-term holding. If such investments are trade investments, they form part of current assets and are, therefore, marked to market. Other non-operating assets are considered at their fair market value. Capital work-in-progress is considered at book value.
- Cash and cash equivalents are considered at their book value.
- Future liabilities that are expected to accrue on account of under-provision or non-provision thereof in the books of account will be reduced from the realisable value of assets to estimate the net realisation that could accrue in case of a break-up of the company. Examples could be retrenchment compensation to workers, VRS to employees, PF and other statutory dues, penalties payable for statutory defaults etc.

7.7.3 Valuation of Goodwill

In the case of companies that have a substantial amount of goodwill or brand value, this is generally valued on the following basis.

Method I: Super Profits Method

Under this method, it is assumed that the company generates super profits because of its goodwill. In asset-based valuation, the value of goodwill subsumes the value of all the intangibles that are embedded in the business of the company.

- Step 1: The net capital employed in the business is computed.
  Capital employed = Net fixed assets + net current assets or
  Capital employed = Shareholders' funds + debt capital – non-cash reserves and fictitious assets
- Step 2: The Return On Capital Employed (ROCE) is computed as:

$$\text{ROCE} = \frac{\text{Operating profit before interest on borrowings and taxes}}{\text{Capital employed}}$$

- Step 3: The future maintainability of the ROCE is ascertained.
- Step 4: The future maintainable ROCE is compared with the average of comparable companies in the industry as well as the industry average. By this comparison, the normal ROCE is determined.
- Step 5: With the help of the normal ROCE, the operating profit of the company under valuation is required to generate the normal ROCE on its capital employed is determined. Let this be termed as the Required Operating Profit.

- Step 6: The required operating profit under step 5 is reduced from the actual operating profit under step 2 to arrive at the Super Profit.
- Step 7: The super profit is capitalised for a given number of years which corresponds to the valuation horizon. This capitalised value is the value of goodwill of the business.
- Alternative Step 7: The super profit, thus, arrived at is discounted with an appropriate factor over the valuation horizon. The super profit may be assumed to be constant or growing at a sustainable rate during this period. The Net Present Value of the super profits of each year, thus, discounted would be the value of goodwill of the business. This alternative is known as the Annuity Method.

ILLUSTRATION 2

Let us assume that in the preceding illustration of ABC Ltd. the following is the further information to be incorporated:

Operating profit after interest before tax: ₹6,300,000
Long-term Borrowings: ₹10,000,000
Working Capital Borrowings: ₹2,000,000
Average cost of debt: 10%
Industry Average ROCE: 22%
Valuation horizon: 5 years
Discount factor: 15%

$$\text{ROCE} = \frac{\text{Operating profit before interest and taxes}}{\text{Tangible Net worth + Debt capital}}$$

$$= \frac{6{,}300{,}000 + 1{,}200{,}000(12{,}000{,}000 \times .10)}{10{,}000{,}000 + 12{,}000{,}000}$$

$$= 34\%$$

The operating profit required to generate normal ROCE = 22% of 22,000,000 = ₹4,840,000.

Super Profit = ₹2,660,000 (7,500,000 – 4,840,000)

Value of Goodwill = 2,660,000 × 5 = ₹13,300,000

$$\text{Alternatively, goodwill} = \frac{2{,}660{,}000}{(1+0.15)} + \frac{2{,}660{,}000}{(1+0.15)^2} + \frac{2{,}660{,}000}{(1+0.15)^3} + \frac{2{,}660{,}000}{(1+0.15)^4} + \frac{2{,}660{,}000}{(1+0.15)^5}$$

= ₹8,917,716

Method II: Normal Capitalisation Method

This method is similar to Method I except that it uses the normal capital employed as the base for determining goodwill. The first four steps will be similar as outlined in method I. After that, the following may be used.

- Step 5: The capital employed in the business of the company that can generate the normal ROCE is determined as follows.

  $$\text{Normal Capital employed} = \frac{\text{Normal ROCE}}{\text{Actual ROCE}} \times \text{Actual capital employed}$$

- Step 6: The difference of the actual capital employed as reduced by the normal capital employed is the value of the goodwill of the company.

  Using the above illustration, the computation under this method would be:

  $$\text{Normal Capital employed} = \frac{22\%}{34\%} \times 22{,}000{,}000 = ₹14{,}235{,}294$$

  Goodwill = ₹7,764,706 (₹22,000,000 – ₹14,235,294)

7.7.4 Arriving at Asset-based Valuation

In order to arrive at the total valuation of a company under asset-based valuation, the asset value as determined under any of the methods discussed earlier is increased by the amount of goodwill of the business to arrive at the final valuation.

Equity Value of the Company = Net Fixed assets + Net Current Assets + Goodwill– Long-term Borrowings – Preference Capital

$$\text{Value per share} = \frac{\text{Equity value}}{\text{No. of outstanding equity shares}}$$

Using the above illustration, the computation would be as follows:

$$\text{Value per Share} = \frac{22{,}000{,}000 - 12{,}000{,}000 + 8{,}917{,}716}{10{,}000} = ₹1{,}892$$

It may be appreciated from the above methodology that even under asset-based valuation, in cases where the company enjoys intangible value due to which its profits are above normal, the future earning potential of the company is captured under the term *goodwill* which is superimposed on the present asset value of the company. Nevertheless, asset-based valuation is not considered a good method of valuation except in cases already described in the preceding paragraphs.

7.8 Financial Forecasting

It may be appreciated from Exhibit 7.2 that both cash flow approach and economic profit approach require the use of financial forecasting, since these are *income-based approaches*. In any income-based approach whether based on profits or on cash flow, it is imperative to capture the future earning potential of the company and develop a forecasting model. Financial forecasting has to, therefore, result in the preparation of the following statements:

- Projected Income Statement (which projects the profitability and sustainable earning potential of the company).
- Projected Cash Flow Statement (which plots the future cash generating capacity of the company and thereby helps in determining the Free Cash Flow).
- Projected Balance Sheet (which brings out the expected asset-liability profile).

7.8.1 Determinants for Financial Forecasting

The forecast for the Income Statement has to capture the financials both from the income side and the expenditure side. The Income Statement is closely linked to the prospects of the company's business as well as the industry prospects and general economic outlook. This paradigm is captured in Exhibit 7.3.

Since equity valuation focuses on forecasted cash flow or profits, it would be necessary to do a business mapping before the numbers are actually determined. The best approach for such an exercise is the *Economy, Industry and Company (EIC)* approach. This is because the macro environment provides certain key variables that go to determine price levels and inflation in the economy. The key macro variables would be the rate of growth of GDP and money supply, rate of savings and capital formation, interest rates and credit off-take, government finances, tax structure and rates, employment and exchange rate. All these factors have a significant bearing on the performance of a particular industry and company. Macro management policies by the government exert influence on the movement of price trends in the economy which affect the prices of

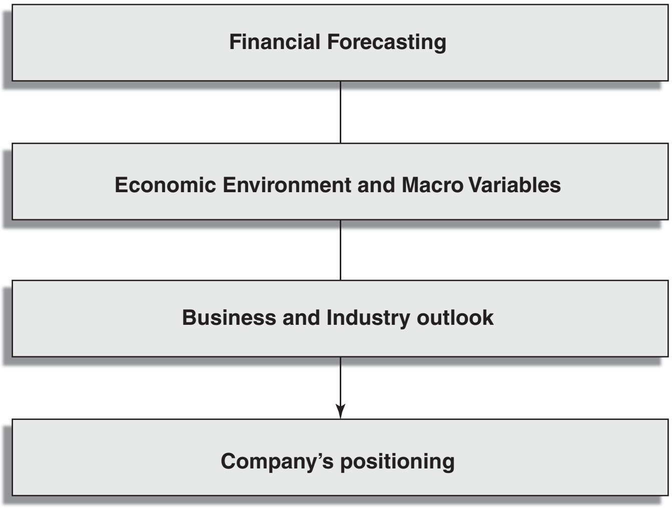


Exhibit 7.3 Determinants for Financial Forecasting

goods and services. Similarly, the tax structure can, sometimes, be skewed to lift the fortunes of a sagging industry or provide succor to a sunrise industry. These measures have an effect on the cost sheet and revenues of a particular company.

At the next level, the industry parameters are considered within the overall macroeconomic framework. It is very important to understand *industry life cycles* and the stage of a particular cycle. Every industry passes through sunrise or pioneering stage, growth and expansion stage, maturity-consolidation and stagnation stage and declining stage. The next step would be to understand the *industry structure*. The level of competition in the industry, entry barriers, regulatory framework to prevent monopolies and cartels and protection policies of the government determine the industry structure. Michael Porter's industry structure model can be very useful in industry analysis.

At the third level, one has to determine the fortunes of the company based on the above two levels of business environment. One of the significant factors that impacts future earnings is also the GAAP (Generally Accepted Accounting Principles) to be followed. Apart from GAAP, the other important parameters to be considered are the following:

- The period of forecast to be done. This is known as the *discrete period* or the *explicit forecast period*. Estimations over unreasonably long periods should be avoided. Generally, five years is considered a reasonable forecasting period for any type of industry. Ideally, the discrete period should cover one complete business cycle or at least 5 years. However, due to any reason if the discrete period has to be longer, it would be advisable to split it into two stages, i.e. the first five years or a business cycle during which complete forecasts with financial statements are developed with a detailed model and a second discrete period with a simplified forecasting model.
- Demand forecasting for the company's products.
- Customer analysis
- Competitive analysis (SWOT) that would determine the sustainability of the key variables.

7.8.2 Revenue Estimates

As far as the revenue profile of the company is concerned, one must ensure to consider the following steps to try and determine the estimated future revenues as reasonably as possible:

1. Setup the period for which forecasting would be relevant and practical. During the forecasting period, any abnormal or seasonal fluctuations in business due to which the revenue or expenditure profile gets distorted has to be suitably adjusted so as not to show undue fluctuations year on year.
2. Identify all possible revenue streams from existing and proposed product and / or service portfolio. The key determinants for revenues are market demand and product pricing. Generally, in business forecasting, the projected sales or revenues become the starting point from where all the other numbers flow.
3. The estimates for market demand would depend on the type of product, current consumption patterns, projected growth, availability of substitutes, emerging customer preferences and so on. The intellectual property of the company such as superior technology, design capabilities, service quality, marketing capability and brand equity also play a major role as differentiators.
4. In multi-product companies such as pharmaceutical formulations, FMCG etc., the product mix becomes a critical issue in revenue estimation. The product mix has to be chosen carefully based on the market trends and value addition of each product.
5. Product pricing should be based on past trends, current prices and adjustments for expected price trends in the industry in general and the company's products in particular. Any superior pricing advantage the company enjoys at present has to be viewed from its sustainability in future. For example, in the pharmaceutical industry, the product prices are subject to the Drug Control Order and competition from generic manufacturers. Pricing advantage may also be nullified by the change in government policy on account of duties and taxes, procurement policies etc. Generally, high value added products command better sustainability of prices and insulation from market forces as compared to low value commodity businesses.
6. Sales to group companies should be accounted for on arm's length transfer price so as to arrive at the true economic potential of the company under valuation.
7. In projecting revenues, care has to be exercised in the usage of a consistent method of accounting, i.e. the accounting for taxes, transportation, insurance and other charges.

7.8.3 Cost Estimates

1. Costs are generally categorised as manufacturing or operating costs, Selling General and Administrative Costs (SG&A) and financial costs.
2. Operating costs are determined by the trends in key input costs, production processes, business logistics and cost advantages, if any. In forecasting future operating cost patterns, past trends and growth in level of operations envisaged in the forecast period need to be taken into account.
3. The SG&A costs are a function of the level of operations to certain extent since most of them are semi-variable costs. However, as far as sales and distribution costs are concerned, future marketing strategy, advertisement and product launch expenses, market penetration costs and other types of cash burn have to be adequately provided for in the cost estimates.
4. The financing costs are a function of the capital structure and the level of gearing in the long term and current capital. In arriving at the financing cost, the probable rating of the company with its lenders has to be kept in mind. This would depend on the existing rating and expected debt servicing capacity in future. In the case of debt securities issued by the company, the probable coupon rates have to be estimated based on trends in the capital market and movement of interest rates.

5. Other items of cost include provisions and write-offs. Provisions are a function of the nature and level of business and the amount of business losses that the company has to meet. Write-off of deferred revenue expenditure and other losses would depend upon the accounting policy as permitted under the Accounting Standards and the policies adopted by the company.
6. The tax status of the company as determined by its constitution, specific provisions of the Income Tax Act, 1961 and the quantum of tax shelters enjoyed by the company would determine the tax liability of the company. Particular attention needs to be given to Section 115JB relating to Minimum Alternate Tax.

7.8.4 Estimation of Capital Requirements and Financing Mix

Apart from revenue and cost estimates, the other necessary estimations for financial forecast are in terms of the future capital requirements of the company on long-term and short-term account in order to meet the revenue and activity projections. In manufacturing companies, the revenue estimates are a function of the capacity utilisation, which can be achieved only if the required production capacities are in place. Service entities such as software, ITES etc. require enough manpower deployment with suitable infrastructure and facilities.

Estimation of capital expenditure requirements has to take into account increased capacity if any, normal capital expenditure to keep existing infrastructure in efficient running condition, technological obsolescence and diversifications. Estimation of working capital requirements should be based on the level of activity projected, envisaged business processes, operating cycle, changes in procurement system for raw materials and other key inputs, desired level of current assets and extent of liquidity required.

Once the estimation of future capital requirements are drawn up, depending on the accepted debt-equity ratio and the level of long-term debt acceptable to the company, the fresh long-term debt during the forecast period have to be estimated. The amortisation schedules of the existing term loans and asset financing borrowings have to be considered in arriving at the total quantum of debt year-on-year. Similarly, based on the availability of current liabilities and internal accruals to finance working capital requirements, the level of projected working capital borrowings is determined.

7.8.5 Further Guidelines for Financial Forecasting

Value creation is driven by the excess of return over cost of capital. The return is dependent upon the level of utilisation of capital (capital turnover) and the margins in the business. Margins are achieved through better realisations and/or efficient cost management. A company may have competitive advantages in any of the above areas due to which it has better profitability. The sustenance of such competitive advantage has to be established for better financial forecasts.

1. It is customary to use ratio analysis in determining future projections and compare the ratios for different years with the past trends. The changing profile of these ratios has to be explained by proper reasoning. Inter-firm comparison of ratios is also a useful tool in determining that the projections are attainable. Sensitivity and scenario analysis can also be performed on the profitability projections to arrive at optimistic, pessimistic and normal level of performance expected in future.
2. Consistency in numbers is the key in financial forecasts so that they appear realistic. It is better to make projections that are attainable with 85–90% efficiency levels rather than leave no room for slippages and contingencies.
3. It is customary to assume returns on idle cash balances that are built up in the forecasting period at the risk-free rate of return prevailing at that time. Similarly, the existing long-term investments in fixed return financial instruments may be assumed to continue at the prevailing rates of return unless they

are proposed to be liquidated in the forecasting period. As far as equity investments are concerned, the expected dividend income thereon based on past trends may be considered year-on-year in the income statement of the company under valuation.

4. It would be necessary to fine tune the numbers after arriving at the initial set of financial projections. This would take care of numbers that are skewed or any other distortions that may arise in the process of forecasting. It is advisable to go through as much iteration as necessary before satisfactorily firming up the forecasted financial model.
5. The projected P&L statement should not consider the benefit of Direct Tax Assets (DTA) during the discrete period, if such assets are not getting set-off against taxable income during the discrete period.
6. Accounting policies considered for forecasting have to be in line with industry norms and Accounting Standards (Country GAAP as may be applicable). In India, IND-AS standards issued by the Institute of Chartered Accountants of India and are mandatory on companies going forward. Otherwise, re-statement of past financials is necessary before using them as a basis for forecasting. One of the instances where such treatment is mandatory is with respect to human resources cost and future provisioning for retirement benefits.

7.8.6 Drawing up Statements of Financial Forecast

As stated above, the financial forecasts culminate in the preparation of the three projected financial statements. The normal sequence is to prepare the income statement, followed by the cash flow and finally the balance sheet. After the income statement is finalised, the *cash flow from operations* is estimated therefrom. Using the other parameters discussed above, the cash flow from financing and investing activities are drawn up.

After the cash flow statement has also been made, the final task is to prepare the balance sheet. For this purpose, the existing balance sheet of the company as on the date of valuation or the immediately preceding financial year-end has to be considered as the starting point. To this balance sheet, the changes brought about by the projected income statement and the cash flow statement is incorporated to arrive at the projected balance sheet year on year.

Illustrative Statements of Financial Forecast

Table 7.3 Projected Income Statement

(₹ Million)

	Year 1	*Year 2*	*Year 3*	*Year 4*	*Year 5*
Export and Domestic Sales	749	1,395	2,070	3,555	4,579
Other Operational Income	7	11	14	18	23
Gross Sales	**757**	**1,406**	**2,084**	**3,573**	**4,602**
Raw material consumption	277	383	452	544	661
Other spares & Consumables	8	11	14	16	20
Power & Fuel	40	47	54	61	61
Direct Labour	27	30	33	36	40
Other manufacturing expenses	17	23	27	33	40
Cost of Production	370	495	580	690	821
Selling, General & Administrative (SG&A)	69	110	153	245	309
Total Expenses	**438**	**605**	**732**	**935**	**1,130**

(*Contd.*)

EBITDA	318	802	1,351	2,638	3,472
Depreciation	58	62	67	68	82
Interest (13%)	169	169	169	169	169
Operating profit	**91**	**571**	**1,115**	**2,401**	**3,221**
Amortisations	5	5	5	5	5
Non-operating Income	67	80	109	173	272
Profit before tax	**153**	**646**	**1,219**	**2,569**	**3,488**
Provision for taxation (actuals)	33	166	370	898	1,188
Profit after taxation	**120**	**480**	**849**	**1,671**	**2,300**

Table 7.4 Projected Balance Sheet

(₹ Million)

Liabilities	*Year 1*	*Year 2*	*Year 3*	*Year 4*	*Year 5*
Equity Capital	500	500	500	500	500
Reserves & Surplus	289	937	1,956	3,795	6,264
Net Worth	789	1,437	2,456	4,295	6,764
Long-term Borrowings	1,300	1,300	1,300	1,300	1,300
Total Borrowings	1,300	1,300	1,300	1,300	1,300
Total Liabilities	**2,089**	**2,737**	**3,756**	**5,595**	**8,064**
ASSETS					
Cash & Bank Bal.	877	999	1,561	2,502	3,900
Investments	1	2	2	3	3
Gross current assets	386	717	1,011	1,503	1,896
Less: current liabilities (there are no bank borrowings)	37	50	61	78	94
Net current assets	349	666	950	1,425	1,802
Gross Fixed Assets	675	775	896	971	1171
Less Depreciation	58	120	187	255	337
Net block of fixed assets	617	655	709	716	834
Capital work in progress	0	25	50	170	250
Net fixed assets	617	680	759	886	1,084
Research and Development Expenses not written off	200	350	450	750	1,250
Others	45	40	35	30	25
Total Assets	**2,089**	**2,737**	**3,756**	**5,595**	**8,064**

7.9 Free Cash Flow

Cash flow-based models for business valuation work on the concept of *free cash flow*. This is because, under these models, the value of a company or asset comes from its capacity to generate cash flows. However, the cash flow parameter used in such valuations is not the cash generated from operations but the cash that remains after the reinvestment needs of the company in working capital and fixed capital are taken care of. Such cash flow is known as *free cash flow to firm* or FCFF.

Therefore, FCFF = Net Operating Cash Flow after tax
+ / – Non-operating income or expenditure
+ / – Changes in Non-operating assets
+ / – Additional investment in capital assets
+ / – Changes in Non-cash working capital

From the above calculation, it is evident that free cash flow is the positive (or negative) cash that is thrown up by the company year-on-year after meeting the reinvestment requirements to sustain the cash flow. It is also the combined cash flow that would be available to all the providers of capital to the company irrespective of debt or equity (financing cash flow). However, the following adjustment needs to be made in computing the Net Operating Cash Flow.

The Net Operating Cash Flow is obtained using the NOPLAT (Net Operating Profit less adjusted tax) which calculated as:

NOPLAT = EBIT – tax on EBIT

The EBIT of a company is the earnings before interest and tax. Since we are computing the NOPLAT based on EBIT, all non-operating income and extraordinary items in the generation of such EBIT have to be excluded. The NOPLAT is calculated as if the company has no borrowings as we are trying to determine the cash that would be available to all providers of capital, debt and equity. Tax on EBIT should be calculated at the effective rate applicable to the company as adjusted for the tax shield on leverage. This can be derived as follows:

Effective rate = Tax provision from the Income Statement + Tax shield on Interest

The computation of FCFF is depicted in Exhibit 7.4.

Net Operating Cash Flow for the year NOPLAT + Depreciation +/– Non-cash items in P&L Account	+/–	*Cash Flow from non-operating activities* Post tax net Non-operating Income + Opening balance of non-operating assets – Closing balance of non-operating assets	+/–	*Cash flow from Reinvestment* Opening balance of gross fixed assets – Closing balance of gross fixed assets Opening non-cash net current assets – Closing non-cash net current assets *Note:* Net Current assets = Current Assets – Non-Interest Bearing Current Liabilities (NIBCL)

Exhibit 7.4 Free Cash Flow to Firm (FCFF)

7.9.1 OCF versus Free Cash Flow to Firm

Operating Cash Flow as computed in a cash flow statement differs from FCFF in the following respects:

- As shown above, OCF is derived as the cash flow generated through the operations of the company while FCFF represents the free cash available to the providers of capital (financing cash flow).

- OCF considers PAT + Depreciation +/- Non-cash items in the P&L Account as adjusted for changes in working capital. To this extent, OCF and FCFF are identical.
- OCF does not consider non-operating incomes and expenditures. These are treated as part of financing cash flow. FCFF includes non-operating cash as well since it measures cash flow available to capital providers irrespective of whether it is generated from operations or not.
- OCF is the cash that accrues after deduction of interest expense and tax. Therefore, it accrues the tax shield available on interest. FCFF considers tax on an unlevered basis assuming tax shields to be relevant only in the short term.
- OCF does not consider reinvestment requirements in fixed assets. FCFF measures the reinvestment requirements in fixed assets during the year. This is because FCFF is a futuristic measure of the aggregate excess cash that the business would generate year-on-year to all capital providers. Therefore, it takes into account the level of capital investments required to sustain such cash flow generation.

7.9.2 Earnings versus Cash Flow

Cash flow is treated as a better measure of value than earnings since accounting profits are influenced by GAAP and are based on the accrual concept. Therefore, the exact timing of the returns is not captured. However, before proceeding to compute free cash flow, one has to keep in mind the differences between the two and the special situations that are encountered in the cash flow approach. These are discussed below:

- Fundamentally, though earnings and cash flows emerge from the same business activity, they measure two different things: cash flow measures the net sum of inflows and outflows during a time period while earnings are the net sum of inflows and outflows from completed operating cycles. Therefore, they provide different views of the on-going cycles. While cash flow is measured from the cash cycle, earnings emerge from the operating cycle. One should appreciate this difference.
- At the outset, cash flow predictions work well for mature companies that generate stable cash flow from operations which is sufficient to maintain their fixed assets and generate ROCE. It goes to say that for such companies, earnings and cash flow are equally predictable and could probably tend to coincide since the impact of depreciation on earnings would not be quite significant.
- In companies that are in the high growth trajectory, the reinvestment requirements would be extremely high due to which, many a time, the free cash flow could be negative. The company has to keep expanding its investments in fixed and current assets and therefore, has to pump in more of long-term cash coming from operations into the financing of such investments. It is possible in such cases that the increased cash flow that would accrue to the company as a result of such growth may actually fall *outside* the discrete period under consideration. The free cash flow pattern in such cases would show negative discrete cash flow and a high terminal cash flow. In other words, the valuation gets skewed to the terminal cash flow. This is an acceptable position in such situations.
- In the case of distressed companies, one has to guard against the reverse phenomenon. The free cash flow could actually be higher than normal since the company is shrinking its current assets and is not in a position to invest in fixed assets for the future. This could give rise to a certain level of current free cash flow that has no sustainability for the future. In such companies, earnings could provide a better picture of the affairs of the company.

From the above discussion, it is evident that though earnings are not a perfect solution in corporate valuation, they are nevertheless important to understand the potential pitfalls of predicting future free cash flows.

ILLUSTRATION 3

Computation of Free Cash Flow

Using the example furnished in Section 7.8.7, the computation of free cash flow for the given financial statements is shown as follows:

Table 7.5 Computation of Free Cash Flow

(₹ Million)

	Year 1	*Year 2*	*Year 3*	*Year 4*	*Year 5*
EBIT	255.0	734.9	1,279.7	2,565.1	3,384.8
Less: Taxes on EBIT (assumed applicable rate of 34%)	86.7	250.0	435.0	872.1	1,150.8
Net operating profit less Adjusted taxes (NOPLAT)	168.3	484.9	844.7	1,693.0	2,234.0
Add: Depreciation and w/off	63.5	66.6	71.6	72.8	86.9
Add: Post Tax Non-operating income = (1-0.34)	44.22	52.8	71.94	114.18	179.52
Gross Cash Flow	**276.02**	**604.3**	**988.24**	**1,879.98**	**2,500.42**
Incremental working capital requirements	349.0	317.2	283.5	475.4	377.1
Normal Capital Expenditure	0	125.0	146.0	195.0	280.0
Gross Investment	**349.0**	**442.2**	**429.5**	**670.4**	**657.1**
Free Cash Flow to Firm	**(72.98)**	**162.1**	**558.74**	**1209.58**	**1843.32**

Notes:

1. *The incremental working capital requirements for each year are computed as closing balance of net current assets as reduced by the opening balance of net current assets.*
2. *Capital expenditure of each year is computed as closing balance of gross fixed assets and capital work-in-progress as reduced by the opening balance of gross fixed assets and capital work-in-progress.*
3. *The changes in non-operating assets (investments) have been ignored since these are negligible.*

7.9.3 Other Factors for Estimation of Free Cash Flow

- The discrete period may be considered for a longer time if it is felt that the business cycle of a company is longer. This could be the case with most cyclical industries wherein the business prospects vary significantly during various phases of the cycle.
- In cases where DTA benefits are not getting set-off during the discrete period, a one-time DTA benefit may be incorporated into the computation of terminal value (refer to Section 7.10).
- The discrete free cash flow model is based on the assumption of a going concern with stable rate of growth beyond the discrete period. If a company is still in the growth phase and a significant expansion is on the anvil during the discrete period, the external debt capital that may be raised in this context is incorporated in the model for computation of FCFF. However, no additional external equity shall be assumed since it would distort the valuation of existing equity.

7.10 Measuring Terminal Value of Free Cash Flow

The terminal value of FCFF after the discrete period is the last determinant under the cash flow method of valuation. This is calculated to perpetuity to capture the value of the cash flow that accrues after the discrete period. It is calculated by considering the FCFF for the *T+1* year, if '*T*' is the last year of the discrete period. The FCFF of the *T+1* year is then valued to perpetuity which is as follows:

$$\text{Terminal Value of FCFF} = \frac{\text{FCFF}_{T+1}}{\text{WACC} - g}$$

Where, g is the expected growth rate of NOPLAT after the discrete period. However, if one were to consider the fact that 'g' would be a function of the reinvestment rate of NOPLAT and the ROCE, the above formula can be expanded as follows:

FCFF after year '*T*' = NOPLAT × [1 – g / ROCE] wherein [1 – g / ROCE] is the reinvestment rate.

$$\text{Therefore, Terminal Value of FCFF} = \frac{\text{NOPLAT}_{T+1} \times [1 - g/\text{ROCE}]}{\text{WACC} - g}$$

ILLUSTRATION 4

If the FCFF of Year 8 of a cash flow projection is ₹525 lakh, which is expected to maintain a 5% constant growth thereafter and the WACC is 15.25%.

Terminal value of the FCFF would be:

525/(0.1525 – .05) = 525 / (0.1025) = ₹51.22 crore

The terminal growth rate assumption is critical in the estimation of terminal value as it has a significant quantitative bearing on the end result. Generally speaking, the perpetuity growth is tempered down and does not correspond to the growth rate applied during the discrete period. This is because, the long term normal growth rate in any business is always the future maintainable rate at the level of consolidation and not what is achieved during the growth phase of a company. Therefore, perpetuity rates are not considered more than 3–4% for manufacturing and trading companies and up to 5% for service companies. This rate can be considered higher at 6–7% for knowledge based and technology driven companies. In limited life companies (SPVs), the terminal value shall include the liquidation value of the assets at their depreciated value. In the estimation of terminal value, adjustment may be made for terminal capex, i.e. normal capital expenditure to be incurred on a continuing basis. This may not be identical to the reinvestment requirements considered during the discrete period. To that extent the terminal year cash flow assessment would be different. In addition, it is customary to provide for a 15% depreciation on terminal capex in the computation of the post-tax terminal cash flow.

7.10.1 Appropriate Tax Rate[2]

There is often a divergence of opinion on the tax rates to be used for cash flow estimations as stated in the preceding paragraphs. The controversy is with regard to the *effective tax rate* and the *marginal rate of tax*. In this regard, the following discussion may be kept in mind before using the appropriate rate:

- The tax rate to be used on NOPLAT for arriving at free cash flow can be the effective rate, if it is justified by the special tax benefits that the company enjoys during the discrete period. However, if a uniform rate has to be considered for the entire model, it would be better to adopt the marginal rate of tax.
- The tax rate to be used in the determination of the post-tax cost of debt is the effective tax rate and not the marginal rate of tax as is often advocated. This is because a company may enjoy significant tax shelters

[2]*For the arguments on effective rate versus marginal rate of tax, readers may consult page number 249 of Investment Valuation – Aswath Damodaran, John Wiley & Sons Inc. Second Edition and page 832 of Investment Analysis and Portfolio Management – Dr Prasanna Chandra – Tata McGraw-Hill.*

due to which its effective tax rate could be lower than the marginal rate. If the marginal rate is adopted, it would result in a lower post-tax cost of debt and consequently a lower WACC. A lower WACC would lead to a higher value for the company. This would mean that higher the deferred tax assets, higher is the valuation. This conclusion can sometimes be anomalous, especially in the case of loss-making companies.

- In measuring the FCFF for the purpose of arriving at the terminal value ($FCFF_{T+1}$), it is always the marginal tax rate that has to be used since all deferred tax assets get neutralised over a period of time and the company will eventually pay tax at the marginal rate.

7.11 Measuring Cost of Equity

The next important component of the cash flow methodology of valuation is the determination of the *cost of equity capital* of the company under valuation. The cost of equity represents the imputed cost of servicing the equity shareholders of the company. Though there are several approaches for this purpose such as the Markowitz Model, the Capital Asset Pricing Model, the Arbitrage Pricing Model etc., the most widely used among these is the Capital Asset Pricing Model or the CAPM.

7.11.1 The CAPM

The CAPM postulates that the cost of equity (opportunity cost of the shareholder) is the sum of the return on risk-free securities and the product of company's systematic risk (beta) multiplied by the market price of risk (market risk premium). It is represented as follows:

$$\text{Cost of Equity} = R_f + \text{Equity beta } (ER - R_f)$$

where,

R_f = risk free rate of return
ER = market rate of return on equity
$ER - R_f$ = the market risk premium for equity (known as *systematic risk*)
Equity beta = the volatility of the return on the stock of the company relative to return on the market.

ILLUSTRATION 5

R_f = 8.0% (rate offered on dated government securities)
ER = 17% (average return from the equity market)
Market risk premium = 9% (17% – 8%)
Beta = 1.08 (assumed for a company)
Cost of equity for the company = 8% + 1.08 × (9%) = 17.72%

In the CAPM formula, the risk premium is the difference between the average return on the stock market and the average risk free return. To calculate the CAPM, we need three variables: the risk-free rate, the market risk premium and the systematic risk (beta). While the risk-free rate is usually pegged to the rate being offered on dated government securities, arriving at the market risk premium is a complex issue. Since the CAPM is forward looking, the expected market premium has to be computed from historical data over a long period of time so as to determine the trends as effectively as possible. Usually, in Indian market conditions, a market risk premium of 6 to 8% is considered acceptable in many situations.

Equity beta is a statistical tool arrived at by regression analysis to measure the performance of a company's stock return vis-à-vis the market return. Technically, it represents the co-variance of the returns on the individual stock with the market returns on the market portfolio divided by the variance of returns on the market portfolio. Thus, beta is calculated as:

$$\beta = \frac{\text{Covariance}\,(X, Y)}{\text{Covariance}\,(Y)}$$

where,

X is the returns on the company's stock – Dependent Variable

Y is the market returns or index –Independent Variable

Beta has been criticised by several academicians for its perceived deficiencies in explaining market return on equity. Beta depends on the type of business, operating leverage and financial leverage in the company, etc. Higher the leverage, higher would be the beta. Since the beta measures the relative volatility, if the volatility of the stock moves in tandem with that of the market, the beta would be equal to 1. If the movement is less than perfect, the beta would be less than 1 and for highly volatile stocks that fluctuate beyond the index, the beta would be more than 1. The beta has to be calculated for a given company using the market price data for about three to five years. The raw beta that is arrived at using regression analysis has to be adjusted for any abnormal events or seasonal fluctuations because of which the stock price was distorted. In the case of many listed companies, the stock exchanges calculate the beta and display the same for the guidance of investors.

In practical valuation situations, the CAPM is adjusted for specific factors of a given case to arrive at the *adjusted CAPM* in arriving at the cost of equity for such company. This is shown below:

$$\text{Adjusted CAPM} = R_f + \text{Equity beta}\,(ER - R_f) + SCRP$$

Where, SCRP is the s*pecific company risk premium* signifying the unsystematic risk (also known as *α risk or alpha risk*) attached to the specific company. While systematic risk reflects the general risk premium attached to equity investments (*portfolio risk*) in a given market and external investment environment, the SCRP denotes the specific risk attached to a company for factors that are internal to it (*strategic or substantial investment risk*). It goes to say that SCRP can be positive if the risk perceived for a company is higher than the market risk and it can be negative when such risk is perceived lower. SCRP is used for off-market investments in listed companies, M&A and private equity transactions.

7.11.2 Arbitrage Pricing Model

The APM is a further refinement of the CAPM Model, in that it considers the sensitivity of the company to several relevant underlying economy and industry factors unlike the CAPM which considers the general market risk premium. Therefore, the APM factors in several betas instead of just one, each measuring the sensitivity of the company to a particular factor. The APM is depicted as follows:

$$\text{Cost of Equity}\,(K_e) = R_f + \text{beta}_1\,(ER_1 - R_f) + \text{beta}_2\,(ER_2 - R_f) + \ldots.. + \text{beta}_n\,(ER_n - R_f)$$

In the above model, each set of beta and market premium measures one particular factor and is independent of other factors. Empirical research on the APM has yielded better results than the CAPM since it can be measured for several factors that may be relevant to the company in particular.

7.12 The WACC

The next important determinant in the cash flow-based valuation model is the post-tax Weighted Average Cost of Capital or WACC. This is calculated using the cost of equity as determined above and the market cost of debt as adjusted for taxes. Since the cost of equity represents the post-tax cost to the shareholder, the additional cost borne by the company for *Dividend Distribution Tax* (DDT) may be added to the cost of equity in determining the WACC. This however, is subject to the changes in tax law from time to time. For a computation of the DDT, please refer to footnote below.[3]

The following example illustrates the calculation of WACC.

ILLUSTRATION 6

Weighted Average Cost of Capital

	Amount	*Pre-tax*	*Tax Rate (t)*	*Post-tax Rate (1-t) or (1+t)*	*Cost ₹*
Cost of Debt					
Long-term loans	450	12.00%	30.0%	8.40%	37.80
Other Debt capital	300	15.00%	30.0%	10.50%	31.50
Cost of Equity					
Equity Share Capital	580	18.00%	16.22[1]%	20.91%	121.28
Preference Capital	400	10.00%	16.22[2]%	11.62%	46.48
TOTAL	1730				237.06
WACC = 237.06 / 1730					
	= 13.70%				

The WACC can also be estimated by taking the individual post-tax cost of equity and the cost of debt separately and multiplying them in the ratio of debt to equity in the capital structure. This is illustrated below for the same example (*supra*).

Weighted Average Cost of Capital

Cost of Debt	*Amount*	*Post-tax Rate (1-t) or (1+t)*	*Post-tax Rate (1-t) or (1+t)*	*Weightage*	*Weighted Rate %*
Long-term loans	450	8.40%	8.40%	0.26	2.18
Other Debt capital	300	10.50%	10.50%	0.17	1.82
Cost of Equity					
Equity Share Capital	580	20.91%	20.91%	0.34	7.01
Preference Capital	400	11.62%	11.62%	0.23	2.69
TOTAL	1730			1.00	13.70
WACC = 13.70%					

[3]The basic rate of dividend distribution tax is presently 15% that has to be increased by a 5% surcharge. On the sum of DDT and surcharge (15.75%), a cess of 3% is levied bringing it up to 16.2225%. Rates and provisions could vary in future based on the prevailing tax law.

7.13 Cash Flow-based Valuation Models[4, 5]

Based on all the parameters discussed in the preceding paragraphs, we are now in a position to come to the actual business valuation models that are used with free cash flow as the base. As mentioned at the beginning of this chapter, we use the DCF methodology for arriving at value and therefore, these models are called the *DCF Models of Valuation*. The architecture of DCF valuation is furnished in Exhibit 7.5 below:

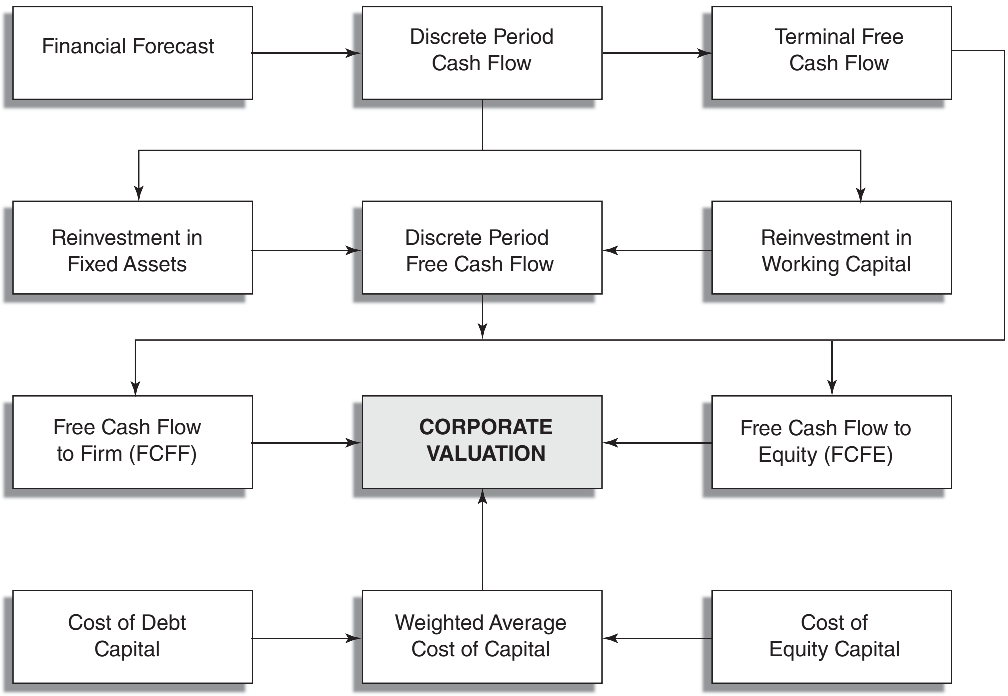


Exhibit 7.5 DCF Valuation Architecture

It may be appreciated from Exhibit 7.5 that the DCF method determines value based on four main parameters: (i) the quantum of cash flow expected to be generated based on the financial forecast, (ii) the timing of the cash flow (as it impacts the discounted value), (iii) the risk associated with the cash flow (which is reflected in the WACC being used) and (iv) the future reinvestment requirements that determine the free cash flow. Therefore, though the DCF approach appears to be objective, there are areas of judgement for the valuer which would impact the ultimate valuation that would be determined under this methodology. While some of the judgemental factors are incorporated into the financial forecast and its consequent cash flow, other factors are built into the WACC so as to reflect appropriate risk attached to the cash flow.

In this section, we will discuss the two prime DCF models of business valuation that are used, namely the *Free Cash Flow to Firm* or FCFF model and the *Free Cash Flow to Equity* or the FCFE model.

[4]ibid
[5]ibid

7.13.1 Enterprise Cash Flow Model (FCFF)

This is perhaps the most widely used method of DCF valuation for several corporate transactions. Under this method, the FCFF is used as the basis for arriving at the value of a company as per the following methodology:

The value of the company under the FCFF model is the sum of (i) the present value of the FCFF arrived at for each year during a discrete growth period, and (ii) the present value of the terminal FCFF at the end of that period.

Expressing this as an equation,

Enterprise Value of Company = PV of FCFF during discrete period ($PVFCFF_1$) + PV of terminal FCFF ($PVFCFF_2$)

Value of Equity = ($PVFCFF_1$ + $PVFCFF_2$) – market value of outstanding debt Value of equity share = Value of Equity/Number of shares

ILLUSTRATION 7

Continuing with the illustration provided in Section 7.8.7 and Section 7.9.2, let us arrive at the following scenario for valuation of a company using the FCFE model:

(₹Lakh)

Y0	*Y1*	*Y2*	*Y3*	*Y4*	*Y5*
Free Cash Flow to Firm (FCFF)	(72.98)	162.1	558.74	1209.58	1843.32
WACC computation Debt ₹1300 lakhs @ 13% Equity ₹789@ 18% WACC = 14.9%					
Discounting factor = 1 / $(1+.149)^n$ where $n = Y_{1\text{-}5}$	0.87	0.76	0.66	0.57	0.50
Discounted FCFF	(63.49)	123.20	368.76	689.46	921.66
PV of FCFF	2039.59				

Growth rate for Terminal FCFF beyond Y_5 = 5%
Paid Up Capital = 5,000,000 equity shares of ₹10 each
Long-term borrowings = ₹1300 lakh
Present Value of FCFF during discrete period $Y1_{-5}$ = ₹20.4 crore (₹2040 lakh as shown above)
Terminal Value of FCFF = 1843.32 / (0.149 – 0.05)
= ₹186 crore
Enterprise Value of the Company = ₹186 + 20.4 = 206.4 crore
Value of Equity = EV – debt – cash and cash equivalents
Value of equity = 206 – 13 – 8.77 = ₹184 crore.
Value per share = 1,840,000,000 / 5,000,000 = ₹368

7.13.2 Equity Cash Flow Model (FCFE)

The FCFE model is an alternative method under DCF valuation that considers the free cash flow available to equity shareholders alone as distinguished from the FCFF model wherein the enterprise cash flow is considered. FCFE model is, therefore, considered as an alternative to the Dividend Discount model as well.

For the purpose of the FCFE model of valuation, the FCFE model is derived as shown below:

Free Cash Flow to Equity = [Profit after tax + Depreciation +/– Non-cash items in P&L Account]
+ / – [Changes in non-operating assets]
+ / – [Additional investment in capital assets]
+ / – [Changes in Non-cash working capital]
+ / – [Changes in Debt Capital]
+/ – [Changes in Preference Capital + Pref. Dividend]

Under the FCFE model of valuation, the value of equity of the company is the sum of (i) the present value of the FCFE arrived at for each year during a discrete growth period, and (ii) the present value of the terminal FCFE at the end of that period.

Expressing this as an equation,

Value of Equity = PV of FCFE during discrete period ($PVFCFE_1$) + PV of terminal FCFE ($PVFCFE_2$)

Value of share = ($PVFCFE_1$ + $PVFCFE_2$)/Number of shares

In the above computation, the present value is determined by using the cost of equity as the discounting rate instead of the WACC as in the FCFF method.

ILLUSTRATION 8

ABC Ltd. has the following information as at the end of the current financial year.

Equity Capital	-10,000 shares of ₹10 each
PV of Free cash flow during discrete period ($FCFE_1$)	-₹100,00,000
PV of Terminal Cash Flow ($FCFE_2$)	-₹50,00,000
The Value per share	-150,00,000/10,000 = ₹1500.

The computation of FCFE is depicted in Exhibit 7.6.

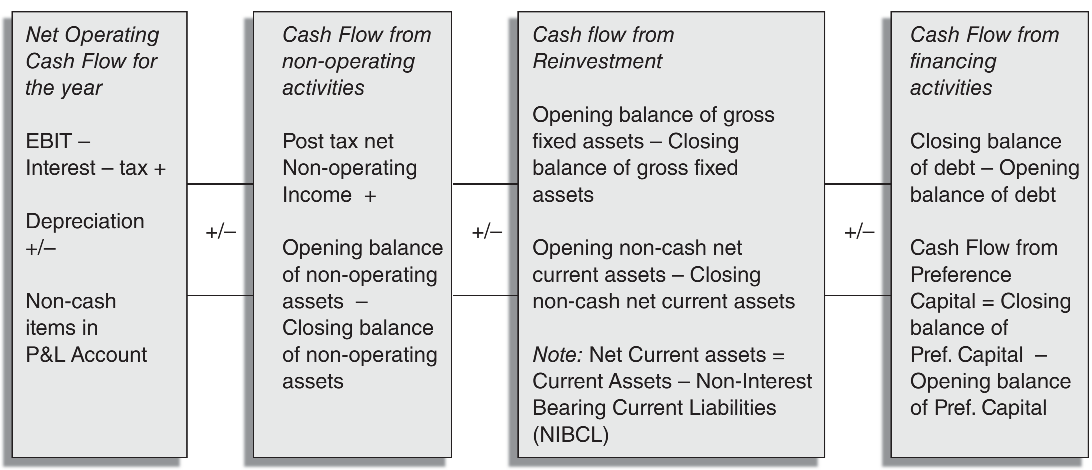


Exhibit 7.6 Free Cash Flow to Equity (FCFE)

Let us look at the contrast between FCFF and FCFE for the purpose of conceptual clarity based on Exhibit 7.4 as compared to Exhibit 7.5:

- FCFF measures cash flow before payment of interest while FCFE measures cash flow after payment of interest.

- FCFF incorporates tax at the effective rate / marginal rate as may be applicable (please refer to the earlier discussion). FCFE incorporates tax at the effective rate.
- FCFF does not consider the net cash flow from financing activity, i.e. changes in debt capital and preference capital while FCFE factors in the two.
- FCFF does not factor in preference dividend while FCFE does.

ILLUSTRATION 9

Continuing with the same illustration provided in Section 7.8.7, we can compute the FCFE of the company as follows:

Y_0	Y_1	Y_2	Y_3	Y_4	Y_5
Profit after taxation	120	480	849	1,671	2,300
Depreciation	58	62	67	68	82
Amortisation	5	5	5	5	5
Gross Cash Accrual	183	547	921	1744	2387
Changes in working capital	349.0	317.2	283.5	475.4	377.1
Capital Expenditure	0	125.0	146.0	195.0	280.0
Gross Investment	349.0	442.2	429.5	670.4	657.1
Changes in non-operating assets	0	0	0	0	0
Changes in long-term debt	0	0	0	0	0
Free Cash Flow to Equity	(166.0)	104.8	491.5	1073.60	1729.9
Cost of Equity = 18%					
Discounting factor = $1 / (1+.18)^n$ where $n = Y_{1-5}$	0.85	0.72	0.61	0.52	0.44
Discounted FCFE	(141.1)	75.46	299.82	558.72	761.16

Growth rate for Terminal FCFE beyond Y_5 = 5%
Paid Up Capital = 5,000,000 equity shares of ₹10 each
Present Value of FCFE during discrete period $Y1_{-5}$ = ₹16.54 crore (as shown above)
Terminal Value of FCFE = 1729.9 / (0.18 – 0.05)
= ₹133.0 crore
Equity Value of the Company = ₹133.0 + 16.54 = 150 crore
Value per share = 1,500,000,000 / 5,000,000 = ₹300[6]

Both the FCFF and the FCFE models are fairly established, though conventionally, the FCFF model takes precedence in transactions. Whichever be the method followed, the essential focus should be on estimation of discrete cash flow and the future maintainable terminal cash flow which has a significant influence on the overall valuation being arrived at.

[6]It is not necessary for the valuation of a company under the FCFE and FCFF models to be identical since they are based on different approaches and assumptions made may not be consistent. In practice, the FCFF is widely prevalent in comparison with the FCFE method in the valuation of non-financial entities. Readers may also refer to the discussion in Section 7.18 of this chapter.

7.14 Economic Profit Model

The economic profit approach to valuation looks at a company's performance by benchmarking it to the capital invested therein and the opportunity cost of such capital. Companies constantly strive to create value by investing capital in the most profitable business opportunities that earn returns at a rate higher than the opportunity cost of capital. This is known as *economic profit*. However, the other approach to valuation discussed in the preceding paragraphs is the expected amount of cash flow that arises to the benefit of the shareholder measured at today's worth. In other words, the cash flow approach looks the ability of a company to maximise cash flow to shareholders. While the economic profit approach tells us the addition to value on a year-on-year basis, the cash flow approach tries to bring in the concept of *present value*. Both the approaches to measuring value are not mutually exclusive but can be used in different contexts. While the economic profit approach is useful to measure short-term value, the cash flow approach is more useful in the long-term valuation of a business due to its ability to cut across time.

$$\text{Economic profit for a given period} = \text{Capital Employed} \times (\text{ROCE} - \text{WACC})$$

Where Capital Employed = shareholders' funds + debt capital.

Using the measure of economic profit as shown above, the value of a company is given as:

$$\text{Value of Company} = \text{Capital Employed} + \text{PV of Future Economic Profit}$$

The PV of future economic profit is obtained by capitalising the current year's economic profit by the WACC.

ILLUSTRATION 10

The ROCE of a company is 26% and its WACC is 14%. The capital employed works out to ₹50 million on an average. Therefore, the economic profit made by the company in a year works out to ₹6 million, i.e. 50 × 12% (26 – 14). The economic profit, thus, obtained is capitalizes at the WACC to obtain the future value of the economic profit. Therefore:

FV of economic profit = 6 / 0.14 = ₹42.86 million.

Value of company = Capital employed + FV of economic profit

= 50 + 42.86 = ₹92.86 million.

7.15 Relative Valuation Models

Relative valuation is an approach that believes that assets and firms have to be valued on the basis of their current market price. The methodology involves the use of certain standardised multiples that can derive value and enable inter firm comparison and value benchmarking. It is due to this reason that this method is known as relative valuation. The popularity of this approach stems from the fact that it is easier to explain and less quantitative than the DCF approach. It also gives an impression that firms seem to become easily comparable in valuation though it is an extremely difficult task to make such comparisons given the divergence between companies. Nevertheless, relative valuation is widely used by research analysts and deal makers such as investment bankers and brokers. For people in the market, it is the current market value that is of importance because what they are interested in is the relative value of companies at a given time and not their intrinsic value. For a transaction to be properly priced, it is the current market value that is relevant. Relative valuation becomes the key to address this issue. It also adds value in terms of providing a direction in case the DCF valuation. However, relative valuation suffers from some disadvantages as well: (i) it does not take into account the future capital expenditure and incremental working capital requirements which could have a significant impact on value, (ii) it is suitable only when companies have reached maturity and are quite stable in their future outlook, (iii) the selection of multiples is subjective and (iv) multiples are driven by external factors which could alter a company's valuation without there being any fundamental shift in its intrinsic value between two given points of time.

Relative valuation is based on multiples that are adopted from two different approaches: (i) *Earnings based multiple* (also known as *Transaction Comparables* or *Deal Comps*) and (2) *Market based multiples* (also known as *Trading Comps*). In the former category, the most commonly used are the EV/EBITDA multiple and EV/Sales or EV/Revenue multiple (also known as *top line multiple*). In the trading comp category, the most common are the Price-Earnings Multiple (P/E Ratio) and the Price-Book Value Multiple (P/BV Ratio).

The P/E ratio is the most widely used market related multiple in valuation. We have already discussed the P/E ratio and one of the variants thereof in an earlier paragraph. However, there are also those firms that are not listed and therefore, lack a market price validation. Therefore, for unlisted companies, trading comps are quite unsuitable and at best, current market multiples applicable to listed surrogates may be used to value unlisted companies. To overcome this difficulty, over the years, relative valuation has developed *firm value multiples* as well that determine the value without reference to the market price. Herein we discuss the important firm value multiples. It may, however, be noted that, relative valuation methods determine the Enterprise value. In order to arrive at the Equity Value, the book value/market value of outstanding debt has to be deducted from the Enterprise Value.

7.15.1 EBITDA Multiple

The first multiple is the *Enterprise Value to EBITDA multiple* that is computed as follows:

$$\frac{\text{EV}}{\text{EBITDA}} = \frac{\text{Value of Firm}}{\text{EBITDA}}$$

Higher the above multiple, higher is the value of the company.

The advantage of using the EBITDA (Earnings before Interest, Tax, Depreciation and Amortisations) in the place of PAT is that EBITDA is a measure of operational efficiency. Therefore, higher the EBITDA, higher would be the ROCE and hence, the efficiency of the capital in business. Companies are given higher EBITDA multiples in valuation looking at the above factors. Secondly, in companies where the EBITDA is positive but the PAT is negative (due to high interest and depreciation burden), this multiple provides a better measure of value. This can happen in the case of projects with long gestation to break-even and profits such as in infrastructure or core sectors.

ILLUSTRATION 11

Using the illustration provided in Section 7.13.1, the above ratio can be computed as follows:

Enterprise Value of the Company = ₹186 + 20.4 = 206.4 crore

EBITDA Y_1 = ₹3.18 crore

EV to EBITDA multiple = 206.4 / 3.18 = 65[7]

[7]Alternatively, under this method, if the EBITDA multiple is determined first, the book value / market value of outstanding debt has to be deducted from Enterprise Value to arrive at the Equity value

7.15.2 Price to Book Value Multiple

The second model of relative valuation is the *Price to Book Value multiple* measured as:

$$\frac{\text{EV}}{\text{Net worth}} = \frac{\text{Value of Firm}}{\text{Net worth}}$$

From a security valuation perspective, the above ratio can also be looked at as:-

$$\text{Price to Book Value Ratio} = \frac{\text{Market Capitalisation}}{\text{Net worth}} \text{ or } \frac{\text{Market Price of Share}}{\text{Book Value of Share}}$$

ILLUSTRATION 12

Continuing with the same illustration, the above ratio can be computed as follows:

Net worth in Y_1 = ₹789 lakh.

EV to Net worth multiple = 206.4 / 7.89 = 26

The difference in both the above approaches is that while looking at the firm valuation multiple, the value of equity is measured while in the latter approach, the market value of the firm is considered.

The disadvantage with this ratio is that it can get distorted due to differences in GAAP and therefore, skew comparison across companies. Since this ratio is dependent on net worth of the company, it is driven both by the ROE and the ROCE.

7.15.3 Earnings Multiple

Apart from EBITDA, the other parameters used in relative valuation include *earnings multipliers or revenue multipliers* such as sales, EBIT or PAT or other variants thereof depending upon the business model of the company being valued. The use of *sales multiple* is desired when the business model has not yet stabilised or there is difficulty in estimating the profit generating capacity. Similarly, in companies that have a strong brand value, the *value to sales multiple* could be significantly higher. The brand value of such companies is measured as:

$$\text{Value of brand} = (V_b - V_g)\ X \text{ sales}$$

wherein V_b represents the value to sales multiple of a company with brand value and V_g represents that of a company in generic or commodity business.

7.16 Contingent Claim Valuation[8]

The relevance of a contingent approach to valuation stems from the fact that not always can the future cash flows from an asset or a company be determined with certainty, especially when the business model contains opportunities that are embedded into it. In such situations, an *option pricing model* is used in valuation by treating such embedded opportunities as options. The first of such models was established by Fisher Black and Myron Scholes in 1972 (known as the *Black Scholes Model*) which has subsequently been refined and extended by many. The principle of the model is that the value of an option can be valued as a function of the current value and variance therein of the underlying asset, the exercise price or the *strike price*, the currency of the option and the risk-free rate of return.

[8]A detailed discussion on option pricing models is outside the scope of this book.

Contingent claim valuation can be used in companies with high intangible assets such as patents in process or patents and copyrights on products that are yet to be commercially exploited. It can also be used for companies sitting on significant mining or exploration rights wherein the future cash flow is based on the reserve assets available with the company. All these are real options existing with the company and are such to be valued based on the cash outcome of the exercise of such options.

7.17 Applicability of Enterprise Valuation Approaches

In conclusion, though several approaches and methods have been described in this chapter, it is necessary to appreciate that none of them can be universally applied. This is because despite the high level of objectivity in these models, valuation continues to be with some level of subjectivity and the judgement of the valuer has to be appropriate. Therefore, the selection of an approach would depend upon the type of business, level of maturity of the company, availability of peer comparison, listing status of the company and judgement of the valuer.

In general, the applicability of various valuation approaches in different types of businesses is outlined in Table 7.6.

Table 7.6 Use of Valuation Approaches

Type of Business/Context	*Appropriate Primary Approaches*
• Asset driven businesses based on large investments and production capacities • Companies in liquidation • Turnaround companies that are in distress and require substantial investments • Real estate companies • Natural resource companies	Asset-based valuation approach
Banks and Financial/Investment entities	Asset approach, Earnings/Market approach
Infrastructure Companies/SPVs	Asset/Earnings approach
Well-established manufacturing companies presently unlisted	Earnings approach
Well-established manufacturing companies presently listed/to be listed	Earnings/Market approach
Trading/service companies	Earnings/Market approach
Knowledge driven businesses	Earnings approach
Brand intensive businesses	Earnings/Market approach
Strategically important/Exclusive businesses	Earnings/Market approach

It may be observed from the above table that other than businesses that are asset driven or condition driven, for the rest of the businesses, it is the earnings approach that dominates primary valuation methodology. In businesses that have considerable knowledge driven value or brand value, it is clearly the earnings approach that has relevance. In companies that are already in the market or about to be listed, the market-based approach weighs in considerable into the valuation along with other appropriate approaches. In the case of banks and financial entities, the earnings method may not be appropriate due to the high leverage in their balance sheets. Most financial businesses operate on far higher leverage than non-financial businesses which is inherent to their nature of business. In addition, most of the assets of a financial business consist of claims on third parties (loans and receivables) and investments. These could fluctuate in realisable value based on the financial position of the counterparties or investee companies. These businesses are also susceptible to externalities such as interest rate and currency movements. Hence, the value of a financial business is more dependent on external factors than internal. Considering all these factors, it is more appropriate to value a financial entity on an asset-based approach than on an earnings approach. In the case of strategically important or otherwise exclusive businesses, the value is derived from their unique positioning which enables them to realise higher earnings. The earnings and / or market approach may be used effectively to value such companies.

7.18 Adjustments and Additional Dimensions in Valuation

7.18.1 Common Adjustments to Enterprise Valuation

In the DCF methodology (or in other approaches which determine Enterprise Value or EV), certain adjustments need to be made to the EV to accommodate for specific items in the balance sheet or the income statement. These adjustments are basically made to the present value arrived at under the DCF method to reduce any present liabilities or add any off-balance sheet assets that are perceived to be inadequately reflected in future cash flow. For example, a company may perceive a value for a patent it has a good chance of getting which has not been accounted for in the future cash flow computations.

The adjustments stated above relate to (i) arriving at the adjusted EV and (ii) arriving at the adjusted Equity Value. The various adjustments that are possible in both the contexts are furnished below in the context of a DCF valuation. The same may be applied in the context of a multiple based valuation or other methodology of arriving at the EV as well. Some of the common adjustments that may be required to be made based on the facts of each case are mentioned as follows:

Enterprise Value as per DCF or other methods = xxxx
Add Market Value of Surplus Assets (if any)
Add Goodwill/Premium/Intangible value/other appreciable asset value (if applicable)
Add Present Value of Concessions/subsidies/tax benefits
(if not already considered in the DCF computation)
Less Under-provision for future liabilities
Less Cost of ESOPs not written off/to be written off
Add/Less adjustment for audit qualifications
Add/Less Contingent assets/liabilities

Adjusted Enterprise Value (EV) **xxxx**

In some situations, wherein a particular method is appropriate but falls short of requirements, certain improvisations may be required such as:

- For companies with high level of embedded intangibles such as brands or human resources, it may be necessary to use a higher growth rate than normal during the discrete and terminal periods. This has already been mentioned in the discussion on terminal value above.
- Use of option pricing model for valuing the potential of a possible upside and adding it to the DCF value obtained without such upside.[9]

[9]It may, however, be clarified herein that option pricing models are not used to determine the value of a cash flow pattern that is perceived to be highly uncertain or risky. In such situations, it would be appropriate to consider a higher discounting rate.

- Use of a higher or lower cost of equity or WACC, as the case may be to reflect higher or lower risk in the expected future cash flow.
- A differential WACC may be used for the discrete period and the terminal period (as is the case with the tax rate), if it is found that the risk profile of the company in the respective terms could be different. Typically, this could be the case with a long gestation large-sized project as in the infrastructure sector.
- Surplus assets on valuation date should be considered separately by including their market value or expected cash flow arising there from.
- New equity shares arising in future are considered only in the context of mandatory convertibles or warrants existing on or off the balance sheet as of the valuation date. In the case of optionally convertible instruments existing on the valuation date, a suitable assumption needs to be made about the exercise of the conversion option.

7.18.2 Arriving at Equity Value and Value Per Share

The relationship between Enterprise Value (EV) and Equity Value needs to be understood clearly to value the ordinary share appropriately. DCF or other earnings-based valuation methods provide a continuing value for a business or the *going concern value*. If the going concern concept is itself suspect, earnings methods are not used. Instead, the break-up value method is used to arrive at the liquidation value.

Considering the above said premise, the connotation of EV for a business is the cumulative value of the claims of all stakeholders on the future cash flows of the company on a going concern basis. Therefore, current assets (including operating cash and cash equivalents) and current liabilities present on the balance sheet as of the valuation date are irrelevant for the computation unless the current ratio is less than 1.0. It is assumed that current assets and current liabilities will cancel each other out in the long term and therefore, they are ignored to arrive at the EV. The EV, thus, arrived at (Section 7.18.1) is the *operating EV of the company* before considering idle free cash on the balance sheet. Idle free cash is different from normal operating cash. Therefore, it needs to be considered as an addition to EV.

In order to arrive at the Equity Value from the EV, further adjustments are required. Firstly, outstanding long-term debt on the books as of the valuation date is expected to get liquidated over time at its present value. Therefore, it has to be deducted from EV. In case, there is idle cash on the balance sheet it is assumed to be used to square up the debt on the books. Therefore, only the net debt has to be deducted. It is also necessary to consider priority claims on the equity cash flows from preference shareholders which need to be deducted from EV.

Therefore, the relationship between EV and Equity Value can be shown as follows:

EV + Idle Cash – Present Value of Debt – Preference Capital = Equity Value

or EV = Equity Value + PV of Debt + Preference Capital – Idle Cash

ILLUSTRATION 13

Estimated Market Cap = ₹100,000,000
Debt o/s in books = ₹20,000,000
Preference Capital = 5,000,000
Idle Cash on books = ₹5,000,000
Enterprise Value (EV) = 100,000,000 + 20,000,000 + 5,000,000 (Pref) – 5,000,000 (cash)
= ₹120,000,000

Working the other way,
Equity Value = 120,000,000 – 20,000,000 – 5,000,000 (Pref) + 500,000,000 (cash)
= ₹100,000,000
If debt and preference capital are non-existent, the equation becomes,
EV = Equity Value – Idle Cash on the Balance sheet
= ₹95,000,000

Therefore, the more a company accumulates idle cash on the balance sheet, the less is its Enterprise Value. This is because cash on the balance sheet has no relevance to long-term equity holders who have a claim on the FCFE of the company. It is assumed that the idle cash will be deployed in the growth of the company to generate future FCFE on a going concern basis.

Continuing the above reasoning, the following situations are also applicable:

- A listed company with more cash and less debt on its balance sheet will have an EV that is less than its Market Cap. This is because:

  EV = Equity Value + PV of Debt – Idle (non-operating) Cash

  So, EV = Market Cap – Idle Cash (net of debt)

ILLUSTRATION 14

Current market Cap = ₹100,000,000
Debt o/s in books = ₹20,000,000
Idle Cash on books = ₹30,000,000
EV of the company = 100,000,000 – Cash (Net of o/s Debt)
= 100,000,000 – 10,000,000
= ₹90,000,000

- A listed company which is leveraged and has less cash on its balance sheet will have an EV that is higher than its Market Cap.

ILLUSTRATION 15

Current market Cap = ₹100,000,000
Debt o/s in books = ₹50,000,000
Idle Cash on books = ₹1,000,000
EV of the company = 100,000,000 + Net o/s Debt (after reducing idle cash)
= 100,000,000 + 49,000,000
= ₹149,000,000

Based on the above discussion, Equity Value is arrived at as follows:

Adjusted Enterprise Value (EV)	**xxxx**
Less Market Value of Net Outside Debt (Debt – Idle Cash)	
Less Redeemable Preference Capital	
Equity Value	**xxxx**
Less Minority Interests*	
Add Associate Interests*	

Adjusted Equity Value attributable to majority (A)[10]	**xxxx**
Less Stock Options o/s and valid	
Adjustment for outstanding Convertibles / Warrants	
Adjusted Number of diluted equity shares (B)	**xxxx**
Value per Share (A) / (B)	**xxxx**

7.19 Special Cases in Valuation

The DCF method is ideally suited for mature non-financial businesses with a cash flow model that can be extrapolated fairly well. Extending the same logic, DCF is ideally suited for large projects that are under implementation, public-private partnership with limited life, limited life projects or joint ventures, regulated or contract driven businesses such as mines, oil exploration etc. At the same time, a start-up business may also use DCF primarily since most of the value creation is in the future and the cash flow model is yet to stabilise. However, the assumptions that the valuer needs to make in such cases have to be thought carefully in order to substantiate future claims. This aspect is discussed in the context of technology companies below.

7.19.1 Banks and Financial Companies

As explained in the previous paragraph, financial businesses such as banks and investment companies may require being valued on their NAV basis since their assets are mainly financial and their realisable value can be easily estimated. Even if the earnings approach needs to be applied, valuing on the basis of the FCFE is more appropriate. Enterprise value method of free cash flow presupposes valuing a company irrespective of its capital structure which is inappropriate in the context of a financial business. Such businesses cannot be valued independent of their leverage as the capital structure mainly consists of demand and term deposits. However, when earnings approach is used, relative valuation would be a better methodology than a DCF model. In listed financial entities, market based multiples are also used with appropriate weightage in the overall valuation to reflect peer comparison.

7.19.2 Limited Life SPVs

The same logic *(supra)* may also be applied in the context of valuing infrastructure SPVs or companies that are highly leveraged due to the capital intensive nature of their business. In addition, such companies have a back ended cash flow structure due to which the discrete period will need to be extended beyond the usual five years to such time that the company attains a stable cash flow. In PPP projects, there is no relevance of terminal cash flow other than realisable value of assets, if any. The DCF model is based entirely on discrete cash flow extending for the whole life of the concession agreement.

7.19.3 Insurance Companies

Valuation of insurance companies also poses a problem due to the inherent nature of their businesses. The premia income being the primary source does not always cover the total costs which include operating costs, reinsurance premia, commissions etc. Insurance companies also derive considerable amount of portfolio

[10]* Minority Interests and Associate Interests are factored in while arriving at valuation of Holding companies on a consolidated basis wherein there are subsidiaries with minority stakes or Joint Ventures.

investment income by investing their short-term and long-term funds. Their liabilities are no clearly definable from their balance sheet due to the liability of future claims. Therefore, a balance sheet based fair value estimation is more appropriate for insurance companies as well.

7.19.4 Valuation of Holding Companies

In conglomerate structures, the valuation of a holding company is a complex exercise but is becoming more commonplace these days with several Indian conglomerates adopting this structure. A holding company may be taken public or infused with private equity which makes it necessary to put the valuation of such a company in perspective. In the context of value integration, the whole relevance of a holding company is lost if it is not valued appropriately to reflect the value of its investments in underlying assets. At the same time, it does not mean the same things as the valuation of a company with all the business undertakings being on its balance sheet.

There are basically two methods of valuing holding companies: (i) the *bottom-up approach* and (ii) the *top-down approach*. Under the bottom-up approach, the underlying operating companies are separately valued and added to the outside investments, cash and cash equivalents available on the holding company's balance sheet. The effect of inter-company transactions as well as minority interests in each of such companies have to be netted out in arriving at such valuation. Similarly, the effects of common interests such as sharing of infrastructure, utilities, publicity budgets and expenses incurred by the holding company on the operating companies have to be factored in. In valuing the operating companies, a *control premium* is applied to the controlling stake held by the holding company in each of the subsidiaries. Similarly, if the holding company's stake in the operating company is a minority stake, a *minority discount* is applied. The minority discount may be higher to compensate for lack of marketability in the stake, if the underlying operating company is unlisted. The gross value of the holding company would be the aggregate of the values arrived at in the above manner for all the underlying operating companies and the net asset value on its own balance sheet. On the gross value, thus, arrived at, a *lack of control discount* or *holding company discount* is applied to compensate the investor for lack of control on the underlying operating businesses. These *tiered discounts* are legitimate in the context of holding companies as far as non-promoter investors are concerned due to the several corporate layers separating the investors from the cash flow rights in the operating companies. The net value arrived there from would be the valuation of the holding company. The benefit of the bottom-up approach is that it appears to be the most comprehensive and thorough way to value the holding company equity, because the value of each underlying asset would be separately identified and substantiated. The drawback is that this method assumes a *break-up* of the underlying businesses which can be overcome, if each of them is valued on a going concern basis.

The other method of valuing a holding company is the top-down approach wherein the underlying operating companies is not valued individually. Instead, the valuation is done on the basis of an investment valuation considering the holding company an investor in each of the operating companies. Assuming a going concern basis, a regular stream of dividends is assumed from the operating companies with the rest of the earnings assumed to be reinvested in their respective businesses. The resulting dividend cash flow at the holding company level is valued using the *dividend discount model* by applying a composite cost of equity reflecting the composite risk of all the underlying companies and a composite growth rate. Thereafter, the holding company discount is applied to arrive at the valuation of the holding company. This method is fairly simple since it does not involve individual valuation of underlying companies on a stand-alone basis. Instead it focuses on cash flow at the holding company level and applies the DCF methodology. However, it suffers from the drawback of over-simplification of a complex process of valuation of a holding company and may not stand the test of a fairness opinion.

In cross border conglomerate structures, the additional dimension would be the differences in the GAAP and tax regime of the host and the destination country and differences arising from foreign exchange translations. There could also be capital account convertibility restrictions that disallow free up streaming and down streaming of funds from parent to the subsidiary and vice-versa. Therefore, valuation needs to be determined based on the *situs* of valuation.

7.19.5 SOTP Valuation

Sum-of-the-parts (SOTP) or *break-up* analysis is exactly similar to the bottom-up approach discussed in the context of a holding company, except that it is applied to a diversified company with several business divisions that are dissimilar and have their own characteristics. For example, a company that has mining, steel, cement and construction businesses as separate SBUs would be a likely candidate for a SOTP valuation. The problem with such companies is that a uniform approach to valuation or risk rating cannot be adopted to the entire company due to the distinct nature of each business. Furthermore, the company cannot be bracketed under any one of the constituent industries since each of them could be valued differently by the capital market. The company could have significant presence in each of its diversified businesses and bracketing it in one of them alone could lead to an anomalous valuation or throw the valuation out of perspective.

The unique advantage of the SOTP approach is that it allows different valuation metrics to be used for valuing each constituent business. For example, one division may be value providing more weightage to DCF while another could be valued on EBITDA multiples, the third on revenue multiple, the fourth on asset-based methods and so on. Each segment is valued using ranges of trading and transaction multiples appropriate for that particular segment. Relevant multiples used for valuation, depending on the individual segment's growth and profitability, may include revenue, EBITDA, EBIT and net income. A DCF analysis for certain segments may also be a useful tool when forecasted segment results are available or estimable. While valuing each business, cognisance has to be taken for unrealised profits in inter-divisional transfers, common facilities and overheads and the presence or absence of arm's length transfer pricing between divisions.

The Enterprise Value (EV) of the company is obtained by aggregating the sum of the parts. From the EV, the outstanding debt and other non-operating adjustments are made to arrive at the equity value. The EV is compared to the industry P/Es of the constituent businesses in the market and the peers in each segment to validate the SOTP valuation and arrive at the fair value of share of the company.

SOTP is quite useful not only in the valuation of a diversified company for a transaction but also in the context of analysing value creation or erosion in each business segment. In several companies, it is also possible that the value created by one division is getting eroded in another, especially if they are linked to the same value chain. In such cases, the sum of the parts adds up to less than the whole due to value being destroyed in a particular segment of the value chain. For example, in a composite textile mill, the spinning and weaving divisions may be creating value which is being eroded by the processing division. As such, the garment division which is the *last mile* to the market is unable to stand up to price competition. SOTP analysis is a useful methodology to gain a quick overview of a company by providing a detailed breakdown of each business segment's contribution to earnings, cash flow and value.

7.19.6 Intangible Valuation

The soft side of valuation revolves around the qualitative attributes of a company such as strong values and business ethics, professional management, highly motivated human resources, loyal suppliers, satisfied customers, highly valuable brands, quality leadership, fair business practices, strong legal compliance, transparency in financial reporting and practices and social and environmental responsibility. While it may be possible to value brands and human resources separately, many of the other intangibles are not. In such cases, the valuation arrived at is increased by a margin of premium so as to reflect the strong positive attributes of the company. Alternatively, these could also be captured in the cash flow model or in the WACC being applied.

Valuation of intangibles is an integral part of a valuation exercise to determine the value of a company that has strong intellectual property, brands, goodwill or other commercial rights such as copyrights, licences and approvals, concession rights, franchise rights that have economic value. It is often said that conventional valuation approaches do not fully capture these intangibles which may have to be separately valued and added to the conventional value. Though there are more than 30 methods applied for different purposes in measuring intangible value, only a few of them are financial methods. These can be broadly classified into the same approaches used in conventional valuation, i.e. (i) cost approach, (ii) income approach and (iii) market approach. The cost approach tries to estimate the cost of acquisition or cost of replacement of the intangible right or asset. The income approach follows the DCF or the Economic Value model and tries to estimate the earnings, cash flow from the use of the intangible asset as reduced by the costs of operation such as royalties, licence fee etc. The present value of such net cash flow is arrived at to value the intangible asset under the DCF approach. The discounting rate applied is a risk-adjusted rate that has to be determined based on applicable statutory and contractual limitations for the use of the intangible asset. In case of valuation of companies that have licensed their intellectual property for royalty consideration, the present value of the royalty payments may be estimated and capitalised to arrive at the intangible value. The income approach may also use the excess income estimation attributable due to the intangible asset (such as a brand) and use an earning multiple to value such brand. The market approach is based on the deal comp method using the multiples applied in deals that are done for similar intangible assets of comparable companies.

7.19.7 Start-ups and Technology Companies

Valuation of technology companies, i.e. companies with high intellectual inputs, technical skills, high levels of investment in technology and human resources pose a challenge for valuation. Such companies are usually in information technology, research and development, bio-technology, life sciences, knowledge process outsourcing, legal process outstanding and other such intellectually intensive industries. Such businesses are characterised by low levels of tangible assets, high intangible content in investment, revenues and costs, high value addition and margins. Though conceptually, the DCF methodology is sound enough to be applied even in the case of technology and knowledge driven businesses, the estimation of the variables required for valuing these firms under the DCF methodology could pose problems.

The first problem area is in the estimation of cash flows. Most technology firms in their initial phase are cash negative. Even if they are cash positive on revenue account, their free cash flow would more often than not, be negative due to their high reinvestment needs. This makes the valuation back-ended relying heavily on the terminal value. Therefore, one must use a longer discrete period to establish stable and acceptable discrete cash flow and a more reasonable terminal cash flow. The accounting treatment of research and development costs as revenue costs, amortisation of ESOP costs etc. pose further problems in estimation of free cash flow. Secondly, the rate of growth of technology firms could vary widely over time due to technological shifts and differences in the abilities of companies to be able to read these changes correctly and invest accordingly. In India, the growth rates of the leading IT firms such as TCS, Infosys and Wipro showed varying growth rates for a 20-year period between 1992 and2012. While TCS still maintains leadership, the growth rates of all IT companies slowed down considerably after 2008. Therefore, considering a future maintainable growth rate for a knowledge or technology driven company is a challenge in the context of valuation. Thirdly, most knowledge driven businesses are equity financed due to the lack of tangible assets to secure debt financing. Due to this reason, the WACC of such companies corresponds closely to their cost of equity. The cost of equity would require significant SCRP (Specific Company Risk Premium) to be applied considering the business model, stage of development, technological issues and so on. The high mortality rate of technology firms would mean that the going concern concept which is so fundamental to valuation, may itself be at risk. Therefore, the SCRP to be applied in a given situation becomes a significant parameter in the valuation arrived at. If DCF estimations are difficult in a given situation either for a start-up or a technology company, the earnings multiple method using a weighted average multiple can be more appropriate. In unlisted companies, the use of comparable valuation based on listed surrogates is appropriate.

Valuation of start-ups and infant companies poses most of the challenges that are akin to a technology company, especially since most start-ups are in the technology / knowledge space.

7.20 Arriving at Fair Value

The valuation of a company obtained under various methodologies can either be in a narrow range of difference or vary significantly based on the variables that are considered. In a general sense, it all depends on the assumptions made in each model since each of them works on a different level of market inefficiency. For instance, the relative valuation assumes that the market is inefficient in pricing the company under valuation but is efficient in pricing all the other companies to which it is being compared. On the other hand, the DCF models are built under the premise that over a long-term horizon, markets tend to correct asymmetries. The contingent claim valuation in any case, is based on uncertainty.

Keeping in view the above framework, valuation has to incorporate as many of the subjective factors as possible and give them an objective shape. In many transactions, valuers use a combination of methods to arrive at a *fair value* which basically narrows down the range of differences under each method. In the end, the fair valuation has to find favour with the market and the parties to the transaction. Fair Market Value has been defined as *"the estimated price paid for a hypothetical transaction, on the date of valuation, between a willing buyer and a willing seller in an arm's length, well marketed transaction, where in each party has acted willingly, knowledgeably and without compulsion."*

ILLUSTRATION 16[11]

Method	***Value per Share ₹***	*Weight applied*	***Weighted Value per share ₹***
Discounted Cash Flow	125	1.00	125
Earnings Multiple (EV/EBITDA)	110	1.00	110
Market Multiple (P/E)	85	0.50	42.5
Market Multiple (P/Book Value)	75	0.50	37.5
Book Value (NAV)	42	0.50	21
Total		**3.50**	**336**
Fair Value per share = ₹96			

[11]A standard approach to providing weightages has been developed by convention for mergers which is acceptable to judicial and regulatory authorities. This has been discussed in a subsequent chapter in the context of M&A valuation.

7.21 Valuation and Investment Banking

The dependence of investment banking on valuation cannot be over-emphasised. Investment banking requires valuation of companies for a variety of transactions such as raising of capital through debt security issues, pricing of initial public offers and other types of equity offers, venture capital and private equity, equity buybacks, de-listing offers, LBOs and mergers and acquisitions. In fact, valuation finds a place in almost everything that an investment bank does. However, not every transaction follows the same type of valuation methodology. By and large, the established methods detailed in this chapter are followed for most transactions. However, in some situations, investment banks could deviate into unique methods of valuation depending upon the facts of a case, especially in the case of acquisitions and valuation of young companies. It is also a known fact that strategic acquisitions involve many a time, a strategic premium that could stretch the valuation beyond the fair value. However, such instances do not make the basic valuation methods irrelevant. On the other hand, they affirm the relevance of these methods to validate or counter the credibility of transaction prices.

The relevance of valuation in investment banking may be appreciated from the various transactional purposes for which it is used by investment bankers which is illustrated in Exhibit 7.7.

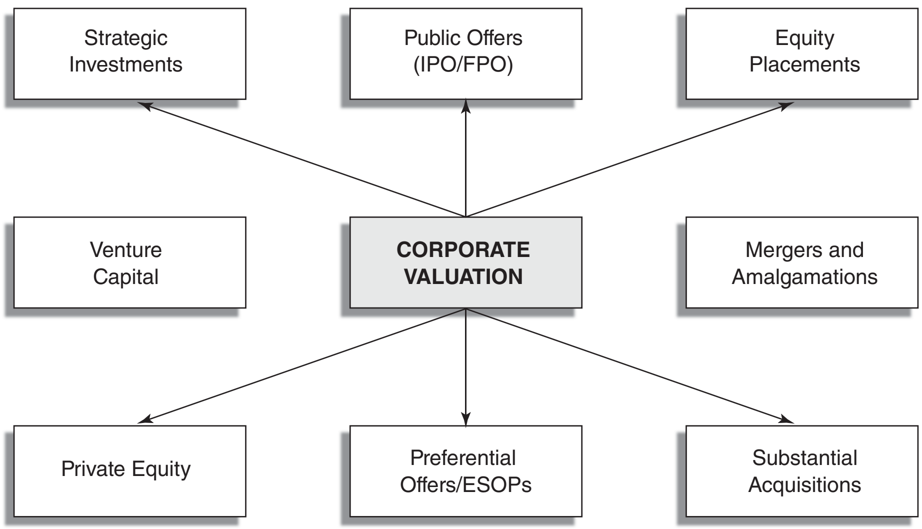


Exhibit 7.7 Valuation in Investment Banking

The application of corporate valuation in investment banking is universal as may be appreciated from the above Exhibit. However, the application of valuation methodologies by investment bankers depends upon the purpose of the valuation, type of transaction, timing of the transaction and prevailing market conditions. More often than not, transactions are executed at transaction prices that emerge from valuation done by investment bankers, negotiations made on the deal and relative position of the parties to the transaction. Therefore, transaction pricing could vary from fundamental valuation. One has to appreciate the difference between *value* and *price*. In the words of Warren Buffet, "*Price is what you pay, value is what you get*". While the process of valuation determines value, the deal mechanics determine the price.

It may also be noted that in valuing a company, the method used would provide either the enterprise value or the equity value depending upon the method being used. If the enterprise value is obtained, the equity value has to be derived by reducing the debt and preference capital interests there from. Furthermore, the equity value obtained is an estimate 100% equity interest in a company. However, in many transactions, this may not be the case. Similarly, there is a fundamental difference in the quality of listed equity vis-a-vis unlisted equity. Therefore, further adjustments would be required to the valuation obtained to arrive at the transaction price in specific transactions.

7.21.1 Context of Valuation in Investment Transactions

It is extremely important to appreciate the context of valuation in investment transactions. Valuation is the fundamental factor in deciding the outcome of investment transactions. Whether the transaction relates to a listed or unlisted company, valuation decides pricing. However, what is important to realise is that transaction valuation is about discovering the stand-alone value of a company prior to the investment. This stand-alone value becomes the entry price to the investor. Due to the proposed investment, the value of the company has to increase substantially in future to provide appreciation in the investment or an exit to the investor at a much higher valuation. The differential between entry price and the future value or exit price provides the expected return to the investor. If this expected return meets the hurdle rate of the investor, the transaction becomes doable. The challenge to investment bankers is to ensure that the valuation expectations of investee companies and the return requirements of investors are in tandem so that transactions become executable.

Based on the above said general theme of transaction valuation, investment bankers use multiple approaches to valuation for various transactions suitable to the given context. These are explained further in the discussions in subsequent chapters of the book relevant to each type of transaction illustrated in Exhibit 7.7.

7.22 Judicial Review and Regulatory Oversight on Valuation[12]

Valuation becomes an extremely contentious issue in transactions involving sale or transfer of business or significant investments which are common in corporate transactions. However, until recent years, valuation remained vastly an area that regulatory authorities did not find necessary to regulate. Even in judicial reviews, valuation came up as a subject matter in the context of taxation or in the context of an amalgamation of two companies under Section 393 of the Companies Act. However, when the stakes get higher, valuation becomes one of the main points of contention between transacting parties or other interested stakeholders. In recent years, certain developments took place in this direction so as to make certain provisions mandatory under law. Similarly, some judicial pronouncements also throw light on the position courts would take with regard to valuation. These aspects are briefly listed as follows:

- Valuation of shares is a matter of regulation for QIPs and PIPEs made by listed companies under the ICDR Regulations of SEBI. These aspects are discussed in the Chapter 11 on Private Placements.
- The RBI has laid down that acceptable methods of valuation are to be applied in the determination of fair value by a SEBI recognised Category I merchant banker or a chartered accountant in the case of transfer of shares by a resident in India to a non-resident.
- Valuation can be a matter of judicial review in a merger petition involving two companies under Section 232 of the Companies Act. These aspects are discussed in Chapter 15.
- Valuation is subject to the provisions of Regulation 8 of the Takeover Code 2011 with regard to pricing of open offers under the Code for substantial acquisitions or counter offers. These aspects are discussed in Chapter 16.

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[12]Further discussion on this aspect and a summary of the TOMCO case and Miheer Mafatlal case are furnished in a subsequent Chapter in the context of Mergers and Amalgamations.

- In the context of an amalgamation or a capital reduction, a listed company is obligated under the provisions of the listing agreement to share with the stock exchange the scheme or petition being filed with the High Court/Tribunal. These aspects are also discussed in Chapter 15.
- In addition to the above regulatory and judicial oversight, valuation may also be challenged in a court of competent jurisdiction for judicial review by minority shareholders or creditors opposing a resolution based on valuation, the Central Government on grounds of public interest, the stock exchange or SEBI and the revenue authorities on proper grounds.
- Generally speaking, the courts have always maintained that valuation is a technical exercise to be done by the experts and that courts will interfere only on grounds of lack of fairness or when a blatant error has been committed in the valuation process. "*If a valuer adopts the prescribed method or any other recognised method of valuation, the valuation cannot be assailed unless it is shown that the valuation is made on a fundamentally erroneous basis, or a patent mistake has been committed, or the valuer adopted a demonstrably wrong approach or a fundamental error going to the root of the matter" – Hon'ble Supreme Court in G L Sultania vs. SEBI –(2007) 78 CLA 425 (SC).* In the famous case involving an amalgamation scheme, the Supreme Court has maintained the same position that the role of the court would be only to ensure that there is fair play. "*A company court does not exercise an appellate jurisdiction. It exercises jurisdiction founded on fairness. It is not required to interfere only because the figure arrived at by the valuer was not as better as it would have been if another method would have been adopted."* – Supreme Court in *Hindustan Lever Ltd. vs Tata Oil Mills Co. Ltd. AIR 1995 SC 470*. However, while deciding on the fairness of valuation, the courts generally seek established methods to be applied by valuers and to that extent if there is no substantiation in a given valuation methodology, it may be overruled. The following are conventionally used practices in such cases:
  - In unlisted companies, the profitability and dividend track record is used as an indicator to judge the value of a share to an investor. Listed surrogates may be referred to for necessary guidance.
  - In listed companies, the market price prevailing on the valuation date influences judicial review to a significant extent, especially for companies that are frequently traded.
  - Asset valuation using break-up value method is largely applied in cases relating to winding up. Other asset-based valuation methods may be applied when earnings approach is not feasible. This trend is seen more in taxation cases. Similarly, in merger of companies, asset valuation plays an important role in arriving at stamp duty liability.
  - The facts of a given case will be taken into account to decide whether there is a case for judicial intervention. The methods applied by the valuer in the given case should stand the test of fairness. If the methods applied are logical and reasonable, courts will not sit in judgement of one method vis-a-vis another.

IMPORTANT TERMINOLOGY

APM
Book Value
Bottom-up Approach
Break-up Value
CAPM
Contingent Claim Valuation
DCF Methodology
Deal Comps
Discrete Period
EBITDA Multiple
Economic Profit
Fair Value
FCFE
FCFF
Free Cash Flow
Market Capitalisation
OCF
P/E Ratio
PEG Ratio
Price to BV Multiple
Relative Valuation
Replacement Value
ROCE
SOTP
Terminal Value
Top-down Approach
Trading Comps
WACC

TEST YOUR UNDERSTANDING

PART - A

I. Pick the right answer(s) or the alternative that best fits the description from the alternatives provided under each question.

1. Under the DCF method of valuation, the market value of debt is reduced from the PV of the FCFE:
   (a) True (b) False
2. NAV of a company is:
   (a) Asset values as reduced by liabilities
   (b) Assets valued at the correct price as reduced by the negotiated values of liabilities
   (c) Book value of assets as reduced by book value of liabilities
   (d) Book value of assets as reduced by book value of outside liabilities
   (e) Book value of assets
3. Free cash flow is the cash flow available to a company in a given period of time that can be used for meeting increased working capital margin requirements for its operations year on year.
   (a) True (b) False
4. Free Cash flow is the cash flow available to a company in a given period of time that can be used for meeting the reinvestment requirements in the business for future growth.
   (a) True (b) False
5. If the IRR of the future free cash flow of a company is equal to its WACC, the valuation of the company is zero.
   (a) True (b) False
6. The tax shelter enjoyed by a company due to interest payments has the effect of increasing the FCFF of the company.
   (a) True (b) False
7. If the marginal rate of tax is used in the estimation of the post-tax cost of debt it has the effect of increasing the valuation of the company.
   (a) True (b) False
8. The CAPM measures the unsystematic risk of a company by taking into account the correlation between the volatility of its stock vis-a-vis the volatility of the market.
   (a) True (b) False
9. The WACC of a company that has a high debt-equity ratio is substantially lower than that of a company with a low debt-equity ratio. Therefore, the valuation of the former company would be substantially higher than that of the latter company.
   (a) True (b) False
10. The EBITDA multiple approach to valuation assumes that there are no financial costs to be incurred by the company.
   (a) True (b) False
11. The P/E ratio is a way of analysing the volatility of a company's stock in relation to its earning potential.
   (a) True (b) False
12. In the estimation of value by the DCF method, the surplus cash balances in the company's balance sheet as of the valuation date are added to the DCF value. Only the operating cash balance is deducted.
   (a) True (b) False
13. If a company has no future prospects, DCF valuation cannot be used as the company's going concern concept is not fulfilled. The best method to use in such a situation is the replacement cost method.

(a) True (b) False

14. In arriving at the Equity Value of a company from the Enterprise Value, the claims of preference shareholders, creditors and employee stock options are deducted.
    (a) True (b) False
15. In an asset heavy company, the book value of assets on the valuation date are added to the DCF estimation in order to arrive at the Enterprise Value.
    (a) True (b) False

PART - B

16. What are the drivers to value? How should a company strive to maximise value?
17. How is the valuation of a bond different from that of equity? Why are there so many methods of valuing equity?
18. What are the fundamental approaches in the valuation of equity? Do you feel that the free cash DCF models are the most appropriate?
19. What is economic profit? Is it superior to the cash flow approach?
20. How do you differentiate operating cash flow from free cash flow?
21. What are the essential ground rules in financial forecasting? Why is it necessary in valuation?
22. Do you agree with asset-based valuation? Does it provide an adequate explanation of value?
23. Explain relative valuation and the main models used therein.
24. What is contingent claim valuation? When is it used?
25. What is the code of ethics that a valuer has to adopt in the process and methodology of valuation?

For answers to Part A, refer to Appendix B at the end of the book.

Annexure Security Valuation—Bonds and Equities

Bond Valuation Terminology

As has been noted in the earlier chapter, a bond or debenture (hereafter, referred to as only bond), akin to a promissory note, is an instrument of debt issued by a business or governmental unit. In order to understand the valuation of bonds, we need to recapitulate certain bond-related terms that have been discussed in Chapter 3.

Par Value: This is the value stated on the face of the bond. It represents the amount the firm borrows and promises to repay at the time of maturity. Usually, the par or face value of bonds issued by the business firms is ₹100. Sometimes, it is ₹1,000.

Coupon Rate and Interest: A bond carries a specific interest rate which is called the coupon rate. The interest payable to the bond holder is simply: par value of the bond x coupon rate. For example, the annual interest payable on a bond which has a par value of ₹1000 and a coupon rate of 10 percent is ₹10 (₹100 x 10 percent).

Maturity Period: Typically, corporate bonds have a maturity period of 3 to 10 years, whereas government bonds have maturity periods extending up to 20 years. At the time of maturity, the par (face) value plus perhaps a nominal premium is payable to the bondholder.

Basic Bond Valuation Model

As noted above, the holder of the bond receives a fixed annual interest payment for a certain number of years and a fixed principal repayment (equal to par value) at the time of maturity. Hence, the value of a bond is:

$$\text{Value} = I\,(\text{PVA}_{r,n}) + F\,(\text{PV}_{r,\,n})$$

where I is the annual interest payable on the bond, F is the principal amount (par value) of the bond, r is the required return on the bond, and n is the maturity period.

ILLUSTRATION 17

A ₹100 par value bond, bearing a coupon rate of 12 percent will mature after 8 years. The required rate of return on this bond is 14 percent. What is the value of this bond?

Since the annual interest payment will be ₹12 for 8 years, and the principal repayment will be ₹100 at the end of 8 years, the value of the bond will be:

$$V = ₹12\,(\text{PVA}_{14\%\,,8\text{ yrs}}) + ₹100\,(\text{PV}_{14\%,\,8\text{ yrs}})$$
$$= ₹12\,(4.639) + ₹100\,(0.351) = ₹90.77$$

ILLUSTRATION 18

A ₹1,000 par value bond, bearing a coupon rate of 14 percent, will mature after 5 years. The required rate of return on this bond is 13 percent. What is the value of this bond?

Since the annual interest payment will be ₹140 for 5 years and the principal repayment will be ₹1,000 at the end of 5 years, the value of the bond will be:

$$V = ₹140\,(\text{PVA}_{13\%\,,5\text{ yrs}}) + ₹1{,}000\,(\text{PV}_{13\%,\,5\text{ yrs}})$$
$$= ₹140\,(3.517) + ₹1{,}000\,(0.543)$$
$$= ₹1{,}035.4$$

Bond Valuation with Semi-annual Interest

Most of the bonds pay interest semi-annually. To value such bonds, we have to work with a unit period of six months, and not one year. This means that the bond valuation equation has to be modified along the following lines:

- The annual interest payment I, must be divided by two to obtain the semi-annual interest payment.
- The number of years to maturity must be multiplied by two to get the number of half-yearly periods.
- The discount rate has to be divided by two to get the discount rate applicable to half-yearly periods.
- Value = $I/2$ (PVA $_{r/2,\ 2n}$) + F(PV $_{r/2,\ 2n}$)

ILLUSTRATION 19

A ₹100 par value bond carried a coupon rate of 12 percent and a maturity period of 8 years. Interest is payable semi-annually. Compute the value of the bond, if the required rate of return is 14 percent.

The value of the bond is:

= 6 (PVA $_{7\%,\ 16\text{ yrs}}$) + 100 (PV $_{7\%,\ 16\text{ yrs}}$)

= ₹6 (9.447) + ₹100 (0.388) = ₹95.5

Equity Valuation using Dividend Models

According to this approach, if the expected future dividend is assumed to be constant, the value of the equity share is the capitalised value of such future dividend computed as:

$V = D / c$ where, the value 'V' is derived by dividing the amount of dividend 'D' by the cost of equity 'c'.

However, if it is assumed that the dividend declared would not be constant but would grow at an expected constant rate, the formula should be modified as:

$V = D/(c - g)$ where, 'g' represents the constant growth rate of dividend. This formula is known as the Gordon model.

The above model can be expanded to incorporate a two-stage growth or a three stage growth or growth based on specific number of years (H model) etc.

ILLUSTRATION 20

If a company pays a dividend of ₹4 on a ₹10/- share and the expected rate of dividend (cost of equity) is 20%, the value of the share would be,

$$V = 4/0.20 = ₹20.$$

If the company's present dividend is expected to grow at 5% per annum, the valuation would then be,

$$V = 4 / 0.20 - 0.05 = ₹26.67$$

Dividend discount model can also be used for a single period valuation if a shareholder is expected to hold an equity share only for a specified period of time and enjoys dividend during the period of holding. This would be represented as:

$$P = \frac{D}{(1+r)} + \frac{D}{(1+r)^2} + \cdots + \frac{D}{(1+r)^n} + \frac{M}{(1+r)^n}$$

Where, 'P' is the value of the share, 'D' is the expected dividend year-on-year, 'n' is the number of years of holding and 'M' is the market value of the share expected in year 'n' when the shareholder is expected to sell the share.

Equity Valuation using Market Multiples

The most commonly used market multiple for the valuation of a stock is the Price-Earnings multiple or the '*P/E ratio*' as it is popularly known as.

P/E ratio = Market Price per share/EPS

Therefore, Market Price per share = P/E ratio X EPS.

ILLUSTRATION 21

PE Ltd. has an after tax profit of ₹10 million and a paid-up capital of ₹20 million divided into 2,000,000 shares of ₹10 each. It currently trades at a P/E multiple of 32. What is the current market price of the share?

EPS of the share = 10,000,000/2,000,000 = ₹5

P/E ratio = 32

CMP = 32×5 = ₹160 per share

Due to its simplicity of use and comparability, the P/E ratio is the most widely adopted measure for determining the price of the share of a company. However, sometimes, such comparisons are not done between comparables. Therefore, it is necessary to appreciate the determinants that drive the P/E ratio. They are the following:

- The Return On Equity (ROE) of the company. Higher the ROE, higher is the P/E and vice versa. This is also explained by the fact that higher the ROE, higher would be the EPS considering the equity base to remain constant.
- Expected rate of growth which as defined earlier is the product of the reinvestment rate and the ROCE of the company. If the company has a high ROCE and ploughs back higher mounts of profits into reinvestment, the growth rate increases and consequently the ROE.
- The level of financial risk. Higher the leverage, higher would be the cost of equity and consequently, the P/E ratio would be lower. The converse is also true.

While purchasing a share in the market, one expects to generate earnings out of such share. In this respect, the P/E ratio determines the number of times the current earnings of the share that the market is willing to pay for it. Higher the P/E ratio, higher is the confidence reposed in the share by the investors. P/E ratios are complied by the stock exchanges either by considering the current EPS (in which case it is known as the current P/E) or by considering the earnings of the previous four quarters (in which case it is known as the trailing P/E). A variation of the P/E ratio is the *price-earnings ratio to growth* (known as the PEG ratio). The PEG ratio is defined as:

PEG ratio = P/E ratio/expected growth rate of EPS.

The PEG ratio takes into account not only the current earnings but also the expected growth rate of such earnings in future. Therefore, if the Current P/E of a company is 30 and the expected growth rate of EPS is 20%, the PEG ratio is calculated as 30/20 or 1.50.

Section 2

Core Investment Banking Services

Domestic Issue Management

8

LEARNING OUTCOMES

- This chapter explains about Investment Banks which act as Issue Managers. Management of public securities issuance is one of the most important service functions of an investment bank and one of the most important aspects of core investment banking.
- This chapter details various facets of issue management from an Indian perspective. It also discusses at length the conceptual issues and advisory role played by the Lead Manager at various stages in a public offer. It does not cover the public offer regulations in their entirety but focuses on the regulations that are important from a conceptual and strategic perspective.
- In the Indian capital market, issue management is an onerous job as it involves a whole lot of compliance and statutory functions, apart from successfully placing the offer to the public.
- This chapter introduces the intricacies of the Listing Decision, i.e. how a company should look at listing from its strategic, financial and the market perspective.
- Pricing of IPOs, FPOs and Rights Offers, instrument choices and implications, method of delivery, price discovery mechanism in book-built offers, process overview and other important conceptual facets of public offers have been discussed.

8.1 Introduction

As discussed in Section I, globally, one of the core business verticals in investment banking is the intermediation services associated with issuance of securities through public offers (IPOs and FPOs) and to a lesser extent in rights issues made by various issuers. Indian investment banks are no different in this respect and the functions they perform in this area are collectively referred to as '*issue management*'. The definition of an '*issue*' is *an offer of sale or purchase of securities by any body corporate ……through a merchant banker* and the term *'issue management'* has been defined under the Securities and Exchange

Board of India (SEBI) (Merchant Bankers) Regulations 1992 as *an activity which will inter alia consist of preparation of prospectus and other information relating to the issue, determining the financial structure, tie up of financiers and final allotment and refund of the subscriptions.* As per the framework envisaged under the SEBI (Merchant Bankers) Rules, 1992 and SEBI (Merchant Bankers) Regulations 1992, the main activity of a merchant banker is issue management.

The concept of an Issue Manager is unique to India due to the definition of the specified functions. In the US markets, the equivalent term is *Managing Underwriter* which means '*an underwriting firm that organises the underwriting of a share issue*'. This is because, in the US model of public offers, the role of an investment bank is primarily of the underwriter and marketer for the issue. The task of preparation of prospectus that has been included under issue management in India, is primarily done by the law firms in the US. Issue management, in India, encompasses a wider role for the merchant banker associated with the issue. The merchant banker is also thrust with a responsibility for ensuring disclosures from the Issuer Company and statutory compliance regarding the offer.

In India, though the term 'merchant banker' is used under the SEBI law, the term that is used to denote an Issue Manager is *Lead Manager* which has also been used in the regulations *(ibid).* If there is more than one Lead Manager associated with an issue, the main Issue Manager would be called the *Lead Manager* and the others would be known as the *Co-lead Managers*. In a book-built offer, the corresponding terms used are *Book running Lead Manager and Co-book running Lead Manager*.

8.1.1 Eligibility for Issue Management

Given the fact that merchant bankers are entrusted with the responsibility of issue management by law, the regulatory framework is designed to ensure that they have sufficient competence and exercise diligence in their work such that the issuers comply with all statutory requirements concerning the issue. At the same time, the merchant banker shall have high levels of integrity so that quality issues alone are brought to the primary market. Keeping these objectives in mind and investor protection as the paramount objective, the SEBI has laid emphasis on ensuring that merchant bankers fulfil the eligibility criteria and merits for registration on an on-going basis. Merchant bankers are precluded from carrying on any business or fund-based activity other than that associated with the securities market. All merchant bankers need to have a valid registration certificate under the SEBI (Merchant Bankers) Rules, 1992 to perform the role of merchant bankers to issues. Merchant bankers are also bound by the Code of Conduct and must comply with the general obligations and responsibilities stipulated under the regulations.

The activities that a merchant banker is authorised to do in connection with an issue are issue management, underwriting and associated activities such as advising or providing consultancy or marketing services for the issue. In order to legally and contractually bind the Issue Manager vis-à-vis the issue, the ICDR Regulations[1] provide for an agreement to be entered into by the Issue Manager with Issuer Company at the inception of the engagement providing for the duties and responsibilities of the Issue Manager and other terms and conditions.

8.1.2 Types of Issues Requiring Issue Manager

Presently, there are no stipulations by SEBI on the maximum number of merchant bankers to be appointed for a public issue or a rights issue and this matter is left to the convenience of the issuer and the merchant banker. However, there are stipulations on mandatory appointment of merchant banker for a public or a rights issue. The ICDR Regulations prescribe that the issuer shall appoint one or more merchant bankers, at least

[1]The ICDR Regulations form the statutory framework for public offers in Indian capital market. These regulations have been referred extensively in this Chapter and have been explained in subsequent paragraphs.

one of whom shall be a lead merchant banker and shall also appoint other intermediaries, in consultation with the lead merchant banker, to carry out the obligations relating to the issue. Where the issue is managed by more than one merchant banker, the rights, obligations and responsibilities relating *inter alia* to disclosures, allotment, refund and underwriting obligations, if any, of each merchant banker shall be predetermined and disclosed in the offer document.

The provision to Regulation 20(1) of the SEBI (Merchant Bankers) Rules, 1992 also prescribes that *"where there are more than one lead merchant bankers to the issue, the responsibilities of each of such lead merchant bankers shall clearly be demarcated and a statement specifying such responsibilities shall be furnished to the Board at least one month before the opening of the issue for subscription"*.

8.2 Going Public—Conceptual Framework

While more often than not, the IPO decision is driven by market factors, the issue to be discussed is whether the IPO decision is purely market driven or not. Before we discuss the determinants of the IPO decision, it is imperative to understand the significance of an IPO and what it does to a company. Every company when it is unlisted offers an ownership or equity opportunity to an outside investor which, for the purpose of the present discussion, has been termed as the *private or off-market window*. The investors who invest in an unlisted company are either the promoters or strategic long-term investors or pure financial investors who come in for a time bound period. The differentiator between a promoter, strategic investor and financial investor is in terms of the investment objective. A promoter's prime concern is *control* while that of a strategic investor is *business opportunity*. On the other hand, the financial investor looks at *return on investment*. These investors invest through the private window that cannot offer the facility of anytime entry or exit into the company's equity capital. The private window also does not provide any price validation for the company's unlisted stock, which has to be derived from time to time through various valuation methodologies.

When a company makes an IPO, what it actually creates is a second ownership opportunity that can be termed as the on-market window. The on-market window, unlike the off-market window, provides anytime entry and exit facility to investors from the company's equity capital. Therefore, it is meant either for the retail investors who would wish to have instant liquidity for their investments or for speculators who intend to make profits through regular trading in the company's stock. In order to serve the interests of retail investors, the market window also performs the function of validating the company's worth on a continuous basis through an organised trading mechanism called the stock exchange which provides market quotes for the company's stock.

Being a continuous evaluation mechanism, the on-market window is market driven—it can be overheated at times or be indifferent to the company's fundamentals. During times of bull market activity, the market window may overvalue a company's share while in a bear phase, the market price could be lower than the company's fundamental value. This phenomenon is known as *price asymmetry*. Market price asymmetry occurs due to gaps in information flow or due to excessive speculation (termed as *irrational exuberance*) or other external factors that could influence market sentiments. Due to this phenomenon, though empirically speaking, the market price tends to conform to the trends in the intrinsic worth of a share in the long term, at any given point of time; it only represents the instant entry or exit price for an investor.

Unlike the on-market window, the off-market window need not be driven by the market price of a company's share, though it has some influence in its determination. A strategic investor would be prepared to pay an entry premium for the company's share, which may result in the company's share being valued at much more than its current market price. The premium that a strategic investor would want to pay is arrived at based on long-term considerations that have more of a business perspective than a pure financial perspective. Since strategic deals are usually made off-market even in the case of listed companies, a *strategic premium* is the extra consideration that is expected to be paid in such transactions. Similarly, in control transactions, the controlling shareholders of a company would be expecting more than the current market price as the transaction is about transfer of controlling stakes in the company. On the same count, financial investors could pay more than the current market price since they wish to take a long-term view on their investment.

Continuing on the same lines, private investors may look for exit routes that are different from the market window available to retail investors. The off-market window provides exit routes such as a secondary sale to another private investor, buyback by promoters and a strategic sale to another company. But in some cases, the private investors (primarily the financial investors) would wish to make use of the on-market window as an exit route. This is achieved by taking the company public through an IPO, which opens up the on-market window. Alternatively, the financial investors may exit by making an *offer for sale* of their shares to the retail investors which also opens up the on-market window. Lastly, financial investors may just want the company to make an IPO and open up the on-market window which can be used by them from time to time to make gradual sale of their holdings at the best available market prices.

This brings us to the discussion on how exactly an IPO should be perceived. Since an IPO is a significant milestone in the life of a company, it could have several implications which are listed as follows:

- It can be a source of finance if it is meant to finance a specified end use.
- It creates a new ownership opportunity called the on-market window and a class of investors called the *retail investors*.
- It can be a liquidity event since it creates an exit route for the existing and future investors of the company.
- It creates market capitalisation for the company, which is the aggregate value of all its issued shares as multiplied by the current market price.
- The market capitalisation of the company can act both as an enhancement or a deterrent for future fund raising by the company by issuance of further stock in the company.
- Being listed can open-up the gates for hostile takeover attempts on the company.
- It makes future acquisition of stakes in the company quite expensive and cumbersome by the controlling shareholders.
- It brings with it additional costs of regulatory compliance, certain restrictions on future capital transactions and cumbersome procedures.

From the above implications, it is evident that an IPO can act as a double-edged sword. In good times, it enhances shareholders' wealth but in difficult times, listed status can become a hindrance and a drag on the company's performance and growth.

8.3 The Listing Decision—Considerations for an IPO

The moot point can, therefore, be stated as "when does having a market window make sense to a company?" This can be answered with reference to two stages—the pre-IPO stage and the post-IPO stage. The pre-IPO discussion relates to the timing of the IPO decision, while the post-IPO discussion is about continuance or discontinuance of the listed status. The timing issue has been discussed in the following paragraphs while the continuance issue has been discussed in the chapter on *de-listing*.

Timing an IPO is a strategic, financial and investment banking or market decision. The strategic decision to make is to determine whether listing fits into the company's overall corporate philosophy and if so, whether the company is mature enough for it. The financial decision to make is to decide whether the company needs the capital proposed to be raised, how much and how effectively it should be raised. The investment banking decision is to determine the appropriate structure, pricing, timing and marketing strategy for the IPO.

8.3.1 The Strategic Dimension

The strategic decision for an IPO is fundamental and needs sufficient introspection. A company may prefer to remain private, if its business model allows this and there are no compelling reasons to go public. For example, in Europe, some of the largest companies are privately owned and have even acquired publicly held companies at times. In India, Maruti Udyog was the largest privately held company with net sales of ₹92.71 billion which, after two decades of existence, went public in 2003. The second largest company, Tata Sons with revenue of ₹90 billion in 2015, hived off TCS into a separate company and took it public after decades of private existence. Some companies such as Hero Cycles, Nirma Consumer Care, TVS, Cadila Pharmaceuticals and Interglobe Aviation were large privately held. Bennett Coleman & Co., the owner of the Times group is presently unlisted. There are also several subsidiaries of multinational companies that are privately held. Prominent in this list are Vodafone, LG Electronics, Hewlett Packard, Ford India, Samsung Electronics, IBM, Honda Siel, Coca Cola, Hyundai, etc. More recently, the 2016 Forbes list of the largest private companies in USA listed 223 companies with a combined turnover of $1.62 trillion. The top company in the list was Cargill, the agricultural products company with a turnover of $120.4 billion. In recent years, several private companies in India have also been well known brands such as MTR Foods, Flipkart, Wagh Bakri Tea, CavinKare, Amira Foods, Apeejay Surrendra Group, VVF Ltd., Vini, Vivek's, Nilgiris, etc. Reports by financial analysts, in recent years, showed that private companies generated higher return on net worth on a comparable leveraging than their listed peers in India.[2] Similar findings in Europe suggested that most of the top private European firms were found to be either family, foundation or employee owned with little to no external equity investment.

Therefore, whether to go public or not is primarily a matter of corporate philosophy. In the case of family owned companies that are conservative, going public may not be viewed with much favour. For multinational subsidiaries, going public may not be considered a good option since it would entail more regulations in foreign jurisdictions for no commensurate benefits. In the case of public sector undertakings, going public is a privatisation decision.

Looking at the above list of companies, it might seem that going public is not a good idea at all if businesses can be built on equity sourced from private wealth and debt sourced from banks and the public. This is not entirely true, since being a publicly listed and traded company has its merits as well. For a start, a company has better visibility and corporate image, if it is listed. Market analysts and investors attach more credibility to well-performing listed companies since they have a market validation on one hand and a better regulatory scrutiny on the other. Listed companies are also more amenable to better corporate governance and, therefore, attract the best valuations and human resources. Lastly, IPO opens up the large retail window with immense potential for fund raising, if the company performs to the expectations of the market. Several corporate managements prefer to raise funds from the public issue market than through private or strategic route since it creates a large family of small shareholders as compared to having a few private or strategic shareholders with significant stakes. Management find it difficult to push through decisions with private investors while getting public shareholder approval through general meetings is considered a simpler task.

From the above, it is evident that IPO can be a mixed bag for a company. Therefore, strategically speaking and given a choice, a company should go for an IPO only when it is mature enough for it. This would depend on the following points:

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[2]Business Standard reports for 2014 and 2015.

- Does the company need the IPO as a liquidity event for its existing investors or for employees holding stock options? In other words, are there no off-market exits or value unlocking options available so that the IPO can be pushed further into the future?
- Has the company matured enough to unlock value? Every company eventually needs to unlock value by sharing its wealth with a wider section of investors and growing bigger with their support thereafter. This is probably the only way corporations grow to become citadels of wealth creation for a fairly long time.
- Is the company's business model retail-oriented with strong brand presence so as to identify with the retail investor?
- Is the company's visibility in the market sufficient enough for investors to perceive its business model to the full extent and unlock value for its shareholders by listing?
- Is the company confident of strong financial growth in the future to sustain the pressure of constant market validation after listing?

8.3.2 The Financial Dimension

The next dimension of the IPO decision is a financial one. In some industries, going public may not be a decision of choice. In capital intensive industries, such as cement, steel or shipping, heavy engineering, automobiles, infrastructure, refineries, pharmaceutical formulations, energy, transportation, etc., the business model is so large that going public could become inevitable to maintain balance in the capital structure. Companies engaged in these kinds of businesses need to go public sooner or later to finance their business plans. They would also require multiple rounds of public offers, after the IPO, to keep financing their growth and consolidation. Therefore, in such cases, IPO and public offers are more of financing than strategic decisions.

The same is true with certain green-field businesses that need to look at an IPO, more as a source of finance than as a strategic move. Though regulations have been brought in to prevent risky companies making IPOs, it is possible for fundamentally strong and well-conceived business plans to go public at the initial stage itself. Reliance Petroleum is a case in point that went public even before its project was implemented.

The second financial aspect relating to the IPO decision is to evaluate if unlocking value through an IPO is the need of the hour or other options are available. As explained above, as long as a company has access to equity through private or strategic route with no exit compulsions in the short-term, it is not under pressure to go public. Strategic equity does provide better pricing as explained above. A case in point is Bharat Petroleum Corporation Ltd. While the erstwhile Disinvestment Ministry in the Union Government maintained that a strategic sale to a private investor would realise higher value for the privatisation, the Petroleum Ministry insisted on the public issue route for its privatisation. However, in the case of Hindustan Petroleum Corporation Ltd., the Petroleum Ministry agreed to a strategic sale. The main argument in favour of a public issue in privatisation process is that it is more transparent and leads to better sharing of wealth. This argument may be well-taken in the context of privatisation but is not valid in a different context.

Table 8.1[3] lists out controlling premiums paid by strategic investors for taking stakes in a sample set of companies.

The following Table 8.2 provides a perspective into the average and median strategic premium paid in Indian corporate sector in the period 2003–2010.

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[3]As reported by the erstwhile Disinvestment Ministry.

Table 8.1 Sample Data on Strategic Premium

Acquirer	*Company Acquired*	*Stake Acquired*	*Market Price (₹*)*	*Offer Price*	*Premium*
Gujarat Ambuja Cement (Now Ambuja Cement)	ACC	7%	215	370	72%
Dr.Reddy's Labs	American Remedies	64.9%	89	175	97%
HUL	Rossell	100%	43	173	298%
British Gas	Gujarat Gas Co.	64.3%	125	270	117%
Alcan	Indian Aluminium	20%	93	200	116%
Swedish Mach.	Wimco	20%	20	35	74%
Delco	Sawhney Paris	57%	71	117	65%
Subra Holding	Silverline Tech.	51%	22	30	37%

* As at the time of acquisition.

Table 8.2 Sample Data on Control Premium[4]

Financial Year	*Number of Transactions*	*Average Premium on Previous 26 Weeks Market Price*	*Average Premium on Previous 2 Weeks Market Price*	*Median Premium on Previous 26 Weeks Market Price*	*Median Premium on Previous 2 Weeks Market Price*
2010	30	66%	22%	38%	8%
2009	44	46%	37%	29%	20%
2008	38	36%	19%	26%	12%
2007	29	33%	16%	20%	11%
2006	25	43%	9%	37%	4%
2005	11	88%	23%	49%	6%
2004	11	71%	23%	52%	12%
2003	6	99%	52%	88%	48%
Total	**194**	**60%**	**25%**	**42%**	**15%**

In the USA, the Mean Premium worked out to 44% and the Median Premium to 31% during the period 1998–2007 as per the Factset Mergerstat Control premium study. It may, however, be understood that the above tables provide a perspective on control or strategic premium which would not apply for sale of non-controlling stakes. Nonetheless, for the purpose of comparison with an IPO, the argument remains that strategic sale may generate a higher valuation for a company than an IPO. This is a topic of constant debate and gets revived whenever IPO markets are active and the jury is still out on the issue. But the fact remains that this dilemma needs to be addressed in every case whenever a listing decision needs to be taken vis-à-vis an off-market share sale, stake sale or a divestiture.

The third aspect of the financial dimension is to evaluate how much capital is proposed to be raised through the IPO and its deployment. Generally, IPOs that have well laid out investment plans sell better than

[4]Source: Ernst & Young presentation at the ASSOCHAM National Conference.

those that do not have convincing application for the funds. Investors need to be shown an investment avenue in the company that can generate the expected return on their funds. Sometimes, the requirement of funds for the company could be too large to be raised through an IPO without causing too much dilution of promoter stakes. In such times, the company should formulate an ideal issue structure in consultation with the merchant banker and prune down the size of the issue, if necessary. Similarly, if the fund requirements were too small to warrant an IPO, it would not be prudent to go ahead with it.

8.3.3 The Investment Banking Dimension

Lastly, the IPO decision is also driven by investment banking considerations. Merchant bankers take a call on the IPO proposal based on the business plan and financial position of the company, expected future performance, prevailing conditions in the primary market, expected issue pricing, size of the offer and post-issue capital structure. The key drivers for the merchant banker are the market conditions, his own placement strength and the main selling points in the issue. For example, if the post-issue capital structure involves high dilution of the promoters' stake, it may not be received well by the market. On the other hand, if the promoters are bringing in additional contribution in the issue at the same issue price, it adds to the marketability of the issue.

Usually in strong market conditions, merchant bankers tend to be aggressive and push companies to go public. The logic put forward in such times is that when there is money for the asking at good pricing, issuers should go ahead and make best use of the opportunity even if they have no use for the funds right away. For instance, in the technology boom, Indian software companies such as Infosys, Wipro and Satyam raised significant funds from the US market and kept the liquid cash for future use. However, issue norms could always become more stringent and companies might not be able to raise funds in good market conditions without any immediate deployment plans.

In depressed markets, it would be difficult for a company to plan an IPO and get a good pricing and response for the issue. It would even be difficult in such a market to find a merchant banker who would be confident of selling the issue comfortably. Therefore, most companies would defer their IPO plans even if they have matured enough and have a requirement for funds. Here again, there are examples in Indian market such as Biocon, TCS, DLF, Emaar MGF, Wockhardt Hospitals and many public-sector companies that had to defer their IPO launches based on market conditions prevailing at that time. In the years following the financial crisis in 2008, several public offers were planned and deferred due to sluggish market conditions.

8.3.4 Listing Decision—The Final Take

To summarise and conclude the discussion on the IPO decision, the following points stand out:

- IPO creates an *on-market window* for a company. But the business plan should be mature enough to handle the pressures of listing in the long term.
- Timing is an important criterion in the IPO decision. Companies need to go public only when they have to unless the market conditions are irresistible. Till then, private and off-market strategic sale of equity to wholesale investors gets better valuation than an IPO.
- IPO is a mixed bag for a company. It is an irreversible process for a long time. Even after that, backtracking through delisting involves a heavy cost. Therefore, the IPO decision should be taken considering the strategic, financial and merchant banking dimensions.
- For certain projects and businesses, going public is an imperative. In such cases, the IPO should be structured to deliver best results.

- From a controlling shareholders' perspective, listing their company would make future acquisition of stakes by them quite expensive and cumbersome. Furthermore, being listed can open the gates for possible hostile takeover attempts on the company. Therefore, promoters need to be resourceful enough to ward off corporate raiders, if needed. At the same time, if the company is not managed well, its market capitalisation is bound to be lower and could lead to a bid on the company. In other words, in the listing decision is contained a lesson the promoters and managers need to learn—if the company does not create value, they may not be controlling it for long. This is the stark reality of market mechanics to which the company would be exposed to on listing.
- Stake sale through the market is not an option for controlling shareholders, if they wish to transfer control. In such cases, off-market divestiture is a better option.

According to a survey done in the UK by the London School of Economics (LSE) some years ago, more than 70% of the issuer companies stated that fund raising was their chief objective of going public. Around one in ten of all respondents stated that the extra credibility and profile afforded by being traded on a stock market was the major motivator in going public. This was recognised by 71% of respondents who found that the extra profile and credibility associated with being a listed company was a major benefit to their company.

One of the conditions brought in by SEBI in the ICDR Regulations in 2012 was a restriction on the tendency on the part of issuers to make public offers by timing the market without any stated purpose for the utilisation of funds. The stipulation now restricts companies from making public offers or rights issues stating that the funds would be used for *general corporate purposes*. This term has been defined to mean and include such *identified purposes for which no specific amount is allocated or any amount so specified towards any such purpose by whatever name called*. The utilisation of public issue proceeds for general corporate purposes shall not exceed 25% of the size of the offer.

8.4 Strategic Considerations for FPO

A public offer by a listed company is different from an initial public offer by an unlisted company more in terms of the considerations involved rather than the process. A listed company has to take into account several additional strategic factors from time to time. The presence of a market price on a continuous basis for the company's share makes the pricing and other decisions relating to the issue more difficult. To a large extent, FPO is driven by similar considerations as an initial public offer. The pricing, however, takes into account the market factor that is absent for an unlisted company. In this sense, it may be said that the pricing of FPO is closer to reality than that of an IPO. Some of the major considerations in FPO are the following:

- The pricing of the offer has to be in line with market performance of the share in the recent past. The factors that have a bearing on the pricing would be the market capitalisation, expected future prospects for the company, the size of the issue, the addition to floating stock, the expected post-issue price, the pricing of previous offers made by the company, investors' experience with the company's share in the past, the type of industry, the average industry price-earnings multiple and other relevant quantitative and qualitative criteria.
- The choice of FPO as a means of finance for the company's fund requirements needs to be assessed with respect to other alternatives in the equity and the debt route. Obviously, FPO adds to the equity capital base of the company and would, therefore, impact the future market capitalisation.
- The extent to which the controlling shareholders wish to preserve their stakes by contributing further capital would also determine its size. This would largely depend on their financial capability and the pricing of the FPO. The ICDR Regulations of SEBI do allow free pricing of FPOs without any restrictions. Since there is no minimum price criterion in FPO, it could sometimes be a cheaper and better

way for promoters to hike their stakes in the company. It would also send a strong signal to the market, if promoters contribute in the FPO. If promoters are not in a position to subscribe in the offer, it would mean consequent dilution in their stake post-issue. In such a situation, there would be a constraint on the size of the offer. The dilution factor is also a function of the price of the issue. If the FPO is steeply priced, the dilution may not be significant, but the success of the issue may be in question. The merchant banker has to take all these factors into consideration and adopt a cautious approach that is best suited under the circumstances to meet the stated corporate objectives.

- The timing of the issue is also a significant factor that determines its size and pricing. In a strong primary market, the company may look at FPO more favourably while the contrary is true in tough market conditions. The merchant banker has to take a call on the appropriate timing so that the issue goes through with a good pricing that leaves both the issuer and the investor happy.

8.5 Strategic Considerations for a Rights Issue

Before embarking on a rights issue, the company in consultation with its investment banker has to weigh in the implications vis-à-vis alternative methods to achieve its objectives. The evaluation could be in terms of the following considerations:

- Is the primary objective of the rights issue to raise funds or to reward shareholders or to seek consolidation of promoters' stakes? If the objective is to raise funds, is the rights issue an adequate source of finance for the company's fund requirement considering the likely price and desirable expansion in equity capital.
- If the objective is to provide an incentive for shareholders' loyalty, the rights option has to be evaluated vis-à-vis alternatives such as a bonus issue or a higher dividend payout. If the company prefers to retain cash, bonus issue is a better option. If the company proposes to raise funds while rewarding shareholders, a rights issue is a better option. However, rights issue involves floatation costs.
- The overall conditions in the primary market and the likely response of shareholders to the issue at the proposed price. The likelihood of the rights evoking a mediocre or poor response and its repercussions on the market price of the share need to be factored in as well.
- Availability of alternate sources of raising equity capital such as private equity or private placement apart from opportunities to seek additional bank borrowings. These sources may, sometimes, be better than the option of making a rights issue if the past market trends have been weak.
- The expansion in equity base and the consequent increase in the free float may depress the share price in the short term. A well-performing company with less free float is likely to trade at higher levels. However, this is not sacrosanct since institutional investors normally prefer companies with higher free float. Companies with lesser free float may also suffer from lack of institutional buying support. In this respect, a rights issue may be good for companies with lesser free float in absolute terms.
- The investor would compare the rights price with the carrying cost of his holdings or the cum-rights price in the market. If the investor is an existing shareholder, the entitlement is automatic. However, for a market investor, the entitlement to the rights is possible only if the company's shares are acquired from the market at the cum-rights price (i.e. before the record date).
- The future prospects of the company and the proposed utilisation of the funds need to find favour with existing investors keeping in view the past track record of the company and the judiciousness of the fund deployment plan.
- The medium-term expectation of the company's market performance considering that there would be a drop in the market price ex-rights and that it would take some time for the price to go back to the present levels or even more.

8.6 Regulatory Framework for Public Offers

As mentioned earlier, a public issue or public offer is a process of inviting interested investors at large (known as the *public*) to subscribe to securities issued by a company through advertisement and issue of a public offer document called the *prospectus* or offer document. The word *public* has not been specifically defined under corporate law governing public issues but it has been referred elsewhere to mean any person other than promoters or controlling shareholders and their related parties. It includes institutional investors and preferential investors such as employees and existing public shareholders of the issuer or its related group companies.

The issue process is highly regulated in all countries and is subject to local regulations of the respective capital market and the listing guidelines of the local stock exchange where listing of its shares is sought by the company. Public issue is a time bound process and the subscriptions from the public are invited during a pre-announced period of days. Subscriptions are made by the public using the application forms provided for the purpose through designated channels. Investors take the decision to subscribe based on information furnished in the prospectus or abridged prospectus and making an assessment of the investment potential of the security. The public issue attracts different types of institutional and non-institutional investors, both domestic and foreign. In order to comply with regulations and bring quality issues to the market, most countries mandate investment banks to lead the offers.

The regulatory framework for public offers in India is contained in the following legislations and regulations framed there under:

- So far, public offers are regulated under the SEBI ICDR Regulations as they relate to disclosures, investor protection, procedures and documentation. These regulations have revolutionised disclosure standards in India in relation to offer documents and have brought in far reaching changes with regard to public issue processes.
- Other aspects of public offers such as allotment of shares, share capital, irregular allotments, mis-statements in offer documents etc. are governed by the Companies Act 2013.
- Public offers are governed by the provisions of SCRA and the LODR Regulations[5] for the purpose of listing and post-listing compliance for continued listing.
- The issue of shares to non-residents is governed by the Foreign Exchange Management Act.

8.7 Overview of Important Stages in an IPO

8.7.1 Process Overview of Public Offers in India

Based on Exhibit 8.1, it would be appropriate to take a brief look at the processes involved in making public offers in general and an IPO in particular. The process is more or less similar for IPO/FPO.

8.7.2 Approvals and Appointments

Public issue process being quite elaborate and highly regulated, companies has to begin preparations well in advance of a proposed public offer. One of the first considerations for timing the offer would be the financial year in question and the finalisation of the accounts of the company. Accordingly, the company seeks approval from the shareholders for the proposed offer.

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[5] SEBI (Listing Obligations and Disclosure Requirements) Regulations 2015.

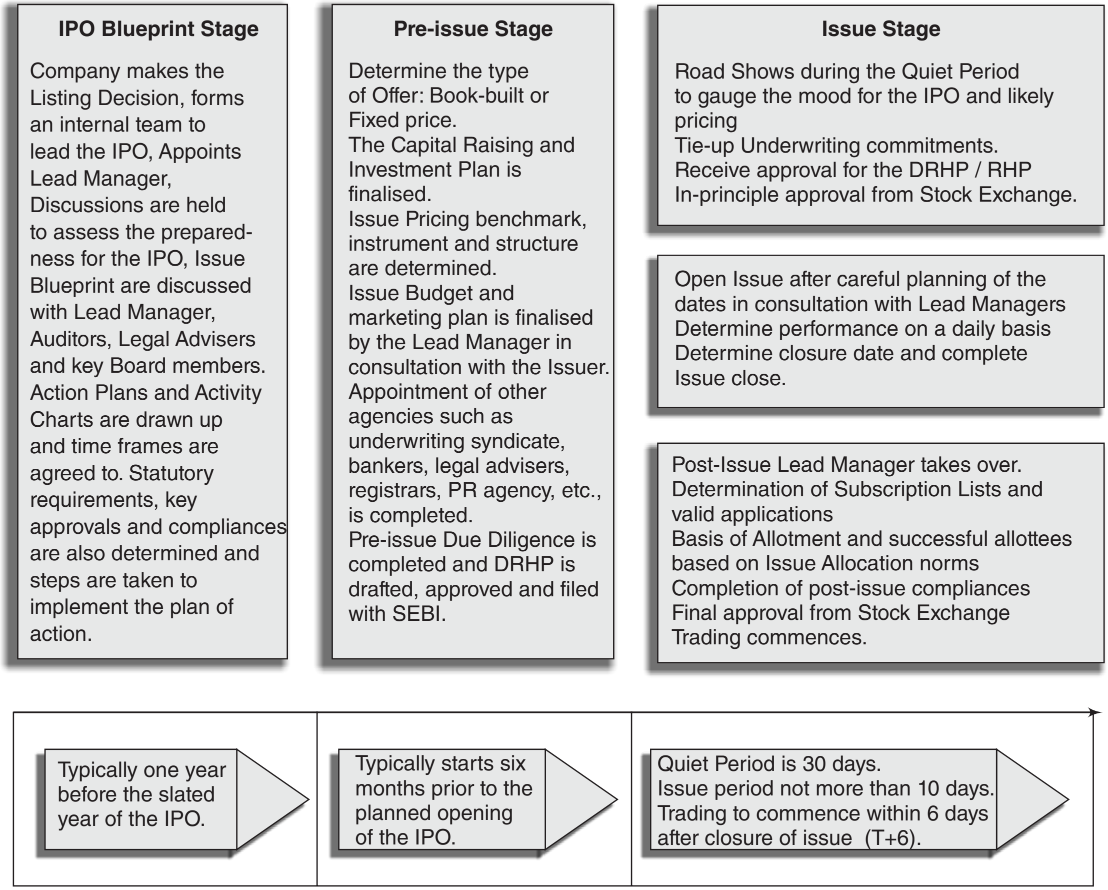

Exhibit 8.1 Important milestones in an IPO

Informal discussions start with several investment banks about the company's project or fund raising plan and the probable issue alternatives available to the company. Investment banks make presentations to the company evaluating the company, the probable issue structure and offering their services. The company's management examines the proposals and recommends to the board of directors for the appointment of the Lead Managers (LM) to the issue. After the discussions, the company finalises the appointment and enters into a Memorandum of Understanding (MoU) with the Lead Manager. If there is more than one LM for the issue, they have to finalise the inter-se allocation of responsibilities for the issue between them. In consultation with the LM, the company appoints other agencies such as registrar to the issue, bankers to the issue, the printer and the advertising and public relations agency. The company usually forms an internal issue team as well to co-ordinate all the work relating to the issue. The internal team comprises of the CFO, company secretary and compliance officer and support staff. The compliance officer shall directly liaise with SEBI with regard to compliance with various laws, rules, regulations and other directives issued by SEBI and with regard to investor complaints. The outside professional agencies which would be appointed or associated in the issue process are the auditors, legal advisors of the company and to the underwriters and other advisors or consultants, if any.

8.7.3 Pre-issue Process

The issue process begins with the LM conducting a due diligence on the company and preparing the offer document in compliance with all statutory requirements. The company's internal team has to, therefore, keep ready a separate due diligence file containing all the necessary documents and certifications required from the management, the company secretary, the auditors and the legal advisors of the company. The LM also draws up the issue budget estimated to be spent on the issue. The main components of these expenses are fees for LM, underwriters, registrar and bankers, brokerage, postage, stationery, issue marketing expenses and statutory costs. It may be mentioned here that the guidelines issued by the Ministry of Finance/SEBI on issue managers' fee and other expenses have to be kept in mind while drawing up issue budgets. The board of the company has to approve the issue budget and the draft offer document prepared by the LM.

Once the draft prospectus is approved, it is filed with SEBI for their observations. According to the ICDR Regulations, a public offer or a rights issue (of value more than 50 lakh) shall not be made unless a draft offer document has been filed with SEBI through the lead merchant banker at least thirty days prior to registering the prospectus, red herring prospectus or shelf prospectus with the ROC or filing the letter of offer with the designated stock exchange, as the case may be. SEBI would convey its observations, objections if any, within 30 days of filing of the draft prospectus. SEBI would also place the draft prospectus on their website for comments from the public. The draft prospectus should also be made available to the public by the LM. The draft document shall also be hosted on the websites of the LM and the underwriters. On filing the offer document with SEBI, the company enters into a *quiet period* during which corporate communications and advertisements are regulated.

Simultaneously, the company has to make listing applications to all stock exchanges where the shares are proposed to be listed. The stock exchanges would also vet the draft prospectus and prescribe necessary changes, if any. The LM has to ensure to carry out all the modifications to the satisfaction of SEBI and stock exchange authorities. The LM should obtain and furnish to SEBI, an in-principle listing approval of the stock exchanges within 15 days of filing the draft offer documents with them. The board of the company approves the final offer document. The company should also enter into a tripartite agreement with the registrar and all the depositories (presently NSDL or CDSL) for offering the facility of offering the shares on dematerialised mode. According to the current norms, all securities issued through public offers can be traded in demat mode alone after listing.

8.7.4 Fixed Price Offers

A fixed price offer is also known as a 100% retail offer. Under this method, all the investors are issued shares at the price stipulated by the company and announced beforehand through its Offer Document. The price is arrived at by Issuer Company based on its fundamentals and market factors in consultation with its investment banker. The main advantage of this method is that it does not provide any scope for ambiguity in issue pricing. However, that in itself becomes a drawback as it does not allow any say for the investor in price determination. In addition, a fixed price offer can, sometimes, lead to underselling or overselling the company, if the demand for its share is misread by the merchant banker. If the issue is over-priced, there is a possibility of a devolvement that would put pressure on the underwriters or the promoters. Sometimes, another disadvantage of this method could be that being a 100% retail offer, the issue has to be marketed to a wide cross section of the investor community, thus, increasing the floatation costs.

The main advantage of this system is that it is possible to get a wide dispersal of shareholding among the retail investors that would add depth to the trading in the stock after listing. Secondly, this method does not require approaching QIB investors to subscribe to the issue, which could sometimes prove to be difficult, as these investors need to be convinced. On the other hand, small investors can be persuaded easily if a reasonable short-term market opportunity is visible in the issue. Noting this trend, the ICDR Regulations stipulate comparatively stiffer entry norms for issuer companies in the 100% retail route.

Due to the apparent inflexibility in a fixed price issue, it has a lot of uncertainty attached to it in difficult market conditions. Therefore, after the introduction of the book-built system of making issues, most companies prefer to use the book-built route even if they are, otherwise, eligible for the fixed pricing route.

In a fixed price offer, if the offer is proposed to be underwritten (since it is optional), the LM solicits underwriting from prospective underwriters. Underwriters can be financial institutions and banks, non-banking financial companies, other merchant bankers and brokers to the issue.

The final offer document is filed with the Registrar of Companies (ROC) on the same date as is mentioned in the prospectus. The prospectus after filing with the ROC shall have a validity period of ninety days within which it has to be issued. The LM and the company would then decide the plan for marketing the issue, release of advertisements, despatch of stationery, finalising the collection centres and date of opening of the issue.

The marketing of the issue is usually co-ordinated by the LM with the advertising agency. The *road shows* for the issue would be a combination of press meetings, brokers' meetings and investors' meetings in important centres, one-on-one meetings with journalists, main brokers and investor associations. All advertisements and issue materials that are issued at this time have to comply with regulatory requirements. The regulations prescribe that the company shall not issue statements that are forward looking, misleading or enticing the public. The LM finalises the despatch schedule to all stock exchanges, SEBI, collection centres, investor associations, brokers and underwriters. Every application form shall be accompanied by the abridged prospectus.

8.7.5 Book-built Offers

Book-built issue is defined as a *"process undertaken by which a demand for the securities proposed to be issued by a body corporate is elicited and built up and the price for such securities is assessed for the determination of the quantum of such securities to be issued by means of a notice, circular, advertisement, document or information memoranda or offer document"*.

A book-built mechanism allows the issuer company to make a public issue through the process of *price discovery* rather than through a price that is fixed beforehand. This mechanism, to some extent, overcomes the deficiency in the fixed price issues with respect to over-pricing or under-pricing an issue. It, however, operates on the basis of a *floor price*, or a *price band* that is fixed by the company in consultation with the merchant banker. The floor price for a book-built issue is more or less determined on the lines of a fixed price issue. However, the market response during the issue marketing is also taken into account unlike in a fixed price issue wherein the price is fixed even before the marketing of the issue can commence. The book-built issue follows a bidding process wherein bids are received from investors based on the floor price or the price band as the case may be. After all the bids are evaluated, the final price known as the *cut-off price* is arrived and it becomes the price at which all investors uniformly are allotted shares in the company. In this respect, the book-building process provides a limited amount of price discovery for the issue.

The procedural aspects of a book-built issue differ from those of a fixed price offer in certain respects especially with regard to bidding by investors and price discovery. As far as the offer document is concerned, the draft prospectus to be filed with SEBI would be a *Draft Red Herring Prospectus* that does not specify the issue pricing and, therefore, the total amount of the issue. A Red Herring Prospectus is a prospectus that does not have particulars on the price of the securities offered or the quantum of securities offered. Based on the DRHP, issue marketing is commenced so as to gauge the likely investor appetite for the issue. The road shows are made to ascertain the demand for the company's issue and the comfortable price for the investors. The Issuer Company decides on the floor price based on the response received during the road shows for marketing the issue and the advice given by the BRLMs. Once the comments from SEBI and other agencies are received and incorporated, the *Red Herring Prospectus* is issued by the company for the purpose of the issue with a 'floor price' or a 'price band' indicated therein along with the number of shares on offer. It would also indicate the total size of the issue at the floor price or at the upper and lower ends of the price band. The investors have to bid for shares in the issue based on the information provided in the Red Herring Prospectus. All the bids will be updated on a real-time basis and the information would be available to investors.

There are also differences in a book-built issue with regard to the marketing of the issue. The issue is marketed on a wholesale basis through a team consisting of the Book Running Lead Manager (BRLM) and Co-BRLMs (if necessary), who would form an underwriting syndicate with other merchant bankers and underwriters. The syndicate members are appointed by the BRLMs and they perform the function of generating bids for the public issue from investors. The BRLMs or the syndicate members shall appoint stock brokers for the purpose of accepting bids, applications and placing orders with the company. The bids from investors would be received through the appointed brokers.

Investors put in applications through the collection centres designated for the issue by the syndicate. The investors make payments in favour of the escrow account opened with the escrow bankers appointed for the issue. The collection centres receive the payments and send them to the escrow bank for collection. Each applicant has to specify clearly the category under which the application is being made, i.e. QIB or non-institutional or retail. Each category would be treated differently and would, therefore, have separate allotments. QIB investors can bid placing a margin amount in escrow while the others have to bid paying the full amount with their bid forms. Applicants can bid for three different prices and quantities at or above the floor price or within the price band as may be applicable. Once the bidding period closes, the bankers send confirmation of payments received and the registrars process the valid applications. The Book Running Lead Managers and the company decide the cut-off price based on the valid bids received in consultation with the BRLMs. The cut-off price is the final price fixed for the public issue after price discovery. After the bidding for the issue is closed and the final issue price has been fixed, the final prospectus is filed with the ROC. This is because the final prospectus needs to mention the issue price that can only be fixed after the issue has closed and the bids are evaluated. Those investors who have bid on or above the cut-off price shall be eligible to become allottees.

8.7.6 Alternate Book-built Offer

An *alternate method of book building* has been prescribed under Part D of Schedule XI of the ICDR Regulations, only to be applied in the case of FPOs entirely at the option of the issuer. This method is identical to the above methodology except that in the case of QIBs, the determination of the cut-off price and the allocation of shares to such investors is different. Under this method, the issuer shall disclose a floor price in the Red Herring Prospectus. Alternatively, the issuer shall announce the floor price at least one working day before opening of the bid in all the newspapers in which the pre-issue advertisement was released.

QIBs shall bid at any price above the floor price. The bidder who bids at the highest price shall be allotted the number of securities that he has bid for and then the bidder who has bid at the second highest price and so on, until all the specified securities on offer to QIBs are exhausted. Allotment shall be on price priority basis for QIBs. For this purpose, the issuer may: (i) place a cap either in terms of number of specified securities or percentage of issued capital of the issuer that may be allotted to a single bidder; (ii) decide whether a bidder be allowed to revise the bid upwards or downwards in terms of price and/or quantity; and (iii) decide whether a bidder be allowed single or multiple bids. Where, however, the number of specified securities bid for at a price is more than available quantity, and then allotment shall be done on proportionate basis. Retail individual investors, non-institutional investors and employees shall be allotted specified securities at the floor price (employees may be given at 10% less). Allotment to such investors shall be made proportionately as under the normal method of book building.

The main improvement that the alternate system provides is that the issuer can have various descending prices at which shares are allotted to non-retail investors which improves the price realisation. Consequently, the benefit thereof is partly passed on to the retail investors who will get shares at the floor price. In contrast, under the normal method, all investors are allotted shares at the cut-off price. In other words, under the normal system of book building, a single cut-off price is discovered for all investors (*Dutch auction* system) while under the alternate method, various prices are discovered for the QIBs (*French auction* system) and such prices are different from the price applicable to other categories of investors.

It may be noted that the choice of making a fixed price or a book-built offer is not left entirely to the company. If a company does not fulfil the primary eligibility conditions for making a public offer (discussed below), it has no option but to make a book-built offer. However, if a company fulfils those conditions, it may at its option, choose either the 100% retail route or the book-building route. Within the book-building route, the company may adopt either the normal method or the alternate method described herein (Exhibit 8.2).

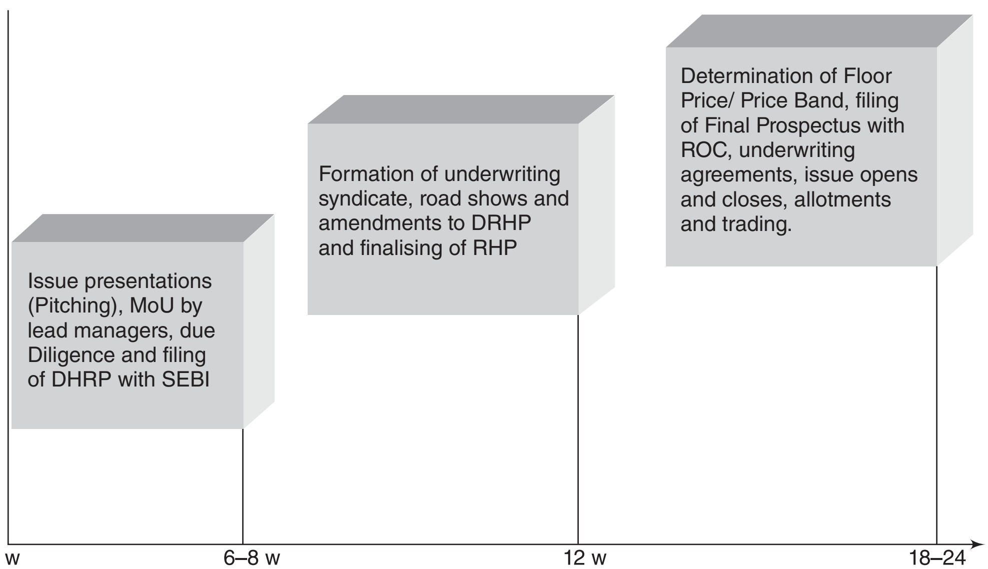

Exhibit 8.2 Illustrative book-built public issue process in weeks

8.7.7 Post-issue Process

The responsibility of finalising the basis of allotment in a fair and proper manner lies with the Executive Director or the Managing Director of the designated stock exchange along with the post-issue LM and the registrar. The basis of allotment is arrived at as per the prescribed procedure on proportionate basis according to the over subscription received for the issue.

The main task of a post-issue LM is to coordinate the process of collection of subscription figures from the bankers to the issue, processing of applications by the registrar, despatch of allotment letters and refund orders to all the successful and unsuccessful applicants within the prescribed time, attending to investor grievances expeditiously and ensuring the listing of the shares on the stock exchange(s). Trading commences on the date fixed by the stock exchange after grant of listing permission to the issuer company. The time to be taken between issue closure and listing of the shares was brought down to 12 days in 2010 by SEBI which was proposed to be brought down to 7 days in due course in line with global standards.

8.7.8 IPO Listing Day Volatility Regulation

IPO listing day price volatility is a common phenomenon in Indian capital market. Therefore, SEBI brought in new norms for listing day trading to curb volatility.[6] These norms are listed as follows:

- For issues with size up to ₹250 crore, listing day trading shall be in the band of 5% of the call auction price or issue price. Call auction session is conducted for 60 minutes prior to normal trading session on listing day.
- For issues beyond ₹250 crore, it shall be 20% of the said price.
- The call auction session shall be used to discover an equilibrium price based on order matching through the system. At market orders cannot be placed in the call auction session.

The IPO of Multi Commodity Exchange (MCX) was the first public issue introduced under the new system which commenced in 2012.

8.8 Role of Investment Banker as Issue Manager

Merchant bankers with valid registration certificates from SEBI have been provided with statutory exclusivity in managing public offers of securities (IPOs and FPOs) and rights issues. Therefore, whenever there is an offer of securities to the public, the involvement of a merchant banker becomes mandatory. It goes without saying that SEBI and the statute place complete reliance on merchant bankers to ensure that compliance of law in matters of issue is maintained. Apart from statutory compliance, SEBI also expects issue managers to perform their role with diligence and ensure quality of the issues that they bring to the capital market. Viewed from this perspective, the role of merchant bankers has profound significance to the long-term growth and development of the capital market and for the sustenance of investor confidence. From a business perspective too, issue management forms the biggest chunk of revenues for investment bankers in years when the primary market for public issuances is very vibrant. The ICDR Regulations clearly prescribe that the post-issue merchant banker shall continue to be responsible for post-issue activities till the subscribers have received the securities certificates, credit to their demat account and the listing agreement is entered into by the issuer with the stock exchange and listing/trading permission is obtained. In addition, the responsibility of the lead merchant banker shall continue even after the completion of issue process.

In the overall process of issue management, the merchant banker plays a variety of roles as an expert advisor to the management of the issuer company, as an external agency who performs due diligence on the company, as event manager and coordinator to ensure timely completion of the issue, as a watch dog for statutory compliance and as a person in fiduciary capacity for the protection of the interests of investors. This multi-faceted role of the merchant bankers, places tremendous responsibility on them. During the issue, they become the interface between Issuer Company and SEBI. Merchant Bankers are expected to explain

[6]SEBI Circular No.CIR/MRD/DP/ 01/2012 and No. CIR/MRD/DP/ 02/2012 dated January 20, 2012.

any lapses, shortcomings or failure in statutory compliances on the part of the issuer in connection with the issue. SEBI has a system of awarding penalty points for erring merchant bankers for violation of the operational provisions of the ICDR Regulations. An additional dimension of merchant banking is to guard against conflict of interest at every stage with other assignments that may be taken up as investment bankers. Though the ICDR Regulations provide certain restrictions on the conflict of interest issue, it is more of an area of self-regulation for merchant bankers. Any merchant banker on whom four or more penalty points have been imposed may be restrained from filing any offer document or associating or managing any issue for a particular period.

8.9 Overview of Issue Management

Based on the process overview provided in Exhibit 8.1, we will now discuss the main areas of issue management and the functions of the merchant banker therein.

8.9.1 Appointment, Agreement and Inter-se Allocation of Responsibilities

The appointment of the merchant banker as Lead Manager has to be accepted very carefully. The ICDR Regulations stipulate that a merchant banker "*shall not lead manage the issue if he is a promoter or a director or associate of the issuer company*". Therefore, before taking up an assignment, the guidelines have to be interpreted and it has to be ascertained if the appointment is legal. The agreement with the company for the assignment has to be drawn up immediately since it defines the relationship and becomes a material document for inspection.

In case there is more than one Lead Manager, the inter-se allocation of responsibilities has to be drawn up on a suitable basis. This statement becomes the basis on which the merchant banker becomes answerable to SEBI at a later date. Since this statement forms a part of the offer document as well, care has to be exercised in allocating responsibilities. Generally, the preparation of offer document and pre-issue compliance, marketing and syndication of underwriting and post-issue compliance can be the broad areas of division of responsibility.

8.9.2 Issue Structuring and Pricing

This is one of the most critical advisory functions performed by the Lead Manager after carefully assessing market factors, dilution of promoter equity, fulfilment of lock-in requirements, possibility of pre-marketing the issue through firm allotments and related issues. In a fixed price issue, the pricing is arrived at in conjunction with the issue structure. In a book-built issue, the pricing is done before hand to more or less arrive at the possible structure but the floor price is announced only after the issue marketing is completed.

8.9.3 Due Diligence

Under the ICDR Regulations, due diligence forms a significant statutory requirement that have to be performed by the Lead Managers. Regulation 64 casts a general obligation on the merchant banker stating that *"the lead merchant bankers shall exercise due diligence and satisfy himself about all the aspects of the issue including the veracity and adequacy of disclosure in the offer documents. The lead merchant bankers shall call upon the issuer, its promoters or directors or in case of an offer for sale, the selling shareholders, to fulfil their* *obligations as disclosed by them in the offer document and as required in terms of these Regulations. The responsibility of the lead merchant banker shall continue even after the completion of issue process".*

The areas that are examined from a due diligence perspective are in line with such an exercise performed for other corporate transactions. However, from a public offer perspective, there is significant emphasis laid on justification of any claims made by the company in the offer document through published sources, verification of the background of promoters, capital structure, promoters' contribution and lock-in, project and financing pattern, price justification and basis for the issue price, supporting documents for current business, future business plan, material contracts and documents. Additional certifications for tax benefits, outstanding litigation, statutory compliances, approvals and licences etc. would also need to be produced for verification at the time of due diligence.

8.9.4 Preparation and Filing of Offer Document

The offer document has to be prepared with care and craft as it not only has to conform to the statutory requirements but live up to the image of the Issuer Company as well. The main contents of this document have already been enumerated above. But the presentation skills of the merchant banker are put to test while writing the business section of the prospectus. The Management Discussion and Analysis has to be written well to discuss the important issues from a management perspective as it reposes the confidence of the investors. All the certifications required to be included in the offer document have to be obtained in the specific formats required. The filing of the offer document with SEBI has to be accompanied by several enclosures as explained already.

8.9.5 Underwriting and Pre-issue Compliance

The pre-issue compliance work is heavy on the merchant banker in terms of several requirements of the ICDR Regulations, tying up underwriting if required, selection and negotiation of terms of other intermediaries, formulating the issue budget and making preparations for roll out of the issue. While selecting underwriters, the Lead Manager has to ensure that the underwriters are not over-exposing themselves so that it may become difficult for them to fulfil their underwriting obligations. The Lead Manager shall carefully assess the overall exposure of the underwriters belonging to the same group or management in an issue. .

8.9.6 Liaison with SEBI and Stock Exchange

After the filing of the draft offer document with SEBI and the stock exchanges and making it public, the Lead Manager has to expeditiously attend to the modifications or amendments required at short notice. The lapses in the due diligence would also come to light during this stage. Precious time cannot be lost at this stage in going back to the drawing board. Rejection of listing approval by the stock exchange can be disastrous for the issue. Since the new SEBI norms stipulate that trading has to commence on the sixth day after closure of the issue, the Lead Manager has to ensure that listing approval is in place before proceeding with the issue.

8.9.7 Coordination with Other Functionaries

Issue management being a concerted team effort is performed with the help of several agencies and intermediaries apart from the Lead Managers. These are: registrars, bankers, advertisement agencies, brokers to the issue, underwriters to the issue, printers and couriers. Lack of coordination with printers and couriers can lead to increase in costs due to wastages or the issue stationery not reaching all the required places in time.

In addition, professionals such as auditors of the company, company secretary, legal advisors and experts whose opinions are included in the offer document also play important roles in the issue. It is customary for the Issuer Company to form a core team for the issue management including the key officials and the compliance officer and the merchant banker so as to do the backup work and to complete all the issue related milestones on a time bound basis.

8.9.8 Issue Marketing

Issue marketing includes road shows, pre-issue meets with journalists and media men, brokers, investor associations etc. The merchant banker's presentation skills are put to test once again at this stage. The barrage of questions from various quarters needs to be answered professionally and competently. Proper homework needs to be done on the probable questions that may be posed including those on pricing, promoters, financial performance, competitor analysis, etc. The merchant banker has to co-ordinate with the advertising agency to ensure that all the important persons attend the road shows and other issue meetings. The merchant banker has to ensure that no publicity material or report is issued with information other than what is contained in the offer document, no incentives other than underwriting commission and brokerage are offered through advertisement or by any other means, the advertisement code is strictly followed.

8.9.9 Functions during the Issue

The main function during the issue is to ascertain daily figures from the bankers or the stock exchange as the case may be and to take decision on the closure of the issue based on the procurement of minimum subscription. The merchant banker should also carefully ensure that the issuer company or others associated with the issue do not publish any advertisement stating that the issue is over-subscribed or indicating investors' response to the issue during the period when the issue is still open for subscription by the public.

8.9.10 Post-issue Compliance

The ICDR Regulations provide that the post-issue manager has to actively associate with the allotment, refund and despatch and shall regularly monitor the grievances arising there from. Close co-ordination has to be maintained with the registrar and the merchant banker has to depute its officers to the offices of the various intermediaries to monitor the flow of funds from collecting bankers, applications and processing thereof and finalisation of the basis of allotment and the intimations to investors are completed. The merchant banker shall accord high priority to redressal of investor grievances and take all preventive steps to minimise the number of complaints. SEBI has to be kept informed of the important developments about the issue during the intervening period of filing post-issue reports.

8.10 Conceptual and Strategic Perspectives in Issue Management

There are several aspects of issue management that involve conceptual clarity for the investment banker as they have a profound effect on the outcome of the issue and the post-issue performance of the company. They also become the key determinants of issue strategy formulation and investment bankers are expected to provide expert advice to the Issuer and its management team so as to achieve the most desirable outcomes. These are discussed in the following sub-sections:

8.10.1 Pricing of IPOs

Mr. D R Mehta, former Chairman of SEBI once said, *"A study conducted on the IPO market in the US showed that of the 4,222 companies that had IPOs from 1 Jan.90 and 31 Dec.98, 32.8% were delisted, 35.2% traded below their offer price and 31.6% traded above the offer price."* Pricing a public offer issue is, thus, an enigma even in mature capital markets.

The SEBI introduced free pricing of shares for public offerings in 1992. As per the current SEBI Disclosure and Investor Protection Guidelines 2000 (ICDR Regulations), every company either unlisted or listed, which is eligible to make a public issue can freely price its share.

Pricing is one of the most important challenges for a merchant banker in a public offering. Appropriate issue price can not only ensure success of the issue but provide good returns to the prospective investors as well. This would build an investor friendly image for the company and make it a market favourite so that the company can come back to the primary market with subsequent issues from time to time. Therefore, proper issue pricing can be a win-win situation for the company and the investors as well.

Notwithstanding the above, pricing is a sensitive issue and the merchant banker has to carry the management of the company with him on the pricing. Over pricing an issue is an over kill that should be avoided even if it results in short-term gain for the issuer and the merchant banker. At the same time, the issue price should provide reasonable returns to existing investors in a company who wish to make an exit in the issue. Therefore, issue pricing is a trade-off between immediate gains and long-term returns to the Issuing Company and its promoters. The merchant banker has to weigh these expectations against market realities and decide the best pricing.

Pricing versus Valuation

Pricing of a share for the purpose of a public issue, though related to valuation of a security, is quite different from valuation in many respects. At the outset, valuation and pricing deal with different purposes. Valuation is all about estimating the worth of a company. It provides an efficient benchmark in pricing issues or in conducting other types of transactions such as M&A and private equity. Pricing is based on the type of the transaction and other variables such as the timing and market parameters. In that sense, pricing an IPO is different from pricing a private equity or M&A transaction. When a company is acquired, the sellers are basically giving up a right to a future stream of cash flows. Therefore, it has to be looked at in those terms. In an IPO, the owners dilute their stake to some extent such that they have a smaller share in a bigger pie which could even be more than the pie that they enjoyed all for themselves prior to the IPO. Therefore, they really do not give up anything. IPO pricing is all about providing an entry to new investors to a future stream of cash flows of the company and a profit-making opportunity on sale of its share.

Pricing an issue, therefore, refers to *setting the offer price*. Before arriving at the pricing of a public offer, the Lead Manager and the underwriters have to understand the valuation of the company. Pricing an issue is done keeping in mind the qualitative features, and by using selected multiples as benchmarks. The usual parameters used are the Price to Earnings Ratio (P/E Ratio) and Price to Book Value Ratio. The P/E ratio on the proposed offer price based on the pre-issue Earnings Per Share (EPS) should correspond to the industry P/E currently existing in the market and leave room for the investor to make gains. Therefore, if the current industry average P/E of pharmaceuticals is 10, and the pre-issue EPS of a pharma company is ₹7.50, the ideal P/E to be adopted for the issue pricing would be about 6 times the EPS, i.e. ₹45 per share. Assuming that the share would list at a P/E of 8, the opening price would be ₹60. Early sellers would make gains of around ₹5–10 before the selling pressure starts to bring the market price down. The price could ultimately settle between ₹45 and ₹50 in the first six to twelve months. This kind of a conservative pricing would ensure that in the immediate future after listing, the share does not quote below its offer price and erode investor wealth.

Such erosion in the short term does not augur well for the prospects of the company's scrip in the longer term. This approach of pricing is known as the *'method of discounting'* wherein the Lead Manager sets the price at something lower than what he estimates as the fair value of the share. According to a study, it was found that the average discount applied on fair value averaged around 16% in the US markets. In Indian market, though, the trend has been to price IPOs aggressively, especially in recent years. However, an average discount of around 15% to the expected trading price in the short-term may be considered reasonable considering that there are retail investors who would want to be early gainers. It will be observed from the pricing analysis furnished in the following paragraphs that IPOs that have been priced with wide variance to industry P/E such as Cairn Energy or Jet Airways traded at considerable discount to market price while those that were priced at lesser than industry P/E such as Tech Mahindra traded well above their offer prices. It may be appreciated that early gainers are not looked at favourably in the US markets since IPOs are predominantly sold in chunks to larger investors.

Illustrative Methodology in IPO Pricing

One of the key challenges in IPO pricing is to arrive at the future potential trading price band of the company's share in the short-term post-listing. Since the market conditions are unpredictable, it would not be possible to forecast too much into the future. Nevertheless, going by the prevailing market conditions at the time of the issue, it would be possible to arrive at price benchmarks that would prove useful in fixing the price band for the issue. As the objective is to find out a reasonable price band, one has to decide on a conservative pricing at the lower end, and an aggressive pricing on the upper end. As this is purely a quantifying effort of the company's fundamentals, it need not be reflective of the primary market sentiments. After arriving at this price-band, the upward or downward bias can be determined based on the market conditions.

Generally speaking, most Issue Managers look at the EPS and the P/E ratio in determining the two points of the range. The EPS values can be moderated using the weighted average of the past three normal financial years with the weightage being biased towards the immediately preceding year. This is because the latest year is presumed to be representative of the earning potential in the near future.

ILLUSTRATION 1

Financial Year	**Y-2**	**Y-1**	**Y**
Earning per Share (EPS) in ₹	7.10	4.59	2.68

Therefore, the weighted average EPS would be:

$$(3 \times 7.10) + (2 \times 4.59) + (1 \times 2.68)/6 = 5.52.$$

The next step would be to ascertain the industry average P/E for the relevant industry to which the present company belongs. This is known as *Trading Comparable (Trading Comps) Analysis.*

Let us consider the following illustrative figures.

	Highest	**Lowest**	**Average**
Price/ Earnings multiple (times)	32.5	3.50	18.60

Considering the average industry P/E of 8.60, and multiplying it with the weighted average EPS, one could arrive at the most conservative price or the lower end of the trading price band that the scrip of the issuer company can rule. This would work out to be:

$$5.52 \times 18.60 = ₹102.67 \text{ say } ₹103$$

Looking at the EPS for similar, comparable companies in the industry, it is possible to find industry leaders whose shares are quoted very well and others whose shares are not fancied by the market. It is possible that none of the P/E figures reflect a true picture of the respective scrip. While the fancied scrips may quote at exorbitant P/E ratios, the laggards would have a below industry average P/E. Considering these variations, the P/E of the IPO candidate at its upper end can be pegged. If the company has made private placements or preferential offers in the past, that could also be a guiding factor as to how the investors may perceive the company's offering. If on the basis of the above analysis, it is perceived that the company's upper end P/E could be in the range of 22 to 24, the upper price limit can be found out by applying the company's highest EPS in the period in question.

Therefore, the most optimistic price would be as follows:

Highest EPS = ₹7.10 × PER of 24

Thus, the upper price limit works out to ₹170

The price band, thus, arrived at ranges from ₹103 to ₹170, as shown above. As per the ICDR Regulations, since the price band cannot extend by more than 20%, it has to be fine-tuned further to come into the acceptable range. Therefore, using the price points obtained above and considering other qualitative factors, market factors and issue structure, the pricing bias can be determined to arrive at the price band for the issue. If the merchant banker prefers an upward bias, the price band could be around 85–90% mark of the price range. There is a need to provide a margin for listing gains so that the issue becomes attractive for short-term investors (known as *flippers*) and the trading is healthy in the aftermarket. This *flippers' margin* is usually in the range of 10–15%. The final price band or floor price for the issue, as the case may be, is always decided by the issuer in consultation with the merchant bankers, who being the experts in assessing the market conditions can have a feel of the *market clearing price*.

Case Study

Sampling Analysis of IPO Pricing in Indian Primary Market

Furnished in Table 8.3 is a comparative table of IPO pricing of some selected IPOs made in the Indian capital market in recent years to provide an indication to the reader on pricing parameters adopted by issuer companies in different sectors.

Table 8.3 IPO Pricing Parameters [Bull Phase (2003–07)]

Particulars	*Jet Airways*	*Deccan Aviation*	*Biocon*	*Cairn Energy*	*Tech Mahindra*	*GMR Infra*
1. Adjusted EPS						
Year 1	(5.34)	(7.08)	5.6	—	6.17	2.47
Year 2	(17.84)	(15.12)	7.9	—	8.97	2.41
Year 3	19.44	(61.80)	25.5	0.52	18.32	2.50
Weighted Average	2.88	(30.67)	14.1	—	13.18	2.47
2. Final Offer Price (Cut-off) determined through book-building route (₹ Per share)	1100	148	315	160	365	310
3. P/E ratio in relation to Offer	57	(9.79)	25	—	19.9	84
Price	24	24	14	25	30	—
Industry P/E	—	—	25	—	29	18
Peer Group Average						

(*Contd.*)

4. Average RONW						
Year 1	–15%	–ve	24.8%	—	15.65%	17.78%
Year 2	–94.17%	–ve	27.9%	—	21.06%	7.72%
Year 3	105.17%	–ve	53.9%	—	38.25%	9.65%
Weighted Average	18.7%	–ve	37.5%	—	28.75%	10.36%
Minimum RONW on total networth required to maintain pre-issue EPS	9.55%	NA	24.2%	—	29.14%	3.78%
5. NAV per share (₹)						
Before Offer	26.46	(25.15)	23.6	—	59.18	21.57
After Offer	203.59	42.21	52.7	—	62.88	41.42

It may be observed from Table 8.3 that among the sample considered therein, there are issues that are grossly overpriced as compared to some that are evenly priced. For example, the pricing of Deccan Aviation was at ₹148 for a company that was yet to generate profits at the time of the issue. Jet Airways was overpriced in relation to the industry average P/E multiple probably because of the qualitative and business justifications such as a strong brand and market share. Biocon was evenly priced considering that it had a good track record. GMR Infrastructure and Cairn Energy were primarily holding companies and all the numbers are derived from their underlying subsidiaries. Notwithstanding that, they were overpriced; especially the Cairn issue. Tech Mahindra among the above sample was the only company that seemed to have the maximum upside potential for investors.

Let us now look at how these issues fared in terms of investor response (Tables 8.4–8.6).

Table 8.4 Investors' Response

Name of the Issuer	*Issue Price ₹ per share*	*Number of Times Subscribed*	*Listing Price/Aftermarket Trading Price ₹ per share*
Jet Airways	1100	16 (80% top end ₹1125)	685
GMR Infra	210	8.6	315/152
Tech Mahindra	365	75 (QIB portion)	1500
Cairn Energy	160	1	148
Biocon	315	NA	475
Deccan Aviation	148	1	97

In line with the pricing analysis made above, we find that those issues that were high priced (Jet Airways, GMR Infra, Cairn Energy, Deccan Aviation) could not sustain the momentum post-listing either immediately or in the medium term. Two of these issues (Deccan Aviation and Cairn Energy) even faced difficulty in getting subscribed comfortably since in addition to over-pricing, the market conditions during their IPOs were adverse. In the case of Jet Airways, though the issue received good response due to strong market conditions, the share could not sustain the issue price after some time. This was a clear case of over pricing since the post-issue performance of a share is what vindicates its pricing. Biocon was more evenly priced and, therefore, provided good returns to investors in the medium term. Tech Mahindra could be called an underpriced issue due to the fact that the share opened very strongly and posted more than 450% growth in six months after listing.

Table 8.5 Additional Data on IPO Pricing Parameters (Bear Phase 2009–12)

Particulars	*Gujarat Pipavav Port*	*SKS Micro finance*	*Jaypee Infratech*	*India Bulls Power*	*Oil India*	*NHPC*	*Adani Power*
1. Final Offer Price (Cut-off) determined through book-building route (₹ per share)	46	985	102	45	1050	36	100
2. P/E ratio in relation to Offer Price	Loss making	35.86	37	71	10.1	37	NA
Industry P/E	41	NA	35	21	21	97	20
Peer Group Average	41	NA	NA	—			
3. NAV/Offer Price (times)	NA	6.70	6.58	2.4	2.2	2.25	8.10

Table 8.6 Investors' Response

Name of the Issuer	*Issue Price ₹ per share*	*Number of Times Subscribed*	*Listing Day Price ₹ per share*
Gujarat Pipavav Port	46	19.94	54–58
SKS Microfinance	985	13.7	1088
Jaypee Infratech	102	1.00	93–98
Indiabulls Power	45	21.8	35–45
Oil India	1050	30.8	1019–1156
NHPC	36	23.74	36–39
Adani Power	100	21.64	98–105

In the bear phase, that followed between 2008 and 2012, the IPO market witnessed reduced number of IPOs/FPOs, especially in the larger sized offers. Furnished above are some of the larger IPOs done during this period. While Adani Power was a new company without any operations at the time of its IPO, Jaypee was a SPV based on a concession for a road project. SKS Microfinance (which subsequently went into trouble and declined considerably in market capitalisation) caught the fancy of investors at the time of its IPO due to its first mover advantage. Gujarat Pipavav Port was making losses g at the time of its IPO. Both Oil India and NHPC are government companies and the issue pricing was quite appropriate considering their leadership position in their respective industries. The pricing of all the others appeared to be on the higher side since listing gains were quite modest except in the case of SKS Microfinance. The lack of quality issues during this period also helped the cause of these IPOs considerably.

Case Study

MCX IPO

Multi Commodity Exchange (MCX) made its IPO in 2012 through the book-building route in a price band of ₹860–1032 per share of face value ₹10. As per the offer document, the offer P/E multiple was 29.86 computed on basic EPS for the company. The offer price to book value ratio was high at 4.9 times and since the company was the first commodity exchange to go public, no peer comparison was available. One of the distinguishing features of this IPO was that it was entirely by an offer for sale by selling shareholders and as such there was not going to be any equity expansion consequent to the IPO. Moreover, because of its strong parentage and first mover advantage, the company enjoyed the confidence of investors at large. The company realised this fact and priced the issue aggressively in a not so favourable market. The unavailability of other quality issues at that time also helped the company. The company received an IPO grading of 5 which meant that it had the highest rating possible. Therefore, though the pricing was aggressive, it received overwhelming response in all categories and the cut-off price was fixed at the cap. The company performed exceedingly well in aftermarket trade and thereafter.

Table 8.7 Notable IPOs and Trends (Resurgent Phase 2013–14 Onwards)

Name of Issuer	*Issue Highlights*
1. Just Dial	The public issue of Just Dial services was the most successful in 2013. Issue was opened around end of May 2013 It listed on June 5th and closed on the first day with a handsome gain of 15% on the offer price. The price band was ₹470–543. Cut-off Price was ₹530. IPO grading by CRISIL was 5/5. The issue offered a 10% discount and a safety net to retail investors up to ₹50,000. The net was to be triggered for a 20% fall in market price below the offer price. The offer price of ₹530 was at a P/E of 90 without any peer comparison. The offer price was close to 10 times the Book Value (BV) of share. The total issue budget amounted to 4.55% of the issue size and was borne entirely by the selling shareholders. The public issue was entirely an offer for sale by the selling shareholders and the company did not raise any capital.
2. Snowman Logistics Ltd.	Incorporated in 1993, Snowman Logistics is an integrated temperature controlled logistics service provider. Its IPO came in August 2014 with a price band of ₹44–47 per share was well received getting oversubscribed 60 times. It listed at ₹75 and traded well thereafter. It was a public issue of shares to raise capital.
3. Interglobe Aviation	Interglobe Aviation runs Indigo Airlines with the largest market share in India currently. The company also runs Ibis Hotels in association with Accor Hotels. The IPO had both primary and secondary components. The offer price was ₹750 per share of ₹10 each and the issue size ₹1272 crore. It received good QIB support (18 times oversubscribed) but the retail component was undersubscribed. However, the issue closed successfully with overall subscription of 6 times. A notable feature was that the company was a profit-making aviation company at the time of its IPO. It listed comfortably at ₹855 and traded at over ₹1000 after about 9 months after listing.

(*Contd.*)

4. Coffee Day Enterprises	Coffee Day Enterprises Ltd., a loss-making company, made a new issue of shares for ₹1150 crore at an offer price of ₹328. The company had very well-known anchor investors such as Blackrock, Merrill Lynch and Swiss Finance Corp. The QIB response was good but other categories were undersubscribed. Overall, the IPO received subscription of 1.82 times the issue size. It listed below the offer price at ₹317 and went down to ₹217 on first day close in the aftermarket. It was trading below the offer price even after 9 months after listing.
5. Equitas Holdings Ltd.	Equitas Holdings Ltd. is Chennai based financial services provider focused on individuals and Micro and Small Enterprises (MSEs) in microfinance, business and vehicle finance and housing finance. The IPO had an Offer for Sale (OFS) and a public issue component. Equitas holds a RBI licence to start a small bank. The issue size was ₹2175 crore made at an offer price of ₹110 per share. The offer was highly successful with total bidding of 17 times overall with aggressive response from QIBs and Non-Institutional Investors (NIIs). The scrip listed at ₹144 and was trading at ₹175 after 2 months of listing.
6. Alkem Laboratories	Alkem Laboratories is a successful pharmaceutical company. The IPO shares were fully subscribed on the second day of the offering. The company raised almost ₹1,350 crore, being one of the highest IPO capital raises in 2015.The offer was priced at ₹1050 per share and received phenomenal over-subscription in all categories. It listed at ₹1380 and was quoting at ₹1680 one year after listing.
7. Infibeam	Infibeam's listing was the first listing in India from the e-commerce sector. It was cash positive at the time of IPO but a loss-making company. It had not raised any P/E capital prior to its IPO. The IPO was a new issue of shares to raise funds to the tune of ₹450 crore at ₹432 per share, valuing the company at ₹2300 crore (post-IPO). The scrip listed at ₹453 and quoted at ₹691 after 2 months of listing. However, the IPO itself was just about subscribed at 1.11 times with the QIB portion remaining under-subscribed.
8. Narayana Hrudayalaya	NHL is one of the most successful hospital chains in India and a reputed healthcare provider. It had private equity investors and, therefore, the IPO was primarily to provide them an exit. The IPO had predominantly an OFS component with a small component of new issue. The total size of the issue was ₹613 crore and the offer price was ₹250 per share. The scrip listed at ₹291 and quoted at ₹320 after 6 months. The IPO received good response in all categories.
9. Ujjivan Financial Services Ltd.	Ujjivan Financial Services Ltd. made an IPO with an OFS and an issue component aggregating to ₹888 crore. The offer was over-subscribed in all categories by 40 times overall with very high response from QIBs and NIIs. The offer price was ₹210 per share. The scrip listed at ₹231 and was trading at ₹375 two months after listing. Ujjivan is a microfinance company.
10. BSE Limited	The first stock exchange in India to go public by listing its shares on the NSE. The IPO was a 100% offer for sale by existing shareholders. The issue size was a little over ₹1240 crore. The offer constituted up to 28.26% of the fully diluted post-offer issued share capital of BSE. The offer P/E was about 17 with no peer comparables. The offer price was ₹806 per share and the IPO received overwhelming response of 51 times. It made impressive listing gains and was trading at around ₹1000 in the aftermarket.

Table 8.8 Issue Performance and Listing Price

Name of the Issuer	*Issue Price ₹ per share*	*Offer Size ₹ Cr.*	*Number of times subscribed*	*Listing Premium / Discount % ₹ per share*
Interglobe Aviation	765	3009	6	11.90
Equitas Holdings	110	2177	12	30.91
Alkem Laboratories	1050	1348	12	31.43
Coffee Day	328	1150	2	–4.57
Ujjivan Financial	210	883	41	8.10
Infibeam	432	450	1	6.02
Narayana Hrudayalaya	250	613	6	16.40
Mahanagar Gas	421	1039	45	28.27
Dr. Lal Path Labs	550	632	24	30.36
Parag Milk Foods	215	737	1	0.33

8.10.2 IPO Pricing Discussion Summary

From the above discussion on IPO pricing, the following conclusions can be drawn:

- IPO pricing is all about *setting an offer price* as distinguished from valuation which is about finding the intrinsic value of a company.
- IPO pricing is about setting an entry price to the right to accrue future cash flow as compared to pricing for a delisting which is the consideration to the seller for giving up the right to accrue future cash flow.
- IPO pricing is a combination of various parameters in addition to valuation. A notable feature is that in companies that have private equity investment, the IPO is made primarily to provide an exit to such investors. Such IPOs have an OFS component and due to the presence of high quality investors, such issues are rated highly and receive excellent response from investors. They may even be able to charge a higher price than their fundamentals demand. The years 2014–16 saw several such highly successful P/E-backed IPOs. Similarly, in an IPO that has high Anchor Investor participation, there would be good response from other investors as well. This is because anchor investors are QIB investors and their support is an endorsement of the quality of the IPO.
- Companies that overprice their issues would eventually find their share not being able to support its offer price. Qualitative justifications do not sustain price in the long term if they are not backed by financial performance.
- Underpricing is also not a good feature as it amounts to under selling the company. This would be evident if the share price climbs significantly post-listing and stays buoyant thereafter in the long term.

8.10.3 Pricing of FPO

For a listed company, the market price becomes a ruling benchmark and if the FPO is priced equivalent to or more than the ruling market price, the shareholder or investor is better off buying the shares from the market than to subscribe to the rights. This factor has to be borne in mind for pricing a FPO.

This brings us to the discussion on how to price a FPO. Unlike in an IPO, where the company has no prior record of a quoted market price, in the FPO of a listed company, the market price plays a major factor in pricing. Though the fundamentals such as the EPS, book value of share and industry related P/E ratios are important considerations, what is of primary relevance in pricing is the ruling market P/E ratio of the company. If a company is quoting at a P/E multiple which is above its peers in the industry, the FPO can be priced accordingly. However, if the company is under-valued in the market, the pricing of the FPO is also impacted to that extent. The pricing would impact the capital structure and the post-issue equity base of the company as well. The quantum of funds to be mobilised should be determined in conjunction with the pricing as per the above criteria. The subtle difference between rights and FPO pricing is that since a rights offer is restricted to the existing shareholders, it is priced more favourably to the investor as compared to a FPO which would be available to new investors as well. The FPO of Punjab National Bank in 2006 is a good case in point, which was probably aggressive in the short-term. The FPO was made at an offer price of ₹390 per share but in aftermarket trading, it even went down below ₹300. However, it recovered impressively later on in the medium term to reflect the fundamental strength of the bank.

Case Study

Tata Steel FPO

Tata Steel made a FPO of ₹3477 crore through the book-building route in 2011 with a price band of ₹594–610 per equity share. At that time, the ruling market price of the company's share was around ₹608. Therefore, the cap was fixed at almost the current market price. As per the offer document, the offer price translated into price-earnings multiple of 10.6 which was around the industry average of 10.9 but was lesser than the trading multiples being enjoyed by its peers at that time. The offer price-book value ratio was also pegged at 1.32 times. Though the primary market was not very buoyant at that time, the company priced the offer at marginally less than the ruling market price since the company perceived that its market valuation at that time was attractive to investors. The offer was received well by QIB investors and the cut-off price was fixed at the cap of ₹610 per share. The share performed well on the listing day closing at ₹625. It remained above the offer price for few more months before starting to drop thereafter. Considering the size of the issue and the market prospects at that time, the company could have priced it lower in the range of ₹550–575 considering that there was to be price correction due to additional shares being added to the free float after the FPO.

Case Study

Power Finance Corporation FPO

Power Finance Corporation, a GoI enterprise, made a FPO in 2011 for ₹4578 crore through the book building route in a price band of ₹193–203 per share. The ruling market price of the share at that time was higher at around ₹230 per share. As per the offer document, the offer P/E multiple was 9.85 times at the floor price and 10.36 times the cap and it compared favourably with the ruling P/E multiple of its peer, Rural Electrification Corporation which was at 9.83. The offer price-book value ratio was 1.62 times. The issue was received better by QIB investors but it got subscribed in all categories. Therefore, the cut-off price was fixed at the cap of ₹203 per share which translated into a discount of around 12% on the average ruling market price. The share quoted below offer price on listing day and closed at ₹199 due to profit booking which is understandable. However, it performed well in aftermarket trade thereafter and remained above the offer price until June 2011.

Case Study

Power Grid Corporation FPO

Power Grid Corporation, a GoI enterprise made a FPO under the book building route in 2010 for ₹744.23 crore in a price band of ₹85–90 per share. The FPO consisted of both a new issue of shares by the company and an offer for sale by the GoI. After excluding employee reservation, the balance of the offer consisted of the NPO. As per the offer document, the offer price at ₹90 constituted an offer P/E multiple of 20 and an offer price-book value multiple of 2.38 times. The prevailing market price at that time was in the range of ₹100 per share. The offer received good response in all categories and was oversubscribed almost 15 times overall. Therefore, the cut-off price was fixed at ₹90. It traded well on listing day and closed at ₹96. It continued to hold firm in aftermarket trade thereafter well above the FPO price.

Case Study

NMDC Ltd. FPO

NMDC Ltd., a GoI enterprise made a FPO under the book building route in 2010 for ₹9,967.3 crore in a price band of ₹300–350 per share. The FPO consisted of an offer for sale of secondary shares by the GoI, thereby meant only to raise resources for the GoI through a disinvestment. The offer price P/E multiple at ₹300 amounted to 27.35 times and the offer price to book value ratio was abnormally high at 8.82 times. However, the company is a market leader in its sector which dealt primarily with natural resources such as metals and minerals. Its P/E ratio was also very high in comparison with its lesser peers in the market. The ruling market price at the time of the FPO was around ₹350 and due to its aggressive pricing, the FPO was not received well by the non-institutional and retail category which were under-subscribed. Therefore, the cut-off price was fixed at the lower end of the band at ₹300 per share. On the listing day, post-FPO, it traded at close to the cut-off price and thereafter, the price came down steadily in aftermarket trade.

8.10.4 Pricing of Rights Offer

A rights issue by definition is to the existing members of the company to provide additional financial assistance to the company. In that sense, a rights issue is the primary source for a listed company to seek additional capital from the primary market. Since existing shareholders had provided funds to the company when it reached out to them in its IPO, it is but natural to look them in future as the first option. However, hidden herein is also the fact that since they had financed the company in the past, the company has to provide them better terms to finance it a second time as compared to the terms it would be offer to first time subscribers. In other words, a rights issue has to be priced more favourably for an investor than a public issue. For a listed company, the market price becomes a ruling benchmark and if the rights issue is priced equivalent to or more than the ruling market price, the shareholder or investor is better off buying the shares from the market than to subscribe to the rights. This factor has to be borne in mind for pricing rights offer. The other parametres of pricing a rights offer are similar to what are discussed for a FPO under paragraph 8.10.3.

ILLUSTRATION 2

Rights Limited furnishes the following particulars as of a recent date.

EPS = ₹7.50
Current Market Price (CMP) = ₹75
Book Value per share = ₹60
Industry average P/E ratio = 14
Total quantum of funds proposed to be raised = ₹40 crore
Present issued and paid-up equity capital = 5 million shares of ₹10 each
IPO price three years ago = ₹60 per share

Based on the above data, the implication of the rights issue may be determined as follows:

Present equity capital (5 million shares)	₹50,000,000
Present EPS = ₹7.50 CMP = ₹75 Company P/E = 10 Industry P/E = 14 Since the company is under-valued, the rights pricing has to be linked to the company P/E. Therefore, if the rights pricing were fixed at a P/E of 5 or 6, the proposed price of the right share would be in the range of ₹37.50 to ₹45. Assuming that the price is fixed at ₹40, the capital structure would work out as follows.	
Total number of fresh shares to be issued under the rights issue (₹40 crore/₹40)	10 million
Increase in paid-up equity capital	₹10 crore
Post-issue paid up capital	₹15 crore
Expansion in equity capital as a percentage of pre-issue capital	200%
Post-Issue net worth (Pre-issue net worth + expansion in equity capital + proposed premium)	₹70 crore
Return on post-issue net worth required to maintain pre-issue EPS	16.07%

It may be noted from the above that the company needs to earn at above 16% on its net worth in order to sustain the current market price in the medium term after the rights issue. This would depend on the proposed utilisation of the funds. Similarly, the pricing of ₹40 for the rights issue looks attractive at a discount of almost 47% to the CMP. Considering the fact that the company has been undervalued in the market, the pricing of ₹40 could provide the required succour to shareholders. The company had made a premium issue three years ago at a price of ₹60 and looking at the CMP, it may reasonably be assumed that the company's share may have quoted below its offer price in the past. Therefore, a rights issue at a pricing below the IPO pricing would be construed as an investor-friendly step by the management and the rights issue could receive encouraging response from the shareholders.

In rights pricing, it is also important to understand the underlying objectives. If the objective is to seek fund support from the shareholders, there is a need to carry them along and therefore, an investor-friendly pricing on the above lines may augur well for the company. However, if the rights issue is being made to seek consolidation of promoters' stakes through the back door, it may have to be priced steeper to dissuade the shareholders from applying in the rights issue. However, in such case, a choice has to be made between direct entries for the promoters through the preferential allotment route vis-à-vis the rights issue.

Table 8.9 Rights Issue Pricing Data

Issuer	*Year*	*Rights Price ₹ per share*	*Ruling Market Price ₹ per share (Average)*	*Premium %*	*Discount %*
Bharat Forge	2004	560	565		0.90
Sterlite Industries	2004	550	456	21	
CESC	2004	60	85		29
Ceat	2005	50	80		37.5
Nicholas Piramal	2005	175	240		27
Aditya Birla Nuvo	2006	793	790	0.38	
GTL Infrastructure	2007	10	45		78
Tata Steel	2007	300	501		40
Tata Motors	2008	340	437		22
Hindalco	2008	96	136		29
Indian Hotels	2008	70	79		11
Thomas Cook	2008	35.50	48		26
United Breweries	2008	177	180		2
Suzlon Energy	2010	63	85		26
Adani Enterprises	2010	475	485		2
EIH Associated Hotels	2012	100	149		33
Network 18	2012	30	38		21

The above table provides a sample of rights issues made in both the boom phase (2004–07) and the bear phase that followed thereafter (2008–12). It may be observed that other than a couple of issues that were made at premium to market price, the rest of them made right offers at discount to prevailing market price. To a large extent, this depends on market sentiment and the objective behind the issue. During the bear phase, companies sought to raise funds through rights issues as the primary market was, otherwise, quite dormant. Therefore, in order to ensure success of the issue, it was essential to offer substantial discount to market price. However, if the market sentiment is strong or a rights issue is planned for consolidation of stakes by promoters, they could be priced at market price or at a premium thereon.

8.10.5 Concluding Observations on FPO and Rights Pricing

An empirical research paper shows that the trend in rights and FPO pricing (known as Secondary Equity Offers or SEOs in USA) in India has been to time the market to the advantage of the issuer. The conclusions are furnished below:

"Using a sample of 144 rights issues and 33 FPOs offered during the period 2000–2014 for our study, we find that the firms offering these rights issues and FPOs underperform significantly in the long run. Investing in an SEO at the close of the trading day and holding it for 5 years, on an average, gave returns of only 28% (5% annualised) which is 17% (3% annualised) less than the returns given by the firms similar in size, price-to-book ratio (P/B) and age and in the same industry that did not issue SEOs. The results are significant and are in line with those observed in the developed economies like the US. Therefore, we conclude that our results are consistent with the "management timing" hypothesis and that the Indian managers have actually been able to take advantage of the pockets of opportunities when their firm's stock is overvalued to raise new secondary equity".[7]

8.10.6 Types of Instrument

The type of security to be offered to the investor in a public offer depends mainly on factors that are considered in the selection of the type of issue. The investors' appetite at a given point of time largely determines the type of security to be floated. The timing of the offer and the prevailing market conditions has a significant bearing on the choice of instrument for a public offer. When primary markets were buoyant between 2003 and 2007, it is observed that the accent of the investors was towards pure equity offerings. However, when investor confidence in equity was low and prevailing interest rates were high in the years following the 2008 financial crisis, investors preferred pure debt instruments due to better safety and coupon rates. The markets, thereafter, picked up once again in a good way for pure equity offerings in IPOs, especially those backed by private equity funds. But the appetite for long-term debt instruments also continued to be buoyant. Many issuers of debt instruments approached their investors for reduction in the coupon rates or for buyback of the debt instruments when interest rates started to head southwards after 2014.

Notwithstanding the above said market trends, the financial fundamentals and existing capital structure of the issuer company should also be kept in mind while structuring the security on offer. For instance, in the 1990s, several large issues involving projects with long gestation period issued debt securities or staggered convertibles in public offers. This is because staggered convertible delays the expansion of the equity base and has a sobering effect on the EPS so as not to impact share price adversely. However, in the phase of issues starting with the year 2003, the accent was on high priced pure equity issues and debt securities in public offers became non-existent. Reliance Petroleum Ltd. is a case in point. When it came for a public issue for its refinery project in Jamnagar (Gujarat) in 1993, it made a public issue of a complicated debt convertible. However, when Reliance Petroleum Ltd. (second version) went public in 2006 also for a refinery project in Jamnagar, it made a public issue of pure equity at a premium. Both the issues were enormously successful but at different points of time.

Choosing Pure Debt and Convertibles

As far as issue of debt securities or debt convertibles is concerned, one of the key areas for a merchant banker is to assess the credit-worthiness of Issuer Company in the context of its existing long-term debt obligations and the assets that have been offered as security for the same. There are two important considerations in raising debt: the future expected cash flow generation which that would need to service the future debt

[7]NSE Working Paper 'Long Run performance of Rights Issues and FPOs: Evidence from India' by Soumya G. Deb and Krishna C. Kamisetty.

obligations; and the future financial cost that has to be met out of the future pre-debt servicing profits. If the financial costs were steep, the profits would take the burden. On the contrary, if the cash flows were not robust enough, the principal repayments would come under pressure. It is also imperative to create a debt service reserve to the extent stipulated under the Companies Act and ICDR Regulations. Keeping these factors in mind and the overall financial health of the company, the end use of the proposed debt issue and the security to be created to back the debentures, the merchant banker comes up with the structure of the proposed debt issue. The debt-equity ratio prior to and immediately post the proposed offer, the debt service coverage ratio, the asset cover and interest cover play an important role in determination of the amount of debt that can be raised, the coupon rate, the yield to the investor, the accounting costs for the issuer company, tax breaks on the financial costs, redemption terms and other important parameters.

While examining the instrument that has to be offered, the merchant banker keeps in mind the probable rating that the instrument may manage to get. If it is evident that the instrument would not get a good rating, suitable credit enhancements have to be built in so that the structure manages to get a rating better than that of the stand-alone instrument. The rating also determines the coupon rate and the yield that has to be built into the instrument. Apart from the return to the investors, other features such as the marketability of the instrument, its unit value, minimum lot, tax benefits that it can be entitled to etc. also need to be examined. If required, sweeteners such as a conversion option, step up rates, call option etc. need to be provided so that the offer becomes attractive. Suitable exit options to Issuer Company need to be factored in as well.

Other situations when the choice of a pure debt instrument or convertible is better are given as follows:

- If the issuer company requires debt finance for which accessing the capital market is a better option than raising term loans from financial institutions and banks. This situation holds good in a buoyant primary debt market wherein the costs of a public floatation taken together with the coupon rate payable on the debt instrument work out cheaper than the interest and other costs payable on term loans. Secondly, the syndication process for a term loan may itself be a longer process than accessing the capital market, if the chances of the public float meeting with an encouraging response are bright.
- If accessing the public issue market is a better option than looking towards private placement of debt securities. Again, this condition holds good only if the company finds that access to the retail debt market is a better option to raise a large amount of funds rather than accessing primarily QIB investors in the private placement. In the nineties, whenever huge amount of debt funds had to be raised from the primary market, issuers preferred the public issue market to the private placement route. However, post 2001, the private placement market met most of the debt financing requirements from the capital market for corporate issuers as compared to the public issue route. Each of these routes has its own advantages. While the public offer route provides greater dispersal and liquidity for the instrument, its secondary market volumes may not be high if there is no significant retail trade. On the other hand, debt securities that are issued privately but listed subsequently are traded mostly in the wholesale debt segment of the market driven by institutional demand. Presently, there is good appetite for institutional bonds in public offers and corporate bonds in private placements.
- Sometimes, accessing the public issue market with a debt convertible is triggered off, since the company cannot afford to expand its equity base immediately with a public offering of pure equity. This happens in large capital-intensive projects wherein the gestation time for the project to yield good cash flow to equity is significantly long. Equity issues cannot be marketed in such cases with a promise to yield good returns in the distant future. Therefore, a debt convertible would be ideal in such situations by providing the investor with a coupon rate during the gestation period with the comfort of looking at the upside when the project begins to yield cash flow to equity. As far as Issuer Company is concerned, its equity capital is expanded in stages so that the earnings per share is not unduly depressed in the initial phase. Secondly, during the initial years, if the instrument that has to be traded in the secondary market is pure

equity, it would trade at low prices, thereby jeopardising the company's market capitalisation. On the other hand, during such phase, if the company floats a debt instrument with a reasonable coupon rate, it may find some trading volumes. In the past, several major projects such as Reliance Petroleum (first issue), Essar Oil, MRPL and others had relied on the debt convertible route to raise funds from the public issue market.

It may be pertinent to note that the ICDR Regulations do not prescribe that a company should list its equity shares first through an IPO before issuing convertible instruments. Therefore, it is possible for an unlisted company to make an IPO using convertibles. Similarly, listing of pure debt instruments is made through a separate set of Regulations called the SEBI (Issue and Listing of Debt Securities) Regulations 2008. So, it is possible even for a company that has not yet listed its equity through an IPO to make a public offer of pure debt instruments. Hence, there is enough flexibility in the regulatory mechanism for Issue Managers to take a call on the choice of instrument for a public offer and advise their issuer clients accordingly.

Some of the interesting structures in recent years have been in rights issues more than in public offers. Some of these are discussed as follows.

Case Study

Tata Steel Issue

Tata Steel came out with a composite issue in 2007. It was a simultaneous but unlinked issue of 121,794,571 equity shares of ₹10 each at a premium of ₹290 per equity share aggregating to ₹36,538 million to the equity shareholders on rights basis in the ratio of 1 equity share for every 5 equity shares held on the Record Date (November 5, 2007) and 548,075,571 Cumulative Compulsorily Convertible Preference Shares (CCPS) of the face value ₹100 each at a price of ₹100 each aggregating to ₹54,808 million in the ratio of 9 cumulative compulsorily convertible preference shares for every 10 equity shares held on the Record Date ("issue"). 6 CCPS of face value of ₹100 each was proposed to be compulsorily and automatically converted into 1 Equity Share fully paid up of ₹10 each at a premium of ₹590 on September 1, 2009 without any application or any further act on the part of the CCPS holder. There was no redemption envisaged for the CCPS. The CCPS carried a coupon rate of dividend of 2% until conversion. CCPS would be converted into equity shares of the Company on September 1, 2009 in the ratio of 1 equity share for every 6 CCPS. On conversion of CCPS into equity shares, the difference between the conversion price and the closing market price of equity shares on September 1, 2009 was to be treated as long-term capital gain/loss as the case may be for the investor. The CCPS did not confer any right on the holders thereof to participate in any offer or invitation byway of rights or otherwise to subscribe for additional shares in the Company.

Case Study

Indian Hotels Issue

Indian Hotels (Tata Group company operating the Taj group of Hotels) came out with a rights issue in 2008. It was a simultaneous but unlinked issue of 120,570,299 equity shares of ₹1 each at a premium of ₹69 per equity share aggregating to ₹8,439.92 million to the equity shareholders on rights basis in the ratio of 1 equity shares for every 5 equity shares held on the Record Date, i.e. February 28, 2008 and 60,285,150, 6% Non-Convertible Debentures (NCDs) of ₹100 each with detachable warrants in the ratio of 1 NCD with detachable warrant for every 10 equity shares held on the record date ("issue"). The NCDs with detachable warrants prior to conversion aggregated to ₹14,468.44 million and the total issue of equity shares and NCDs assuming full conversion of detachable warrants into equity shares during the warrant conversion period at warrant exercise price aggregated to ₹23,511.21 million. Each NCD was proposed to be redeemed at the end of 3 years from the date of allotment at the face value of ₹100. NCDs had a coupon rate of 6% and interest was payable annually. The NCDs were secured against the assets of the company in favour of the trustee. The Company retained the right to repurchase the NCDs at discount, at par or at a premium at its discretion, at any time in the open market or otherwise. The detachable warrant could be freely and separately traded. The warrant holder was entitled to exercise his right to apply for one equity share of ₹1 each at the Warrant Exercise Price for each warrant held, at any time during the Warrant Exercise Period. The warrant exercise period was fixed after 6 months from the date of their issue for a period of 30 days and the Warrant Exercise Price was fixed at ₹150. Save and except the right of subscription to the company's equity shares as per the terms of the issue of warrants, the holders of the warrants in their capacity as warrant holders were not entitled to any other rights or privileges available to equity shareholders.

Case Study

Network 18 Media and Investments Issue

Network 18 made a rights issue of Partly Convertible Cumulative Preference Shares (PCCPS) of ₹200 each for cash at par to its equity shareholders on a rights basis in the ratio of one PCCPS for every 5 equity shares held as on the Record Date i.e. March 18, 2008. Each PCCPS had one detachable warrant and the warrant was proposed to be issued only after the PCCPS became fully paid up within 75 days of allotment. The PCCPS were proposed to be listed and available for trading. Each PCCPS consisted of two parts. Part A of the PCCPS had the convertible portion which was to be compulsorily and automatically converted into 1 equity share. From the issue price of ₹200 an amount of ₹50 (₹5 towards face value and ₹45 towards share premium) was to be appropriated towards issuance of each Part A. Part B of the PCCPS consisted of the non-convertible portion. After conversion of Part A into equity, Part B was proposed to continue to be traded as a preference share for the balance amount of ₹150. The shareholders were required to accept the PCCPS as a whole; part acceptance of the Part A or Part B was not allowed. Part B had a coupon rate of 5% payable annually as dividend. Part B was proposed to be redeemed at the end of five years from the date of allotment at the balance amount of ₹150.

The detachable warrant was entitled to the right to apply for one equity share of ₹5 each at the exercise price which was fixed at a 50% discount to the average of the weekly high and low of the closing prices of the equity share of the company on the stock exchange with a higher aggregate trading volume during the 90 day period immediately preceding the week in which the Board of Directors of the company would inform the stock exchanges about fixing the record date for the warrant exercise period. The warrant exercise price was payable in full on application for issue of the entitled shares. The warrant exercise period was fixed as the period commencing after 24 months from the date of allotment up to 48 months from the date of allotment. The date of allotment for the warrants was the same as that of the PCCPS.

8.10.7 Green Shoe Option

The term 'Green Shoe Option' has its origins in the public offer made in USA by the Green Shoe Manufacturing Company in 1919 which used this option for the first time in its underwriting agreement. It means an option of allocating shares in excess of the shares included in the public issue with prior disclosure of the intention to do so and further subject to regulatory approval. The Green Shoe Option in India is governed by the ICDR Regulations, which envisage such option being exercised by an issuer through a post-listing price stabilising mechanism, which has to be executed through a Stabilising Agent (SA). The Green Shoe Option can be exercised for a maximum of 15% of the size of the issue. If in an IPO through the book building route a company opts for a Green Shoe Option, at the time of seeking approval from the shareholders for the issue, it shall also seek approval for allotting further shares to the SA after the stabilisation period. The company has to appoint the SA who would be responsible for price stabilisation. The Book Running Lead Manager to the issue is appointed as the SA.

The SA will operate a separate demat account called the 'Special Account for the GSO shares of …' to which the promoters of the company would lend shares of their own equivalent to the Green Shoe Option. When a Green Shoe Option is exercised, the lock-in provisions do not apply to the extent of shares that have been lent by the promoters to a SA from the date of such lending till the date of their return back to the promoters.

After the issue is complete, if the green shoe option is to be exercised, the allotment of the additional shares would be done out from of the GSO account. The additional shares would be allotted on a pro-rata basis to all investors. The amount received from the allottees for the shares under the Green Shoe Option would be credited to a separate account called the 'Special Account for the GSO proceeds of…. After the trading commences, the SA would use the proceeds in the GSA account to buy shares from the market so as to suck the excess liquidity, if any in the market and thereby stabilise the price. The shares bought would be credited to the GSA demat account. The stabilisation period should be disclosed in advance in the offer document and it shall not exceed 30 days from the commencement of trading. After the stabilisation period is over, the GSO demat account is examined and the difference between the total quantity lent by the promoters to the account initially vis-à-vis the number of shares bought from the market during the stabilisation period is ascertained as the shortfall. The company would proceed to allot fresh shares to the GSO demat account to the extent of the shortfall which would be paid for by the SA from the GSO proceeds account. The SA would return the entire shares to the promoters and square up the GSO demat account. There could be a balance in the GSO proceeds account depending upon the price at which the SA bought shares from the market. Such balance, if any, shall be transferred to the investor protection account and the account shall be closed.

In the end analysis, under a Green Shoe Option the following position emerges—if the SA buys shares from the market, to the extent of such purchase, the company does not make any excess allotment of shares to the promoters and the issue size does not go up. If the SA does not buy a single share from the market, the entire Green Shoe Option becomes an increase in the issue size for which the company receives the funds and the equity capital would go up to that extent as well. The decision of buying shares from the market for price stabilisation is entirely left to the judgement of the SA who shall be primarily responsible for price stability.

Case Study

Tata Consultancy Services

The extract of the prospectus of the Tata Consultancy Services Ltd. IPO showing the disclosure on the use of Green Shoe Option is being reproduced herein below.

Tata Sons and TCS Limited intend to establish an option for allocating Equity Shares in excess of the Equity Shares that are included in the offer in consultation with the BRLMs and the Stabilising Agent and to operate a price mechanism in accordance with the applicable ICDR Regulations. Green Shoe Lenders will transfer the equity shares to the Stabilising Agent upon exercise of the Green Shoe

Option. The Green Shoe Option will be exercised only with respect to Equity Shares that are owned by Green Shoe Lenders. Tata Sons as the Green Shoe Transferor, has agreed to transfer up to 8,317,880 equity shares to the Stabilising Agent, in case the Green Shoe Option is exercised by Stabilising Agent.

We have appointed one of the BRLMs, JM Morgan Stanley Private Limited, as the Stabilising Agent, for performance of the role of Stabilising Agent as envisaged in Chapter VIIIA of the ICDR Regulations, including price stabilising post listing, if required. However, there is no obligation to conduct stabilising measures. If commenced, stabilising will be conducted in accordance with applicable laws and regulations, such measures may be discontinued at any time and will not continue for a period exceeding 30 days from the date when trading permission is obtained from the Stock Exchanges. The Stabilising Agent will borrow Equity Shares from Green Shoe Lenders. The equity shares borrowed from Green Shoe Lenders or purchased in the market for stabilising purposes will be in demat form only. On June 9, 2004, TCS Limited entered into a Stabilising Agreement with Green Shoe Transferor, the Green Shoe Lenders and JM Morgan Stanley Private Limited as the Stabilising Agent. The Green Shoe Lenders have agreed to lend the following number of equity shares for the purpose of Green Shoe Option:

Name of the Green Shoe Lender	Number of Equity Shares
Tata Sons	3,690,080
Sheba Properties Limited	1,394,750
Kalimati Investment Company Limited	981,062
Aftaab Investment Company Limited	751,988
Shapoor Pallonji Mistry	750,000
Cyrus Pallonji Mistry	750,000
Total	8,317,880’

8.11 Key Regulatory Perspectives in Issue Management

8.11.1 Choosing the Type of Issue and Method of Delivery

One of the fundamental regulatory aspects that determine the public offer is the type of issue to be made in a given case and the proper method of delivery. It has already been explained that a public offer can be made either through a fixed price offer or a book-built offer. Sometimes, the type of issue is also determined by the eligibility criteria applicable to Issuer Company. The eligibility criteria are discussed in a subsequent paragraph.

The choice of the type of issue and method of delivery depends on several factors such as the stature of Issuer Company and its visibility in the capital market, the current state of the market and the flavour of the season, the necessity for underwriting the offer, the requirement for price discovery, the spread of shareholding desired by the company etc. If the market is buoyant and the flavour is for book-built offers, the company could benefit with a higher pricing by going in for a book-built offer. If the company is extremely visible with strong fundamentals and desires a spread of shareholding, it may opt for a 100% retail offer.

Sometimes, the costs involved in the issue also become a factor for decision-making. Retail issues are more expensive since they involve direct marketing to investors. Book-built issues involve a significant amount of non-retail categories and are, therefore, pre-marketed to the large investors. This brings down the uncertainty factor in the issue. Though underwriting is optional for fixed price offers, since the uncertainty factor is high, underwriting may be preferred and that further pushes up the issue cost. The investment banker takes a call on all these aspects and advises the company accordingly.

8.11.2 Determining Eligibility Criteria for an IPO

One of the most important provisions in the ICDR Regulations is about the eligibility of a company making an IPO through a public offer. The fixation of eligibility criteria is significant as it is vital to sustain the confidence of investors in the capital market over the long term. SEBI has over the years brought in several changes to the eligibility criteria to ensure that good quality issues are brought to the market. However, this is considered to be an area that requires constant review from the regulator. The present guidelines are discussed below:

- **Primary eligibility conditions:** A company can make an IPO of pure equity or convertibles only if it meets *all* of the following conditions. These conditions apply *mutatis mutandis* to an offer for sale as they apply to a public issue.
  - The company should have net tangible assets of at least ₹3 crore in each of the preceding 3 full years (of 12 months each), of which not more than 50% is held in monetary assets. Provided that if more than 50% of the net tangible assets are held in monetary assets, the company has made firm commitments to deploy such excess monetary assets in its business/project. 'Project' means the objects for which the funds are proposed to be raised through the IPO.
  - The company has a minimum average pre-tax profit of ₹15 crore on a consolidated basis during the three most profitable years out of the immediately preceding five years.
  - The company has a net worth of at least ₹1 crore in each of the preceding 3 full financial years (of 12 months each).
  - In case the company has changed its name within the last one year, at least 50% of the revenue for the preceding 12 months is earned by the company from the activity suggested by the new name.
  - The aggregate size of the proposed issue and all previous issues made in the same financial year by the company does not exceed five times its pre-issue net worth as per the audited balance sheet of the last financial year. For this purpose, the aggregate size of the issue should be reckoned with the net public offer through the offer document + reservations + promoters' contribution through the offer document.
- **Alternative eligibility condition:** An unlisted company not complying with the primary eligibility criteria can still make an IPO of equity shares or convertibles, if the issue is made through the book-building process and the issuer undertakes to allot, at least 75% of the NPO to QIBs and to refund full subscription money, if it fails to make the said minimum allotment to QIBs.
- **Additional conditions:** The following additional conditions *inter alia*, shall also be kept in mind as regards eligibility to make an IPO.
  - In an IPO consisting of an offer for sale, equity shares proposed to be offered should have been held by the sellers for a period of at least one year prior to the filing of draft offer document with SEBI. In case of equity shares arising from convertibles (including depository receipts), the period of one year will be reckoned cumulatively including that of the convertible. Offer for sale made by the government in the case of PSUs and any shares acquired under a scheme sanctioned by the High Court under Sections 391–394 of the Companies Act are exempt from the one year requirement.
  - No company shall make an IPO unless firm arrangements of finance through verifiable means towards 75% of the stated means of finance, excluding the amount to be raised through proposed issue, have been made.

It may be appreciated from a reading of the above provisions that SEBI attaches a lot of importance to the quality of companies coming to the public issue market. The mandatory conditions ensure that the company has a track record of at least 3 years with minimum net worth and profit record. This would ensure that paper companies could not go public just after incorporation making tall claims of future business potential.

Similarly, there is a cap on companies making retail issues with unduly high premia. This is because under the free pricing regime, there is a tendency on the part of the issuers to make high priced issues. If such issues are allowed to go through the 100% retail route, there may not be a proper price validation. The share price may come down below the offer price after listing due to lack of buying support. Therefore, it has been stipulated that high priced issues beyond specified limits need to go through the book-building route with a compulsory offering of 75% of the NPO to QIBs who are informed investors.

8.11.3 Capital Structure

The capital structure of the company post-issue has to be structured so as to reflect the desirable position for the company and for the marketability of the issue as well. As per the ICDR Regulations, the following should be the determination of capital structure of a company in the context of a public issue.

- Proposed Issue Size = Promoters' contribution in the proposed issue if any + Offer through the offer document.
- Offer through the offer document = Reservations to the permitted reserved categories + NPO. Offer through offer document should not include promoters' contribution in the proposed issue, if any.
- NPO = Net Public Offer made to Indian public (Should not include promoters' contribution / reservations).

For the purpose of the above determination, promoters are defined both under the ICDR Regulations and under the Companies Act to the effect of meaning individuals or bodies corporate who are in control of the affairs of Issuer Company either by virtue of controlling shareholding or otherwise.

The starting point for determining the capital structure according to the guidelines is the pre-issue capital structure. The general steps required for capital structuring are mentioned as follows:

1. Taking into consideration the issue size and proposed pricing, the total number of new shares to be issued is determined. In the case of a fixed price offer, the offer is determined beforehand. In the case of a book-built offer, the capital structure would be based on the number of shares or the floor price, as the case may be. The fund requirement for the company is the main parameter in many issues. If fund raising is not the main objective, least dilution of existing shareholders' stakes could be the main parameter.
2. Based on the pre-issue paid-up capital and the number of new shares determined under step 1, the total issued and paid up post-issue capital is arrived at.
3. The post-issue paid up capital is superimposed over the pre-issue capital structure to determine the post-issue capital structure.
4. The individual shareholder components in the post-issue capital are examined for regulatory compliance under the Companies Act, ICDR Regulations, the Securities (Contracts) Regulation Act, Foreign Exchange Management Act and the Listing Guidelines of the stock exchange. In case these are not satisfied in full, the whole process is iterated till a satisfactory structure is arrived at. The important provisions among these relate to promoters' contribution, lock-in of promoter shares, as may be applicable under the ICDR Regulations, minimum public shareholding post–issue and non-resident shareholding.
5. The merchant banker has to be satisfied on the capital structure from the marketability aspect as well. Otherwise suitable changes are made within the permissible statutory parameters.

Following is the capital structure of Biocon Ltd. at the time of its IPO.

Case Study

Biocon Ltd.—Capital Structure

Table 8.10

Details	*Pre-Issue*	*Post-Issue*
Pre-Issue Capital Number of Shares	90,000,000	
Promoters' Contribution in the Offer		NIL
Firm Allotments		NIL
Size of the Offer (Offer through the Offer Document)	10,000,000	
Post Issue Capital Number of Shares		100,000,000
Number of Shares held by Promoters % of holding 3 year lock-in 1 year lock-in	61,540,279 68.37%	61,540,279 61.54% 20,000,000 41,540,279
Relatives of promoters	717,982	717,982
Private Equity Funds	11,112,268	11,112,268
Others	16,629,471	16,629,471
Reservations in the Offer		NIL
NPO		10,000,000
Total	90,000,000	100,000,000

8.11.4 Issue Structure and Minimum Public Shareholding

The issue structure refers to the following parameters. Here again, the below-mentioned points apply to 100% retail issues and these have to be considered with suitable modifications for book-built issues.

- The face value (nominal value) of the share, the premium thereon and the final offer price. In book-built issues, the final pricing is not done until after bidding is over, but a floor price is mentioned.
- The minimum and maximum amount of subscription per applicant.
- The terms of the issue with regard to payment of the offer price and eligibility criteria for applicants.
- Promoters' contribution, if any, in the issue and details thereof.
- Reservations, if any and details thereof as per applicable ICDR Regulations.
- Net Public Offer
- Anchor Investors' allocation, if any, in the QIB component of the NPO.
- Underwriting, either mandatory or discretionary.
- Cost parameters for the issue and an acceptable Issue Budget.

In determining the above parameters, one of the significant elements is the size of the NPO which depends on the regulatory requirements. The Lead Manager has to assess whether the issue structure permits sufficient floating stock for healthy trading in the aftermarket, given the size of the company's post-issue capital. For example, in the case of i-Flex Solutions Ltd., almost 70% of the post-issue capital was locked-in and about

20% was held by a financial investor. This left a floating stock of around 10% (the least required) in the market for trading. Some companies prefer low float in the market so that the price remains firm. There are also large issuers such as Larsen & Toubro and Reliance Industries that sometimes suffer from a liquidity overhang in the market. Determining an adequate free float vis-a-vis dilution to existing shareholders requires considerable expertise on the part of Issue Manager.

Determining Free Float

In order to enable the healthy growth of the capital market with adequate free float in stocks, the regulations provide for minimum public shareholding to make an IPO and for continuous listing thereafter. These rules are prescribed in the SCR Rules [rule 19(2)(b)] and the SEBI circulars on the subject as amended from time to time. The current provisions are contained in the said rule as amended in 2014[8] which states that a company seeking listing pursuant to a public offer (IPO/FPO) shall ensure the following conditions listed in Table 8.11.

Table 8.11 Free Float Requirements

Size of the Issuer's Post-Issue Capital calculated at the Offer Price	% of Equity Shares or Debentures convertible into Equity Shares issued by the Company to be offered to the Public through the Offer Document
(i) Upto ₹400 crore	25%
(ii) Above ₹400 crore but below ₹1600 crore	Such % as would be equivalent to the value of ₹400 crore at the offer price
(iii) Above ₹1600 crore	10%

Provided that under categories (ii) and (iii) in the above table, Issuer Company shall bring the public shareholding to the level of at least 25% within a period of three years from the date of listing as prescribed by SEBI. SEBI has stipulated that such increase shall be made by increasing the public shareholding to the extent of at least 5% per annum beginning from the date of listing of the securities, in any of the prescribed methods.[9] It is further provided that the company may increase its public shareholding by less than 5% in a year, if such increase brings its public shareholding to the level of 25% in that year.

For the purpose of the above requirements, public shareholding shall mean "equity shares of the company held by public including shares underlying depository receipts if the holder of such depository receipts has the right to issue voting instruction and such depository receipts are listed on an international exchange in accordance with the Depository Receipts Scheme, 2014. Provided that the equity shares of the company held by a trust set up for implementing employee benefit schemes under the regulations framed by SEBI shall be excluded from public shareholding".[10]

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[8]Securities Contracts (Regulation) Third Amendment Rules, 2014 vide notification dated 18 November 2014.

[9]In terms of Circular No.CIR/CFD/DIL/10/2010 dated December 16, 2010, Circular No. CIR/MRD/DP/ 05/2012 dated February 1, 2012 and Circular No.CIR/CFD/DIL/1/2012 dated February 8, 2012, SEBI prescribed the following methods for increasing the public shareholding in a listed company to the mandatory 25% of its issued capital:

(a) Issuance of shares to public through prospectus; or
(b) Offer for sale of shares held by promoters to public through prospectus;
(c) Sale of shares held by promoters through the secondary market; or
(d) Offer for Sale by Promoters through stock exchange mechanism; or
(e) Through an Institutional Placement Programme (IPP) in terms of Chapter VIII-A of SEBI ICDR Regulations, 2009, as amended from time to time.

[10]Securities Contracts (Regulation) (Amendment) Rules, 2015 notified vide notification dated 25th February, 2015.

The concept of having free float of non-promoter or non-controlling shareholder interests in a listed company is not unique to India. For the healthy existence of a secondary market and investor protection, it is necessary to have a certain amount of freely tradable shares at all times. Otherwise, due to the lack of adequate trading volumes, price discovery is impacted and market valuations can get seriously distorted. Therefore, it is necessary to insist on minimum public shareholding at the IPO stage and for retaining the continuous listing of the company thereafter. Internationally, many countries have similar free float requirements at IPO stage such as Singapore (12% to 25% on a graded scale), London (25%) and Hong Kong (15% to 25%).

Let us now look at issue structure of the IPO of Tata Consultancy Services Ltd.

Case Study

TCS IPO ISSUE STRUCTURE

Equity Shares offered by:

	Number of Equity Shares
The Company	22,775,000
Selling Shareholders	
Tata Sons	14,457,116
Other Selling Shareholders	18,220,484
Total by Selling Shareholders	32,677,600
Total	55,452,600
Of which:	
Employee Reservation Portion	5,545,260
Therefore,	
Net Offer to the Public	49,907,340
QIB Portion	29,944,410
Non-Institutional Portion	7,486,090
Retail Portion	12,476,840
Green Shoe Option Portion	8,317,880
Equity Shares outstanding prior to the Offer	455,500,029
Equity Shares outstanding after the Offer	478,275,029

MCX IPO

	Number of Equity Shares
Issued Capital before the Public Offer	50,998,369
Present Offer through the Prospectus	6,427,378
Selling Shareholders	
Financial Technologies India Ltd.	2,643,916
SBI (Equity)	2,112,025
Other Selling Shareholders	
Total by Selling Shareholders	6,427,378
Of which:	
Employee Reservation Portion	250,000

Therefore,

Net Offer to the Public	**6,177,378**
QIB Portion	3,088,689
Out of which Anchor Investor Portion	926,606
Balance available for other QIBs	2,162,083
Of which available to Mutual Funds	108,104
Balance available to QIBs including Mutual Funds	2,053,979
Non-Institutional Portion	926,607
Retail Portion	2,162,082
Equity Shares outstanding prior to the Offer	50,998,369
Equity Shares outstanding after the Offer	50,998,369

The MCX IPO consisted purely of an offer by the selling shareholders and there was no public issue component therein. Therefore, the issued capital of the company remained constant before and after the offer. The selling shareholders were the promoter and investors who had invested prior to one year before the public offer. In this respect, the MCX public offer is one of the few IPOs that have been made only for the purpose of listing and providing exit to sellers and not to raise capital for the company. The offer constituted 12.60% and the NPO component constituted 12.11% of the post offer paid-up equity capital respectively. Since the post-issue equity capital of the company calculated at the offer price amounted to more than ₹4000 crores, the company could come out with the IPO by offering less than 25% to the public in terms of Rule 19(2)(b) of the SCR Rules.

8.11.5 Offer Document and Disclosures

The ICDR Regulations and Company law provide exhaustive provisions for the presentation of prospectus/ offer document since this is an important area of regulation for SEBI. The ICDR Regulations have taken the disclosure requirements to the standard of international best practices thereby making the offer documents voluminous. For example, the prospectus for the Reliance Petroleum issue made in 1993 was in excess of 100 pages which was a trend setter of sorts at that time. Over the years, several new provisions have been added to the disclosure requirements thereby increasing the size of the offer documents further. The Red Herring Prospectus of several issues, in recent years, averaged around four to five hundred pages.

Some of the compelling disclosures as specified in Schedule VIII of the ICDR Regulations that have a bearing on issue pricing and its marketability are discussed as follows:

- *Risk factors:* Disclosure of risk factors is quite stringent. Risks are categorised as follows for an IPO: Risks in relation to first issue; General risk relating to investment in equity related securities; Risk factors specific to the project and internal to Issuer Company; and External risk factors beyond the control of the company that may affect the industry or the economy that may have an impact on Issuer Company. The risk factors have to be weighed in on the basis of their materiality. All risks have to be presented as envisaged by the management along with proposal to mitigate the risks.
- The *objects of the issue* shall be disclosed stating whether the company proposes to raise the funds for fixed asset creation or for meeting working capital requirements. In the case of asset creation, the clear break-up has to be provided. In the case of a project, activity-wise break-up needs to be given. The complete details of the investment plan and how it is expected to grow the business positively shall be explained. This disclosure is very important since any deviation from the objects of the issue at a subsequent date will trigger an exit for the investors.

- An *undertaking* shall be given by Issuer Company confirming that firm arrangements of finance through verifiable means towards 75% of the stated means of finance, excluding the amount proposed to be raised in the issue have been made. This disclosure is also important as the funds proposed to be raised through the public issue cannot be diverted to any other use without the consent of the investors. The ICDR Regulations prescribe that if the utilisation of the designated funds for the said objectives is not fulfilled to the extent of 75% of the funds raised, an exit to investors has to be provided.
- The *management discussion and analysis* of the financial condition and results of operations as reflected in the financial statements. This is a very important disclosure requirement and represents the management's view on the company and its immediate future for the next twelve months.
- No future financial projections of Issuer Company are permitted to be furnished in the offer document.
- The *basis for the issue price* and a suitable justification for the premium being asked, if any, shall be provided. In other words, the issue pricing has to be justified both qualitatively and quantitatively as prescribed.

8.11.6 Disclosure for Basis of Issue Price

Every issue, irrespective of its pricing has to be justified for the proposed pricing based on the requirements of the ICDR Regulations. Under Schedule VIII of the ICDR Regulations, an illustrative method has been furnished for companies to disclose the basis for the issue price, which is reproduced in Table 8.12.

Table 8.12 Basis for the Issue Price

BASIS FOR ISSUE PRICE**	
1. Adjusted EPS (for past three years)	
(a) Year 1	₹41.00
(b) Year 2	₹8.39
(c) Year 3	₹13.82
(d) Weighted Average	₹10.94
2. P/E Ratio in relation to Issue Price	
(a) Based on Year 3 EPS	₹37.63
(b) Industry P/E	
Highest	61.2
Lowest	0.8
Average	25.3
3. Return on Net worth	
(a) Year 1	27.36%
(b) Year 2	28.77%
(c) Year 3	33.45%
(d) Weighted Average	30.88%
4. Minimum Return on Total Net worth after the Issue needed to maintain EPS at ₹13.82	14.65%
5. Net Asset Value (NAV)	
(a) As at end of the Year	₹46.40
(b) After Issue	₹94.29
(c) Issue Price	₹520.00

**The computations furnished are illustrative and cannot be correlated. To be computed on fully diluted basis.

In the case of issues made in the book-building route, the disclosure mentioned at (4) above need not be made and the disclosure at (5) above should be furnished only as at the end of the last balance sheet. This is because, in the case of book-built issues, the issue pricing is not decided beforehand and, therefore, the basis of the offer price related to the proposed offer price cannot be computed.

In the case of a price band for a book-built issue, the financial ratios stated under (2) and (5) above shall be computed with reference to both the floor and cap of the price band.

8.11.7 Differential Pricing and Price Band

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

- Retail individual investors or retail individual shareholders and employees (applying for not more than ₹2 lakh) may be offered specified securities at a price lower than the price at which NPO is made to other categories of applicants; Provided that such difference shall not be more than 10% of the price at which specified securities are offered to other categories of applicants;
- 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;
- 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.
- In case the issuer opts for the 'alternate method of book building' (*supra*) 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 10% of the floor price.
- The floor price/cut-off price and the price decided for a fixed price offer shall not be less than the face value of the share, as may be applicable.

8.11.8 Underwriting

As per the ICDR Regulations, the following provisions apply to underwriting of public offers:

- Where the issuer making a public issue (other than through the book building process) or rights issue, desires to have the issue underwritten, it shall appoint the underwriters in accordance with Securities and Exchange Board of India (Underwriters) Regulations, 1993. It may be noted that in such issues, underwriting is optional at the instance of the issuer.
- Where the issuer makes a public issue through the book building process, underwriting is mandatory and such issue shall be underwritten by book runners or syndicate members. Provided that in the case of book-built offers that do not satisfy the standard eligibility conditions but are accessing the market through the alternate eligibility conditions (*supra*), the 75% component of the NPO proposed to be compulsorily allotted to QIBs for the purpose of compliance of such eligibility conditions cannot be underwritten. The balance 25% of the NPO shall be mandatorily underwritten.
- The issuer shall enter into underwriting agreement with the book runner, who in turn shall enter into underwriting agreement with syndicate members, indicating therein the number of specified securities which they shall subscribe to at the predetermined price in the event of under subscription in the issue.
- If syndicate members fail to fulfil their underwriting obligations, the Lead Book Runner shall fulfil the underwriting obligations.

- Where 100% of the offer through offer document is underwritten, the underwriting obligations shall be for the entire 100% of the offer through offer document and shall not be restricted up to the minimum subscription level.

8.11.9 Cut-off Price in Book-built Offers

The *cut-off* price is the price that is finally fixed as the offer price in a book-built issue. Obviously, the concept of a cut-off price does not exist in a fixed price issue. The method used to determine the cut-off price is the *proportionate basis method* whereby all successful allottees will be allotted shares at the same price discovered through book building and the amount of shares allotted would be based on the bids received. This method is the same as applicable in a book-built public offer and is known as the Dutch Auction process.

The cut-off price has to be determined after the subscription lists are closed and the valid bids received are evaluated. Under the ICDR Regulations, retail investors have the option of bidding at a specific price or at by just indicating cut-off price in the application form without mentioning any specific price. However, institutional and HNI investors have to bid at specific prices within the price band or above the floor price fixed for the offer. Revision of bids is also possible under the Regulations.

The valid bids are evaluated for looking at the price at which the company receives full subscription equivalent to the size of the issue. However, this should also be seen in line with the allotment requirements under the Regulations wherein each category has to be allotted not more than a specific percentage of the issue. Therefore, it may happen that in certain cases, though in the institutional and HNI categories, the company may be able to fix a higher cut-off price, considering the retail component, the cut-off price may have to be fixed lower. Ultimately, the objective is to ensure that the cut-off price results in Issuer Company getting the highest bid price among all categories that also fulfils the requirements under the Regulations related to the allocation to various categories of bidders.

Case Study

i-flex Solutions Ltd.
(Presently Oracle Financial Services Software Ltd.)

i-flex made an IPO through a combination of a public issue and an offer for sale. The total shares offered to the public were 3,961,700 of ₹5 each comprising of a public issue of 3,360,000 shares and an offer for sale of 601,700 shares. The floor price for the IPO was ₹530 per share. The issue was made under the 100% book-building route wherein at least 60% of the issue was allocated on a discretionary basis to QIBs. Further, not less than 15% of the issue was made available for allocation on a proportionate basis to non-institutional bidders and the remaining 25% of the issue was made available for allocation on a proportionate basis to retail bidders, subject to valid bids being received at or above the final issue price.

The company received 10,879 valid bids for 9,898,540 shares resulting in a 2.5 times over-subscription. The valid demand considering the highest value bid in the case of multiple bids from institutional, non-institutional and retail bidder categories is as shown in Table 8.13.

Table 8.13 Bidding Details

Category	*Number of Valid Bids*	*Number of Shares Bid*	*Subscription (Times)*
Institutional Investors (QIBs)	70	6,242,080	2.63
Non-Institutional Investors (NIIs)	119	1,513,760	2.55
Retail Investors	10,690	2,142,700	2.16

A sample of the final demand at different bid prices is as shown in Table 8.14.

Table 8.14 Bid Analysis

Bid Price (₹ per share)	*Number of Shares*	*Percentage to Total*	*Cumulative Shares*	*Cumulative Percentage*
800	460	0.01	620	0.01
700	1,780	0.02	3,830	0.04
650	4,640	0.05	9,070	0.09
620	27,960	0.28	39,120	0.39
610	14,170	0.14	53,180	0.53
600	202,340	2.00	253,520	2.51
590	7,920	0.08	260,960	2.58
580	98,160	0.97	325,620	3.22
570	121,620	1.20	429,400	4.25
560	146,770	1.45	560,070	5.54
550	755,880	7.48	1,219,800	12.07
540	1,228,890	12.16	2,376,840	23.51
530	8,142,490	80.54	10,109,370	100.00

In the above case, the bulk of the bids were received at the floor price of ₹530 per share and therefore, the company fixed ₹530 per share as the cut-off price.

IMPORTANT TERMINOLOGY

Alternate Book-built Offer
Book-Built Offer
Book Running Lead Manager
Capital Structure
Co-lead Manager
Draft Red Herring Prospectus
Due Diligence
Fixed Price Offer
Flippers' Margin
Floor Price
FPO
Green Shoe Option
Inter-se Allocation of Responsibilities
IPO
Issue Marketing
Issue Structure
Lead Manager
NPO
Offer Document
Post-Issue Management
Pre-Issue Management
Price Band
Prospectus
RHP
Road Shows
Setting the Offer Price
Trading Comps Analysis

TEST YOUR UNDERSTANDING

PART A

I. Pick the right answer(s) or the alternative that best fits the description from the alternatives provided under each question.

1. In an offer for sale, the securities are issued by the issuer company but the selling shareholders receive the proceeds since they have already paid for the securities to the company.
   (a) True (b) False
2. In a FPO, the securities issued are listed in the same way as the existing securities and are therefore fungible unless; they are of a different nature in which case, they are listed separately.
   (a) True (b) False
3. NPO is that part of a public offer that has to compulsorily consist of securities that need to be listed.
   (a) True (b) False
4. If a group of HNI individuals float an investment fund by pooling their resources, the fund would be a QIB ifit is pooled in India. If it is pooled outside India, it becomes a FPI.
   (a) True (b) False
5. A company makes a private placement of shares in order to save on issuance costs. Thereafter, for the purpose of listing, the company decides to make an IPO of the same shares. Is this possible under the SEBI ICDR Regulations?
   (a) Yes (b) No
6. Under the SEBI ICDR Regulations, free pricing of an issue is allowed in the following circumstances:
   i. The company has net tangible assets of at least ₹3 crore in each of the preceding 3 full years of which notmore than 50% is held in monetary assets.
   ii. The company has a minimum average pre-tax profit of ₹15 crore on a consolidated basis during the three most profitable years out of the immediately preceding five years
   iii. The company has a net worth of at least ₹1 crore in each of the preceding 3 full financial years.
   iv. The issue is made through book building route with a minimum of 75% of the NPO allotted to QIBs
   v. The aggregate size of the proposed issue and all previous issues made in the same financial year by the company does not exceed five times its pre-issue networth.
   (a) True (b) False
7. In a book-built issue, the offer document that mentions the cut-off price is known as:
   (a) The Draft Red Herring Prospectus (b) The Draft Herring Prospectus
   (c) The Red Herring Prospectus (d) The Herring Prospectus
   (e) The Prospectus
8. In a book-built issue, the offer document that mentions the price band is known as:
   (a) The Draft Red Herring Prospectus (b) The Draft Herring Prospectus
   (c) The Red Herring Prospectus (d) The Herring Prospectus
   (e) The Prospectus
9. In a book-built issue with a price band, the retail investors can bid at:
   (a) The Floor Price (b) The Cap
   (c) Any price within the price band (d) The cut-off price
   (e) Higher than cut-off price (f) Lower than cut-off price.
10. One of the disclosures supporting Issue Price is:
   (a) The ROCE required to maintain pre-issue capital base
   (b) The minimum RONW required to maintain post-issue EPS

(c) The minimum post-issue ROCE required to maintain pre-issue EPS
(d) The minimum RONW on post-issue networth required to maintain pre-issue EPS
(e) The minimum RONW required on pre-issue networth required to maintain pre-issue EPS

11. In a Green Shoe Option, the SA receives shares from:
(a) The promoters
(b) The company
(c) The existing shareholders
(d) The investors
(e) Customers
(f) The Floor Price
(g) Friends and relatives
(h) Fan Club
(i) The demat account.

12. In a book-built offer, a company receives subscriptions as follows:
i. 1.5 times at the Floor Price,
ii. 0.3 times at FloorPrice + ₹20,
iii. 0.2 times at Floor Price + ₹30,
iv. 0.2 times at Floor Price + ₹40,
v. 0.1 times at Floor Price + ₹50, and
vi. 0.1 times at Floor Price + ₹60.

The cut-off price can be fixed at:
(a) Floor Price + ₹60
(b) Floor Price + ₹50
(c) Floor Price + ₹40
(d) Floor Price + ₹30
(e) Floor Price + ₹20
(f) The Floor Price
(g) None of the above.

13. A debenture redemption reserve (DRR) is used as follows:
(a) The cash required for redemption comes out of the DRR
(b) The DRR is debited to realise the proceeds for redemption
(c) The DRR is built up over the life of the debentures to provide necessary funds
(d) The debentures are amortised over the life of the DRR
(e) The DRR is co-terminus with the write-off of the debentures
(f) The DRR isused to write-off the profits of the company.

14. In a public issue process, the due diligence on the issuer company is performed by:
(a) The auditor
(b) The private equity investors
(c) QIBs
(d) The Underwriters
(e) The Prime Lead Manager
(f) The Co-lead manager
(g) The BRLM
(h) The lead manager responsible for pre-issue process
(i) The lead manager responsible for post-issue process.

15. A company proposes to issue rights of shares in the ratio of 1:1. Every right share will also have a NCD tagged along at a face value of ₹100. Shareholders have to take the NCD compulsorily if they wish to take the share. This has the following implications:
(a) The rights issue will be held invalid.
(b) The company will be prosecuted for restrictive practice
(c) The merchant banker will be held negligent of due diligence
(d) Directors of the company will be held liable in personal capacity
(e) Investors can demand refund of money.
(f) The rights issue is valid.

16. Amazing Ltd. proposes to come out with a right issue at ₹145 per share of ₹10 each. The current marketprice of its share is ₹190. The ratio of rights announced is 1:2 (i.e. one rights share for every two shares held in the company). A shareholder presently has the following portfolio in the company:
    - 500 shares purchased @ ₹86 per share
    - 200 shares purchased @ ₹113 per share.
    - 350 rights shares purchased in an earlier rights issue @ ₹90 per share.
    - 210 bonus shares received in an earlier bonus issue.
    - 400 shares purchased a few days ago from the market @ ₹180 per share cum rights.

    Compute the economic value of the 'right' for the shareholder.
17. In a 100% book-built offer in the Indian market, the lead manager has to provide underwriting for the Green Shoe component of the offer.
    (a) Yes (b) No
18. The green shoe option component in a public issue need not be allotted on the same lines as the NPO component. Since these are secondary shares, they should be allotted based on the under-subscription in each category of applicants.
    (a) True (b) False
19. The green shoe option is provided to the company to oversell its public offer component to the extent of 15%. Since these are secondary shares for which the company does not receive any funds, the question of deployment of those funds does not arise.
    (a) Yes (b) No
20. A company intending to make a public offer has to maintain the minimum RONW on post-issue net worth required to maintain the pre-issue EPS.
    (a) Yes (b) No
21. In a book-built IPO, the lead manager discovers the cut-off price at the level wherein complete subscriptions equivalent to one time of the offer have been received. Those bids below and above this price will be rejected.
    (a) True (b) False
22. In a 100% book-built offer, Total Offer Size – Promoters' Quota – Permitted Reservations = NPO
    (a) True (b) False
23. In a Dutch auction method for an IPO, the lead manager decides to arrive at the cut-off price by taking into consideration the single price at which the maximum number of bids have been received and ignore all other bids either above or below such cut-off price. This method is acceptable under the regulations.
    (a) Yes (b) No
24. A company decides to offer 'debentures' on rights basis and provides that each debenture comes with an attached warrant that would be compulsorily converted into a share upon payment of additional consideration. A shareholder contests the issue calling it misleading and illegal. The company defends itself by stating that this does not amount to 'tie-in' sale. The company is right.
    (a) Yes (b) No
25. A company decides to make an IPO in three distinct parts: (a) public issue of shares, (b) offer for sale of shares and (c) issue of fully convertible bonds. The pricing for all the shares is distinct from that fixed for the bonds but the company issues a common offer document explaining all the three components. This kind of issue is not allowed under the regulations.
    (a) Yes (b) No

26. In the offer document of an offer for sale, the number of shares being sold through the offer by the selling shareholders has to be mentioned, though the pricing is determined by a process of book building.
    (a) Yes (b) No
27. The NPO component is defined as:
    (a) The component left after netting out promoters' contribution and reservations from the offer document
    (b) The component left after netting out promoters' contribution and reservations from the offer in terms of the offer document
    (c) The component left after netting out promoters' contribution, reservations and QIB portions from the offer to the public
    (d) The component left after netting out promoters' contribution, reservations, QIB and HNI components from the offer in terms of the offer for sale
28. In an IPO, the investment banker decides to use a novel pricing methodology based on the following: (1) the valuation based on the present value of the future cash flow from long term supply contracts will be given 30% weightage, (2) the cost-saving from renewable energy usage will be given 20% weightage, (3) gains from forex options in the money will be given 20% weightage and (4) super-profits arising from brands will be given 30% weightage. The price per share based on normal pricing methodology works out to ₹125 per share. The novel pricing results in a pricing of ₹176 per share. Fair value based on equal application of both the methods results in a valuation of ₹150 per share. Peer valuation in the market is at ₹190 per share. The applicable price for the IPO is:
    (a) ₹125 per share (b) ₹176 per share
    (c) ₹150 per share (d) ₹190 per share
    (e) Any of the above (f) None of the above
29. The NPO in a public offer is calculated as:
    (a) 25% of paid-up capital and free reserves
    (b) 25% of the paid-up capital and cash reserves excluding goodwill
    (c) 25% of the post-issue issue equity capital for an IPO and 25% of the QIP for a FPO
    (d) 25% of the post-issue issue equity capital for an IPO and 25% of the offer for a FPO
    (e) None of the above
30. In a green shoe option, the stabilising agent has the right to refuse the repurchase of shares from a shareholder if the market price has fallen but has recovered before the repurchase.
    (a) Yes (b) No
31. A company wants to make a public offer of convertible debt securities. The investment banker says that this is not possible since the company is unlisted. The CFO of the company says that though the company is unlisted, an issue of debt securities can be made with an option to be converted into equity later on. Whose opinion is right in the context of SEBI regulations?
    (a) CFO (b) Investment banker
32. A company wants to create security on its debentures in favour of the debenture trustee. The investment banker says that this is not possible since the company is unlisted. The CFO of the company says that though the company is unlisted, a debenture trustee can be appointed for the debenture issue since listing has no relevance in the given context. Who is right?
    (a) CFO (b) investment banker
33. Nevada Properties is a company engaged in real estate development and construction. The company decides to make a public issue of a fully convertible debt security that gets converted into a REIT investment within 2 years. The REIT proposes to invest the funds in a portfolio of real estate projects. The REIT has a lock-in of 3 years whence it would be redeemable and its NAV would be published daily.

The regulator pulls up the company on the ground of misleading investors. The charge is that the company will convert a debt instrument into a real estate investment with consequent increase in risk without any choice and proper disclosure to the investor. The company claims that it would be issuing a real estate security on which SEBI has no jurisdiction to regulate. Decide.

(a) The public issue is valid (b) Misleading and therefore legally invalid

(c) Legally valid but morally invalid.

34. In a green shoe option, the company allots an additional 15% of the issue to the public shareholders. Based on market making thereafter, the market maker did not have the necessity to buy any shares from the market. Therefore, the company proceeded to allot the entire 15% shares to the promoters. One of the institutional shareholders alleges that this amounts to a creeping acquisition beyond the limit of 5% permitted under law and complains to SEBI to take action against the company and the investment banker. Who will SEBI find correct in the given situation?

(a) The shareholders (b) The company and investment banker

PART B

35. What is issue management in the Indian context? What are the important aspects thereof?
36. What are the regulations for appointment of issue managers in public offers?
37. What are the considerations in deciding the type of offer to be made and the instrument?
38. How does one arrive at pricing for an IPO? In what ways is it different from valuation of the share of acompany?
41. What are the key disclosures in an offer document for a public offer?
42. What considerations does a lead manager take into account for determining the capital structure and theissue structure?
43. Issue allocation and basis of allotment connote the same process. Do you agree with this statement?
44. Does an issuer company necessarily make the highest available price as the cut-off price in a book builtissue? If not, what are its options and what should be the considerations thereof?
45. What are the underlying factors to be considered for taking the IPO decision? Elaborate.
46. How many methods are there in making an IPO? What are their features?
47. How does the book building method score over the fixed price method? How is the issue price determinedunder the book building method?
48. Explain the procedural aspects of a book built issue.
49. Why is the listing decision so important for a company? What are its various dimensions and how does acompany consider the various aspects of these dimensions?
50. Public Issues are expensive and issuers take market risk in pricing and capital raising. The compliance cost of maintaining a listed status is also enormous. Under what circumstances does it make financial sense to consider public equity as a viable financing option?

For answers to Part A, refer to Appendix B at the end of the book.

9 Underwriting

LEARNING OUTCOMES

- This chapter deals comprehensively with the subject of underwriting which is not only an important function of investment banking but is also an important capital market service.
- Underwriting is the core function of investment banks in connection with public offers and therefore requires market infrastructure and a business model to be built by the investment banks.
- Underwriting provides the key financial guarantee required for issuer companies to take market risk and bring security issuances to investors through the public offer route.
- Underwriting follows different patterns and contractual structures in the Indian market as compared to its US counterpart.
- In the US, underwriting is a fund-based activity while it is predominantly a fee-based service model in India.

9.1 Concept and Definition

As has been discussed in earlier chapters, one of the main activity in the primary market is the issuance of new securities through public offers. Public issues are one of the most significant fund-raising methods for well established companies world over. Nevertheless, as an issuer, every company undergoes a process of uncertainty with regard to public offers. If a particular issue goes through successfully, the issuer company would be able to raise the intended amount of capital. If the issue is not successful, at the worst, the company cancels the issue and refunds all subscriptions that may have been received. In such a situation, the company has to meet entire expenses incurred for that issue out of its internal funds. This would leave the company in a worse position than it would be not making the issue at all.

The inherent risk in public offers is a serious concern for most issuers since public offers are market driven processes. No one can exactly predict the outcome of a public offer, as it is dependent on several variables. Having said that if the market risk is not mitigated in some way it would become a deterrent for issuer companies to come to the market and thereby jeopardize the growth of the capital market. Recognising the importance of this risk mitigation, the concept of underwriting evolved and has become one of the most vital services in connection with a public offer. Understandably, underwriting is one of the important core functions of an investment bank.

9.1.1 Definition

Underwriting may connote different service obligations depending upon the way it has evolved as an area of capital market service. In the Indian context, underwriting is defined in the Securities and Exchange Board of India (SEBI) (Underwriters) Regulations 1993 as *an agreement with or without conditions to subscribe to the securities of a body corporate when the existing shareholders of such body corporate or the public do not subscribe to the securities offered to them.* An underwriter, according to the same regulations means *a person who engages in the business of underwriting of an issue of securities of a body corporate.* Let us analyse these definitions.

Firstly, underwriting is always in connection with a proposed issue of securities by a body corporate. It is not a general understanding between a company and an underwriter. The specific underwriting commitment has to be documented through an underwriting agreement. Secondly, underwriting is an agreement by the underwriter to subscribe to the securities being issued *in case* the persons to whom they are offered do not subscribe to them. Therefore, underwriting is a service that consists of taking a *contingent obligation* to subscribe to an agreed number of securities in an issue if such securities are not subscribed to by the intended investors. The underwriter's job is to market the underwritten securities to investors and procure subscriptions for such securities.

Thirdly, underwriting is primarily a fee-based service provided by an underwriter since there is no fundamental obligation to subscribe to the underwritten securities. If the issue is fully subscribed to by the investors, the underwriter has no further obligation to the issue. However, if investors do not subscribe to the issue fully, the obligation falls upon the underwriter to pick up the unsubscribed portion of the issue. In such a situation, underwriting becomes a fund-based service since the underwriter has to purchase the securities that have remained unsubscribed by investors. It is due to this reason that underwriting is a risky activity for investment banks that requires careful assessment of issues before they can be taken up for underwriting. In addition, underwriting requires sufficient financial resources to be allocated to such activity.

9.1.2 Sub-underwriting

Sub-underwriting is used by an underwriter to spread the risk assumed in underwriting an issue of shares. Sub-underwriting is a process under which the underwriter appoints other people to underwrite his/her own underwriting obligation. For example, if A has an underwriting obligation with XYZ Ltd. for 10,000 shares, A may choose to appoint B and C to underwrite 5,000 shares each out of A's total obligation. B and C would then be called sub-underwriters to A and A would be the underwriter to XYZ Ltd.'s share issue. A sub-underwriter has the same obligation to the underwriter as the underwriter has to the issuer company. The underwriter normally shares the underwriting fee with the sub-underwriters for their efforts. The underwriter enters into sub-underwriting directly with the sub-underwriter through a sub-underwriting agreement.

Notwithstanding a sub-underwriting arrangement, the underwriter shall remain primarily responsible for the underwritten shares and any failure on the part of the sub-underwriters to fulfil their obligations shall not absolve or discharge the underwriter's obligation to the issuer company. In other words, the issuer company is not a party to sub-underwriting arrangements. It is not required to take cognizance of any sub-underwriting arrangements of its underwriters and can require the underwriters to fulfil their obligations even if their sub-underwriters have not done so. Since sub-underwriting agreements do not concern the issuer or the lead manager, these do not become a part of essential documentation for a public issue. However, for the purpose of ascertaining the fulfilment of obligation by an underwriter, the subscriptions procured by the sub-underwriters are also included along with those procured by the underwriter directly.

9.1.3 Underwriting Commission

The underwriter's compensation for the services rendered is the fee that is paid by the issuer company. This fee, which is known as underwriting commission, is paid as a percentage of the value of underwriting (the total number of securities underwritten multiplied by the offer price per security). Underwriting commission is payable irrespective of whether the underwriter ultimately has any requirement to purchase the underwritten securities or not. Underwriting commission should not be confused with *brokerage* that is paid to a stock broker for dealing in shares or for procuring subscriptions. Brokerage is merely a marketing commission while underwriting commission is compensation for taking underwriting risk besides procuring subscriptions.

The payment of underwriting commission is governed under the articles of association of the company and if the articles prescribe a rate, such rate shall apply. Within the ceiling prescribed under the articles, an issuer company is free to negotiate lower rates of commission with underwriters. SEBI regulations do not prescribe any ceilings on issue and underwriting costs.

9.1.4 Underwriting Agreement

The underwriting agreement is the document that establishes the contract between the underwriter and the issuer company. It forms a part of material contracts for the issue and requires to be approved by the concerned stock exchange apart from being filed with the ROC as part of the prospectus registration. The SEBI evolved a model underwriting agreement, which is recommended and should be followed to the extent possible by all underwriters. The present regulations do not prescribe any format as such. An underwriting agreement should contain the following main provisions:

- Amount being underwritten
- Provision for sub-underwriting
- Computation of devolvement
- Procedure for effecting or discharge of underwriting obligations
- Right to receive commission as per agreed terms
- Statutory declarations

9.2 Regulatory Framework

Underwriting activity in India is regulated under the SEBI (Underwriters) Regulations 1993 as amended from time-to-time. The regulatory framework for underwriting activity under the above said regulations is summarised as:

- Underwriting business can be taken up by financial institutions, commercial banks, mutual funds, merchant bankers registered with SEBI, stock brokers and NBFCs. All the above entities except registered merchant bankers are required to be registered as underwriters with SEBI.
- All underwriters shall have necessary infrastructure, past experience, minimum of two employees and shall comply with the minimum capital adequacy requirement as stipulated from time-to-time and further comply with additional capital adequacy requirements of the concerned stock exchanges.
- Underwriters have to enter into legally binding agreements with the issuer companies. The underwriting agreements have to be approved by the stock exchange wherein the shares are proposed to be listed.
- In the case of financial institutions, banks and mutual funds, the issuer company has to apply separately prior to finalisation of the issue for underwriting support.
- Underwriting commissions shall be as per the terms of the underwriting agreement.

- All underwriting contracts have to be classified as material contracts and disclosed as such in the offer document and filed with the Registrar of Companies prior to the issue of the offer document.
- Sub-underwriting is permissible provided there are contracts to evidence the same.

Besides the above points, underwriters should also comply with a Code of Conduct in conducting their business. The code prescribes *inter alia*, the following main provisions:

- Underwriters should avoid conflict of interest and make necessary disclosures of their interests, if any.
- An underwriter should abide by the award of the Ombudsman in case of disputes with the issuer company in arriving at contractual obligations and liabilities.
- An underwriting firm or any of its employees shall not render directly or indirectly, any investment advice about any security publicly unless a disclosure of its interest has been made as prescribed.
- Underwriters or their employees, directors, etc., cannot indulge in insider trading in the securities they underwrite.

9.3 Devolvement

The amount of financial support to be provided by an underwriter in an under-subscribed issue of securities is known as *devolvement*. Devolvement happens when an underwriting firm procures lesser subscriptions from investors than what has been underwritten by it. However, the extent of devolvement on an underwriter also depends upon the extent of subscriptions procured by other underwriters to the issue and the overall performance of the issue. If a particular underwriter has been able to market the issue and procure enough subscriptions to cover his or her underwriting completely, such underwriter will not face any devolvement even if the issue has been under-subscribed overall.

The following method of computation is recommended by SEBI for the purpose of arriving at devolvement of underwriters.

1. All eligible applications received from investors towards subscriptions for the securities in the issue shall go to reduce underwriters' obligations to that extent. However, to ascertain each underwriter's devolvement, if any, the following steps should be followed in sequence.
2. All procurements made by a particular underwriter or his/her sub-underwriters out of (1.) above, shall be allocated to that underwriter.
3. All applications forming part of (1.) above but invested directly by investors without being routed through underwriters/sub-underwriters shall be allocated *pro-rata* to all underwriters in the ratio of their underwriting obligations.
4. After following steps (2.) and (3.), if any underwriter has been allocated more than his/her underwriting obligation, such excesses shall be allocated pro-rata to other underwriters who still have a deficiency.
5. Devolvement is the positive balance that remains in the account of a particular underwriter after the above steps are completed. If the issue is fully underwritten, the total of all the individual amounts of underwriter devolvement shall be amount of under-subscription in the issue.

ILLUSTRATION 1

ABC Ltd. makes an issue of 10,000 shares of ₹10 each at par aggregating to ₹1,00,000. The issue has been underwritten fully by two underwriters X and Y to the extent of ₹50,000 each. The issue has been closed and the following is the information available on the subscriptions.

	Amount ₹
Valid subscriptions received –	76,500
Received through underwriter X–	27,500
Received through underwriter Y–	34,800
Direct subscriptions received –	14,200

Examine the underwriters' devolvement.

Solution:

			Amount ₹	
	Total shares on offer	–	1,00,000	
	Valid subscriptions received	–	76,500	
	Under-subscription (Total devolvement)	–	23,500	
	Computation of individual devolvement	–	X	Y
	Total underwriting obligation	–	50,000	50,000
Less	Valid subscriptions procured	–	27,500	34,800
Less	Direct subscriptions allocated	–	7,100	7,100
	Devolvement (₹)	–	15,400	8,100

It may be observed that the total of the individual components of devolvement is equal to the under-subscription in the issue.

ILLUSTRATION 2

ABC Ltd. makes an issue of 10,000 shares of ₹10 each at par aggregating to ₹1,00,000. The issue has been underwritten fully by four underwriters P, Q, R and S extent of ₹20,000, ₹30,000, ₹35,000 and ₹15,000 respectively. The issue has been closed and the following is the information available on the subscriptions.

		Amount ₹
Valid subscriptions received	–	76,500
Received through underwriter P	–	11,700
Received through underwriter Q	–	22,400
Received through underwriter R	–	8,300
Received through underwriter S	–	22,600
Direct subscriptions received	–	11,500

The underwriters are paid a commission of 2.5% on subscriptions received and 2% on devolvements. Compute the underwriters' devolvement and the commission receivable by each of them.

Solution

			Amount ₹			
	Total shares on offer	–	1,00,000			
	Valid subscriptions received	–	76,500			
	Under-subscription (Total devolvement)	–	23,500			
Computation of individual devolvement		–	*P*	*Q*	*R*	*S*
	Total underwriting obligation	–	20,000	30,000	35,000	15,000
Less	Valid subscriptions procured	–	11,700	22,400	8,300	22,600
Less	Direct subscriptions allocated	–	2,300	3,450	4,020	1,730
	Gross devolvement	–	6,000	4,150	22,680	(9,330)
Less	negative balance of S allocated	–	2,200	3,290	3,840	9,330
	Net Devolvement (₹)	–	3,800	860	18,840	0

It may be observed that the total of the individual components of net devolvement is equal to the under-subscription in the issue. It may also be noted that the devolvement when added up with the procurement and allocation of each underwriter, should be equal to the underwriting obligation of respective underwriter. All figures have been rounded off in multiples of ₹10 since the devolvement has to result in subscription to shares of ₹10 each.

From the above basis of arriving at devolvements, it may be understood that a bigger underwriter gets a higher allocation of direct subscriptions and negative balances of other underwriters. For instance, in the above illustration, *R* gets an allocation of ₹4020 from direct subscriptions, which is the highest among all underwriters. It may be noted that this is because such allocation is made pro-rata on the basis of underwriting obligations and not on the basis of procurements. Due to this reason, it may be observed that *Q* gets an allocation of only ₹3450 though *Q* has procured almost three times more than *R*. It may thus be deduced that in under-subscribed issues wherein the direct subscriptions are high, those underwriters who have underwritten more and procured less benefit more than those who underwrite less and procure more.

Computation of underwriting commission		*P*	*Q*	*R*	*S*
Valid subscriptions procured	–	11,700	22,400	8,300	22,600
Commission @ 2.5% (A)	–	292.50	560.00	207.50	565.00
Net Devolvement	–	3,800	860	18,840	0
Commission @ 2.0% (B)	–	76.00	17.20	376.80	0
Total commission receivable	–	368.00	577.20	584.30	565.00
Overall underwriting commission (%)	–	1.84	1.924	1.70	3.77

It may be observed from the above pattern of determination of underwriting commission that the maximum reward goes to the underwriter whose procurements are the maximum irrespective of the amount underwritten. Therefore, *S* gets the maximum commission though the amount underwritten by *S* is the least. As a corollary, *R*, who is the least efficient of all the underwriters, gets the least percentage of commission though the amount underwritten by *R* is the maximum. In addition, *R* has to take a fund exposure of ₹18,840 in the issue, the highest among all. If one were to consider the interest cost on the amount invested by *R* at say 10% for two months, the net rate of overall underwriting commission falls to just 0.77% which is a full 3% less than that of *S*.

This basis of payment of underwriting commission is just and equitable since it provides an incentive for an underwriter to market an issue rather than to merely underwrite it. From an issuer's perspective, it would be better for the issue to be marketed extensively so as to achieve a wide spread of shareholding than to get the shares concentrated into the hands of a few underwriters.

9.3.1 Devolvement Notice

As per SEBI's model underwriting agreement, the following procedure is envisaged in the case of an under-subscribed issue.

- The issuer company shall within 30 days after the date of closure of the subscription list communicate in writing to the underwriter (the devolvement notice), the total number of securities remaining unsubscribed, and the number of securities to be taken up by the underwriter or subscriptions to be procured therefor.
- The company shall make available to the underwriter the manner of computation of devolvement and also furnish a certificate in support of such computation from the company's auditors.

- The underwriter on being satisfied about the extent of devolvement, shall within 30 days after the receipt of the devolvement notice, make or procure the applications to subscribe to the securities and submit them along with the required payment to the company.
- In the event of failure of the underwriter to do so, the company shall be free to make alternative arrangements without prejudice to legal remedies against the underwriter for failure to meet devolvement requirements, including the right to claim damages.

From the above mechanism, it is evident that if a company has to enforce devolvement on underwriters, it has to initially close the issue and declare it to be an under-subscribed issue. Thereafter, it has to send devolvement notices to respective underwriters. Many a times, issuer companies hesitate to go through the devolvement route since that would cause humiliation in public. In addition, the company has to live with the stigma of a devolved public issue, which could even affect its market prospects and the opportunity to make future public offers. Due to this reason, several issuer companies prefer to get underwriters to bail out an issue prior to closure of subscription lists so that the issue can be officially closed as a successful issue.

It may be understood that when an issue has not fared well, the company has two options, either to get the issue bailed out prior to close of the subscription lists with the help of underwriters, brokers and other large investors, or to go through the devolvement route by declaring the issue under-subscribed and issuing devolvement notices to underwriters. In borderline cases, more often than not, companies prefer the first option. Only if the issue is heavily under-subscribed and they are compelled, companies go through the second option.

9.4 Business Model

Underwriting is essentially a fee-based business though many a times, if underwritten issues are not successful, the underwriter ends up with a significant exposure to issuer companies and consequently to market risks. Keeping this in view, SEBI has prescribed the requirements of minimum capital adequacy and a cap on the underwriting obligations that can subsist at any given time. Regulation 7 prescribes the minimum capital adequacy is ₹20 lakh and Regulation 15 prescribes that the maximum underwriting obligations cannot be more than 20 times the net worth of the underwriter.

There are several investment banks that specialise in underwriting and do not get into issue management per se. These firms depend upon underwriting commission as the principal source of income. However, since the business model is fraught with risks, they develop an extensive network of sub-underwriters, brokers and distribution agents to market the securities underwritten by them. This is because, as seen in Illustration 2, an underwriter firm's first objective is to be in a safe position by covering the underwriting obligation with procurement so that there can be no devolvement on it irrespective of the fate of the issue.

The main drivers to a viable underwriting business model are: the net worth of the underwriter since it determines the volume of business that can be undertaken; the amount of devolvement; and capital losses arising therefrom. Let us try to see how this works with an illustration.

ILLUSTRATION 3

Assumptions:
Present Net worth – ₹25 lakh
Devolvement probability – 0.25
Devolvement quantum – 50%
Cost of debt – 12%

Average cycle time – 3 months
Underwriting commission – 2.5% on procurement and devolvement
Tax rate – 30%
Capital loss on devolved securities = 15%

Solution

Based on the above assumptions, the business projection can be worked out as follows:

Business Cycle		*Q1*	*Q2*	*Q3*	*Q4*	*Total*
Present Net worth		25.00	26.40	27.88	29.44	
Maximum Underwriting	20	500.00	528.00	557.57	588.79	
Devolvement probability	0.25	125.00	132.00	139.39	147.20	
Devolvement quantum	50%	62.50	66.00	69.70	73.60	
Loan financing required		37.50	39.60	41.82	44.16	
Cost of debt (Qtr)	3%	1.13	1.19	1.25	1.32	
Underwriting Commission	2.50%	12.50	13.20	13.94	14.72	
Capital loss on devolved securities	15%	9.38	9.90	10.45	11.04	
PBT		2.00	2.11	2.23	2.36	
Tax	30%	0.60	0.63	0.67	0.71	
PAT		1.40	1.48	1.56	1.65	**6.09**

If the above model is analysed further, it is observed that every 1% increase in devolvement probability leads to a 24% decline in annual profit. Similarly, a 1% increase in devolvement quantum leads to a 12% decline in annual profit. Continuing further, a 1% increase in capital loss on devolvement leads to a 33% drop in annual profit. Since underwriting is a capital driven business, an operating loss has a spiralling effect by eroding net worth on one hand, and impacting future volume of business on the other.

From the above discussion, it emerges that an underwriter has to endeavour to minimise the impact of the above three factors to create a successful business model. This can be accomplished through improved distribution networks and investor base, qualitative assessment of issues to be underwritten and building financial strength so as to minimise distress sale of devolved securities in the secondary market post-listing.

9.5 Underwriting in Fixed Price Offers

Under the present regulatory framework, underwriting is optional for a fixed price offer. Therefore, if an issuer company feels that the issue is strong enough to sell on its merits, it may decide to take the risk and opt for not underwriting it. In such a case, the company only pays brokerage for marketing its securities to investors and saves on underwriting commission. The underwriting decision is normally taken in consultation with the lead manager who has a good understanding of the market.

The regulations further stipulate that if a fixed price offer is underwritten, the lead manager(s) managing the issue shall undertake a minimum obligation of 5% of the total underwritten amount or ₹25 lakh whichever is lower. This regulation supposes that in stipulating a mandatory participation of lead manager in the underwriting risk of the issue, a sense of responsibility would be inculcated to bring quality issues to the market.

9.6 Underwriting in Book-built Offers

As per prevalent regulations, underwriting is compulsory in book-built offers to the extent of the NPO and the issuer company does not have any discretion therein. For a company that satisfies the standard eligibility conditions for an IPO, it has the choice of making a book-built offer to the extent of 100% of its NPO. In such a case, underwriting becomes mandatory for the entire NPO. However, if a company is making a compulsory book-built offer under the alternative eligibility condition, underwriting cannot be done for the compulsory portion of 75% of the NPO that needs to be subscribed only by QIBs. In such cases, underwriting would be mandatory only to the extent of 25% of the NPO that is to be offered to non-QIB investors. Underwriting has to be done by the book runners and the syndicate members.

In book-built offers, the book runner assumes the responsibility for the overall underwriting. In case there is more than one book runner, the inter-se allocation among the book runners determines the extent of their obligation. The book runner(s) enter into underwriting agreement with the issuer company. In the case of an under-subscription in the issue, it devolves on the book runners.

In order to spread the risk, the whole underwriting obligation is shared between the book runners and the syndicate members and is coordinated by the book-runner in-charge of syndicating the underwriting. The syndicate members enter into an underwriting agreement with the book runner(s) indicating the number of securities that they wish to subscribe at the predetermined price. However, in the event of the syndicate member(s) failing to fulfill their underwriting obligation, the book runner(s) shall be responsible for bringing in the amounts required to make good devolvement.

> The Company and the Underwriters have entered into an Underwriting Agreement for the Equity Shares proposed to be offered through the offer. Pursuant to the terms of the Underwriting Agreement, the Book Running Lead Managers (BRLMs) shall be responsible for bringing in the amount devolved in the event that the members of the Syndicate do not fulfil their underwriting obligations. Pursuant to the terms of the Underwriting Agreement, the obligations of the Underwriters are subject to certain conditions to closing, as specified therein The above Underwriting Agreement is dated —. In the opinion of our Board of Directors and the BRLMs (based on a certificate given by the underwriters), the resources of all the above mentioned underwriters are sufficient to enable them to discharge their respective underwriting obligations in full. All the above-mentioned underwriters are registered with SEBI under Section 12(1) of the SEBI Act or registered as brokers with the Stock Exchange(s). Allocation among underwriters may not necessarily be in proportion to their underwriting commitments. Notwithstanding the above table, the BRLMs and the Syndicate Members shall be responsible for ensuring payment with respect to Equity Shares allocated to investors procured by them. In the event of any default in payment, the respective underwriter, in addition to other obligations defined in the Underwriting Agreement, will also be required to procure/subscribe to the extent of the defaulted amount as specified in the Underwriting Agreement. Allotment to QIBs is discretionary as per the terms of this prospectus and may not be proportionate in any way and the patterns of allotment to the QIBs could be different for the various underwriters.

Exhibit 9.1 Standard Disclosure of an Underwriting Agreement and Obligations of Underwriters in an Offer Document for a Book-built Offer

9.7 Assessment of an Issue for Underwriting

As explained above, the critical risk factors in underwriting business are—devolvement probability, devolvement quantum and capital loss from devolved securities. As a corollary, in order to mitigate these risks, the critical success factors are capital adequacy and the capacity to procure subscriptions. Capital adequacy comes through financial strength but it would not suffice unless the capacity to procure is augmented with it. The capacity to procure depends upon the distribution network and investor base of the underwriter and the marketability of an issue. While underwriters build an expansive network of brokers, sub-brokers and marketing agents over a period of time, they have to carefully assess the marketability of every issue that they underwrite.

Assessment of an issue for underwriting should always be made from an investor's perspective since the issue is successful only when it finds favour with investors. As explained in Chapter 3, institutional investors look at primary issues from the perspective of medium-term growth while the retail investors by and large, look for short-term profit booking within the first 3–6 months after listing. Institutional investors are driven more by the fundamentals of the issue and are therefore keen to wait for appreciation in the market price over a longer time frame of one to two years. A lot depends on factors such as the industry, pricing of the issue, fundamentals at the time of issue, past track record, soundness of the business plan, financial performance, level of brand visibility, etc. These factors determine the equilibrium price of the company's share in the market that a large investor looks for. However, retail investors are driven more by profit motive and arbitrage opportunities than by fundamentals. Therefore, what matters more to retail investors is the affordability of the share, post-issue floating stock and possibility of price appreciation.

Keeping the above mind-set of institutional, HNI and retail investors in mind, underwriters have to look at the potential of the issue to meet these expectations and their own distribution strengths to reach these investors. Many underwriters and brokers develop a strong and loyal investor base that can support significant number of issues. Underwriters have to convince these investors and recommend the issue strongly. Needless to say, unless investors make money through such recommendations, the support will not continue. Therefore, underwriters have to assess the above factors thoroughly and arrive at the optimum level of subscription they can expect from their own investor base for a particular issue before entering into an underwriting commitment.

9.8 Safety Net

- 'Safety net' is a mechanism whereby an issuer company enters into an understanding with its merchant bankers or underwriters or any other financial intermediary to provide a limited period facility to investors subscribing to the issue. The arrangement would be to provide the investors with a buyback facility for the securities subscribed by them in the public issue at the issue price. For example, if an investor has been allotted 100 securities in a public issue at a price of ₹60 per security, if a safety net has been offered by the company, the investor may choose to sell all or any of those securities to the safety net provider for a price of ₹60 per security. Obviously, the investor would choose to exercise the safety net only if the market price falls below the offer price in post issue trading. SEBI has imposed certain regulations on the operation of a safety net keeping in view the need for such facility to be provided only for small investors. Therefore, the following regulations apply to safety net arrangements: Any safety net scheme or buyback arrangements of the shares proposed in any public issue shall be finalised by issuer company with the lead merchant banker in advance and disclosed in the prospectus.
- Such buyback or safety net arrangements shall be made available only to all original resident individual allottees.
- Such buyback or safety net facility shall be limited up to a maximum of 1,000 securities per allottee and the offer shall be valid at least for a period of 6 months from the last date of despatch of securities.
- The financial capacity of the person making available buyback or safety net facility shall be disclosed in the draft prospectus.

Safety net is thus an additional protection that may be made available by an issuer company to small investors entirely at its option. Issuer companies usually do so as a marketing factor for the issue. Secondly, providing a safety net in a high priced issue may also send a signal to prospective investors about the confidence of the company in its pricing and post-issue performance of the scrip.

The financial intermediary or underwriter that provides the safety net has to be covered for all losses that it may book on account of purchase of shares at the issue price from investors. This would however depend on the understanding reached with the company and the promoters. Under the provisions of the Companies Act, the company cannot offer to buyback such securities or compensate for the losses. Therefore, the safety net provider has to exit either through the market by holding on to such securities for a period of time or sell them to the promoters at some agreed price so as to book some profit. In addition to the arrangement reached for disposal of purchased securities, the safety net provider may negotiate remuneration to be paid by the issuer company for its services.

Safety net was used in some public in earlier years such as Infotech Enterprises Ltd. wherein the lead manager IDBI Bank had offered a safety net. In recent times, the RBI instructed banks to refrain from providing such services in connection with public offers. However, other financial intermediaries may still do so. Safety net provision will not be required as the market matures and issuers become more responsible in issue pricing and investors become more equipped to make informed investment decisions.

9.9 Underwriting—US Model

Underwriting is the core function of investment banks in the US with regard to floatation of new securities in the primary market. This is the reason that many a times they are referred to as underwriters or lead underwriters instead of being called lead managers as in India. Given the crucial role played by underwriters in the US public offer delivery model, the entire issue activity is largely determined through underwriters and their syndicates. The lead underwriters not only syndicate underwriting but also decide on the issue pricing, allocations to underwriters and syndicate members. The syndicate members and security firms play an influential role in determining the allocations to their investors. The top equity underwriters in US market include Goldman Sachs, Merrill Lynch, Morgan Stanley Dean Witter, Credit Suisse First Boston and J.P. Morgan. Top debt underwriters include Merrill Lynch, Donaldson Lufkin Jenrette and Morgan Stanley Dean Witter.

9.9.1 Definition

Underwriting as discussed so far in this chapter from the Indian perspective is more of contingent obligation on the underwriter to purchase securities issued by the company. In the US system of public offers, underwriting has a wider meaning and follows a different model. According to the Bloomberg definition, to underwrite is '*to guarantee, as to guarantee the issuer of securities a specified price by entering into a purchase and sale agreement to bring securities to the market*'. An underwriter has thus been defined as '*a firm, usually an investment bank, that buys an issue of securities from a company and resells it to investors. In general, a party that guarantees the proceeds to the firm from a security sale, thereby in effect taking ownership of the securities*'.

At the outset, underwriting as per the above definition is a contract of purchase and sale. It guarantees the issuer company of purchase of specified securities by the underwriter at a specified price. The underwriter resells the purchased securities to investors. This function of underwriting is performed by the underwriting syndicate which is a group of investment banks that work together to sell new security offerings to investors. The underwriting syndicate is led by the lead underwriter who is the head of a syndicate of financial firms that are sponsoring an initial public offering of securities or a secondary offering of securities.

9.9.2 Types of Underwriting

Under the prevalent US market mechanism, there are broadly two types of underwriting—firm underwriting and best efforts underwriting. Most of the issuers prefer the first route since the risk to the issuing company is passed on to the underwriter. Best efforts underwriting is used when the underwriters are not confident of being able to sell the issue to the investors.

In firm underwriting, the underwriter enters into a purchase contract with the company. The price of the securities is frozen a day before or usually on the morning of the date on which the registration statement becomes effective. By such time, the underwriters would have completed the road shows and marketing for the issue and would have practically pre-sold the issue to investors although technically, investors' bids cannot be accepted until the registration statement becomes effective. Therefore, the price is fixed based on the response received from investors and the spread required by the underwriters. The lead underwriter in consultation with other underwriters negotiates with the company and finalises the price of the securities for the public offer. Thereafter, the issue is sold to investors through allocations to various syndicate members and dealers.

In best efforts underwriting, which is very uncommon in the US market, the underwriting is more on the lines of an agency function as is the case with brokerage houses in India. The investment banks would make best efforts to sell the stock and whatever is not sold is not issued by the company. Therefore, in this model, there is no contract for purchase and sale by the underwriter. There is only an agreement to market the securities for a consideration. Therefore, it is a non-fund activity for investment banks and as such not very popular. It is resorted to when companies are small and relatively unknown.

9.9.3 Underwriting Documentation

There are mainly three underwriting contracts that are drawn up in firm underwriting. The first and most important is the *Underwriting Agreement* which is the contract between a corporation issuing new publicly offered securities and the managing underwriter as agent for the underwriting group. This agreement is signed between the issuer company and the lead underwriter, which is a contract for purchase and sale of the securities being issued. The lead underwriter agrees to purchase the securities at an agreed price that is determined just before the contract is signed. As already stated, this happens hours before the registration statement becomes effective. The underwriting agreement provides for the terms of the offering, which include the underwriter's representation to buy and pay for the securities, the timing of the offer and green shoe option if any, available to the underwriter. The agreement also provides for a cancellation clause whereby the underwriter may withdraw the offer after the effective date but before closing date due to specified reasons.

The second contract is the *Agreement among Underwriters* that defines the mutual obligations between all the members of the underwriting syndicate inter se. It designates the syndicate manager who would represent them. The lead underwriter is usually the syndicate manager. This agreement draws up the underwriting obligations of the members of the syndicate.

The third contract is the *Dealer Agreement*, which is basically a distribution agreement akin to a brokerage contract in India entered into market the securities. The dealers, known as the *selling group* are not part of the underwriting syndicate and have no role in underwriting the offer. They are security firms that are contracted merely to distribute the securities and move the market. Unlike brokerage contracts in India for a public offer, dealers in US offers are not paid a fee for distribution services. Instead, the dealer agreement provides for the dealers to purchase securities generally at a discount to the offer price so that they can sell them to investors at the issue price. Therefore, the dealers make a profit on the securities dealt with by them for the public offer.

9.9.4 Underwriting Compensation

As stated above, in firm underwriting the pricing of the offer is determined just before the registration statement becomes effective. However, this is the price at which securities are offered on the face of the prospectus and therefore, the price the investors pay for subscribing to the securities on offer. This is however not the price which the issuer company gets. The issuer company gets a lower price, which is determined through negotiations with the lead underwriter. The spread between the price to the investor and price received by the issuer is known as the *underwriting spread*. It is also known by other names such as *underwriting discount* or *gross spread* or *selling concession*. All the members of the syndicate are paid out of this spread. The varying amount of underwriting obligation and risk taken up by each syndicate member is reflected in the compensation schedule.

In addition to the underwriting spread which is basically the return for the underwriting risk, the lead underwriter is also paid a *manager's fee* as compensation for preparing the offer. This is also the compensation for conducting the key functions of due diligence review on the issuer company, structuring the offer and syndicating the underwriting.

To cover the expenses incurred by the underwriting syndicate such as advertisement, legal expenses and out of pocket expenses to distribute the offering, an *underwriting allowance* is also paid by the issuer company.

Lastly, there is a *selling commission* that is paid to dealers (selling group) under the dealer agreement that is allocated among all the dealers based on the amount of securities they accept to sell. This is structured as a dealer discount as explained earlier.

From the above discussion, it is evident that a lead underwriter gets three types of compensation from the issuer company—the manager's fee; the underwriting allowance and the underwriting spread. The other syndicate members get the underwriting spread and a share of the underwriting allowance from the lead underwriter. The dealers get selling commission and a portion of the underwriting allowance from the syndicate members.

ILLUSTRATION 4

American Corporation wishes to make a public offer of 10 million shares. After road shows, the lead underwriter Morgan Stanley makes an assessment that the issue could be sold to investors at $25 per share. Based on the above assessment, the price to the issuer is negotiated and fixed at $22.5 per share. Expenses are capped at 1% of the issue and manager's fee at 0.5%. The syndicate consists of four other underwriters with of them taking 15% of the total underwriting. Each underwriter has a dealer network. Each syndicate member negotiates a dealer discount of 5%. Determine the compensation schedule.

Solution

The total offer size is $250 million and the cash to Issuer Company would be $225 million less deductions for expenses amounting to a total of 1.5% of the size of the issue, i.e. $3.75 million. Therefore, net cash to company would be $221.25 million making the total issue expenses 11.5% of the issue size.

The total cash kitty available to underwriters and the selling group would be $28.75 million. This consists of an underwriting spread of $25 million, expense fund of $2.50 million and manager's fee of $1.25 million.

1. Lead underwriter's underwriting obligation is 40% of the issue amounting to $4 million shares. The total underwriting spread to be received @ $2.5 per share is $10 million. Dealer discount thereon amounts to $1.25 per share amounting to $5 million. Net underwriting spread to lead underwriter is $5 million. The total compensation including other components would be as follows:

Manager's fee	-	0.5% of issue size (10,000,000 × 25)	=	1,250,000
Expenses	-	1% of underwriting obligation	=	1,000,000
Net underwriting spread	-		=	5,000,000
Total				7,250,000

2. Each syndicate member receives the following:

Expenses	-	1% of underwriting obligation	=	3,75,000
Net underwriting spread	-		=	1,875,000
Total				2,250,000

3. All selling group members receive a collective compensation of $ 12.5 million.
4. Reconciliation

Lead underwriter	=	7,250,000
Syndicate members	=	9,000,000
Dealers	=	12,500,000
Total		28,750,000

MakeMyTrip Ltd.'s Offer on NASDAQ

The following disclosure was provided in the Prospectus with regard to underwriting.
The following table sets forth the underwriting discounts and commissions:

	Per Share		*Total*	
	Without Over-allotment	*With Over-allotment*	*Without Over-allotment*	*With Over-allotment*
Underwriting discounts and commissions	$ 0.78	$ 0.78	$ 4,090,320	$ 4,703,868

The estimated expenses of this offering that are payable by us, exclusive of the underwriting discounts and commissions, are approximately $1.0 million, including registration fees of approximately $24,200, estimated printing fees of approximately $150,000, estimated legal fees and expenses of approximately $650,000 and estimated accounting fees and expenses of approximately $90,000. The underwriters have agreed to pay for certain expenses in connection with this offering.

9.9.5 Underwriter's Risks in Firm Underwriting

The lead underwriter assembles the entire underwriting syndicate and a selling group. While the syndicate takes on the underwriting risks in the offer, the selling group does not assume any risk. The lead underwriter tries to spread the underwriting risk across the syndicate by entering into the agreement among underwriters as discussed earlier. Therefore, in firm underwriting contracts, the lead underwriter is responsible for purchase of the securities from the issuer company. This purchase obligation is spread among the syndicate by the lead underwriter. As far as the issuer company is concerned, the lead underwriter is responsible.

The main risk in firm underwriting in this model is the risk of being saddled with unsaleable stock. According to Thomas Liaw, this is a combination of waiting risk, pricing risk and marketing risk. Waiting risk is the risk of adverse market trends during the waiting period prior to the registration statement becoming effective. This risk is largely borne by the issuer company since at this stage the underwriting agreement is not yet entered into. This risk is mitigated to some extent by making arrangements for shelf registration of prospectus, which the SEC rules allow.

Pricing risk is the risk of over pricing the offer. This risk is borne by the underwriters. The risk mitigation mechanism is to execute the underwriting agreement just before the registration statement becomes effective.

By this time the market mood would have been assessed adequately for the lead underwriter to take the pricing decision. However, the actual pricing risk occurs when the market goes adverse in the days following the signing of the underwriting agreement.

Marketing risk is the inability to spread the securities among investors. To mitigate this risk, the lead underwriter spreads the underwriting among a broad group of syndicate who move the market for the stock not only prior to the offer, but also in after-market trading. If underwriting is spread widely, it also ensures publicity and coverage by research analysts.

In addition to the above risks identified by Thomas Liaw, there is an additional significant risk, which is the risk of the stock trading at below the offer price in after-market trading. This risk arises when the offer was overpriced, or the issue is sub-standard, or the marketing was improper or there is undue selling pressure from short-term investors. This is a major risk for underwriters since it tarnishes their image and credibility in the new issue market. In such cases, the underwriters resort to price stabilisation by providing buying support. If stabilisation is done, SEC rules do not allow underwriters to sell the stock purchased under stabilisation at more than the purchase price. Losses incurred due to stabilisation are shared equally by the underwriters. However, if price continues to fall, underwriters may withdraw stabilisation support at their discretion. In order to mitigate this risk, underwriters are choosy about their selling syndicates and allocations. The selling syndicates in turn are choosy about their investors. Many a times, bulk placements to large institutional investors are preferred to prevent selling pressure. Even in the case of non-institutional investors, the securities firms allocate shares to investors based on their track record with them. They discourage investors with short-term perspective and disqualify those who regularly sell securities in the first 15–30 days of listing.

9.9.6 Green Shoe Option

The concept of a green shoe option and its functioning in the Indian capital market has been discussed in Chapter 8. Green shoe options are prevalent under the US regulations that allow issuer companies to issue additional securities in a public offer. In public offers wherein there is huge demand for securities, the SEC regulations permit issue of additional securities at the issue price. Green shoe option can be exercised up to an additional 15% of the issue size within 30 days from the effective date. The additional securities should be used to cover allotments to customers.

Since in firm underwriting, the underwriter takes all the risks, under the US system, it is the underwriters who take the call on exercising the green shoe option judging the response to the issue. The prospectus has to disclose the fact that the green shoe option may be used by the underwriters. The green shoe option is exercised by the underwriters only when there is unsatiated demand for the stock in the offer. The issuer company benefits from the additional proceeds net of underwriting compensations. Green shoe is therefore an option given to the underwriter to make excess allocations if required in a hot issue.

Case Study

MakeMyTrip Ltd.'s Offer on NASDAQ

The following disclosure was provided in the prospectus with regard to Green Shoe Option:

"We and certain selling shareholders have granted to the underwriters an option, exercisable for 30 days from the date of this prospectus, to purchase up to an additional 2,17,500 ordinary shares from us and 5,69,100 ordinary shares from such selling shareholders at the public offering price set forth on the cover page of this prospectus, less the underwriting discounts and commissions set forth on the same. The underwriters may exercise such option solely for the purpose of covering over-allotments, if any, made in connection with the offering of the ordinary shares offered by this prospectus. To the extent the option is exercised, each underwriter will become obligated, subject to certain conditions, to purchase about the same percentage of the additional ordinary shares as the number listed next to the underwriter's name …bears to the total number of ordinary shares listed next to the names of all underwriters…".

9.10 Comparison of Indian and US Models

Based on the discussion so far, it is possible to now construct a comparative analysis of the respective underwriting patterns in Indian and US capital market (Table 9.1).

Table 9.1 Comparative Scheme of Underwriting

Process	*India*	*US*
Nature of service	The Indian model is fee-based and becomes contingently fund-based	The US model is fund-based.
Method of underwriting	Standby support that would devolve on the underwriter only if the issue is under-subscribed	Firm underwriting wherein the underwriters guarantee the issue irrespective of investors' response
Nature of underwriting contract	It provides a contingent obligation on the underwriter to purchase the securities on offer	It is a contract of purchase and sale wherein underwriters purchase securities from the issuer at a lower price and sell them to investors at the offer price
Purchase price of securities	At the offer price	At a discount to offer price. The lead underwriter on behalf of the syndicate negotiates the price with the issuer company. Sometimes this could be through competitive bidding between different underwriting syndicates, especially if the issuer is a large corporation. The price at which dealers get the securities is negotiated by each syndicate member with its respective dealer network
Extent of obligation to purchase	To the extent of devolvement	To the extent of amount underwritten
Role of underwriter	Providing marketing support, moving the market through distribution and taking up devolvement if any	Taking the risk of guarantee, pricing the offer, moving the market and allocations to dealers and investors
Compensation	Underwriting commission. This is a fee earmarked as a percentage to the underwriting obligation	Main compensation is the underwriting spread, i.e. the spread between offer price and the price paid to the issuer company. This is a profit (or loss) on the purchase and sale of securities
Nature of underwriting risk	Contingent risk that is a function of market risk, waiting risk and pricing risk	Actual risk which is a function of market risk, waiting risk and pricing risk

(*Contd.*)

Green shoe option	Decided by the issuer. Used in an over-subscribed offer to provide additional allotments to investors	Decided by the underwriter. Used in an over-subscribed issue to provide additional allocations to investors
Price stabilisation	Compulsory when green shoe option is exercised. Price stabilisation is used to prevent price crash due to excess liquidity. Funds used for price stabilisation are those collected from investors out of the green shoe option. There would not be any losses on account of price stabilisation. Price stabilisation is complementary to green shoe option	Used in an under-subscribed or weak offer to support issue price in after-market trading. Funds used for price support are those of the underwriters. Losses arising from price stabilisation are borne by underwriters. Price stabilisation is the antithesis of green shoe option
Allocations	Allotments are made directly to investors as per SEBI guidelines by the issuer company in consultation with the stock exchange. Post-issue lead manager oversees the function. Therefore, allotments are governed by statutory norms	The lead underwriter decides allocation of shares to syndicate members. The syndicate members in turn decide allocations to their investors and dealers. Dealers decide allocations to their investors. Allocations are entirely at the discretion of underwriters
Documentation	Underwriting agreement is between issuer and each underwriter; broker agreement is between issuer and broker to issue	Underwriting agreement is between issuer and lead underwriter; agreement among underwriters is between syndicate members; dealer agreement is between syndicate member and dealer

9.11 Bought Out Deals

Bought Out Deals (BODs) were of common occurrence in the IPO boom in the early nineties in India during which several companies went public through a BOD and subsequent offer for sale to the public. Bought out deal is an alternative to a straight IPO (retail or book-built) whereby a company places certain amount of stock with an investment bank with the understanding that it would take the company public by making a secondary offer within an agreed time frame. The term 'bought out deal' refers to the fact that the investment bank buys the entire stock meant to be issued to the public from the issuer company. Thereafter, at the appropriate time, usually within 9–12 months, the investment bank makes an offer for sale to the public thereby listing the company.

The risk in a bought out deal is similar but not exactly the same as that in firm underwriting. In a firm underwriting for an issue, the risk is in terms of being saddled with stock that would be listed but not having demand with investors. In a bought out deal the risk is in terms of being saddled with unlisted stock in case the issue cannot be made due to adverse market trends setting in after the bought out deal is done. Due to this risk, sometimes an investment bank may bring in a syndicate of other investment banks or other investors if it has to spread the risk. BOD is a recognised route for companies to go public on the OTC Exchange of India. BODs done to take companies public on other stock exchanges have to comply with the other requirements as applicable to normal IPOs.

Bought out deals were in vogue due to several advantages they offered to smaller companies in terms of saving in time and expenses of making retail IPOs. At the same time, the company is assured of funds from the investors that are not guaranteed in a public issue unless it is fully underwritten. Usually, the BOD is structured keeping in view the ultimate public offering so that investors are assured of an expected return with an exit within a given time frame. BODs done in the past had a normal maturity profile of around 6–12 months. However, after the markets collapsed in 1996, there were several BODs that could not reach their logical ending since the offers for sale could not be made. One such company was Divi's Laboratories Ltd. that finally went public in 2003 through the 100% book-built route. BODs are rare occurrence in present day capital market since issue sizes have gone up significantly and therefore, investment banks cannot take unlimited risk.

Bought out deal is prevalent in the US market and is known as *bought deal*. It was first used in the eurobond market in 1981 in the issue made by General Motors Acceptance Corporation wherein CSFB bought the entire issue of $100 million. In the case of smaller companies, it is also possible to have BODs, known as *bought deals*. The first such deal was done in 1981 by CSFB when it bought the entire issue of General Motors Acceptance Corporation without putting in place an underwriting syndicate. It is possible to use the bought deal as an alternative for firm underwriting since the underwriter would buy up the entire issue with confidence of selling it to institutional investors.

In the US market since public offers are designed primarily for institutional investors, a BOD is akin to a public issue being sold entirely to one or two large investors. However, in the Indian context, a BOD is more of a mezzanine round of investment made by an investment bank with a view to take the company public in a short time thereafter.

IMPORTANT TERMINOLOGY

Agreement Among Underwriters
Best Efforts Underwriting
Bought Deal
Bought Out Deal
Dealer Agreement
Devolvement
Devolvement Notice
Firm Underwriting
Green Shoe Option
Gross Spread
Manager's Fee
Safety Net
Selling Commission
Selling Concession
Selling Group
Sub-underwriting
Underwriting
Underwriting Agreement
Underwriting Commission
Underwriting Discount
Underwriting Spread

TEST YOUR UNDERSTANDING

PART - A

I. Pick the right answer(s) or the alternative that best fits the description from the alternatives provided under each question.

1. In the Indian context, underwriting services can be provided by insurance companies if they obtain a separate registration with SEBI even if they are already registered with the IRDA since they form a part of QIBs.
   (a) True (b) False
2. Devolvement is nothing but the subscription to be taken up by an underwriter in a public offer that is in excess of his underwriting obligation.
   (a) True (b) False

3. In computing the devolvement liability of an underwriter, the pro-rata excess procurement of other underwriters is netted out of the under-procurement of the first underwriter.
   (a) True (b) False
4. In a book-built offer, the underwriting obligation is only to the extent of the NPO as reduced by the promoters' contribution and reservations.
   (a) True (b) False
5. In a fixed price offer, the underwriting obligation is to the extent of the NPO as reduced by promoters' contribution and reservations.
   (a) True (b) False
6. In a public issue, the issue has under-performed till the last day. The management requests the underwriters to subscribe to their commitments and close the issue successfully, which the underwriters refuse to do. This has the following implication(s):
   (a) The company can proceed legally against the underwriters
   (b) The underwriters can be given firm allotments without their asking
   (c) The company can cancel the issue
   (d) The company can reduce the size of the issue
   (e) The underwriters can be arrested for fraud
   (f) The company can be prosecuted for false claims.
7. In a public offer in the US, the underwriters commit the issue price to the issuer company but the actual offer price is different from what is committed to the company.
   (a) True (b) False
8. In the firm underwriting model prevalent in the US, the underwriter's liability is always limited to the difference between the final offer price to be public and the underwritten price promised to the issuer company.
   (a) True (b) False
9. In determining the devolvement of an underwriter:
   (a) The negative procurement of an underwriter is apportioned to the other underwriters
   (b) The excess procurement of one underwriter is apportioned to the devolved underwriter
   (c) The underwriter with the maximum procurement is absolved of any commitment
   (d) The underwriter with the maximum underwriting commitment is absolved of devolvement
   (e) The procurement by an underwriter that is in excess of his underwriting commitment is ignored
   (f) The procurement by an underwriter that is in excess of his underwriting commitment is the devolvement.
10. In a Bought-out Deal (also known as a Bought Deal), the investment bank that makes the BOD:
   (a) Takes the company public through a public offer
   (b) De-lists the company
   (c) Holds its stake till maturity
   (d) Makes an Open Offer to the public
   (e) Exits through an Offer for Sale of secondary shares
   (f) Makes a preferential allotment
   (g) Makes the company buyback the equity.
11. Devolvement for an underwriter is the excess of his underwriting obligation over the issue subscription.
   (a) Yes (b) No
12. In best efforts underwriting, the underwriter uses his best efforts to fill in the devolvement and the balance if any, has to be written off by the company.
   (a) True (b) False

13. In firm underwriting, the company expects to receive the total issue proceeds at the underwritten price from the underwriters irrespective of whether the public offer price is higher or lower.
    (a) Yes b) No
14. If the minimum subscription in an IPO has not been subscribed including the devolvements on the underwriters, the promoters can then fill in the gap to meet the requirements.
    (a) Yes (b) No
15. In a public issue under the book-built mechanism in India, the investment banker ties up the underwriting commitments from the syndicate members. When the issue devolves, one of the syndicators who has underwritten 10% of the offer backs out stating financial incapacity. The i-banker informs the company about it and states that since the issue can be closed with 90% subscription, the underwriting obligation of the defaulting underwriter can be waived by the lead manager. The company insists that according to the underwriting contract, the lead underwriter is liable for the defaulting underwriter. Who is legally right?
    (a) The company (b) The lead underwriter
16. In a contingent underwriting for a book built IPO, the lead BRLM can stipulate the floor price above which he will not be willing to undertake the responsibility of his 15% mandatory underwriting commitment.
    (a) Yes (b) No
17. In a firm underwriting model, the final offer price to the public is determined by the lead underwriter before the offer opens for public subscription though the price negotiated with the company in the underwriting contract may remain unchanged.
    (a) Yes (b) No

PART - B

18. What is underwriting? Why is it necessary in an issuance of securities by a company?
19. Is underwriting a fee-based service or a fund-based service?
20. Explain the model of fee-based underwriting as is used in India.
21. In a contract of underwriting in the US market, how do the underwriters dispose-off the securities that they underwrite?
22. What are the different types of underwriting compensations? How are they computed?
23. In a bought-out deal, if the investment banker cannot bring the public offer what is the outcome?
24. Explain the different types of underwriting risks and their mitigation mechanisms.
25. Explain the working of green shoe options in the US capital market.

For answers to Part A, refer to Appendix B at the end of the book.

10 Global Capital Market Offers

LEARNING OUTCOMES

- This chapter gives an overview of Global Bond and Equity Capital Markets, types of bonds and bond structures.
- The Depository Receipt mechanism for cross border equity issues, its working mechanism, process for fungibility and reverse fungibility under Indian Regulations.
- Convertible bonds, Indian experience with FCCB issues.
- Indian regulatory framework for cross-border issues by Indian companies.
- IDRs and their issue in India.
- Process overview of offers made in USA and UK, role of investment bankers abroad and comparison with the Indian framework.
- Role of investment banks in cross-border offers.
- Corporate Inversions
- Overseas listing options for Indian companies, case studies in overseas offers by Indian companies.
- General templates in overseas capital market offers.

10.1 Introduction to Global Capital Markets

The international capital market is a part of the larger international financial market that is broadly defined as a financial market transcending national geographical boundaries. In other words, in the international financial market, funds are raised from lenders or investors in a country by borrowers or issuers from another country or conducting transactions in currencies other than the domestic currencies of respective countries. Considering this character of the international financial market, it can be outside the regulatory purview of any single country. The international capital market consists of the global bond and equity markets and the bond market includes convertibles as well. Besides, there is also a huge derivative market with the underlying assets ranging from stocks to commodities, foreign currencies, metals and other exotic varieties. The segments that are relevant to the present discussion are the bond and equity markets.

The importance of the global capital market can be assessed from the magnitude of finances raised in such market. The basic function of the market is to perform the function of capital intermediation from investors to issuers of financial securities. The American and European capital markets have performed this function for several decades in the previous century. The need for raising global finance from external capital market arises due to the imbalance in global capital flows over a period of time due to which, the excesses in certain economies need to be diverted to the deficit and needy economies. These imbalances are reflected in the current account balances of each country in its trade with its global trading partners. If cross border global capital flows do not happen, the trade imbalances will deepen and bring global trade to a standstill. Post Second World War, given the dependence of the world on oil from the OPEC countries, these countries built up huge surplus. Given that the USA was a consumption economy, its trading partners such as Japan and Germany built up vast current account surplus. By the mid-eighties, investment opportunities in the developed economies were becoming lesser requiring investors to look elsewhere for growing their money. The huge infrastructure and development projects undertaken in the developing economies and the opening up of their economies to global investors provided the answer to this. The economies of the 'Asian Tigers' provided a huge growth opportunity till the south-east Asian crisis in 1997 came in between and reversed the fortunes. The emerging markets such as China, Latin America and India are the other markets that attracted global capital flows, though the India's share therein had not been as significant as that of China.

It is important to appreciate the necessity of free capital flows across economies of respective countries for the development of an international capital market. Most developed economies such as the USA, the UK, Germany and Japan have removed restrictions on capital flows. The eighties and nineties saw a greater integration and cross-border floats in the international capital market. Despite the growth and sophistication in this market, it is far from being a perfect market. Market inefficiencies give rise to arbitrage opportunities for global investors.

Historically, beginning with the fifties, a truly international financial market developed in Europe, mainly centred in London. What led to the establishment of the international financial market in a big way was the creation of the *euro* market in the fifties and sixties. The euro market is a market in which financial instruments—both short and long-term, are denominated in a variety of currencies other than the domestic currency of the host country where they are transacted. Gradually, the financial markets of other developed countries such as the USA, Canada, Switzerland, France, Japan and Australia opened up to offshore investors through the euro market. The concept of a euro market in the context of the bond market is discussed further in the following paragraphs.

10.2 International Listing Centres

An international listing brings with it several benefits to a domestic company. Internationally listed companies enjoy the advantage of being able to access a broader shareholder base, increased liquidity outside the home market and greater ability to raise capital abroad. It brings international visibility in financial markets as well as with international customers and business partners. Being listed abroad also makes it easier to look for other forms of international fund raising such as bond issues or ECBs. It also makes it possible for a company to look for international opportunities for acquisitions using the foreign exchange raised from international listings. The benefit for local investors is that they do not have to go through the expense and difficulty of buying shares through the issuer's home stock exchange. Furthermore, all share prices and dividends are denominated in the investor's local currency.

Foreign listings are meant for the larger and grown up companies which are already listed in India as it makes it easier to market its issue abroad. A larger company may seek foreign listing for a higher valuation, to maximise issue proceeds or to broaden its investor base. However, a major deterrent to a foreign listing is that a company must comply with the regulations of the foreign jurisdiction and its stock exchange, which may be more stringent than those at home. Many leading companies in the world list on foreign stock exchanges indirectly, through GDRs which facilitate foreign exchange listings. However, extra compliance due to multiple listings should not be a deterrent if it makes a better strategy. Many multinational corporations and financial conglomerates are listed in multiple jurisdictions.

International listing centres are stock exchanges in the global capital markets that attract investors from across the globe to the security issuances on their markets. Automatically, issuers from across the world aim to be listed on one of these centres so as to attract global capital and visibility. To become an international listing centre, a stock exchange has to be in a jurisdiction that has a freely floating currency with no capital controls and securities laws that support international companies to list there.

The New York Stock Exchange (NYSE) and NASDAQ in New York are the two American stock exchanges which are among the most favoured international listing centres. London has also been traditionally one of the most favoured international listing centres due to its long history in the global capital markets. The London stock exchange has two segments – the main stock exchange and the Alternative Investment Market (AIM) meant for smaller growing companies from across the world. AIM has easier listing norms as compared to the LSE main segment but enjoys the advantage of equal visibility from global investors. Since its inception in 1995 until 2012, AIM succeeded in listing more than 3000 companies across the globe. Vedanta Resources, the apex holding company of the Vedanta group with several metals and minerals business interests in India is one of the well-known companies of Indian origin listed on AIM, London.

Apart from the LSE, the other main international listing centres in continental Europe are Luxembourg, Paris and the Deutsche Borse Group's Frankfurt Stock Exchange, which is one of the world's largest trading centres for securities. It is the largest German stock exchange and one of the most important centres in Euro Zone. Around 50% of the companies listed on the Frankfurt Stock Exchange are non-German issuers. The Luxembourg Stock Exchange is the largest in Europe for corporate bond issues and is also credited to have listed the first ever *Eurobond*. Being one of the leading banking and financial centres of the world, Luxembourg is home to some of the largest institutional investment funds and private bankers. Many Indian companies also prefer to list on this exchange for their international bond and GDR offerings prior to going to American stock exchanges.

In Asia, Tokyo Stock Exchange is one of the oldest stock exchanges dating back to 1870 and a well-known international listing centre. It has contemporary world class trading and settlement systems and is a well-known bond market for Indian companies. Several international investors raise bond capital in Tokyo due to its traditionally low interest rates and invest elsewhere, a business known as '*carry trade*'. Hong Kong is the next international listing centre that has gained importance after 2000 after an internal re-organisation with a view to make it a preferred international listing centre. The Singapore Stock Exchange is equally important in Asia due to its proximity to India and well established securities market, legal framework, language advantage and a favourable investment treaty with India. In fact, having a holding company in Singapore would be ideal for most growing Indian business groups to raise international capital and grow in overseas markets. The UAE also offers good listing possibilities for Indian companies in future through two of its well-known exchanges in Dubai and Abu Dhabi. While Abu Dhabi Stock exchange is mostly for UAE incorporated companies, the NASDAQ Dubai Stock Exchange was set up with the intention of attracting overseas companies to Dubai. With a favourable tax and investment climate, Dubai has the potential to become an international listing centre of reckoning.

India has taken its own initiative in setting up an International Financial Centre along with the presence of stock exchanges that can act as International Listing Centre as well for Indian and non-Indian companies. The Gujarat International Financial Tec-City (GIFT) is also India's first smart city to be promoted as a global centre for banking and finance, insurance, financial services, financial technology services and financial markets. It is positioned as a special economic zone enjoying fiscal and tax incentives to enable flow of international capital and as a destination for international business and finance.

The National Stock Exchange promoted a subsidiary exchange called the NSE IFSC Ltd. which applied to SEBI for an in-principle approval to start an International Stock Exchange at GIFT. At the time of writing, it was reported that the exchange was expected to commence operations in 2017. Earlier, the Bombay Stock Exchange or the BSE Ltd. received an in-principle approval to start a similar exchange at GIFT. These exchanges would introduce several products in ECM and DCM segments as well as currency and commodity futures among others. SEBI issued detailed operational guidelines for international stock exchanges to be set up in GIFT and future international financial centres to be set up in India.

10.3 The International Bond Market

As mentioned earlier, the international capital market has three main segments – the debt market, the equity market and the derivatives market. Within the debt market, the bond market is very vibrant and is an integral part of the sources of debt capital for foreign issuers. The international bond market has the following sub-segments: (i) the *Domestic Bond Market* of certain countries, (ii) the *Foreign Bond Market* and (iii) the *EuroBond Market*. The domestic bond market is useful to raise funds primarily from domestic investors but to a certain extent; foreign investors may invest in them as well, depending upon local regulations. Foreign bonds are useful for an issuer to raise funds from the overseas capital market by floating them for subscription in a foreign country. Foreign bonds do have the limitation of addressing the local regulatory requirements in the country of issue and therefore, cannot be issued simultaneously in more than one country. But the true international bond market is the euro bond market that allows issuers to address investors from several markets. From a fund-raising perspective, Indian companies are dependent on the euro bond market as it serves their requirements the best.

10.3.1 Domestic Bonds

These are bonds issued by domestic companies in a particular country to mainly domestic investors. Participation by overseas investors in such bonds is possible in countries such as the US, Japan, France etc. wherein foreign investors are allowed to invest in such bonds floated by domestic companies. Domestic bonds are denominated in the currency of the country of issuance and are usually fixed-interest, fixed maturity instruments with tenures ranging from 1 to 30 years. These are issued either through a public offer or through private placements. The issue of these bonds is subject to domestic regulations of the country of issuance such as disclosure requirements, filing of offer document and payment of domestic taxes. These can be unsecured bonds, asset backed bonds or mortgage bonds, as the case may be, depending upon local regulations. Apart from USA and Great Britain, the domestic bond market in other countries has not been a big source of raising finance from foreign investors. The domestic bonds in the Indian market are those issued by PSUs, financial institutions and banks and companies. These are discussed in earlier chapter.

10.3.2 Foreign Bonds

Foreign bonds are issued within the domestic capital market of a country by a foreign issuer for subscription exclusively by domestic investors. For instance, if an Indian company such as ICICI Bank or Reliance issues a dollar denominated bond in the US market or a Euro denominated bond in the EU market for subscription by local investors, it is a foreign bond in those markets. The main requirement for the issue of these bonds is that the local regulations of the host country need to permit such issue. USA, Japan, Germany, Switzerland and UK are the largest markets for foreign bonds not including others such as France, Belgium and Sweden etc. Bonds issued by foreign issuers in such markets are called by different names such as Yankee Bonds in USA, Samurai Bonds (through public issue), Shibosai Bonds (through private placement), Shogun Bonds (non-Yen denominated) in Japan, Bulldogs in UK, Matador Bonds in Spain, Rembrandt Bonds in Netherlands etc.

One of the main features of the issue of foreign bonds is the compliance with local regulations in the country of issue since these are domestic issues made in the respective countries by foreign issuers. For instance, the public issue of Yankee Bonds requires compliance with local listing requirements of the SEC in the US, which include stringent disclosure requirements apart from compliance with US GAAP accounting. An alternative to the public issue of a Yankee Bond is provided in the USA through what is popularly known as the 144A route. Rule 144A adopted by the SEC in 1990, provides a safe haven for bonds issued on a private placement basis to QIBs from the stringent listing requirements under the Securities Act, 1933. Under US regulations, QIBs are those investors that have invested not less than a hundred million dollars in non-affiliate investments. Bonds issued under the 144A route can be traded between QIBs under the permitted dealing systems of the NYSE (System 144A), NASDAQ (Portal) and the AMEX (Situs). The opening up of the 144A window ballooned the offerings by non-US issuers in the US market in the nineties and approximately $8 billion of securities were issued by 118 issuers in the first four years itself as compared to just five non-US issuers participating in the US private placement market in the ten years preceding the amendment to Rule 144A. The limitation of this route is that it allows the issuers to tap only the QIB investors in USA. On the whole, the US market for foreign bonds both through a public issue and through the 144A route offers long tenors to issuers and access to huge fund base with the US investors, especially the QIBs. However, this is primarily a market for high quality paper and the appetite for paper from issuers in the emerging markets is relatively small.

The Japanese market for foreign bonds opened up in the eighties after de-regulation and reforms by the Japanese government. The Samurai Bonds offered through a public issue have been tapped by several issuers successfully, including the IDBI in 1984 and again in 1990. However, these are also subject to stringent Japanese requirements on rating, size and maturity periods, underwriting and documentation. The Japanese Ministry of Finance lays down the guidelines that have to be conformed to in this regard. Even the Shibosai Bonds issued through private placement route are subjected to certain stipulations of the Ministry and these can be offered to banks and institutional investors.

The Swiss, UK, French and the Dutch markets for foreign bonds are also active and have varying requirements. In the Swiss market, private placements are not very popular and for public offers, the compliance requirements include approval from the Swiss National Bank.

10.3.3 Euro Bonds

Perhaps, the most important segment of the international bond market is the euro bond market. These are issued and sold in a jurisdiction outside the country of denomination. Unlike domestic bonds and foreign bonds that are issued in the same denomination as that of the country in which they are issued, euro bonds are in a different currency. For example, a dollar denominated bond issued by a non-US issuer in USA is a foreign bond while the same bond issued outside of US would be a euro bond. Other than the denomination aspect, what makes a euro bond different is also the fact that since it is issued outside the regulatory jurisdiction of the country of denomination, it is not entirely regulated by the local laws of that country. Euro bonds represents direct claims on the issuer but denominated in the currency of a country to which the issuer may not belong. Therefore, these bonds are external to the domestic market of the country of denomination and they are not tied down to any location or individual domestic markets.

The euro bond is a culmination of the process of finding an alternative to the regulatory load of domestic and foreign bond issues in the US markets. The regulatory constraints on size, disclosures, accounting and listing requirements etc. in the US markets on foreign bonds led to the emergence of the euro bond in 1964. Apart from regulatory requirements, the incidence of tax played an important part as well. In the US, the Interest Equalisation Tax was imposed on foreign bonds that lowered the post-tax yield to investors on foreign bonds to make them comparable to domestic bonds. However, over the years, domestic bonds and euro bonds have almost compared similar in returns. Similar regulatory constraints were present in other markets leading to the growing importance of the euro bond. However, it is not entirely correct to assume that euro bonds are unregulated offerings. There are regulations in several countries that govern the issuance of euro bonds denominated in their currencies. As far as the primary issues of euro bonds are concerned, most governments and regulatory authorities have, in conjunction with their central banks, issued regulatory guidelines on the issue processes, underwriting, size of issues etc. The reason for such regulation is to ensure that excessive claims on the country's currency do not create a payment crisis that could impact the value of the denominated currency. Secondly, since these securities are not subject to stringent national law, the governments find it to be obligatory on them to shield their domestic investors to a certain extent from such securities. Secondary market trades in euro bonds are largely self-regulated under the auspices of the International Securities Market Association. Most issuers prefer to bring their issues under the jurisdiction of English law or the law of the country of denomination under the terms of the issue.

As far as the US market is concerned, a public issue of euro dollar bonds (dollar denominated bonds issued outside the US) cannot be made to US investors unless the issue is registered in the USA under the Securities Act 1933. Therefore, euro dollar issues are made with the statutory declaration "*These securities have not been registered under the United States Securities Act 1933 and may not be offered, sold or delivered, directly or indirectly, in the United States or to US persons as part of the distribution of securities*". Once the issue is completed, there would be a *cooling-off* period of 90 days during which time no secondary market trades are allowed. After the cooling-off period, the investors are allowed to undertake secondary market deals provided they furnish suitable declarations to the effect that they are not US citizens or agents for US citizens. During the cooling-off period, no individual bond certificates are issued. Only a representative non-tradable share of a *global bond certificate* is issued to each investor. The global bond certificate represents the entire issue. After the cooling-off, the representative shares are exchanged for individual bond certificates. Though euro bonds cannot be sold to US citizens via a public offer outside the US, it is always possible for a US investor to purchase these securities in the secondary market after they start trading. Most euro bonds are listed on stock exchanges such as Luxembourg or London but the secondary trades are almost always on OTC basis between bond dealers.

Euro bonds can be issued in the US market using the 144A route whether they are listed outside the US or not. In other words, euro dollar bonds can be issued by way of a public offer and listed on a stock exchange outside the US with a private placement thereof being made to QIBs in the US using the 144A route. Alternatively, euro dollar bonds can be issued entirely using the private placement route both in US and outside ensuring that they are subscribed to only by QIBs in the US. However, the 144A route has to be adhered to very strictly as per the SEC norms.

Investment banks that manage euro bond issues are well aware of the nuances of offering them through a public issue and through a private placement. Using the flexibility of the private placement route, these bonds are generally underwritten and marketed privately through underwriting syndicates and network of banks that have linkages to investors. In addition, bulk of the marketing is made across countries other than the currency of denomination. In addition, since trade in the country of issue could result in withholding taxes for the investors, the bonds are structured to neutralise incidence of withholding tax on income distribution and capital gains. This is usually accomplished by floating an intermediary vehicle in a tax friendly state or a zero-tax jurisdiction such as British Virgin Islands or Netherlands Antilles and using this vehicle for making issues of euro bonds.

Euro bonds provide the best window for Indian issuers to raise debt finance from overseas capital market as they can be issued in markets as wide as Europe, USA (through the 144A route), Middle East and Asia either with or without listing using the underwriting syndicates. The pricing is very reasonable and the floatation costs are minimum under the private placement route. In addition, the euro bond offers access to US QIB investors without going through the stringent listing requirements under US law. Therefore, in many respects euro bonds score over foreign bonds as a better alternative to raise pure debt funds from overseas investors.

10.3.4 Masala Bonds

A new kind of Euro bond known as the *Masala Bond* made its advent in recent years as a source of foreign capital for Indian issuers in the international bond markets. The IFC, Washington reportedly made the first issue of masala bonds in international markets in 2014 to raise funds for financing private infrastructure projects in India. Subsequently, in September 2015, the RBI issued detailed framework for issue of masala bonds. HDFC became the first Indian body corporate to make a successful issue of masala bonds in international markets. Several PSUs and prime companies followed suit but it would require some more time for masala bonds to become a significant market for Indian companies.

Masala bonds are ₹ denominated bonds to be issued by Indian non-financial companies, banks and non-banking financial companies, REITs and INVITs in international capital markets. The advantage of such bonds is that they do not carry any exchange risk for the Indian issuer as they are denominated in ₹. The exchange risk is borne by the international investor. However, they are different from domestic bonds in India since these would be listed on overseas stock exchanges. The attractiveness of these bonds would arise from interest arbitrage available if any, to the foreign investor after factoring in the exchange risk.

The main provisions under RBI regulations for masala bonds are as follows:[1]

- Only plain vanilla bonds with coupon are allowed with an all-in cost that is comparable to the prevailing market. No specific caps on cost have been imposed.
- Minimum maturity of 5 years. Call and put option permitted beyond 5 years.
- Since masala bonds are classified as external commercial borrowings though designated in ₹ without exchange risk on the issuer, they are governed by RBI's approval mechanism. Under the ECB policy, RBI stipulated that bond issues up to US$ 750 million per financial year can be raised under the automatic route without any prior approvals. Issues beyond the said amount will require pre-facto approval from RBI.
- Since masala bonds do not carry exchange risk, the end-use stipulations by RBI are more liberal than foreign currency borrowings. Masala bond proceeds can be utilised for any purpose other than purchase of land or private properties, capital market activities and equity investments, on-lending to other bodies corporate for any of the non-permitted aforesaid purposes.
- Foreign investors in masala bonds are allowed to hedge their currency exposures. All FOREX payments to be made for servicing the bonds will be allowed under the automatic route without any further approvals.

10.3.5 Bond Structures

As far as the structure of foreign bonds and euro bonds are concerned, there can be plain vanilla bonds that have a fixed coupon rate and redemption terms. There can also be exotic structures depending upon the

[1]A.P. (DIR Series) Circular No.17 dated September 29, 2015

regulations in each country. In this respect, euro bonds offer more flexibility since they are not tied down to a particular regulatory regime. Most euro bonds are issued without any security and therefore, they are in the form of promissory notes. They mostly offer bullet repayment of principal and can be made exotic by embedding features such as call and put options as well as interest rate derivatives. Similarly, the coupon rates can be fixed or floating depending upon investor appetite and the judgement of the investment banker. The pricing of bonds is made in the same fashion as they are made for domestic bond issues either in India or abroad using a suitable benchmark rate. In the case of floating rate, euro bonds are pegged to the treasury rates in the country of denomination or other suitable international reference rate. Though rating is not a must for euro bonds, it does help in fine pricing and easier placement of the bonds. The tenure of euro bonds are typically between eight and ten years though the tenor patterns keep changing with market trends.

Euro bonds have also gone through innovations such as asset backed euro bonds that have structures, which are rated. Suitable credit enhancements such as over-collateralisations are provided to get better ratings. Other euro bond structures include bonds with currency or equity warrants (either fixed or detachable), convertible euro bonds and bonds with an embedded index derivative. Other structures include zero coupon bonds, deep discount bonds and dual currency convertible bonds. Floating rate notes were very popular during 1984-85 when interest rate volatility was at its peak. Perpetual floating rate notes are another structure that was very popular with banks in UK as they qualified as Tier I capital. Bond structures are becoming more sophisticated and are often structured to suit the requirements of a given set of investors. Similarly, the corporate vehicle of issue is also structured based on tax considerations.

10.3.6 Medium Term Notes

The bond route including euro bonds can also be tapped using the improved structure of a medium-term note or MTN programme. This structure is useful for issuers who need to tap the overseas bond market frequently. Instead of floating separate floatation of bonds, these can be clubbed under a MTN programme. A MTN programme allows for a standardised documentation platform to tap the bond market and makes it flexible for issuers to manage their financing requirements efficiently and cost effectively across a wide variety of maturity patterns and a diversified investor base. Under the MTN programme, several tranches of bonds may be issued either in the same currency or different currencies, different coupon rate structures and other features. The timing of each tranche can be tailored to the market opportunity and the entire documentation and regulatory approvals need to be put in place only once for the whole programme. In the past, financial institutions such as ICICI (now ICICI Bank) had used the MTN route to take one-time approvals from the Government of India and make several tranches of bond issues under a single programme.

10.4 Depository Receipts

10.4.1 Background

The concept of *depository receipts* for underlying shares (also known as depository shares) has been in existence since 1927 in the capital market in USA. Originally, they were designed as an instrument to enable US investors to trade in securities that were not listed on US exchanges. These were known as American Depository Receipts or ADRs. Simply stated *a depository receipt is a security that represents ownership in a foreign security*. Therefore, they are negotiable securities in a foreign jurisdiction that generally represent a company's publicly traded domestic equity. Although typically denominated in US dollars, depository receipts can also be denominated in Euros. Depository receipts are eligible to be traded on all US stock exchanges as well as on many European stock exchanges.

In the context of USA, depository receipts, which include ADRs, GDRs, EuroDRs (Euro Depository Receipts) and NYSs (New York Shares), allow non-US companies to offer dollar-denominated and euro-denominated securities to investors around the globe. The market for depository receipts was largely investor driven till the mid-eighties and the depository banks often issued them without even the consent of the concerned issuers. However, it was in 1983 that for the first time, the SEC made certain disclosure requirements mandatory for ADR issues.

During this period, there was also an additional problem. Due to the SEC regulations, it was not possible to issue depository receipts to US investors without getting them registered under the Securities Act 1933. Therefore, issuers had to issue one set of ADRs to US investors and another set of depository receipts called IDRs (International Depository Receipts) to investors outside the US. With the amendment to Rule 144A in 1990 as explained earlier, it was possible to make private placement of depository receipts to US investors without SEC registration. Thus, was born the GDR (Global Depository Receipt), which could be issued as a single instrument outside the US and simultaneously, using the 144A route, in US as well under separate tranches. Therefore, the current position is that depository receipts can be issued as GDRs in USA and outside without compliance with US law provided they are issued through the 144A route in USA. However, if they are issued through the public issue route in USA, they need to be ADRs that comply with US securities law. The first GDR issue was reportedly made by Samsung Co. Ltd., the South Korean major in December 1990. It had issued a single depository receipt to raise capital both in US and Europe simultaneously using separate tranches.

10.4.2 Depository Receipt Mechanism

The depository receipt mechanism works in the following manner. For the purpose of this discussion, both ADR and GDR are included under the term *depository receipts*.

The depository receipt mechanism is a very useful way of listing and trading of the shares of a company on a stock exchange. It is an indirect mechanism without directly inviting investors to buy the shares and thereafter listing them on the stock exchange for trading in the secondary market. Therefore, it can be regarded as an indirect issue of shares in a foreign jurisdiction with a surrogate listing mechanism. This is accomplished by the issue of intermediary securities called depository receipts that actually front-end the underlying shares against which they have been issued. In other words, the depository receipts represent a mirror image of the underlying shares. The actual extent of representation would depend upon the terms of the issue, i.e. how many depository receipts represent how many shares.

Using the depository mechanism, a company in one jurisdiction can issue depository receipts in other jurisdictions where such issues are permitted. The investors in the other jurisdictions subscribe to the depository receipts, which are issued with the support of an agency that acts as a global depository. The depository's function is to administer the depository receipts for the individual investors and related work such as transfers arising from secondary market trades, dividend distribution, recovery of withholding tax, conversion of the depository receipts into shares etc. The depository receipts are listed and traded on the exchanges where they are listed and in the OTC market in other financial centres. As far as the issuer company is concerned, it issues the requisite shares underlying the depository receipts in its domestic jurisdiction to a domestic custodian against receipt of cash from the investors for the depository receipts. These shares represent the issued capital of the company against which capital has been raised by issue of the depository receipts. However, these shares are not allowed for trading in the domestic market of the issuer company since the depository receipts representing them are already under trade in other markets. Therefore, the depository receipt mechanism creates two distinct pools of securities, one pool being that of the issued shares and the other being that of the depository receipts representing those shares. This relationship is represented below in Exhibit 10.1.

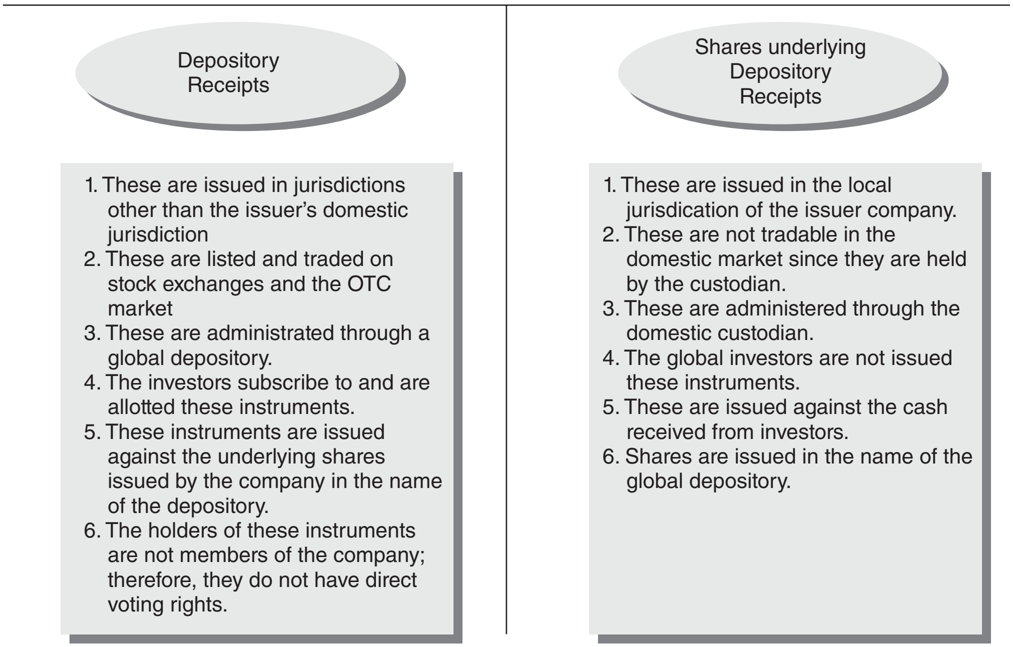

Exhibit 10.1 The Scheme of Depository Receipts

10.5 Equity Issues through Depository Receipts

As explained above, depository receipts are securities that represent ownership in foreign securities. However, depository receipts can be differentiated into four types based on the level of regulation applied to their issue. This classification is based on the US capital market regulation. These types are discussed in the upcoming sections:

10.5.1 Types of Depository Receipts

1. *Unsponsored Depository Receipts:* Depository receipts are those that are issued by the depository even without the involvement of the company concerned. These are unsponsored depository receipts issued in response to market demand, but without a formal agreement with the company. Presently, these are more or less extinct in the US market due to lack of transparency in the whole mechanism.
2. *Sponsored Level I Depository Receipts:* These are the simplest and the fastest growing segment of the sponsored depository receipt programmes in the United States. All sponsored ADRs are issued through a service contract between the issuer and the depository bank and are therefore, eligible to be listed in the US stock exchanges. The Level I ADRs are traded in the U.S. Over-The-Counter (OTC) market and on some exchanges outside the United States. Therefore, compliance with US GAAP is not necessary and SEC requirements on listing are limited. Level I is suitable for companies looking at listing in the US markets with trading facility on the electronic OTC market without complying with stiff SEC norms. However, these securities cannot be listed or traded on a U.S. national securities exchange such as the NYSE or NASDAQ. Since these are sponsored ADRs based on existing freely tradable shares

of the company, the company cannot seek to raise any fresh capital from listing of Level I ADRs. Establishing a Level I program would require:

- The Depository Agreement
- The issuance of the ADRs must be registered with the SEC under the Securities Act 1933.
- The issuer company should obtain an exemption from registration and reporting requirements under of the Securities Exchange Act of 1934 from the SEC pursuant to Rule 12g3-2(b) issued under that Act.

3. *Sponsored Level II Depository Receipts*: As in the case of Level I, the issuer company cannot raise capital under Level II ADR programme. However, the ADRs issued under this programme can be listed on the US stock exchanges without complying with the SEC listing requirements. Therefore, in addition to seeking registration of the ADRs, the respective listing requirements of the stock exchanges should also be satisfied. Moreover, for listing on an exchange or quotation on NASDAQ, the issuer must register under the Exchange Act by filing with the SEC a registration statement on Form 20-F. The Rule 12g3-2(b) exemption discussed above is not applicable to a listed Level II program.
4. *Sponsored Level III Depository Receipts:* These are classified as Level III since they require to comply with the full SEC listing requirements. In addition, compliance with US GAAP is mandatory. Level III ADRs are meant for issuer companies wanting to raise capital from the US market. The ADRs issued under this programme can be listed on NYSE, AMEX and the NASDAQ, provided they meet the respective listing requirements. The incentive for a company to move up the levels would be in terms of credibility and visibility among the investor community and the analysts in the US capital market and in its ability to raise capital. In a typical Level III offering, the issuer deposits shares with the depository in exchange for ADRs, which it then sells to the relevant underwriters. In the context of Indian companies, the shares are deposited with the domestic custodian.
5. *Rule 144A Depository Receipts:* As explained earlier in this chapter, this route is a private placement route for securities in USA. A Rule 144A ADR program is similar to a Level III program in that the issuer is seeking to raise capital in the U.S. through the offering of ADRs, usually through one or more U.S. investment banking firms. These ADRs do not constitute a public offering within the meaning of the Securities Act and are made pursuant to the exemption from the registration requirements of the Securities Act provided by Rule 144A. Therefore, no registration is required with the SEC by filing any forms. In addition, the issuer is not subject to any on-going reporting requirements. An issuer under a Rule 144A ADR program need to obtain the Rule 12g3-2(b) exemption from the SEC. In Rule 144A security offerings, the investment banker acting as the arranger, purchases the shares on a firm commitment basis. In this respect, it is similar to a bought out deal in India. Thus, a Rule 144A offering is quite different from a conventional private placement in which the investment banking firm acts solely as an arranger for a fee and has no fund obligation to take the securities on its books. The Rule 144A offer document is not filed with the SEC nor it is subjected to SEC review. The Rule 144A route is generally very convenient for a global offer of GDRs. Conventionally, it has been seen that after the completion of a Rule 144A offering of ADRs, issuer companies in the USA are encouraged by investment bankers to upgrade to a Level I program to help satisfy secondary market demand. Currently, the SEC requires a cooling-off period of at least 40 days after completion of the Rule 144A offering before the Form F-6 for the Level I program can be filed. Moreover, the Deposit Agreement with the depository for the Level I program is subjected to a detailed review to satisfy that the securities from the 144A program are not being improperly brought into the Level I program.

10.5.2 Issue of Depository Receipts

The schematic representation of an issue of depository receipts is presented below in Exhibit 10.2.

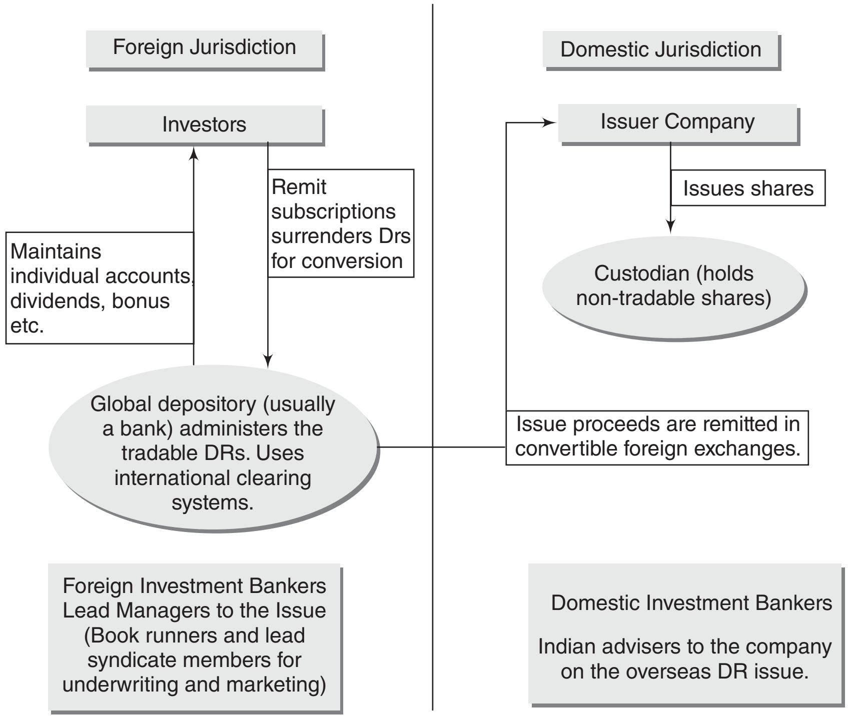

Exhibit 10.2 Schematic Representation of an Issue of Depository Receipts (DRs)

The question that arises from the above diagram is about why should there has to be such a complicated structure of issuing a pool of depository receipts in another jurisdiction which replicate the function of the shares themselves, instead of issuing shares directly to investors? In other words, what is the need for depository receipts, if foreign investors are allowed to invest directly in the shares of the issuer company? Taking the Indian example, since most Indian companies are allowed to issue shares to foreign investors, why should Indian companies look at the issue of depository receipts in overseas markets as opposed to issuing shares directly to non-residents?

10.5.3 Depository Receipts vis-a-vis Direct Investment

The above questions can be answered with a comparative analysis of depository receipts vis-à-vis direct investment by foreign investors in shares of the issuer company.

- Firstly, even if direct issue of shares is permitted to non-resident investors in the parent country of the issuer, the shares can be listed only on the domestic stock exchanges. Therefore, foreign investors need to trade in those shares only in the domestic markets. This difficulty is obviated by the issue of depository receipts that are traded on foreign exchanges and OTC markets.
- Sometimes, the regulatory regime in the parent country does not allow a foreign floatation through a public issue. For example, an Indian company cannot make an issue of its shares abroad to the foreign public and list these shares directly on global exchanges. The only way it can make a public issue of shares to non-residents is by allotting them to registered FIIs and NRIs in a domestic public issue in India. Therefore, if an Indian company wishes to raise capital from overseas investors at large, it would not be possible except through the depository receipt route.

- Foreign investors can invest in issue of depository receipts of an Indian company without getting themselves registered with SEBI or seeking individual approval under the FDI policy. They cannot do so if the investment is in shares directly.
- Since the investors hold and trade depository receipts, there is no tax incidence in India for capital gains made on such trades abroad. Otherwise, if the shares were sold in India, the capital gain would be subject to withholding taxes in India as per the prevalent law. The same would be true of other countries as well where capital gains are taxable.
- Since the foreign investors are not direct shareholders and members of the issuer company in India, they do not exercise direct voting rights in India. Otherwise, the company has to seek their consent for all decisions requiring shareholders' approval, which would be extremely difficult considering that these investors could be spread out across the world.
- Settlement of transactions in depository receipts happens through international settlement systems like DTC in USA and Euro clear or CEDEL in Europe while transactions in shares have to be cleared in domestic clearing houses in India. Therefore, for a foreign investor, international clearing systems are more convenient.
- Payment of dividend and repatriation of capital on direct investment in shares involves exchange risk since shares are designated in domestic currency. In comparison, depository receipts are designated in international currencies such as the dollar, euro, yen and pound sterling.
- Lastly, compliance with Indian foreign exchange law and RBI approvals are not required for sale of depository receipts by foreign investors abroad. However, sale of shares by non-residents to residents to residents requires necessary clearance under FEMA and is also subject to price considerations.

Though the above comparatives are not intended to be an exhaustive list, the point being made herein is that depository receipts offer the mechanism of floating multi-currency instruments in euro markets and are therefore, useful in tapping investors across national borders. It is especially useful for countries like India that do not have free convertibility of currency on capital account. Using the depository receipt mechanism, Indian companies could tap the vast investor potential in Europe and USA in the past.

10.5.4 Status of Depository Receipts in India

From an Indian context, since depository receipts issued by an Indian company in a foreign market would be *foreign securities*, foreign investors can invest in them without getting themselves registered with SEBI or seeking individual approval under the FDI policy, though the issuer company has to ensure compliance with the FDI policy. Due to the fact that depository receipts are foreign securities under Indian law, the foreign investors are not direct shareholders and members of the issuer company in India, they do not exercise direct voting rights in India. However, the overseas depository with whom the depository receipts are vested may exercise voting rights on behalf of all the depository holders. Voting rights shall be as per the provisions of the Companies Act, 2013 which states under Rule 6 that "*...the overseas depository shall be entitled to vote on behalf of the holders of the depository receipts in accordance with the provisions of the agreement ...*".[2]As per current regulations, for the purpose of exercising voting rights, the foreign depository may take instructions from DR holders.

As far as banking companies are concerned, RBI regulations regarding voting rights will continue to be applicable to all shareholders exercising voting rights. There is no tax incidence in India for income or capital gains made on depository receipts which are traded abroad. Payment of dividend and repatriation of

[2]Section 41 of the Companies Act read with Rule 6 of the Companies (Issue of Global Depository Receipts) Rules 2014

capital on direct investment in shares involves exchange risk since shares are designated in ₹. Even though the GoI has permitted hedging of investment exposures in India in convertible foreign currency that would involve complex derivative transactions. Compliance with FEMA and RBI approvals would not be required for sale of depository receipts by foreign investors abroad, unlike sale of domestic shares by non-residents to residents to residents which is subject to FEMA Regulations.

10.5.5 Fungibility of Depository Receipts

The next important aspect of the discussion on depository receipts is about their fungibility. This is a very important concept as it forms the very core of the depository mechanism. *'Fungibility'* makes depository receipts homogenous and convertible into the share underlying them. By making this possible, the foreign investor is given a two-way exit route, i.e. the exit can be either through the sale of the GDR in the overseas market or through the sale of the underlying share in the domestic market. If fungibility is allowed, it makes the prospects for the investor better since the price differential between the depository receipt and the underlying share can be used to advantage. Without fungibility, integration of financial markets is incomplete and the *law of one price* is hindered which can lead to unfair advantage to arbitrageurs.

As mentioned earlier, the ADR became fungible in US market in 1990. As far as the Indian scenario is concerned, the GoI initially prescribed a two-year lock-in period for GDRs to become fungible. However, this restriction was removed later on. Nowadays, the investment bankers acting as issue managers prescribe a cooling-off period during which the depository receipts are not fungible. This period could be between 45 and 180 days depending upon the market conditions and the size of the issue. After the cooling-off period, an investor may if desired, opt for conversion of GDRs/ADRs into underlying ordinary shares and hold them. If these shares are required to be sold at a later date, they can be sold only in the domestic market in India as per the procedure described below.

An investor in depository receipts intending to use the fungibility route for exit has to approach the global depository directly or through a foreign broker for the cancellation of the depository receipt. The depository then directs the domestic custodian in India to release the shares to the counter party broker in India. The custodian informs the issuer company, which in turn would instruct the STA to release the shares. If the shares have been issued in dematerialised mode in India suitable instructions have to be passed on through the domestic depository (NSDL or CDSL) by the STA. The counter party broker receives the credit of shares in its DP account, which are then sold in the secondary market. The proceeds received in rupees are remitted in foreign exchange to the foreign broker by the Indian broker. The foreign broker pays off the investor upon receipt of the proceeds. The net effect of the transaction would be that the total stock of depository receipts gets reduced by the amount that has been converted into shares. It also means that the stock of tradable shares of the company in the domestic market in India goes up by the same extent. Therefore, the property of fungibility of depository receipts could lead to a change in the respective floating stock of the company's tradable equity in domestic and foreign bourses. Exhibit 10.3 shows the implications of fungibility of deposit receipts.

From Exhibit 10.3, it is evident that one-way fungibility of DRs into shares can cause a long-term structural modification to the floating stock in the domestic market that can have a price implication. In the context of a country that has a fully convertible currency, this structural change can be used for a reverse arbitrage, i.e. domestic investors can arbitrage a higher price for the DRs in the overseas market by opting for conversion of their shares into DRs and trading in the overseas market. However, in the Indian context, such reverse arbitrage is not possible on an on-going basis. However, acknowledging the situation, the GoI has allowed limited two-way fungibility.

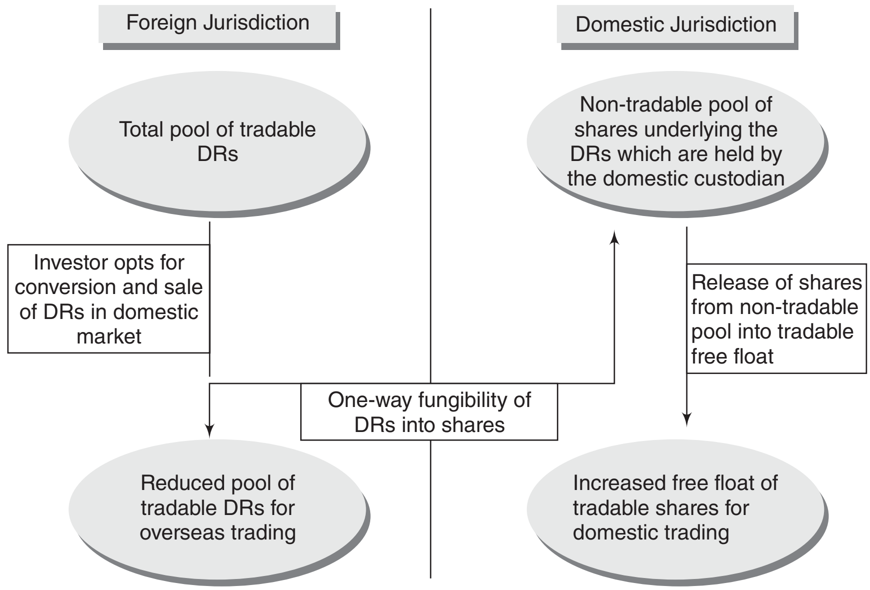

Exhibit 10.3 Fungibility of Depository Receipts (DRs)

10.5.6 Limited Two-way Fungibility of Depository Receipts

Two-way fungibility of DRs implies that DRs and their underlying shares are convertible both ways inter-se but within their respective jurisdictions. Therefore, an overseas investor may convert DRs into shares but these can be traded only in the domestic market. Similarly, a domestic investor may convert shares into tradable DRs but these can only be traded in markets where the DRs are listed. The RBI came out with separate guidelines for limited reverse fungibility of shares into DRs through two distinct methods: (i) an unsponsored issue of ADRs/GDRs in the overseas market through secondary market purchase of shares in India and (ii) through a sponsored ADR / GDR issue whereby Indian investors can hope to encash some of the gains of a higher price in overseas market. Under the first mechanism, individual foreign investors may, at their option, seek issue of DRs, which would be issued by purchase of shares in the domestic market in India. This is purely a demand driven mechanism operated through the secondary market. Under the second mechanism, the domestic investors in India would be given an opportunity to surrender their shares to the issuer company and these shares would then be pooled and converted into DRs to be sold as a public issue of DRs in the overseas market. This would be a process wherein the issuer company would also be involved. The proceeds thereof would be remitted to the domestic investors in India. Therefore, through the issuer company does not receive any funds in the process, the domestic shareholders have the opportunity to make arbitrage gains. Simply put, the sponsored ADR/GDR issue is an offer for sale of existing domestic shares as DRs in the overseas market.

10.5.7 Re-issue of ADR/GDRs

Re-issue of ADRs and GDRs that have been surrendered by foreign investors for being converted into domestic shares. This is permitted to the extent of ADRs/GDRs which have been redeemed into underlying shares and sold in the domestic market. The arrangement is demand driven with the process of re-conversion emanating with the request for acquisition of domestic shares by non-resident investor for issue of ADRs/GDRs. It is, however, subject to a host of regulations including the most important requirement that the re-conversion has to be within the overall FDI caps permitted by the RBI under FEMA. The transaction will be effected through SEBI registered stockbrokers as intermediaries between foreign investors and domestic shareholders under the general permission available under FEMA.

10.5.8 Sponsored ADR/GDR Issues

A sponsored issue of depository receipts happens when the issuer company offers for sale depository receipts corresponding to underlying shares already held by its domestic shareholders. In other words, *it is a depository issue representing secondary shares*. Therefore, a sponsored issue is a non-capital raising issue of depository receipts by the issuer. The domestic shareholders are asked to surrender their shares in the parent jurisdiction and these are issued as fresh depository receipts in the foreign jurisdiction. The proceeds arising from the sponsored issue are paid to the domestic shareholders as consideration for surrender of their shares. The important point to be noted herein is that just as in the case of an offer for sale, in a sponsored issue, the company does not raise any capital.

The sponsored ADR/GDR issue has to be made based on underlying domestic shares through an appointed Lead Manager, the domestic custodian and overseas depository. The price for buy back of domestic shares for the purpose of the sponsored issue would be determined by the lead manager based on 'head room availability'. Suppose, the ADR of a company is currently quoted at the equivalent of ₹8000 in the overseas market and the underlying share in India is quoting at ₹6000, the lead manager would be able to make an offer of a price ranging between these two prices. The lead manager buys them from the local market at prices slightly higher than the prevailing market price and sells them at a slightly lower price in the overseas market than the prevalent ADR/GDR price. This mechanism helps to bring down the gap in prices in both markets and promotes price parity. In addition, it will help companies going to the overseas markets for the first time through the sponsored route. Sponsored ADR issues are also governed by the same regulations as an issue of ADR / GDR against primary shares.

The sponsored route would be available to all shareholders of the company. The company will give an option to the shareholders indicating the number of shares to be divested and the mechanism of how the price will be determined under the ADR/GDR norms. If the shares offered for divestment by domestic shareholders exceed the number to be divested, shares would be accepted on pro-rata basis as in the case of a normal buy back of shares.

10.6 Convertible Bonds

Apart from straight issue of depository receipts, a company can issue bonds that are convertible into depository receipts or the underlying shares at a later date. These are known as convertible bonds that are very similar to FCDs issued in the domestic market. The issue of such bonds has the same advantages as that of a convertible debenture issue in India, in that it does not lead to an immediate expansion of equity.

10.6.1 Issue of FCCBs

Under the Indian regulations, convertible bonds are known as *Foreign Currency Convertible Bonds* or FCCBs. When such bonds are issued in the euro market, they are known as *euro convertibles*. Euro convertibles would help in realising better value for the company's share and is better marketable than a euro non-convertible bond. Most FCCBs are structured as low yield bonds or zero coupon bonds to provide a motivation to the bond holder to convert them to equity. They may also be structured with a redemption premium to protect the yield if it is anticipated that conversion option may not be exercised by many of the bond holders.

FCCBs may be converted into depository receipts or into underlying domestic shares directly. In the former case, they continue to trade after conversion in the overseas market as depository receipts. Indian regulations do not permit the issue of these FCCBs. In the latter case, they are tradable as shares only in the domestic market and the listing in the overseas market ceases after full conversion of the bond. Indian regulations permit the issue of only the second variety of FCCBs convertible into domestic shares.

Though FCCBs can be issued either through an overseas public issue or a private placement, most Indian companies do not list their FCCBs in the overseas markets as these are subscribed by institutional investors and HNIs with a view to convert them into domestic shares in a short time. Therefore, these are essentially instruments with a predominantly equity flavour and do not have much trading depth as bonds in the overseas markets. In a rare move, Larsen & Toubro made a successful issue of $200 million worth of FCCBs in 2009 and proposed to list them in Singapore.

FCCBs with conversion into domestic shares are preferred when the investors are familiar with the domestic capital market and are allowed not only to hold but also to trade in domestic shares. When the domestic markets are strong in India, foreign investors consider FCCBs as a way to keep their option of getting an upside on their debt market exposures. In the recent years, most FCCB issues by Indian companies were of this variety offering conversion in about 6 months from the time of issue.

10.7 Indian Scenario in GDRs/ADRs/Convertible Bonds

Reliance Industries made the first depository issue slightly earlier in 1992 since the scheme had retrospective effect. Indian companies began to tap the euro market through the issue of GDRs and FCCBs immediately after the opening up of the overseas capital markets for Indian issuers by the GoI in 1993. These issues are known as euro issues since Indian companies prefer to float instruments in the euro market initially. This was because they were quite unprepared to float public issues in the US market due to its stringent listing requirements and mandatory accounting as per US GAAP. Some of the euro issues made in the early nineties were partly offered in USA under the 144A route as well. With the passage of time and the technology boom in the late nineties, Indian companies came forward with ADR and ADS issues via public offers in the US markets as well. Indian issuers also used the 144A route to make private placements of depository receipts and bonds in the US market. Some of the well-known Indian companies that listed their equity abroad are ICICI Bank, Infosys Technologies, Wipro, Dr. Reddy's Labs, Satyam Computers etc. Companies such as Reliance Industries, SBI, IDBI Bank, Indian Oil, ONGC etc. are regular in their bond issues abroad. Several Indian companies also issued FCCBs that were convertible into domestic shares in India especially during the boom time in the years 2003–07.

Case Study

Some Notable Overseas Issues by Indian Companies

Tata Steel GDR Issue

Tata Steel made a FPO offering of GDRs amounting to $ 500 million to investors in London's financial market, which was the largest at the time by an Indian company surpassing SBI's $370 million in 1996. The GDRs were listed on Luxembourg Stock Exchange. The issue was managed by Citigroup, JP Morgan and Goldman Sachs. The issue was meant to refinance the debt taken for the Corus buyout earlier by Tata Steel UK, the acquirer. At the time of the FPO, the price of Tata Steel GDR was also ruling firm having risen by 80% from its 2008 price.

The GMR group made a similar GDR offer which was not very well received by investors. Tata Power ($335 m) and Suzlon ($110 m) also raised funds through GDR offers in 2009.

Tata Steel Bond Issue

Tata Steel raised $1.5 billion via dual tranche dollar bonds in overseas market through its Singapore arm, Abja Investments. It was a dual tranche dollar denominated bond. It is a debut dollar issuance by Tata Steel. It was the second largest bond issue from India after that of ONGC Videsh. It was the largest sub-investment grade deal in Asia in 2014. The issue was made to raise funds to refinance its debt obligations of Tata Europe (formerly known as Corus).

Key features of the bond issue were:

- First tranche include $500 million of tenure of 5.5 year bond at a coupon rate of 4.85% over US Treasury. Second tranche include $1 billion of 10 year tenure at a coupon rate of 5.95% over US Treasury.
- The issue was guaranteed by Tata Steel.
- Rated BB+ by Fitch and BB by S&P, the bonds listed on Frankfurt Stock Exchange.

The deal had overwhelming response from investors, as reflected in order book and final pricing. This landmark deal shows investor confidence in Tata Steel credit and its leading position in the global steel industry. It had a peak order book of $11 billion across tranches by the time the books closed at the end of the day and this enabled the issue to be priced about 50 basis points tighter than the initial price thoughts on both the tranches. The issue was distributed 59 percent into Asia and 41 percent into Europe, the Middle East and Africa (EMEA) and others to several long-term buy-and-hold institutional investors, banks and private banks.

Sterlite Industries

Sterlite Industries made a ADS offer of $1.5 billion which was the largest of such offerings at the time by an Indian company in the US market surpassing the issues of Infosys, Wipro, Mahindra Satyam, Dr Reddy's and ICICI. However, 33% of the issue was subscribed by its parent Vedanta Resources (listed on AIM, London) and the balance by institutional investors. In a GDR / ADR(S) offer, the issuer has flexibility to place the securities with a large pool of investors since it is a public issue under Indian law. Therefore, a FPI can underwrite the issue under several sub-accounts. On the same ground, promoters can participate in such issue (as did Vedanta). Typically, in a FPO offer, GDRs are placed at a discount to market price while ADS would be placed closer to the CMP. This was because GDR investors often converted them into underlying shares to play the domestic market under the FPI route. The Sterlite ADS was priced at 6% less than the opening day close.

ONGC Videsh

OVL, the overseas arm of ONGC along with ONGC bought 10 percent stake in Mozambique's Rovuma basin from Videocon Industries for $2.48 billion in June 2013. The stake between OVL and ONGC was split in the ratio of 60:40. To finance its 6 percent buy, OVL in January 2014 raised $1.5 billion one-year bridge loan facility from a consortium of 9 banks. In August 2014, OVL acquired another 10 percent stake in the field from Anadarko Petroleum Corp for $2.64 billion. To pay for the Anadarko stake acquisition OVL raised $2.5 billion in foreign loans. Together the 16% stake led to a whooping debt which OVL planned to refinance through a bond issue.

- The bond issue raised over $2.2 billion in dual currency denominated tranches, the dollar and Euro in the overseas market.
- This was the biggest bond issue from India at the time crossing Bharti Airtel's $2 billion foreign currency bond in May 2014.
- The bonds were raised in 3 equal tranches of 5 year US dollar bond, 10 year US dollar bond and 7 year euro bond. The issue had the order book of over $8 billion due to renewed investors' interest in the India energy story. This was a true benchmark deal in terms of size, tenures, currency mix and pricing, evidencing the global investor appetite for quality Indian credits and strength of OVL and ONGC credit.
- The 5 year US dollar bond was priced at 160 basis points (bps) over benchmark US treasury (coupon 3.25%), while the 10 year US dollar bond was priced at 207.5 bps above the benchmark (4.622%). The 7 year euro bond was priced at 180 bps over mid-swaps (2.5%).

Reliance Communications

Global Cloud Exchange Ltd., ED, a subsidiary of Reliance Communications raised $350 million through debt bond issue from overseas market. The issue was made in 2014 mainly to refinance debt of parent company.

- The notes priced at 100% with a coupon of 7% were non-callable senior secured Regulation S/ Rule 144A Fixed Rate Notes maturing in 2019. $250 million of the proceeds will be used to refinance the Standard Chartered Bank Loan Facility entered into by Reliance Global com B.V., and the remaining proceeds were to be used for capital expenditure and general corporate purposes.
- The bonds received overwhelming response from the market and were significantly oversubscribed. The issue was allocated 22% to the US, 29% to Europe and 49% to Asia. By investor type, 78% of the issue went to fund managers, 13% to hedge funds, 6% to private banks and 3% to other investors.

Reliance Industries' Landmark Issue of Perpetual Bonds

RIL raised $800 million (₹4300 Cr) through perpetual bonds from overseas market to fund its ₹1 lakh crore capex plan to expand petrochemicals business and ramp up oil and gas exploration in the following three to four years.

- The bond has a coupon rate of 5.875%, making it the first issuance of perpetual bond below 6% in the world. There is no coupon step up or rate reset in the pricing of the bond.
- A perpetual bond by definition has no option to repay the principal amount and it is seen as one of the cheapest ways for raising capital. However, RIL has a call option at the end of five years. The bond was listed and bond holders could exit through the secondary market.
- The only other domestic company to issue a perpetual bond at the time was Tata Power through its overseas subsidiary in 2012 in a hybrid structure.

The issue got an overwhelming response as it was oversubscribed four times with almost USD 3 billion. The Notes were distributed to high quality fixed income accounts: around 53% to private banks and 47% to institutional investors. RIL's perpetual bond was historic for many reasons:

- First ever US Dollar senior, fixed for life, non-deferrable perpetual issuance out of Asia.
- Lowest coupon achieved for a US Dollar senior true perpetual issuance globally till that time.
- Largest perpetual issuance and lowest coupon by an Asian company in 2013 (including subordinated and hybrid structures).
- First US Dollar bond issuance by RIL in the public markets since 1997.

10.8 Corporate Inversions

Corporate inversions are quite popular among multinational companies to optimise their group structure. In an inversion process, the ownership may be in one jurisdiction while the economic interests of the business may be in another jurisdiction. This is mostly done to achieve tax advantages or for making capital raising more efficient. In the process, sometimes the group structure is flipped whereby a large flagship company may become a subsidiary of a purely investment holding company.

Some Indian companies prefer to flip their structure by listing their holding companies abroad keeping their operative subsidiaries in India preferably as unlisted companies. One of the leading examples is that of Vedanta Resources, the global apex holding company of the Vedanta group which listed on AIM, London in 2003. Vedanta Resources has operative assets in India in the form of Vedanta India (achieved after successive mergers between Sesa Goa-Sterlite- Cairn India out of which the last one is in process), BALCO and Hindustan Zinc apart from similar interests in other countries such as Indonesia and Australia. The group tried unsuccessfully to take Sterlite Industries private in the past.

Case Study

Essar Group

In 2010, the Essar group also had similar plans to form a global holding company abroad for their energy assets that would have its refinery, power, exploration and production businesses as operative assets and would be listed on AIM, London. This company, known as Essar Energy Plc, was listed on the London Stock Exchange. The company had mixed fortunes, with project delays and declining stock price. It was, therefore, successfully delisted in 2014 by the promoters' holding company Essar Global Fund Ltd.(EGFL), a private company registered in the Cayman Islands acting through one of its several subsidiaries. Presently, EGFL is the apex promoters' holding company for their group interests while there are corporate holding companies for each vertical.

To a certain extent, Cognizant Solutions listed in the US in 1998 follows a similar model. One of the leading IT services companies in the world after Accenture and IBM, Cognizant is headquartered in the US but has significant business presence in India. Two-thirds of its employee strength comes from India and it operates in India based out of Chennai. Similarly, iGate Corporation (formerly Mascon) headquartered in USA was the parent company of the group specialising in business process outsourcing and technology solutions. It was listed on the NASDAQ exchange. Its subsidiary Mastek Systems Corporation incorporated in the US was 100% holding company of iGate Global Solutions Ltd., which was listed on the BSE and NSE in India. iGate Global in India was the main operating company for the group. Subsequent to the global acquisition by Capgemini of France, iGate was delisted both in India and on NASDAQ and taken private. iGate Corporation became a subsidiary of Capgemini to be eventually merged with it.

Case Study

WNS (Holdings)

WNS Holdings Ltd. is the holding company of WNS Global Services Ltd., a global business process outsourcing company based in India. WNS Holdings is a company incorporated in Jersey, Channel Islands and it maintains its registered office there. The company which started as a group company of British Airways went through an acquisition by Warburg Pincus in 2002, after which the holding company structure was put in place with the incorporation of WNS Holdings. WNS Global is the main operative company located in India and has operative offices in USA and other countries. WNS Holdings also has several other subsidiary companies operating in several other countries but the main operations are conducted through WNS Global in India. WNS Holdings made its IPO in 2006 through an American depository share issue and is listed on NYSE. It also made a FPO on the NYSE in 2012. WNS Global is presently not listed in India or elsewhere.

10.9 The FCCB Crisis for Indian Companies (2009–12)

The saga of FCCB issues from India has been that of mixed fortunes for Indian companies. Prior to 2008, FCCBs were the biggest draw for raising capital from overseas markets for Indian companies, especially in the medium sector. With the result, India became one of the biggest issuers of convertible bonds in Asia. The years following the global financial crisis in 2008 were watershed years for FCCB issuers and investors alike. The genesis of the FCCB crisis that showed up in 2009 and became contagious by 2012 can be attributed to the following factors:

- When the markets were at their peak in 2004–2007, FCCBs were the flavour of the season as many companies found it a cheaper way to raise debt capital as compared to rates they were getting in the domestic market. The companies believed that since their shares would only rise, the bonds would eventually be converted into equity instead of being redeemed. Therefore, the issuers at that time believed that they were essentially raising equity capital and not debt. Under this presumption, several fast growing companies took risk by raising huge amount of FCCBs on their books. According to Prime Data Base, 201 Indian companies raised close to ₹72,000 crore through FCCBs during this period. Issuers preferred using FCCBs to reduce their borrowing costs and issued the bonds at very low coupon rates; some were even zero coupon. However, they fixed the conversion prices 25% to 150% higher than the prevailing market prices in expectation of an increase in share prices. Companies such as GTL Infrastructure, Great Offshore, Moser Baer, Welspun Corporation, Zenith Infotech, Aksh Optifibre and Wockhardt belonged to this category.
- The ambitious growth plans of Indian industry during this high GDP growth (2004–07) also coincided with their inorganic growth plans through acquisitions in overseas markets. Conventionally, India does not have an institutionalised mechanism of raising domestic bank loans for acquisition financing. Secondly, the ODI policy of RBI caps the maximum investment by a domestic company in a foreign company to 400% of its net worth. Considering these limitations on equity and debt financing, many companies with ambitious acquisition plans had to look for FCCBs as a way to raise equity funds from overseas sources which could be channelised to finance their acquisitions. Many of these were companies that were not big enough to make ADR/GDR issues abroad. So, a FCCB issue made perfect sense. In this category, belonged Suzlon Energy, Welspun, Hotel Leela ventures, Reliance Communications, Subex Systems, 3i Infotech, First Source Solutions etc.
- The FCCB financing decision between 2004 and 2007 meant that most of these bonds started to mature in 2011 and 2012 which was estimated to be around $1.3 billion only in March 2012. After the financial crisis of 2008, the domestic capital market became lacklustre and range bound which made the conversion prices on the FCCBs unviable at the prevailing market prices. By 2011, share prices of over 70% of the issuer companies were trading between 5% and 60% of their conversion price. So, most investors did not exercise the conversion option and it was estimated that about 97% of the outstanding FCCBs in March

2012 needed to be redeemed. This meant that companies had to raise either domestic debt or promoter equity to bring in the necessary funds to redeem these bonds as they were not envisaged for redemption in the first place.

- The adverse movement of the rupee-dollar parity during this period further added to the woes of Indian issuers. When the FCCBs were issued, the rupee was around ₹41 the US dollar. When the rupee depreciated to ₹56, it sounded the death knell for the issuer companies. It was estimated that only the currency depreciation contributed to increasing the debt burden of these companies by ₹10,000 crore.
- The dwindling corporate performance during this time due to high inflation and consequent increase in production costs, sluggish demand off-take, high domestic interest rates and slowdown in investments meant that several business sectors were adversely hit. This affected the cash flow of these companies in general and consequently, their debt servicing capabilities. The unexpected pile up of FCCB debt meant that a huge cash flow crisis loomed on these companies by the time the bonds came up for redemption.

The FCCB crisis began around 2009 with the default by Wockhardt which defaulted on FCCB payments. The bondholders filed a winding-up petition in the court. Zenith Infotech defaulted on $33 million worth of FCCBs due for redemption in September 2011. By early 2012, other companies such as Cranes Software, JCT, Aftek, Marksans Pharma, Mascon Global, Gremach and Pyramid Saimira were also in the defaulters' list. In 2012, Suzlon Energy's default of $209 million worth of FCCBs was by far the biggest. In 2012, the Standard & Poor report estimated that out of a total of 21 of the 56 companies holding an outstanding of $5 billion FCCBs maturing in 2012 were likely candidates to default on redemption payment. Over 50 companies were found to have not allocated sufficient funds to pay back the FCCBs as they had not anticipated repayment. Bloomberg estimated that the total defaults on convertibles surpassed $700 million in 2012.

Case Study

Suzlon Energy FCCB Crisis

Suzlon grew aggressively on a robust business model but made strategic commitments to inorganic growth through expensive offshore acquisitions (mainly RE Power in Germany) fuelled by debt from domestic and FCCBs raised from foreign sources. The subsequent adverse turn of events made the company slide into losses and by 2012, it reported total net debt of ₹13,017 crore which included FCCBs of ₹3,641 crore. A part of these worth $360 million were redeemed successfully in May 2012 with the help of 45 days' extension of time by bondholders and refinancing through new borrowings, sale of assets and internal accruals. However, Suzlon had on its books further zero-coupon convertible bonds maturing in October 2012 in excess of $220 million.

In September 2012, Suzlon once again approached its bondholders for a four-month extension on its next two tranches of bonds to allow it to close out financing measures and meet its redemption obligations. This time, the bondholders rejected the proposal for extension of the timeline by 4 months as requested by the company. This failure to get an extension resulted in the biggest FCCB default by an Indian company surpassing Sterling Biotech's $184-million default in May 2012.

However, in the middle of the FCCB crisis, there were also companies that were successful in redeeming or converting their FCCBs successfully. Those that could redeem their FCCBs included Tata Steel, Reliance Communications, Bharat Forge Ltd., Kamat Hotels India, Orchid Chemicals & Pharmaceuticals, Ruchi Infrastructure and Aarvee Denims & Exports. Others such as Reliance Communications, Mahindra & Mahindra, Jubilant Organisys, Adani Enterprises and Essar Oil were able to successfully convert their FCCBs to equity.

The options available to FCCB issuers to come out of the crisis were:

(i) *Refinancing the FCCBs*: Refinancing with domestic debt would have meant a steep increase in their debt servicing burden. Considering that these companies were already stretched and presented a low credit profile, none of the Indian banks or capital market was willing to lend them additional debt. In addition, the high domestic cost of borrowing at that time (around 13-14%) and external commercial borrowings at 6-8% made refinancing of FCCBs a huge challenge. On an aggregate basis, according to a Standard & Poor report, FCCB issuers would have required to pay $700 million (approximately ₹3920 crore) a year in additional interest, if they could refinance the FCCBs on their books. In this regard, Reliance Communications was successful in raising new debt of $1.18 billion from Chinese banks to refinance its FCCBs that matured in 2012. Reliance Communications had raised money through FCCBs in 2007 at a conversion price of 30 percent premium over the share price prevailing that time.

(ii) *Conversion into Equity:* Many of the companies were making loss or heavily leveraged denting seriously their valuation. Conversion would have meant a heavy discount to the original conversion price which was difficult from a commercial and regulatory perspective.

(iii) *Hair Cut:* Get bondholders to accept only a partial repayment of their principal (popularly known as '*hair cut'*). This was not acceptable to bondholders who were already reeling from the after effects of the global financial crisis. There was a spate of law suits against defaulting companies by bond holders.

(iv) *Buyback at Discount:* Buying back the bonds at discount to their conversion price was allowed under the regulations. The extant ECB policy at that time provided that an Indian company could buy back FCCBs from the proceeds of - (a) existing foreign currency funds and/or fresh ECB proceeds at a minimum discount of 8%; and (b) from internal accruals with RBI approval at a minimum discount ranging from 10 to 20%. There was no cap on the quantum of buy back out of foreign currency funds/ fresh ECB, whereas a buy back from internal accruals was capped within the range of US$50–100 million. Companies like Welspun Corp. proposed a tender offer buyback of their bonds. In the case of Welspun, FCCBs aggregating to $150 mill maturing in 2014 were offered for buyback in 2011. Bond holders responded with a higher expected buyback price (around $85 for a $100 bond) than what the company hoped for ($75–80). Accordingly, the buyback programme was called off.

(v) *Restructuring the FCCBs:* This was another option for issuers so as to enter into a scheme of arrangement with revised terms. In 2009, Tata Steel rolled over its convertible bond maturing in September 2012 to November 2014 and increased its coupon rate from 1% to 4.5%. Subex Azure rolled over its FCCBs maturing in 2012 to 2017 after a successful exchange offer with 97% of its bondholders agreed to the scheme. According to the company, it issued new secured bonds worth $ 127.72 million with a maturity period up to July 2017 with a conversion price of ₹22.79 per share, offering a coupon of 5.70%, of which bonds worth 4 36.321 million would be mandatorily converted into equity shares at the aforesaid conversion price. It had also extended the maturity period on other existing bonds to 2017. However, the restructuring meant that the new convertible bonds had to be secured and new bond holders appointed their nominee directors on the board of the company. In the case of Suzlon, bond holders rejected the company's plan

(vi) *Raising Equity Funds:* Several companies laden with FCCB debt also looked for options to raise equity either through dilution of existing equity or by sale of non-core assets or by planned divestitures. Wockhardt sold its stake in Wockhardt Hospitals to Fortis Healthcare and sold its nutrition business to Danone for ₹1280 crore while Suzlon divested non-core assets.

Overall, the FCCB crisis presented the real situation of unpredictability over the life of a convertible instrument. In the context of Indian issuers, foreign bond holders also learnt of the limited options they had as unsecured creditors. Though there were a slew of court cases on defaulting companies, considering the time taken in Indian courts for creditors' winding up, it was not a viable option. With a new bankruptcy law in place, the stand taken by Indian courts and Tribunals vis-a-vis foreign unsecured bond holders could decide the destiny of the overseas FCCB market for Indian companies in the years to come.

Case Study

Wockhardt's Winding up Petition

The trustees to the bond holders of Wockhardt case filed a winding up petition in the court after the company defaulted on its FCCB obligations in 2009. The bond holders had some immediate success when the court directed the company to repay the bond holders first, prior to the secured creditors of the company and granted a stay on the winding up petition. The secured creditors of the company, predominantly being the domestic banks were not pleased with this directive. The company also filed for an injunction against the trustees for having approached a court in another jurisdiction in the case since the same case had already been filed at the Bombay High Court. The trustees had filed a similar suit related to FCCB default in a UK court in October 2011. In the course of the proceedings, the company presented a staggered repayment plan to the Bombay High Court which the Court agreed to and set aside the objections from the secured creditors. The liquidation proceedings were thus, stayed until the company could repay as per the approved plan. Meanwhile, the company pursued sale of its non-core businesses which proved successful and was able to repay bondholders. In 2012, the winding-up petition filed against Wockhardt by the Trustees to the FCCBs holders before the Bombay High Court was withdrawn.

10.10 Domestic Regulatory Framework for Depository Issues

Indian companies are entitled to make public offers on overseas stock exchanges by complying with the specific Indian regulations in this regard and the local regulations of the respective foreign jurisdiction and the stock exchanges therein. Such issues are known as *depository issues*. Depository issues may consist of American Depository Receipts (ADRs which in some conditions are also known as American Depository Shares (ADSs)), Global Depository Receipts (GDRs which can be issued globally among several countries except the US) and Foreign Currency Convertible Bonds (FCCBs). Indian companies making global public offers need not be listed in India at the time of making such offer.

For the purpose of regulatory oversight, depository receipts are treated as *foreign securities* in the home jurisdiction of the issuer. Therefore, the regulatory and tax regime for such issues from India were formulated on this theme. However, according to a Supreme Court judgement, SEBI has jurisdiction on the issuer companies in the matter of depository issues in cases of malpractice or market abuse.[3]

The scheme introduced in 1993 was quite restrictive in nature and did not address the changes in the Indian corporate sector. Therefore, it went through went through a complete revamp in 2014 based on comprehensive recommendations of the M.S. Sahoo Committee report. In addition, the introduction of the Companies Act 2013 enabled corresponding developments to be made under the corporate law.

Global public issues and private placements of depository receipts, bonds and convertibles by Indian corporates are governed in the domestic jurisdiction in India by the provisions of the Companies Act, FEMA and the policy framed by the Ministry of Finance from time to time and the applicable provisions of SCRA and tax laws. However, the public offer provisions that regulate domestic issuances are not applicable to overseas offers.[4]

[3]SEBI v. Pan India Advisors Ltd., Order dated 6th July, 2015

[4]Ministry of Corporate Affairs general circular no. 43/2014 dated 13th November 2014 with regard to FCCBs. With regard to ADR/GDR issues, SEBI's ICDR Regulations do not apply to overseas offers by Indian companies.

The overview of the extant government policy framework for these issues is explained in following section:

1. ADR/GDR Issues:

- The issue of GDRs/ADRs shall be in accordance with the provisions of the Companies Act under Section 41 read with the Companies (Issue of Global Depository Receipts) Rules 2014. Further, it shall comply with the Depository Receipts Scheme 2014 issued by the GoI as amended from time to time.
- Such issues also need to conform to the FDI policy of the government. The company satisfies other conditions prescribed in Schedule I to the Foreign Exchange Management (Transfer or Issue of Security by a Person Resident outside India) Regulations, 2000.
- Indian companies raising money through ADRs/GDRs through registered stock exchanges would be free to access the overseas capital markets through an automatic route without the prior approval of the Ministry of Finance, Department of Economic Affairs. Private placement of such securities shall also be covered under the automatic route provided such placement is lead managed by an investment banker. For this purpose, an investment banker managing such issue shall be registered with the SEC, USA, or under the Financial Services Act in UK or with the appropriate regulatory authority in Europe, Singapore or Japan.

2. FCCB Issues:

- The issue of FCCBs shall be in accordance with the scheme for issue of Foreign Currency Convertible Bonds and Ordinary Shares (through Depository Receipt Mechanism) Scheme 1993 *('1993 scheme'*) as amended from time to time. These provisions went through significant amendments in January 2000[5] and thereafter in 2005[6] and 2008.
- The issue of FCCBs should comply with the provisions of the FDI Policy, FEMA, Companies Act, SEBI Regulations, SCRA and the listing agreement in so far as it relates to the underlying issue of securities. With regard to their issuance as bonds, FCCBs are governed by the ECB policy till such time they are converted into shares and would, therefore, go through either the automatic route or the approval route of RBI as determined under the ECB policy. Since FCCBs are governed by the ECB policy, they will be governed by end use restrictions under that policy till the date of their conversion into equity.
- Public issues of FCCBs shall be made only through reputed investment bankers in international capital markets. In the case of private placements, the placement shall be with banks, multilateral or foreign financial institutions, foreign collaborators, foreign equity holders having a minimum holding of 5% of the paid up capital of the issuing company. Private placement with unrecognised sources is not permitted.
- FCCBs can be denominated in any foreign currency but the underlying shares shall be denominated only in ₹. Therefore, the conversion of FCCBs can only be into domestic shares in India.
- The coupon rate and conversion terms shall be fixed by the company on the advice of the investment banker managing the issue. The conversion period of the FCCB is also flexible but the non-converted portion shall have a minimum average tenor of five years. Call and put options cannot be exercised on the debt portion within 5 years. Issue of FCCBs with attached equity warrants shall be permitted only with prior approval of RBI.
- The conversion price for underlying shares in the case of listed companies shall be in accordance with SEBI Regulations based on the type of issue. In the case of unlisted companies, RBI pricing norms shall apply which prescribe any internationally accepted method of valuation of the shares.

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[5]Press Note Ref. No. 15/7/99-NRI dated January 19, 2000 and Notification No. G.S.R. 109(E) dated January 20, 2000 issued by the Ministry of Finance, Department of Economic Affairs, Government of India.

[6]Foreign Currency Convertible Bonds and Ordinary Shares (Through Depository Receipt Mechanism) (Amendment) Scheme, 2005, Notification No.F.No.15/4/2004-NRI Dated the 31st August, 2005.

- The *all-in* cost of the FCCBs shall be 100 basis points less than those prescribed for ECBs. The all-in cost shall include coupon rate, redemption premium, default payments, commitment fee, front-end fee etc. but shall not include issue-related expenses such as legal fee, lead manager's fee and out of pocket expenses.

Issue related expenses covering both fixed expenses like underwriting commissions, lead managers' fee, legal expenses and other reimbursable expenses shall be subject to a ceiling of 4% of the issue size in the case of GDRs and 7% in the case of listing on American stock exchanges. For issue expenses to be incurred beyond the above ceiling, approval of the RBI would be necessary. For FCCB issues, the issue expenses shall not exceed 2% of the issue size in the case of a private placement and 4% in the case of a public issue.

10.10.1 Salient Features of the Depository Receipts Scheme 2014[7]

Under the scheme, a *depository receipt* means "*a foreign currency denominated instrument, whether listed on an international exchange or not, issued by a foreign depository in a permissible jurisdiction on the back of permissible securities issued or transferred to that foreign depository and deposited with a domestic custodian and includes global depository receipt as defined in Section 2(44) of the Companies Act, 2013*". Under Section 2(44), the issuer company has to authorise the foreign depository to issue depository receipts in its name. The other important features of the scheme include the following:

- Firstly, the scheme broadened the scope of permissible securities that can be issued overseas to mean any securities falling under the definition in Section 2(h) of SCRA. Several new instruments such as securitised instruments and derivatives are included in this definition.
- Both listed and unlisted companies (either public or private) are allowed to issue depository receipts. There is no requirement of simultaneous listing in India as was the case under the erstwhile scheme. In addition, any holder of permissible securities may also be an eligible issuer. In other words, unsponsored issue of depository receipts is also permissible under the scheme.
- The issue can be made by way of a public offer or a private placement as may be allowed in the overseas jurisdiction.
- Fungibility of depository receipts into underlying securities and vice versa is possible so long as the FDI policy is adhered to.
- The pricing of underlying shares shall not be less than the applicable price for domestic issues under SEBI Regulations. Therefore, if the company is unlisted in India, no price regulation shall apply. If the company is listed, based on the type of issue, appropriate SEBI pricing regulations would apply.
- No end use pattern has been specified for proceeds raised from overseas issues of ADRs/ GDRs except that these cannot be used for stock market operations and for real estate activity as generally not allowed under FEMA.

10.11 Issue of IDRs in India

Similar to Indian companies making global public offers, the converse is also true. Foreign companies listed overseas may make public offers in India through the issue of Indian Depository Receipts (IDRs). SEBI permitted under its ICDR Regulations, pursuant to the amendments to FEMA Regulations by the RBI, issue of depository receipts by foreign companies in Indian capital market to raise capital. IDRs present

[7]The scheme was notified by the RBI vide Notification No. FEMA.330/2014-RB dated December 15, 2014, c.f. G.S.R. No. 914(E) dated December 24, 2014. Further operational requirements were notified vide notification no. RBI/2014-15/421 A.P. (DIR Series) Circular No. 61 dated January 22, 2015.

a unique opportunity to resident investors in India to invest in foreign companies without any exposure to foreign capital markets and currency risk, FEMA regulations and illiquidity issues. It also presents a good opportunity to domestic institutional investors such as mutual funds and insurance companies to benefit from investing in foreign equity.

The important regulations for companies incorporated outside India to issue IDRs in Indian capital market are explained in following points:

- ***Eligibility:*** An issuing company making an issue of IDR shall be listed in its home country with a track record of good compliance and is not prohibited to issue securities by any regulatory body.
- ***Size of the Issue:*** The issue shall not be for a size of less than ₹50 crore and each applicant shall apply for not less than ₹50,000.
- ***Issue Allocation:*** 50% to institutional investors and out of the balance, 30% should be allocated to retail investors. In case of an under-subscription in the retail quota, the shortfall may be added to other categories. Within each category, allotment shall be on proportionate basis.
- ***Underwriting:*** It is optional in IDR issues. Accordingly, in an underwritten issue, the minimum subscription shall be 90% including underwriters' subscriptions. In a non-underwritten issue, it shall be 90% through subscriptions to the issue.
- ***Fungibility:*** IDRs are not automatically fungible into underlying shares. This is subject to FEMA Regulations.

Case Study

Standard Chartered Bank IDR Issue

In the only issue of its kind in India, thus far, Standard Chartered Bank Plc of UK made an IDR issue in India in 2010. Bank of New York, Mellon acted as its overseas depository. The issue was for 24 crore IDRs through a public issue in the exchange ratio of ten IDRs to a share of Standard Chartered Plc.

Standard Chartered Plc. was incorporated in 1969 through a merger of The Chartered Bank and The Standard Bank Limited. Standard Chartered Plc, listed on both the London Stock Exchange and the Hong Kong Stock Exchange, ranks among the top 20 companies in the FTSE-100 by market capitalisation. The London-headquartered group has operated for over 150 years in some of the world's most dynamic markets and one of the leaders in Asia, Africa and the Middle East.

The public issue made through the book building route at a price of ₹100–115 per IDR did not do well in all categories and had barely managed to get subscribed on closing day to the extent of 90%. The IDR listed quite unimpressively and plunged below the offer price in 2011 and 2012 before reaching back to its offer level in early 2013.

10.12 Listing Options for Indian Companies

Listing options for Indian companies are three-fold:

- Listing in India
  - Domestic listing on Indian markets.
  - Simplified listing under Chapter XC of the ICDR Regulations with or without public issue.[8]
  - Backdoor listing through a merger with a listed company.

[8]Introduced in 2015

- Listing Overseas through depository issue
  - Direct overseas listing with depository offer.
  - Backdoor listing through a merger with a foreign listed company by issue of IDRs by the foreign company to domestic shareholders in India.
- Dual Listing of domestic shares and overseas depository receipts using the applicable method under each option as suggested above.

The above options are now more flexible since the mandatory requirement of listing in India on or before an overseas listing are no longer applicable. In addition, the Companies Act 2013 provides the option for an Indian company to merge with a foreign listed company through the issuance of Indian depository receipts that would be listed in India. In 2015, SEBI introduced an additional option for Indian companies to list in India either through a simplified public offer route or even without an IPO on the *institutional platform* of the designated stock exchange. Under this route, companies that are held less than 25% by promoters are eligible to list if their pre-issue capital is held at least up to 50% (25% for high technology companies) by QIBs.

There are some companies incorporated in India that made their IPO directly in overseas capital markets while remaining unlisted in India. Examples of this kind are rediff.com and Satyam Infoway and more recently, Make My Trip Ltd., the operator of the leading Indian travel portal. In addition, several private companies in the US prefer to *reverse merge* with their listed US counterparts to save on floatation costs. Similarly, an Indian unlisted company may choose to merge itself with a listed company so as to obtain a listing without a public offer.

Case Study

Make My Trip Ltd. IPO on NASDAQ

Make My Trip Ltd. (MMT) incorporated in Mauritius, is the holding company of Make My Trip (India) Private Limited, the main operating company which runs the travel portal makemytrip.com. The portal was launched in 2000 and is presently India's largest travel portal with presence in online airline ticketing, holiday packages and in bus and rail travel ticketing.

MMT made its IPO on NASDAQ Global Market in 2010 to raise US$70 million at $14 per share by diluting about 15% of its equity thereby valuing the company at over $450 million. Morgan Stanley, Pacific Crest Securities, Deutsche Bank Securities and Oppenheimer were the underwriters. The company was loss making at the time of its IPO. According to the SEC filing, the company had $83.56 million in revenues and $6.2 million in losses in 2010. It was backed by venture capital funds SAIF Partners, Sierra Ventures and Helion Ventures who invested in the company between 2005 and2009. It was one of the biggest venture capital exits in India.

The IPO was very successful by pricing at the top end of its expected $12-$14 range. It also exercised the green shoe option for another 15%, bringing the entire amount to $80.5 million. The market received the offer very well and the shares surged 80% on the NASDAQ to $25.16 on listing. It was the best first day performance in an IPO in that year. Even a year after listing, the shares were trading well above the offer price. The company declared marginal profits in 2011.

Case Study

Yatra Online Reverse Listing on NASDAQ

Yatra Online, the corporate entity that owns the yatra.com travel portal in India, is a leading player in the travel e-commerce business and a rival to Make My Trip. Yatra was looking at listing options to provide its PE investors and exit and unlocking value through a listing. Toeing the line of Make My Trip, Yatra was contemplating a global listing. However, the volatility of the markets at the time after the Brexit vote and impending US election and possible rate cuts by the Fed made the markets volatile which made the company look for alternatives. Finally, it settled for a reverse merger with Terrapin 3 Acquisition Corp (TRTL), which is a NASDAQ listed Special Acquisition Company (SPAC). TRTL, was listed in 2014 with a thin capitalisation but backed by Terrapin Partners and associates of the Macquarie group. The acquisition of Yatra by TRTL was structured as a merger so as to give the benefit of listing to the travel company. According to the deal structure, the consideration involved a cash payment to the shareholders of Yatra as well as shares in the combined entity such that they own at least 35% stake post acquisition. The cash component was restricted to $80 million to Yatra shareholders. The cash raised by TRTL in its IPO amounted to $212.75 million, a part of which was allocated under the deal terms to be used for the growth of the business of the combined entity which would greatly benefit Yatra apart from allowing it to get listed on NASDAQ through the reverse merger.

10.13 Public Offers in USA

USA presents the largest listing market across the globe. Some of the largest corporations are listed on the NYSE. The NASDAQ is particularly favoured by technology driven companies and knowledge driven businesses. The Information Technology companies traditionally listed on NASDAQ. Some of the well-known IPOs in the US markets include Netscape Communications (1995), Amazon (1997), Google (2004), Visa Inc (2008), General Motors (2010), LinkedIn's highly successful IPO (2011), Facebook's controversial IPO (2012), Groupon (2011), Twitter, Zynga, Orbitz, Alibaba, Agricultural bank of China, Industrial and Commercial Bank of China and several others. Most leading universal banks in the US such as JPMorgan Chase & Co., Goldman Sachs Group, Citigroup, Wells Fargo, Bank of America and Morgan Stanley are all listed. Similarly, the two well-known global buyout PE funds KKR and Blackstone are both listed.

Case Study

Alibaba Group Holdings IPO

Alibaba's IPO (2014) of $25 billion was the largest IPO ever in the world at the time surpassing Agricultural Bank of China ($22.1 billion in 2010) and Visa ($19.1 billion in March 2008). The IPO was for 320m ADS with a green shoe of 48m. With the IPO, it became the 4th largest market cap company in technology space after Apple, Google and Microsoft.

Alibaba was hugely profitable and the largest e-com, payment gateway and cloud computing company all rolled into one. Primarily it was a Softbank backed company, but was backed later on by Yahoo which owned 40%. Yahoo sold 17% prior to the IPO through a negotiated deal / OFS. Softbank held 34% and Jack Ma, the founder held 18%. The listed company Alibaba Group Holding Ltd., established on June 28, 1999 is registered in the Cayman Islands. It operates in China through many subsidiaries and affiliates. It has several layers of intermediate holding companies due to Chinese FDI regulations. Alibaba was started as a partnership with a large team of 18 management partners who had control. This was the reason why it listed in USA and not in Hong Kong which did not allow dual class shares.

Unlike its peers, Alibaba was profit making at the time of its IPO. Gross Merchandise Value (GMV) was $240 billion, with revenues of $8 billion, pre-tax profits of $3.5 billion, free cash flow of $4.8

billion and ROE of 113%. Twitter and Amazon were making loss at the time of their respective IPOs. Google and Facebook were profitable.

Alibaba's IPO Pricing Peer Comparison

Company	*LTM Net Profit ($M)*	*LTM Sales ($M)*	*IPO valuation ($M)*	*LTM PE at IPO (times)*	*LTM PS at IPO (times)*
Alibaba	4,033.29	9,356.54	167,960	41.6	18.0
Facebook	652	4038	104,000	159.5	25.8
Twitter	–142.557	534.462	24,000	NA	44.9
Google	190.716	2257.952	26,400	138.4	11.7
Amazon	–8.484	30.976	438	NA	14.1

Alibaba's IPO Aftermarket Performance Peer Comparison

Company	*IPO PRICE ($)*	*First day closing price ($)*	*First day gain*
Amazon	18	23.52	30.7%
Facebook	38	38.23	0.6%
Google	85	100.34	18.0%
Alibaba	68	93.89	38.1%
Visa	44	56.5	28.4%
Twitter	26	44.9	72.7%

Alibaba's pricing at 18x P/S appears in the mid-range on peer comparison but compares favourably on P/E comparison. In comparison with Facebook, the pricing of Alibaba was attractive. Facebook was almost flat on first day and lost 50% in the next 12 months to bottom out at $19. Clearly it was overpriced and a hyped-up issue, especially in the days preceding the IPO. Its Offer P/E at 159x was even higher than that of Google (138x). Google was a huge successful retail issue.

Due to the first day glitches that Facebook faced on NASDAQ, both Alibaba and Twitter opted to list on NYSE.

Alibaba raised its final offering price only by only 6% thereby registering a 38% first day gain. Twitter had the highest among its peers at 72%.

Alibaba also ensured that most of the issue allocations went to bulk investors and securities firms which, therefore, did not bring selling pressure. Facebook issue mostly landed with retail resellers and small investors. Since the first day trading was disrupted, it shook their confidence and the company never recovered from it.

10.14 Regulatory Overview and Types of Offers

The main regulations that govern securities listing in the US are The Securities Act, 1933, the Securities Exchange Act, 1934, the stock exchange listing requirements and the security laws of the respective state (known as the Blue-Sky laws). The requirements are similar whether a company lists ADRs or shares on the stock exchange. The regulations provide for different levels of compliance for large corporations and small business companies while making public offers. Understandably, small business companies are provided some relief from the burden and expense of regulatory compliance while still protecting investors. Similarly, non-US companies have a separate integrated disclosure system that makes some accommodations for foreign practices and policies.

Both US and non-US companies, listing on US capital market must first register with the Securities Exchange Commission (SEC), which is the chief regulatory authority for the capital market in the US. The Securities Act prohibits anyone from selling securities to the public unless a *Registration Statement* is in effect covering the securities or an exemption from registration is available. The Securities Act does not evaluate the quality of securities. Rather, it forces the disclosure of all relevant information so that investors can make informed investment decisions. That is why, the Securities Act is also known as the truth-in-securities statute. The registration statement contains two parts. Part one consisting of the prospectus is to be circulated by the underwriters to prospective investors. Part two is not available to investors but to SEC and is available for inspection at the SEC's offices or on their website.

The *Registration Statement* involves filing in specified forms developed by the SEC. The most commonly applicable forms are Form S-1 for US issuers and Form F-1 for non-US issuers. Similarly, Form SB-2 is used by small business issuers. In addition, Form 20-F is also filed which is a detailed report of the company's business activities and financials. The procedure may require the non-US issuers to file Form F-1 (the prospectus) followed by the Form 20-F incorporating particulars not falling beyond six months from the close of the financial year. The Form 20-F registration statement would include detailed disclosure regarding the issuer, including financial statements and reconciliation to US GAAP set forth in a note to the financial statements. The registration statement would be subject to a full review by the SEC, which generally takes 30 days or longer depending on the nature and extent of the SEC's observations. The SEC has to approve the registration statement as a first step towards the public offer.

The prospectus and the supplementary financial information that comprises the second part of the registration statement are reviewed both by the SEC and the NASD Regulations Inc. (NASDR), which is a subsidiary of the National Association of Securities Dealers Inc., the largest self-regulatory organisation for the securities industry in the US. The NASDR regulates the activities of brokers and dealers in the NASDAQ and the OTC industry. While the SEC reviews the prospectus for disclosure standards and compliance with law, the NASDR reviews the underwriter compensation portion of the prospectus. Within the SEC, the Division of Corporation Finance will review the registration statement for accuracy in all material facts and information that would affect investment decisions. Generally, IPOs are scrutinised more closely than FPOs. If an offer has a complex structure, the issuer company may even request for a pre-filing conference with the SEC staff so as to make them appreciate the structure and the review becomes smoother. The SEC attaches a lot of emphasis on the Management Discussion and Analysis (MD&A) section, the risk factors and management compensation. The disclosure on management compensation should be for each individual in the management team. The NASDR concentrates on the fairness of underwriting compensation and the terms and conditions of underwriting. In the US, the NASDR Corporation Financing Rule has developed complex methods of arriving at fairness in underwriting compensations and remuneration for the risks assumed by investment bankers. For this purpose, underwriting is categorised according to the level of risk assumed by the investment banker. The NASDR guidelines stipulate the maximum amount of underwriting compensations that can be paid for different types of public offers.

As in India, under the US law, the issuer company cannot circulate any information other than the prospectus to the investing public. The directors of the company and its management are solely responsible for mis-statements or false claims in the prospectus. The next major regulatory requirement is to state the financial statements included in the filing documents in compliance with US GAAP. For non-US companies, this would require a re-statement of their financial statements as per US GAAP. The areas of divergence between foreign GAAP and US GAAP have to be identified and a reconciliation statement has to be prepared for the purpose of the restatement by the independent auditors engaged for this purpose. This can be a tedious process and therefore, it should be started quite early in the process leading to the issue.

The SEC regulations allow smaller companies from the onerous registration requirements for public offers and make public offers. However, there would be a restriction on the maximum size of the offering. In Regulation A offerings, since they are smaller in size, companies need not file registration statements and audited accounts with the SEC.

Offers may also be made by companies within a particular state only by registering the offer under the Blue-Sky Law of that State. These offers need not be registered under the Securities Act with the SEC. However, the company has to meet all qualifying requirements to be classified as a local company of the concerned State. Needless to say, the offer shall also be made to investors principally belonging to that State.

US issuers can also make online IPOs known as *Direct Offers* (DPO) to investors via the internet. The registration of the securities with the regulators is done using simplified forms and procedures and the issuing company manages the underwriting itself. The cost of a DPO is typically much less than the cost of an IPO; however, the process is still labour-intensive for the company's management. These offers are similar to the online IPOs made in India, except that in the US model, the bids can be made by the investors directly without going through the on-line system of the underwriter / broker as in India. Spring Street Brewery and Logos Research Systems came out with on-line direct offers for the first time in 1996. The DPO is sort of a scaled-down version of the IPO, more suited to many companies that are not as far along in their business development as the typical IPO candidate. Therefore, direct offers are more suitable for smaller IPOs or portions of larger IPOs. Issuer companies would not wish to take a chance with direct offers in large IPOs without the involvement of investment banks. This is because investment banks play a vital role in marketing and generating institutional and high net worth investor support and in post-IPO trading.

10.14.1 Listing Standards in USA

The listing standards depend upon the market in which the proposed listing is to happen. In general, the NYSE is very stringent in its qualitative assessment of admission of a company into its market. Though there are eligibility requirements based on financial, liquidity and corporate governance criteria both on NASDAQ and the NYSE, qualitative assessment plays a major role and the exchanges may decline listing even if all the entry norms are met with. The exchange has broad discretion in listing a company. The fact that a company meets the quantitative initial listing standards does not necessarily mean that it will be approved for listing. The exchange may, sometimes, deny listing or apply additional more stringent criteria.

The minimum listing requirements for NASDAQ and NYSE are summarised below:[9]

- At NASDAQ, the norms are stiffer in based on the market tier being applied for. The IPO admission can be made in any of the three distinctive tiers: The NASDAQ Global Select Market, The NASDAQ Global Market and The NASDAQ Capital Market. The initial financial and liquidity requirements for the NASDAQ Global Select Market are more stringent than those for the NASDAQ Global Market and likewise, the initial listing requirements for the NASDAQ Global Market are more stringent than those for the NASDAQ Capital Market. Corporate governance requirements are the same across all NASDAQ market tiers. The NASDAQ Global Select Market presently has the highest listing standards in the world. The financial requirements are based on a combination of earnings, cash flow, assets, equity and/ or market capitalisation (in case of companies that are already listed elsewhere) criteria. The liquidity criteria are the minimum public float, total number of shareholders and the market capitalisation of publicly held shares post-IPO based on the offer price. The corporate governance requirements are also

[9]The quantitative thresholds may vary from time to time. Readers need to refer to the latest requirements from the listing handbook published by the respective exchange.

spelt out in the form of specific standards. Certain exemptions and phase-ins from these requirements apply to limited partnerships, foreign private issuers, initial public offerings and controlled companies.

- The NYSE financial criteria are: (i) Earnings Test based on pre-tax earnings and (ii) Global market Capitalisation Test for companies already listed elsewhere. The distribution (liquidity) criteria are: (i) total number of shareholders, (ii) minimum public shareholding, (iii) market cap of public shares at the offer price, (iv) minimum offer price and (v) for companies that are already listed elsewhere, the minimum trading volumes of the shares in those markets. The exchange prescribes different thresholds for US and non-US companies.

10.15 Process Flow Overview

The most important part of the process of an overseas floatation of securities is to put in place the issue team. The lead investment banker is the most important entity in the issue team who assembles the syndicate of underwriters consisting of other investment bankers and brokers. Generally, the lead investment bank is also the lead underwriter. Globally, there are several varieties of investment banks ranging from full service international firms to local specialised firms. For non-US issuers, the investment banking team should have the additional experience of listing foreign companies in the US markets. Indian companies generally appoint a domestic investment banker to act as advisor to the issue from India who would advise and help in identification of the foreign investment bank that would lead underwriter (lead manage) the issue.

The other important issue team members are the lawyers, the accountants, the depository bank, the transfer agent (registrar) and the domestic custodian bank. Selecting each of these team members would generally be in consultation with the lead manager for the issue. Domestic custodian bank is generally selected on the basis of their presence in the custodial business and their working relationship with the proposed global depository bank abroad. The law firms play a very vital role in being the issuer's attorney, the lead underwriter's attorney and to deal with the SEC, the NASDR, the stock exchange and the local state securities authorities. Unlike in India, where the investment banker prepares and files the offer document with SEBI and interfaces on behalf of the company, this function is performed for a global issue by the issuer's attorney. In the preparation of the registration statement, the drafts are reviewed by the lead underwriter and its counsel. In preparing the prospectus, the lawyers are engaged to draft the language and narrative as per law, the accountants prepare the specific financial statements that are part of the financial disclosures and the investment bankers provide the underwriting details. Therefore, in the US, a large part of the prospectus preparation is in the hands of the lawyers.

The accounting firm for a US public offer has to be a member of the American Institute of Certified Public Accountants (AICPA) and additionally, be a part of the AICPA's SEC Practice Section. One of the important documents furnished by the accountants apart from re-statement of accounts as per the relevant GAAP would be to furnish *Comfort Letter* on the unaudited financial data appearing in the prospectus and its compliance with the relevant GAAP. Most IPO teams also include consultants and advisors who are appointed for specific duties. The depository is usually a large banking corporation or a trust company. The Bank of New York is the leading depository bank in USA managing substantially more depository receipt programs than any other depository bank.

10.15.1 Process Requirements in USA

1. The issuer company and the lead manager have to sign a letter of intent stating the issue parameters, fee structure and other details as required. The company enters the *quiet period* at this time. It should be careful in meeting the strict requirements of SEC regarding issue of public information other than

the prospectus until the quiet period is over. The quiet period lasts till 25 days after trading of the share has commenced in the secondary market.

2. The preparation of the registration statement has to be commenced at the earliest. As stated, the law firm has to be involved completely on the drafting of the narrative with vital information being provided by the company and the lead managers. The company's business details, the MD&A, the offer structure and other important sections need to be drafted as per the requirement of the SEC on one hand and from the marketability of the issue on the other. It may be appreciated that the prospectus is also the only marketing literature for the issue.
3. While the attorneys are at the preparation of the prospectus and legal due diligence connected therewith, the investment banker and the accountants conduct the process of financial and accounting due diligence for the issue. The investment banker will examine the company's management, nature of business and operations, financial position, past performance, competitive strengths and the stated business plan for the future. Incidental issues such as supply chain dynamics, customer relationships, labour relations etc. would also be examined since they have a bearing on the performance of the company. The accountants will examine financial information and all material supporting documents such as contracts, invoices, legal agreements, vouchers and other evidence in assessing the fairness of the accounting statements. Accounting policies and adherence to the relevant GAAP is examined in great detail.
4. The filing of the registration statement with the SEC is made by the lead manager. After the filing of the registration statement containing the *preliminary (red herring) prospectus* with the SEC, it would be available for circulation among underwriters. The lead underwriter assembles prospective syndicate members for a closed-door meeting to assess their interest and the extent of allocations that need to be made. This meeting will establish the marketability of the issue as well. The underwriting syndicate after it is formed, acts as a distribution channel by recording indications of interest in the IPO on the part of institutional and individual investors.
5. The road shows are commenced with the help of the investment banking team and a specialist public relations company experienced in handling such events especially in compliance with the quiet period regulations. A series of meetings are held with potential investors and analysts in all key financial centres where the issue is being floated or where the potential investors are located. The road show usually consists of formal presentations and question answer sessions, followed by one-to-one interactive meetings set up by the investment bankers and their affiliates.
6. The prospectus has to be then revised according to the observations made by the SEC and the NASDR. The law firm generally assists the investment bankers in complying with the amendments to the prospectus and to file such amendments. During the period between the initial filing of the registration statement and the date it is made effective by the SEC (called the waiting or cooling-off period), the SEC may require information on the circulation of the preliminary prospectus and if the distribution is found insufficient, the declaration of effectiveness may be delayed. Upon the completion of this process, the SEC would declare the registration statement '*effective*' on a particular date ('*Offering Day')*. Typically, the SEC takes 20 days to declare a registration statement effective unless otherwise delayed.
7. The underwriters decide the price to be paid to the issuer company usually on the evening of the previous day the prospectus becomes effective or on the morning of the Offering Day itself. The lead underwriting investment bank negotiates this price with the issuer company. Thereafter, the investment banker and the syndicate of underwriters sign the underwriting contracts. The SEC declares the registration statement effective. Thereafter, the final prospectus goes into print. The law firm of the issuer files the final registration statement with the SEC by including the offer price. The accounting firm delivers the final comfort letter.

8. The underwriters announce the public offer price immediately after the registration is declared effective. The investors have to confirm their indications through the syndicate members immediately after the issue is priced. Many a time, they are given just an hour to do so. The underwriters do the allocations typically on the next day morning. Based on the responses received, the subscriptions lists are drawn up and the over-subscription is determined. The allocations are made on proportionate basis.
9. The secondary marketing trading typically starts on the next day after pricing since investors can ascertain the allocations on that morning itself from the underwriters. The US system is different from the Indian system in this aspect because in India, trading does not commence until after the issue has closed and the allotment process has been completed. Under the US system, the issue does not have any opening and closing dates since there is no necessity to have mandatory allocation of IPO shares. The issue is recorded on a single day, i.e. the date on which the registration statement becomes effective and the pricing is announced. It has to be appreciated here that there is a fundamental difference between the issue process in India and in the US, i.e. in India, the investors purchase the shares in an IPO directly from the issuer company while in the US, they purchase from the underwriters and the selling group members.
10. Sometimes, an issue is conducted on the basis of book building (called *Open IPO*), wherein bidders put in their bids before the prospectus becomes effective indicating a limit price. Shortly, after the SEC declares the issuer's registration statement effective, the auction will close and the underwriter will establish the clearing price. The clearing price is established by tallying all the bids received, ranking them from highest price to lowest price and beginning with the highest price, identifying the price level at which all of the shares can be sold. Once the clearing price is determined, the underwriter and issuer will establish the public offering price, i.e. the price per share customers will pay for securities. In any particular offering under the auction process, the clearing price and the public offering price may be different. Based on negotiations between the underwriter and the issuer, the public offering price may be lower, but will not be higher, than the clearing price.

Case Study

Google Inc.

In a rare phenomenon, Google Inc. used the Dutch auction process for book building its IPO made in 2004. This was because Google wanted more distribution of its IPO allocations to investors. Traditionally, in US IPOs, it is the institutional and high net worth investors who get the IPO allocations at the IPO price. Other investors typically get to buy the shares on the day the trading commences but they tend to pay a higher price than the IPO price depending upon how hot the scrip is in the aftermarket. In order to benefit retail investors at the IPO price, Google used the Dutch auction process wherein the highest bid price would be selected. However, this step by Google generated mixed response from analysts and investment banks who questioned its prudence.

11. The issue achieves closing usually three to five days from the effective date of the registration statement. This gives enough time for the underwriters and selling group members to collect funds from the investors. Typically, the first settlement for IPO shares after commencement of trading happens in three days. The first closing happens around the fifth day from the opening date and a second closing if required, by the eighth day. Based on the subscriptions received, the accounting firm delivers the '*bring-down'* comfort letter to re-affirm what is stated in the comfort letter issued earlier. The lead underwriter transfers the amounts received from subscriptions to the issuer company after deducting underwriting and selling commissions. The law firm has to update the closing documents (Exhibit 10.4).

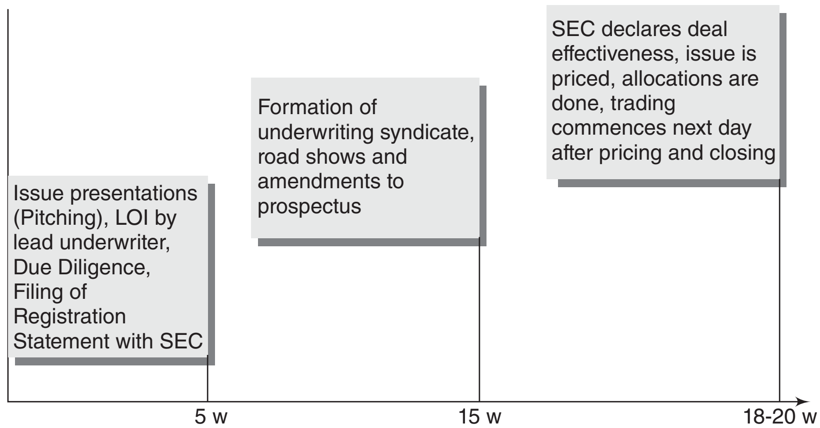

Exhibit 10.4 Illustrative US Public Issue Process in Weeks

10.16 Public Offers in UK

Form the above discussion on US public offers, it may be appreciated that the system followed in US has certain fundamental differences as compared to India. However, the delivery model of UK public offers is very similar to that followed in India. Nevertheless, there are a few subtle differences in terms of various IPO related practices. These are discussed below:

- London Stock Exchange (LSE) has two segments: the Main Market and the Alternative Investment Market (AIM). While most companies list on the main market, the AIM is meant for smaller companies both UK based and outside. Both the segments have different listing norms considering the differences in the profiles of the companies in each segment. The regulator for the IPO process is the UK Listing Authority (UKLA), a division of the Financial Conduct Authority, the regulator for the financial sector and markets in UK. The UKLA performs the role of overseeing the listing process by ensuring that companies comply with disclosure and registration norms pertaining to a public offer. The UKLA admits a security to its official list after ensuring compliance by the issuer company. Thereafter, the LSE grant listing permission by admitting the scrip for trading. The LSE admission criteria for trading are in congruence to the UKLA Listing Rules for public offers and both the UKLA and LSE jointly announce listing.
- In the UK, public offers are hand held by the 'sponsor' enlisted as an approved sponsor with the UKLA. A sponsor is central in the public offer process, much like the lead manager in India or the lead underwriter in USA. However, unlike in India lead managers are merchant bankers and in US where lead underwriters are investment banks, in the UK, a sponsor to an issue can be an investment bank, accounting firm, financial advisor, stock broker or a corporate finance house. However, in most cases, investment banks and broking firms are preferred due to their marketing abilities. The sponsor performs all the liaison work with UKLA, appointment of other agencies and in advising the company on the issue.
- The issue process follows either the fixed price or the book-built method. Book building is generally used for larger offerings. The red herring prospectus is also known as the *Pathfinder Prospectus*. Listing is called *admission to trading*. The day on which the prospectus becomes effective is called the *Impact Day*. The regulatory clearance follows the same pattern as in India or the US. Preliminary meetings are held with the UKLA and the LSE and thereafter, a continuous dialogue till the prospectus is approved. The impact day happens in the week before the admission week. On the impact day, the issue is announced

and the prospectus is approved by the UKLA. Simultaneously, the pricing of the shares is announced. Subsequently, the prospectus is printed and circulated. A formal listing application is made to the UKLA and an application for admission to trading to the LSE at least 48 hours before admission.

- In the admission week, applications are received from investors and allocations are completed. If the issue is over-subscribed, the basis of allocation is applied. If the issue is under-subscribed, the underwriters pick up the shortfall. The share application lists are officially closed after full subscription has been received in the above manner. Thereafter, the basis of allocation is announced to the investors and the admission is jointly announced by the UKLA and the LSE. Trading commences in the secondary market.

10.17 Comparative Schemes of IPO Process

Based on the discussion so far in this chapter on various public offers and processes involved in India, USA and the UK, a comparative chart has been furnished in Table 10.1 so that the reader can appreciate the differences in the framework of public offers in the respective regions.

Table 10.1 Comparative Scheme of Public Offer

Process	*India*	*USA*	*UK*
1. Method of Listing	IPO, offer for sale	IPO, secondary offer	IPO, Introduction, Placing
2. Pricing methodology	Both fixed pricing and book-built methods.	Book-Built	Both fixed pricing and book-built methods
3. Underwriting	Optional, mandatory for book built offers	Mandatory	Optional
4. Allotments	Proportional	Discretionary	Proportional
5. Retail Quota	Mandatory	Non-existent	Non-existent
6. QIB quota	Mandatory in book-built offers	Non-existent	Non-existent
7. Method of floatation	Widespread with retail focus	Close-door and through underwriting syndicate	Close-door and through underwriting syndicate
8. Investor focus	Institutional and retail	Institutional	Institutional
9. Regulatory approvals	SEBI approves offer, Stock Exchange approves listing	SEC approves offer, exchange approves listing though it is mostly concurrent	UKLA approves both offer and listing
10. Pricing announcement	(a) In fixed price offers, it forms part of prospectus circulated prior to opening of the issue. (b) After closure of issue in book-built offers.	On the Effective Date	On the Impact Date
11. Subscriptions	Received during the time issue is open	There is no concept of opening and closing of issue. The issue is recorded as on the effective date.	Received in the admission week

(*Contd.*)

12. Post-issue procedures	Allotments are taken up by the issuer company after issue has closed	There are no allotments made by the issuer company. Closing of issue happens over the next five days after effectiveness.	Allocations are made by the issuer company in the admission week. Share subscription list is closed after allocations are completed and announced.
13. Trading	Commences after completion of post-issue procedures (T+6 presently. SEBI may introduce T+4 in future).	Commences on the next day of effectiveness (T+1)	Commences after share application lists are closed in the admission week (T+2 minimum)

10.18 Role of Investment Bankers in Cross Border Issues

The role of investment banks in cross border offers is two-fold; in the home jurisdiction of the issuer company and in the jurisdiction of the offer. Therefore, it is customary to have two teams to ensure regulatory and offer compliance in each jurisdiction. In the context of an Indian company making a cross border offer, while the offer related banking is done by the global co-ordinating book runner to the issue (the lead manager) and its team, the Indian investment banker becomes the adviser to the offer taking care of the Indian co-ordination. The global book runner is the key underwriter and issue manager and takes critical decisions on pricing, underwriting, marketing and allocations. This bank is also responsible for coordination with the market regulators and stock exchange authorities in the listing jurisdiction. The activity profile of the foreign investment bank and its team has already been outlined in a previous discussion. It may be noted that the key value add of the lead underwriter is to arrive at the appropriate pricing based on the judgement of market sentiment for the offer. If the pricing is attractive, the book is built accordingly and the offer is successful. The pricing in global offers is also based on the book-building method and is, therefore, similar to pricing analogies in domestic offers. Pricing, underwriting and book-building are, therefore, the key responsibilities of the investment banker.

The domestic investment bank performs the key role of helping the foreign investment banker in properly validating the company's business plan in its domestic operating environment according to local laws and regulations. To this extent, the domestic investment banker brings in the local experience to a foreign investment banker handling the cross-border issue. The foreign banker brings in the issue marketing and underwriting capabilities required in the foreign markets. Thereafter, the domestic banker also validates the valuation of the company so as to help the foreign investment bank in its issue pricing decision.

The domestic investment banker also brings in necessary expertise with regard to due diligence and providing necessary comfort letters to the overseas banker, co-ordination on paper work, legal opinions, certifications, disclosures and offer document work which is key to the pre-issue stage of the transaction. The domestic investment bank also helps in structuring the transaction as per the regulations of the Ministry of Finance and the RBI as already discussed herein above. The investment banker should also coordinate necessary regulatory approvals and certifications as may be required from government authorities, due diligence agencies and legal advisers in the domestic jurisdiction. Therefore, the role of the domestic banker is different from conventional functionality of an investment banker in a domestic public issue. It is more akin to the role of an adviser in the transaction to ensure that it is conducted in the best interests of the issuer company and in compliance with local law, regulations and procedure.

IMPORTANT TERMINOLOGY

Admission to Trading	Foreign Bond	Pathfinder Prospectus
ADR	Fungibility	Preliminary (Red Herring) Prospectus
AIM	GDR	Registration Statement
Comfort Letter	IDRs	Road Shows
Convertible Bond	Impact Day	Rule 144A DRs
Depository Receipts	International Listing Centres	Sponsored DR Issue
Direct IPO	Managing Underwriter	Sponsored Level I, II and III DRs
Domestic Bond	MTN	Two-way Fungibility
Euro Bond	Offering Day	Unsponsored DRs
FCCB	Open IPO	

TEST YOUR UNDERSTANDING

PART - A

I. Pick the right answer(s) or the alternative that best fits the description from the alternatives provided under each question.

1. If a number of offshore GDR investors collectively wish to sell their holdings as shares in the domestic market, the option is:
   (a) To seek the company making a reverse sponsored GDR issue
   (b) To sell their GDRs to a FII which canexchange them for shares and sell in the domestic market
   (c) Sell their GDRs to a resident domestic investorwho can seek conversion into shares
   (d) Seek the company to buyback the GDRs and pay for in shares
   (e) Become portfolio investors on the domestic market.
2. In a sponsored ADR issue, the shares surrendered in India are offered through depository receipts in overseasmarkets by way of a:
   (a) Public offer
   (b) Private placement of listed ADRs
   (c) Private placement of unlisted ADRs
   (d) 144A placement
   (e) Rights offer to existing ADR holders
3. Two-way fungibility of depository receipts shall mean that:
   (a) The DRs can be exchanged for shares in the domestic country
   (b) The shares can be exchanged for DRs in the foreign country
   (c) The foreign country and the domestic country can be interchanged to make the issue
   (d) The company can make the issue in either country
   (e) The investor can apply in either country
   (f) The shares are surrendered for sale in the foreign country.
4. A company proposes to make an ADR issue and a sponsored ADR issue together. This has the following implication:
   (a) Both the issues will be held invalid
   (b) The company will be prosecuted in both countries
   (c) The promoters will be held liable to imprisonment
   (d) The foreign merchant banker will be asked to punish the Indian merchant banker
   (e) Directors of the company will be held liable
   (f) Foreign investors can demand refund of money from domestic investors

5. A company proposes to re-issue GDRs, which were surrendered by the foreign investors in exchange for local shares. This has the following implication:
   (a) Such issue is not possible
   (b) The GDRs can be re-issued to domestic investors only
   (c) The reissue would be constituted as a domestic public offer
   (d) SEBI's pricing guideline will apply
   (e) Reissue is possible only to the available headroom
   (f) Reissue should be a public offer.
6. A company proposes to exchange its GDRs with IDRs. This has the following implication:
   (a) The GDRs will be converted into shares and IDRs will be issued against them
   (b) The IDRs are issued against local shares which are exchanged with the GDRs
   (c) The IDRs are issued against the GDRs at an agreed ratio
   (d) SEBI's pricing guideline will apply
   (e) The IDRs and GDRs are valued independently
   (f) The IDRs have to be issued at the CMP of the GDR.
7. A listed Indian company proposes to make a simultaneous FPO and private placement of GDRs in overseas market. This has the following implication(s):
   (a) The entire new shares will be listed in India
   (b) The shares underlying the GDRs will be listed in India
   (c) The shares underlying the GDRs will be added to the FPO
   (d) The GDRs will be listed in the overseas market
   (e) The proposed scheme is not feasible
   (f) The shares will be locked in for 3 years
8. A company proposes to make a simultaneous IPO in Indian and overseas capital market through a GDR issue. It can be done in the following way(s):
   (a) The GDRs have to be issued at the equivalent price as the domestic shares
   (b) The domestic issue can be made through book-building route but the GDR should be at a fixed price
   (c) The cut-off price in the domestic issue becomes the fixed price for the GDR issue
   (d) The cut-off price for the GDR issue becomes the fixed price for the domestic issue
   (e) The cut-off price has to be common for both the issues
9. The commencement of trading after a public issue happens as follows:
   (a) In USA, within 1 day of the registration statement being declared effective
   (b) In UK, within 48 hours of the allotments being completed
   (c) In India within 90 days of SEBI approving the DRHP
   (d) In USA within 48 hours of the underwriters remitting the funds to the company
   (e) In UK, within 90 days of the close of underwriting for the issue
   (f) In India within 7 days of the close of the issue.
10. Foreign Institutional Investors (FIIs) in emerging markets running sub-accounts for investors from other markets can seek fungibility of their DRs into shares so as to sell them in the domestic markets.
    (a) Yes (b) No
11. The Registration Statement submitted to the SEC for an ADR issue shall state the underwritten price of the offer.
    (a) True (b) False
12. The underwriters for a public issue of shares by an US company on the NYSE cannot revise the price upwards after the effectiveness of the Registration Statement but can always revise it downwards.
    (a) TRUE (b) FALSE

13. A company's GDRs are quoting at a premium to the domestic market price of its shares. The company therefore decides to make a GDR FPO. Simultaneously, based on shareholders' demand, the company also decides to float a sponsored GDR issue. The i-banker recommends a composite offer of sponsored and FPO components. The company wishes to have a differential pricing for both the components which the i-banker says is not possible. The i-banker is right.
    (a) Yes (b) No
14. A company's ADR is quoting at a discount of 20% to its domestic share price. In order to rationalise the market, the company proposes a buyback of ADRs. The company's CFO says that it would increase the residual debt equity ratio of the company beyond 2:1. The company's investment banker maintains that this regulation does not apply to buyback of ADRs. Who is right?
    (a) Investment Banker (b) CFO
15. A company that is unlisted in India decides to make an offer for sale of GDRs in London AIM exchange so as to list its GDR. The GDRs will be carved out of the promoters' shares. This amounts to a sponsored GDR issue.
    (a) Yes (b) No
16. In a Rule 144A offer of an Indian company of its ADRs, the underwriters of the issue marketed the instrument to institutional investors only. The ADRs were not proposed to be listed in the US, instead they were to be listed on Luxembourg stock exchange. Some of the US funds require that the company list its ADRs in the US. The investment banker states that this is not possible under Rule 144A. Alternatively, the investment banker proposes a FCCB issue with a conversion option into shares listed in India. The company officials feel the investment banker is misleading the company without being aware of the regulatory requirements. Who is right?
    a. The company b. The investment banker
17. A company proposes to issue Rupee Denominated Bonds to QIBs in the overseas market. These bonds shall be pegged to the 6 months LIBOR with coupon reset every 6 months. However, the interest and principal will be paid in rupees and the exchange risk is borne by the investor. This kind of a bond is called:
    (a) Paneer Bond (b) Idly Dosa Bond (c) Tandoori Bond (d) Masala Bond
    (e) Rabdi Jamoon Bond (f) Jalebi Bond

PART - B

18. What is the eurobond market? What are the other segments of international bond markets? Which is the segment that is most suitable to Indian corporates?
19. What is Rule 144A market? Is it beneficial to issuers?
20. How is a GDR different from an ADR? Can an ADR be issued in the Rule 144A market?
21. How does the depository mechanism function? What is fungibility and reverse fungibility and how do these work?
22. What are the operative guidelines in India for fungibility and reverse fungibility of ADRs/GDRs?
23. Outline the procedure of making public offers in USA and UK capital markets. What are the fundamental differences between the these models and the Indian model?
24. How does the US system of public offers mitigate market risk for underwriters?
25. Does the depository system provide an opportunity for arbitrage trading? If so explain the mechanism.

For answers to Part A, refer to Appendix B at the end of the book.

Annexure 1

General Templates in Overseas Capital Market Offers

1. Offer Structure of Videsh Sanchar Nigam Ltd.–Offering of GDRs representing Equity shares (US$ 527 mn GDR issue) 1997.

The Offering[10]

The Offering	32,130,000 GDRs representing 16,065,000 Offered Shares (assuming that the Managers' Option is not exercised) are being offered outside India. Of such aggregate number of GDRs, 24,330,000 GDRs representing 12,165,000 Offered Shares are being offered by the Company and 7,800,000 GDRs representing 3,90,000 Offered Shares are being offered by the Government of India. The Offered Shares represented by the GDRs being offered by the Government of India are registered in the name of the President of India. GDRs are being offered in the United States only to QIBs as defined in Rule 144A under the Securities Act in reliance on Rule 144A and outside the United States and India in offshore transactions in reliance on Regulation S under the Securities Act. GDRs are not being offered in India.
The Shares	Equity shares of the Company, face value Rupees 10 per share.
The GDRs	Each GDR represents one-half of one share. The GDRs will be issued by The Bank of New York, as depository (the 'Depository') pursuant to the Deposit Agreement, dated as of March 27, 1997 (the 'Deposit Agreement'), to be entered into between the Company and the Depository. The Offered Shares will be deposited The Industrial Credit and Investment Corporation of India Ltd. as the custodian for the Depository (the 'Custodian'). The deposited shares may not be withdrawn from the depository facility until 60 days after the later of the commencement of the Offering and the last issue date of the GDRs, subject to certain limited exceptions. Once withdrawn, Shares cannot be re-deposited under the Deposit Agreement. The effect of such transaction will be to reduce the number of outstanding GDRs. In addition, Shares acquired in the open market may not be deposited under the Deposit Agreement. GDRs sold in reliance on Regulation S under the Securities Act (the 'Regulation S GDRs') will be represented by a Master Regulation S GDR (the 'Master S Regulation GDR') and GDRs sold in reliance on Rule 144A under the Securities Act (the 'Rule 144A GDRs') will be represented by a Master Rule 144A GDR (the 'Master Rule 144a GDR') and together with the Master Regulation S GDR (the 'Master GDRs'). Except in limited circumstances described herein, GDRs in definitive registered form will not be issued in exchange for interests in the GDRs represented by the Master GDRs. Subject to the terms of the Deposit Agreement, interests in the terms of the Deposit Agreement, interests in the Master Rule 144A GDR may be exchanged for interests in the corresponding number of GDRs represented by the Master Regulation S GDR and vice versa. The GDRs and the Offered Shares represented thereby are subject to restrictions on transfer.
Price	US$ 13.93 per GDR

[10]Extracted from the Offering Memorandum dated March 24, 1997.

Manager's Option	The Company has granted to the Managers an option, exercisable from the date of closing of this Offering Memorandum until 30 days after the Closing Date, to acquire up to 5,670,000 additional GDRs, representing 2,835,000 additional shares.
Equity Shares Issued and Fully Paid	Before the Offering: 80,000,000 Shares After the Offering: 92,165,000 Shares, assuming the Manager's option is not exercised.
Use of Proceeds	The net proceeds of the Offering (after deduction of the applicable management and underwriting commission and selling concession, stamp duty and estimated expenses payable by the Company) are estimated to be approximately US$ 434,975,000 assuming the Manager's option is not exercised. The Company intends to use its share of the net proceeds of the Offering (estimated to be approximately US$ 329,255,000 assuming the Manager's option is not exercised) to expand its international services and other telecommunications infrastructure and to make additional investments in telecommunication projects, principally under its Ninth Five Year Plan as well as for general corporate purposes. The Company will not receive any proceeds from the GDRs offered by the Government of India.
Lock-up Period	The Company and the Government of India have agreed to certain restrictions on their ability to issue or dispose off shares and certain related securities during a period of nine months following the date of the Underwriting Agreement (as defined herein). Such restrictions do not apply to contemplated offerings by the Government of India of up to 690,000 Shares in the domestic market and of up to 600,000 Shares to employees of the Company, both scheduled to take place in 1997.
Dividends	Holders of GDRs will be entitled to receive dividends with respect to the underlying Offered Shares to the same extent as the holders of outstanding Shares except that holders of GDRs will not be entitled to any dividend for the financial year ending 31^{st} March 1997. Cash dividends, if any, on the Offered Shares will be paid to the Depository in Rupees after deduction of applicable withholding taxes and except in certain circumstances, will be converted by the Depository into Dollars and paid to the holders of the GDRs (less the Depository's fees and expenses).
Voting Rights	Holders of GDRs will have no voting rights with respect to the Offered Shares while they are represented by such GDRs. The Depository will, if permitted by law and subject to certain other conditions, exercise voting rights with respect to Shares represented by GDRs in accordance with the direction of the Board of Directors of the Company as conveyed by the Chairman thereof. Registered holders of Shares withdrawn from the depository facility will be entitled to vote and exercise other direct shareholder rights in accordance with applicable Indian law, subject to certain restrictions.
Listing and Trading	Application has been made to list the GDRs on the London Stock Exchange. The GDRs are expected to be eligible for quotation through SEAQ International and in the PORTAL market. The outstanding Shares (including the Offered Shares being offered by the Government of India) are listed on the Indian Stock Exchanges. Application has been made to list the Offered Shares being offered by the Company on the BSE and the other Indian Stock Exchanges. The Company has received approval in principle to list such offered Shares on each of these exchanges.

Settlement	The Master Regulation S GDR and the Master Rule 144A GDR will be registered in the name of Cede & Co., as nominee of DTC (Deposit Trust Company). The Master Regulation S GDR will be held by DTC for the accounts of Euroclear and Cedel Bank. The Company will request that DTC not effect book-entry deliveries of Regulation S GDRs evidenced by the Master Regulation S GDR (except deliveries to or between DTC participant accounts maintained by the banks that act as depositories for Euroclear and Cedel Bank or to or between such accounts and the Depository) during the 40 day period beginning on the latest of (i) the commencement of the Offering, (ii) the original issue date of the GDRs and (iii) the issue date with respect to the additional GDRs, if any, issued pursuant to the Manager's option in connection with the Offering (the 'Restricted Period'). Each person owning a beneficial interest in the Master Rule 144A GDR or the Master Regulation S GDR must rely on the procedures of DTC and institutions having agreements with DTC ('DTC Participants'), including Euroclear and Cedel Bank, to exercise or to be entitled to any rights of a Rule 144A GDR holder or a Regulation S GDR holder, as the case may be. So, long as any GDRs are traded through DTC's book-entry system or unless otherwise required by law, ownership of beneficial interests in the Master Regulation S GDR or the Master Rule 144A GDR will be shown on, and transfer of such ownership will be effected only through, records maintained by DTC or its nominee (with respect to DTC Participants' interests) or DTC participants including Euroclear and Cedel Bank. It is expected that the GDRs will be accepted for clearance through the facilities of DTC, Euroclear and Cedel Bank.

2. Offer Structure of Sterlite Industries (India) Ltd.–Offering of 3.5% Convertible Bonds due 1999 convertible into GDRs (US$100 mn FCCB issue) 1993.

The Offering[11]

The Issue	US$ 90,000,000 Convertible Bonds due 1999 are convertible into GDRs each representing one equity share with nominal value of ₹10 each of the Company. The Company has granted to Robert Fleming on behalf of the Managers an option, to cover over-allotments, exercisable on or before the business day prior to the Closing Date, to subscribe for additional Bonds in the aggregate principal amount of US$ -000,000. The Securities have not been and will not be registered under the Securities Act and are being offered and sold in the United States exclusively to a limited number of persons reasonably believed by Robert Fleming to be QIBs within the meaning of Rule 144A under the Securities Act and outside the United States by the Managers in reliance upon Regulation S thereunder.
Conversion Period	From 22nd March, 1994 up to and including 31st May, 1999
Conversion Price[11]	₹--, subject to adjustments for, among other things, sub-division or consolidation of Shares, bonus issues, rights issues and other dilutive effects.

[11]Extracted from the Preliminary Prospectus dated 7th December 1993.

Negative Pledge	The Company will give a negative pledge relating to itself in relation to Relevant Debt. *Relevant Debt* means any present or future indebtedness of the Company or any other person which is in the form of , or represented by, bonds, notes, debentures, loan stock or other securities which are for the time being or are capable of being quoted, listed or ordinarily dealt in on any stock exchange, over-the-counter or other organised securities market and which is denominated or payable or confers a right to make or receive any payment in or by reference to any currency other than Rupees.
Final Redemption	Unless previously redeemed, purchased and cancelled or converted, the Bonds will be redeemed on 30th June, 1999.
Redemption at the option of the Company	The Bonds may not be redeemed by the Company prior to 30th June, 1996 (except in an event of default or for tax reasons) and may only be redeemed thereafter if the Closing Price of the Shares on the BSE has been at atleast 130 percent of the Conversion Price for a period of 30 consecutive days prior to redemption.
Tax Redemption	The Company may redeem all, but not some only, of the Bonds at their principal amount plus accrued interest, in the event of certain changes in Indian taxation which would require the Company to gross up for payments of principal or to gross up for payment of interest at a rate exceeding 10 percent.
Form and Denomination	The Bonds will be in registered form in the denomination of US $ 5000. A single Global Certificate, registered in the name of the Common Depository or its nominee, will be issued in respect of the Bonds and will be deposited on the Closing Date with the Common Depository. Title to the Bonds will be registered in the name of the Common Depository. The issue of Bond Certificates evidencing registration of title to the Bonds in a name other than the Common Depository will be permitted only in very limited circumstances. The GDRs will be in registered form represented by a European Master GDR, registered in the name of the Common Depository or its nominee and an American Master GDR registered in the name of DTC or its nominee.
Listing of Bonds, GDRs and Shares	The existing issued Shares are listed on the BSE (the main trading market for the Shares) and three other stock exchanges in India–the Stock Exchanges of Ahmedabad, Calcutta and Delhi. The Company will apply to have the Shares arising on conversion of the Bonds listed on such stock exchanges. Application has been made to list the Bonds and the GDRs on the Luxembourg Stock Exchange.
Governing Law	English Law
Trustee	Bankers Trustee Company Limited

3. Offer Structure of Offer Document of Dr. Reddy's Laboratories Ltd.–Offering of American Depository Shares representing Equity Shares (US$115.46 mn ADS issue) 2001.

The Offering[12]

American Depository Shares Offered by us………..	11,500,000 American depository shares
ADSs……………	Each American depository share represents one half of one equity share, par value ₹10/- per Share. American depository shares represent ownership interests in securities that are on deposit with the depository. The American depository shares will be evidenced by American Depository receipts. See "Description of Equity Shares" and "Description of American Depository Shares".
Equity shares outstanding after the offering…………	37,338,780 equity shares
Use of proceeds……….	We estimate that the net proceeds from this offering without exercise of the over-allotment option will be approximately US$106.1 million. We intent to use these net proceeds as follows:
	● Approximately US$30 million for drug discovery and development. ● Approximately US$75 million for acquisitions and/or the establishment of marketing operations. We plan to acquire a U.S. generic pharmaceutical company or establish marketing operations to strengthen our presence in the U.S. generic market and/or acquire one or more Indian pharmaceutical companies, and ● The balance for working capital and general corporate purposes.
Risk factors	See "Risk Factors" and other information included in this document for a discussion of factors you should carefully consider before deciding to invest in our ADSs.
NYSE symbol……….	"RDY"

The number of equity shares outstanding after the offering assumes that the underwriters' over-allotment option is not exercised. If the over-allotment option is exercised in full, we will issue and sell an additional 862,500 equity shares in the form of 1,725,000 ADSs.

[12]Since this an extract is from the Preliminary Prospectus, the pricing is not mentioned. The issue was made at a price of US$ 17.88 per FCCB.

11 Private Placements

LEARNING OUTCOMES

- The new distinct legal definition of private placement, relevance of private placements in corporate fund raising and categories of private placement in debt and equity segments.
- Private placements in the purview of investment banking.
- Privately placed debt—categories of bond placements – PSU Bonds, Municipal Bonds, Institutional Bonds, Corporate Bonds, Securitised Debt Instruments, structuring aspects.
- PIPE financing transactions, methods and regulations.
- QIPs and IPPs in listed companies
- Regulatory overview of listed company private placement options
- Pricing and comparative analysis of various private placements
- International private placements
- Private placements and role of investment banks

11.1 Concept and Background

In the previous chapters, the reader has been familiarised with the different categories of public offers made by corporate issuers from domestic and international primary markets to raise capital. Going public is a natural milestone in the life of a company. Since public offers have limitations with regards to cost, time, regulatory compliance, pricing uncertainty and market risk, they may not always be a practicable method of raising funds. Private placements fill in this gap by becoming an alternative method of fund raising from the capital market when a public issue is not a feasible option. In this sense, private placements fall on the borderline between pure capital market fund raising and raising loans from banks and financial institutions. This is because many of the investors in the private placement market are banks and financial institutions. Private placements can be made both by companies that have already gone public in the past (listed companies) and by those that have not (unlisted companies).

11.2 Definitions and Legal Connotations

At the outset, a private placement can broadly be defined as a process of inviting subscription to the securities of a corporate issuer otherwise than through a public offer. According to the Dictionary of Banking and Finance, *'private placement is the act of placing a new issue of shares with a group of selected financial institutions'*. Bloomberg defines a private placement as *'the transferring of securities to a small group of investors. The sale of a bond or other security directly to a limited number of investors …an institutional investor like an insurance company…anti-thesis of public offering'*.

Section 42 of the Companies Act 2013 introduced a definition for the first time under law to state that a private placement *"means an offer of securities or invitation to subscribe securities to a select group of persons by a company (otherwise than by way of a public offer) through issue of a private placement offer letter..."*

Based on the above definitions, it is evident that an *off-market* primary issue of securities *to a select group of persons* is a private placement. The following conditions need to be fulfilled for an issuance of shares to constitute a private placement under law:

- It should not be made through a general offer. A private placement offer letter should be circulated among a target group of investors whose identity is known to the issuer and their names are recorded prior to the issuance of the offer and each offer letter to be specifically addressed to the respective investor as a private invitation.
- The issue of shares shall be to the intended applicants on a '*preferential basis'* only without involving any other existing shareholders or outsiders on the authority of a special resolution passed by the members of the company as per the requirements of Section 62(1)(c).
- The Act further restricts the number of persons to whom such placement can be made to not more than 200 in a given financial year. In counting the 200, QIB investors and employee stock option holders need to be excluded.[1] Any such placement made to more than 200 allottees shall be deemed to be a public offer.

The following categories of issue of shares shall not be regarded as preferential offers even if they are meant for a specific group of investors:[2]

- Issue of bonus shares
- Issue of sweat equity shares
- Issue of depository receipts against underlying shares outside India
- ESOP schemes
- Rights issues

If and when securities issued under private placement are proposed to be listed in a stock exchange at a subsequent date, they need to satisfy regulatory and listing compliance of the respective stock exchange.

11.3 Categories of Private Placement

Though the primary intention behind a private placement is fund raising, sometimes they are also made to accommodate certain strategic objectives. These could fall under two broad heads: (i) consolidation of stakes of promoters or controlling shareholders, (ii) induct a strategic investor or a business partner to further the

[1]Rule 14(2) of the Companies (Prospectus and Allotment of Securities) Rules 2014.

[2]Rule 13 of the Companies (Share Capital and Debentures) Rules 2014. All the specified categories of issues (supra) need not comply with the procedural requirements of private placement.

business strategy. On the contrary, all fund raising private placements are made to financial investors. The above discussion can be summed up as indicated in Exhibit 11.1.

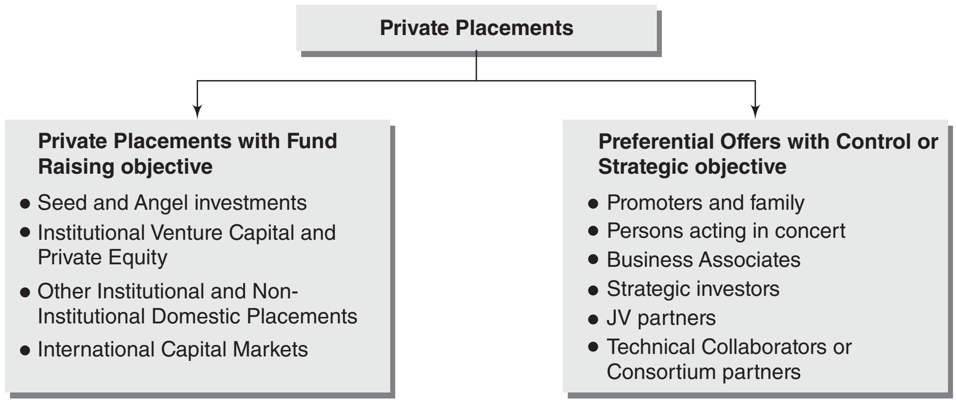

Exhibit 11.1 Types of Private Placements

11.4 Private Placements within the Purview of Investment Banking

As it may be appreciated from Exhibit 11.1, private placements by companies to meet strategic objectives are primarily transactions that are internal to a company and are accomplished with the efforts of the key management team after approvals are taken for corporate actions through appropriate shareholder resolutions and other necessary steps. They do not generally involve the services of investment banks. However, induction of JV or strategic partners could sometimes relate to investment banking services if a partner search or expert negotiations are involved.

The domain of investment banking extends to private placements that are made to financial investors with a fund-raising objective. Financial investors are typically QIBs (both FIIs and DIIs) and NIIs such as HNIs and family offices. The following placements require the services of investment bankers:

1. Private Placement in Listed Companies:
   (i) Private placement of pure debt securities
   (ii) Preferential offers (known as PIPEs): available to both institutional and non-institutional investors (both domestic and non-resident).
   (iii) Domestic placements only to institutional investors: QIP offers and IPP offers.
   (iv) Private placements in overseas capital markets
2. Private Placement in Unlisted Companies
   (v) Private placement of pure debt securities by unlisted companies.
   (vi) Raising venture capital
   (vii) Raising private equity
   (viii) Private placements in overseas capital markets: these are virtually impossible in unlisted companies though technically there is no restriction. So, they are not being discussed here.

In this chapter, private placements that are made by issuer companies under (i) to (v) above, have been discussed. Chapter 12 provides the discussion on (vi) and (vii) as these have their own characteristics and are a specialised domain of service for investment banks.

11.5 Assessment of Private Placement

Private placement market works well when combined with the advantages of both the public market for securities and the alternative platform of institutional and bank borrowing. It does not have a stringent regulatory framework that is applicable for public offers and at the same time does not go through the rigorous due diligence of institutionalised lending. From an issuer's perspective, private placement provides faster access to funds, less market uncertainties and a more cost-effective way of raising funds as compared to public offers. The effectiveness of private placement would however, depend on the maturity of this market in respective countries. Floatation costs would also depend on the type of investors being targeted, size of the offer and the desirable distribution of securities. Private placements are therefore more cost efficient for larger flotations if a widespread distribution is required. There is also lesser paperwork and administrative pressure on the issuer company in satisfying process requirements.

Even under the debt category, private placements offer an efficient mechanism for raising capital. Research in the US markets has shown that private issuers of debt securities do not essentially pay a higher cost due to illiquidity to the investor. The lack of liquidity is seemingly compensated by higher levels of accessibility for the investors to the issuer company. In addition, most privately placed debt is rated and particularly in the Indian market, only instruments with investment grade rating or above get placed eventually with institutional investors. This is because a market for less than investment grade debt (junk bonds) is restricted by regulatory requirements in India.

From an investor's perspective, private placement provides lesser transparency and is therefore suitable for informed institutional and HNI investors rather than for retail investors. A balancing factor though is the opportunity for investors to interact with the issuer company's management on a one-to-one basis and assess investment prospects in the proposal. If privately placed securities are also listed on the stock exchange, they would combine the advantage of liquidity and price validation as well as access to management information on a continuous basis for investors.

11.6 Market Segments for Privately Placed Debt

The private placement market for debt securities in India is based on the type of issuer and consists of the segments depicted in Exhibit 11.2.

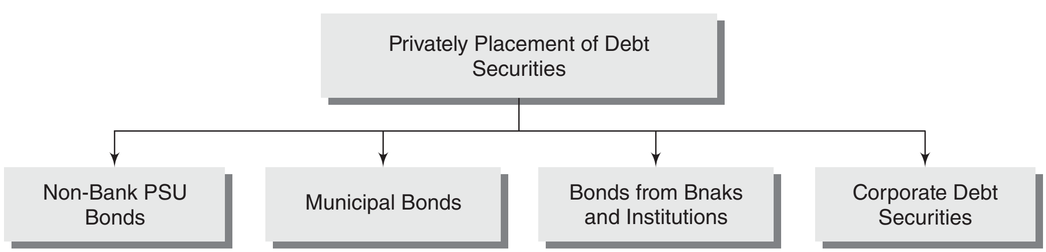

Exhibit 11.2 Market Segments for Privately Placed Debt Securities

The private placement market consists of the PSU bond market, the banks and financial institutional bond market and the private corporate sector debt securities market. All these segments are within the corporate bond market. In the privately placed debt market, the dominant investors are mutual funds, banks, insurance companies and FPIs. To a lesser extent, provident funds, pension funds (EPFO and private funds) also provide investment support to the extent permitted in their respective regulations. HNI investors such as individuals, HUFs and family offices as well as NIIs such as private trusts, investment companies and NBFCs comprise the bottom layer of the investment community.

11.6.1 PSU Bonds

The PSU bond market consists of debt securities issued by public sector corporations set up under separate statutes, government companies incorporated under the Companies Act. Many well-known names such as the NTPC, Power Finance Corporation, Konkan Railway Corporation, Sardar Sarovar Narmada Nigam, Rural Electrification Corporation, HUDCO, NHAI, IRFC, IIFCL and other Central and State Government undertakings raise funds from time to time through private placement route. The essential difference between PSU bonds and other corporate debt is the constitution of the PSUs. In many of them, the government being the main shareholder, provides credit enhancements including a financial guarantee. For example, the bond issue made by Krishna Bhagya Jala Nigam Ltd. was guaranteed by the State Government of Karnataka. Tax free bonds issued by PSUs such as NHAI, REC, etc., are also guaranteed by the government. In 2012, the GOI approved providing unconditional guarantee to Air India for a bond issue that was intended to provide much needed financial restructuring to the ailing airline. In any case, even if there is no explicit guarantee in a particular bond issue, there would always be an implicit guarantee since the government would be the sole or the major shareholder. This kind of a structure not only helps the PSU to raise funds but raise them at competitive rates as well.

11.6.2 Municipal Bonds

The municipal bond segment consists of debt securities floated by urban municipal corporations and local authorities that have tax revenues to finance their development projects. SEBI introduced regulations for the issuance of municipal bonds for the creation of a separate market segment for such securities.[3] The essential difference between municipal bonds and PSU bonds lies in the source of funds to service the bonds. While PSUs have to depend upon operating cash flow, municipal bodies generate tax revenue. So, the rating of a municipal bond depends upon the fiscal health of the local authority and its potential to garner tax revenue. Investment banks such as SBI Capital Markets (India’s leading debt arranger) are reported to have taken up municipal bond placements as a business vertical due to the importance of this emerging market segment in Indian capital markets.

11.6.3 Institutional Bonds

The institutional bond segment consists of all India and state-level financial institutions and commercial banks that raise funds through issue of SLR and non-SLR bonds. SLR bonds are so called since they fulfil the requirements of the statutory liquidity ratio under the banking Regulation Act. SLR bonds constitute an inter-bank offering whereby the bonds issued by a financial institution or a bank are subscribed to by other banks. Financial institutions do not subscribe to SLR bonds since they do not have to maintain any statutory liquidity ratio. The non-SLR bonds are issued to other investors mainly to augment the long-term fund base of financial institutions and banks and provide them the ability to lend to long-term projects. Financial

[3] SEBI (Issue and Listing of Debt Securities by Municipalities) Regulations, 2015which permit issue of such bonds through private placement.

institutions such as PFC, HUDCO, HDFC, NABARD, SIDBI, IRFC, TDFCI, IIFL and others regularly tap the institutional bond market. All the leading banks led by SBI tap the private placement market for both SLR and non-SLR bonds.[4]

11.6.4 Corporate Bonds

The corporate debt market consists of private sector companies and NBFCs that issue privately placed secured debentures and unsecured bonds to financial institutions, banks and other investors to raise funds through the debt route as a substitute for long-term bank borrowings. These debentures offer better advantages to corporates since these are easy to float rated securities. They also become an easier option to raise funds than through term loans that go through long-drawn appraisals. Since many of these debentures are placed with select investors, suitable credit enhancements can be made to get a good rating for the structured obligation and thereby place them at finer coupon rates. In recent years, this market has been used extensively by large corporate groups in infrastructure and construction, and NBFCs for bond financing. The regulations with regard to corporate bond issues by non-banking companies are issued by SEBI[5] and for banks and NBFCs by the RBI.

11.6.5 Securitised Debt Instruments

The emerging segment of the corporate bond market includes securitised debt instruments arising from securitisation of banks loans, real estate investment trusts (REITs) and infrastructure investment trusts (INVITs). Regulations are in place to issue all these kinds of securitised instruments through formation of special purpose trusts (SPVs). Bank debt securitisation is originated by Asset Reconstruction Companies (ARCs) and bank sponsored securitisation SPVs. Securitised debt securities are also known as '*security receipts*' or '*pass through securities'* or PTCs. They usually come with credit enhancements from the sponsors and are issued as rated structured obligations. While the securitisation market is relatively small in India, REIT and INVIT pass through securities are the instruments of promise in the institutional private placement market. Securitised instruments can be issued in the private placement market by banks by complying with RBI regulations on securitisation. Such instruments may also be listed by complying with SEBI Regulations.[6] REITs cannot be issued by private placement unless they are already listed through an IPO.[7] INVITs may issue unit capital through private placement but such placement should be restricted to QIBs and other bodies corporate only.[8]

Case Study

Private Placement Template for Debt Securities

The following are the details of the private placement of 'toll bonds' structured on a private placement basis in 1996 by Infrastructure Leasing and Financial Services Ltd. for MP Tolls Ltd. for the Rao-Pithampur Toll Road Project. IL&FS acted as the sole arranger and placement agent for the issue.

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[4]The RBI empowered banks to issue bonds through private placement with a minimum maturity of 7 years vide notification dated July 15, 2014 to finance infrastructure and affordable housing projects.

[5]SEBI (Issue and Listing of Debt Securities) Regulations, 2008 as in force under which even unlisted companies can privately place debt securities and get them listed.

[6]SEBI (Public Offer and Listing of Securitised Debt Instruments) Regulations, 2008 as amended from time to time.

[7]SEBI ((Real Estate Investment Trusts) Regulations, 2014 as amended from time to time.

[8]SEBI (Infrastructure Investment Trusts) Regulations, 2014 as amended from time to time.

This project was the first surface transport project in India to be built, owned and operated on a commercial format. The project comprised of a road and a bridge network that connects Pithampur Industrial Estate with the city of Indore in Madhya Pradesh. The project was conceived by the Madhya Pradesh State Industrial Development Corporation and its regional subsidiary Madhya Pradesh Audhyogik Kendra Vikas Nigam (Indore) Ltd. In 1990, IL&FS was invited to play the role of project sponsor and developer. Since, at that time, infrastructure projects on a commercial basis were a new concept in India, all the three parties developed legal and commercial formats required to provide the concept an optimum degree of financial efficiency and risk mitigation. The project was to be implemented through a SPV by the name MP Tolls Ltd.

Under the terms of concession provided by the Government of Madhya Pradesh, IL&FS, as project sponsor and developer was entitled to recovery of the project cost along with an assured return of 20% per annum. This recovery is effected through a charge of toll on the users of the infrastructure created in the project. The concession period envisaged was 15 years. On reaching the end of the concession period, the project reverts to the government. IL&FS financed the project at ₹10.14 crore through its internal accruals given the nature of the project and the need to demonstrate commercial viability before approaching the capital market for re-finance.

The issue of toll bonds was made by the project company to provide refinance to the project. The main features of the bonds, which were placed privately with institutional investors, as stated in the private placement memorandum issued in 1996, were as listed in Table 11.1.

Table 11.1 Principal Terms of Issue

Issuer	*MP Tolls Ltd.*
Purpose	To part-finance the discharge consideration for acquiring the operational and toll collection rights of the Rao-Pithampur Toll Road and acquiring related project assets on lease for 15 years.
Total amount offered	₹7 crore
Total number offered	70,000 toll bonds
Face value	₹1000 each
Tenor	Upto 10 years
Coupon rate	Interest at an accelerating rate will be payable from the date of issue on the outstanding principal amount at half-yearly rests in arrears. The yearly coupon rates are as follows: Year 1: 15% Year 2: 15% Year 3: 18% Year 4: 18% Year 5: 18% Year 6: 18% Year 7: 18% Year 8: 18% Year 9: 18% Year 10: 18% Interest would be paid on the outstanding principal amount and the outstanding interest if any, on the following dates of each year—30th June and 31st December.
Bonus interest on redemption	Redemption interest equal to ₹100 per bond, i.e. 10% of the face value will be payable at the end of the 10th year from the date of allotment.

(*Contd.*)

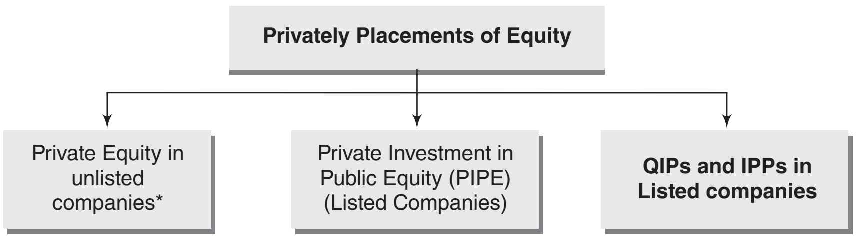
Redemption	The bonds would be redeemed in three equal tranches at the end of the 8th, 9th and the 10th year from the date of allotment.
Early redemption	In case the project cash flows exceed the estimates, the issuer will have an option to accelerate/prepone the redemption of the toll bonds along with the bonus interest on redemption. This would enhance the yield to maturity of the bonds, the extent of which cannot be determined at the time of issue. The redemption of the bonds would be made subject to availability of sufficient cash flows, net of operational and maintenance expenses. The prepayment of the toll bonds as stipulated above would be the responsibility of the Trustees who would ensure the appropriation of the toll revenues as per the stipulated priority.
Principal security	The bonds would be collateralised for all principal payments, interest payments and payment of other charges on the cash flows emanating out of the toll collection on the project.
First Loss Coupon Cover	IL&FS covenants to provide full cash flow cover upto 2.5 years coupon payments to support any shortfalls in the cash flows of MP Tolls Ltd.
Tax implication	The interest payable to the bond holders would be eligible as a tax deductible expense to the issuer MP Tolls Ltd. Public companies/Government companies who are eligible for benefit under Section 36(1)(viii) of the IT Act would be entitled to a rebate of 40% of the total income derived from investment in the bonds, provided the said amount is transferred to a special reserve. The said rebate ceases to be applicable when the aggregate amount credited to the above reserve in the books of the investor exceeds twice the investor's paid up capital and free reserves.
Yield	The yield to maturity on the bonds would be 17.33% per annum. After considering the tax benefit under Section 36(1)(viii) of the IT Act, the investors earn an effective rate of return of 20.52% per annum at the current maximum marginal tax rate. The yield on the bonds would however improve if the bonds are redeemed earlier than the stated redemption dates.
Listing	The toll bonds would be listed on the NSE.
Credit rating	The toll bonds have been rated by Credit Analysis and Research Ltd. and have been given the rating 'AA(SO)' which means high safety, indicating a high degree of certainty regarding timely payment of financial obligations on the instrument.
Market making	IL&FS directly or through its associates, will undertake market making in the bonds subject to all statutory approvals being received.

As may be observed from the template shown above, private placement of debt offers considerable bandwidth to the investment banker in structuring the instrument on offer as it essentially caters to institutional and HNI segment of investors. Coupon, yield, tenor, call and put option, collars and other features can be structured innovatively based on market assessment. Usually it is observed that these debt securities have a life of 5–8 years but longer term securities offered by PSUs, banks and NBFCs are quite common. In recent years, '*structured obligations*' found favour with investors, especially in the case of issuers such as infrastructure developers and their SPVs, construction and real estate companies and IFCs such as erstwhile

IDFC, IIFCL and Srei. Most structured obligations are privately negotiated with a few or sometimes even with a single investor. Instruments are also structured with several payment and security options or other credit enhancements customised to the requirements of investors.

11.7 Market Segments for Privately Placement of Equity

The private placement market for equity and convertibles is based on the type of investors and the listing status of the investee company as depicted in Exhibit 11.3.



*Private equity in unlisted companies is discussed in Chapter 12.

Exhibit 11.3 Market Segments for Privately Placed Equity

11.7.1 Structuring Options

In unlisted companies, Cumulative Convertible Preference Shares (CCPS), convertible debt structures (FCDs), convertible loans and pure equity are favoured depending upon the stage of investment, deal size, stake being offered and other deal specific parameters. Other convertible structures such as warrants with options may also be used to meet deal specific objectives. However, convertible structures are complicated to execute from a regulatory perspective. In PIPEs and QIPs, pure equity is generally the preferred option since it is a simple structure and is also easier to structure as per regulatory requirements.

11.8 Private Investment in Public Equity

According to Bloomberg, *'Private Investment in Public Equity (PIPE) occurs when private investors take a sizable investment in publicly traded corporations. This usually occurs when equity valuations have fallen and the company is looking for new sources of capital'*. From the above definition, it is clear that when private equity is infused into a listed company it would be classified as a PIPE investment. PIPEs were initiated as a corporate financing instrument in the late 1990s in Wall Street and initially associated with the kind of "last resort" capital that companies with poor fundamentals were forced to seek. Let us examine the character of a PIPE in detail.

11.8.1 Private

A PIPE is a private placement transaction between a limited group of investors and a listed company. The private placement of securities is made possible only to the extent permitted by regulations governing issue of securities by listed companies, such as the SEBI regulations in India and the SEC regulations in USA. This notion of a PIPE as a privately negotiated transaction involving a limited distribution of securities is the key differentiator from other issues of securities by listed companies such as FPOs and rights issues.

11.8.2 Investment

A PIPE is a direct investment in a company. Unlike securities of a listed company purchased from other investors in the secondary market, a PIPE involves the purchase of securities in the primary market. In a PIPE, securities are issued directly by an issuer company, and the proceeds from such investment go to that company.

11.8.3 Public

A PIPE is used by a listed company to raise capital. These have to be differentiated from private equity raised by unlisted companies due to the fact that there are several regulatory restrictions on PIPE financings as compared to private investments in private companies. The way in which these regulations and laws are interpreted, make PIPEs a discrete financing alternative, distinct from other forms of private and public investments.

11.8.4 Equity

A PIPE is an equity or equity-linked investment, i.e. securities that involve an equity component, and securities that are convertible or exchangeable into equity.

11.8.5 Rationale for PIPEs

There could be several reasons as to why a listed company that has ready access to the public issue market should prefer a PIPE transaction to raise equity capital. Some of these have already been elaborated while outlining the merits of private placements. These are lesser floatation costs, transaction time and regulatory compliance. However, as far as listed companies are concerned, a PIPE deal offers even a pricing advantage. As may be appreciated from the definition given above, when the secondary markets look bleak, the valuations of most companies fall and may sometimes be much lesser than their intrinsic value. In such times, it does not make much sense for listed companies to look at a public offer to raise equity since the pricing of a FPO has to be in line with ruling market prices. FPOs and rights offers result in underselling issuer companies in bleak market conditions. At such times, PIPE provides an appropriate solution. Investors in PIPEs are mostly institutional investors who are informed investors and can therefore provide a higher valuation to the company looking at its future prospects. Such investors are also provided access by the company to higher level of information that enables them to take such informed investment decision. In addition, institutional investors, especially the private equity funds do not look at short-term exits and are therefore comfortable in pricing the PIPE transactions at higher than ruling market price if they see a significant future value in the company. From the issuer company's perspective, more importantly, a PIPE issue helps in raising equity in a bleak market when the rights and FPO routes are unavailable. In such times, a PIPE makes much better sense.

From the investor's perspective too, a PIPE makes a lot of sense for institutional investors. During weak market conditions, when companies are undervalued, an institutional investor gets a good opportunity to get a sizeable stake at attractive price in well performing companies through the PIPE route. Secondly, there are lesser regulatory limitations in PIPE issues that would limit the extent of allotments available to institutional investors. This situation is most ideal for AIFs who look to take on bigger deal sizes and longer holding periods. Lastly, from an exit perspective, a PIPE issue offers immense possibilities due to the fact that the company is already listed and provides liquidity in the stock. There can be several exit routes through on-market and off-market transactions for PIPE investors. PIPE investors usually look for value investing in bearish markets and cash in when the market gets into the next bull cycle. Due to this reason, AIFs are found to be the biggest players in the PIPE market. The increase in trigger threshold under the Takeover Code to 25% is also a boost for PIPEs in India.

11.9 Qualified Institutional Placements

Qualified Institutional Placement (QIP) is a separate channel for listed companies to raise equity capital other than through public offers exclusively from QIBs. QIPs are primary issuances of new equity. In terms of raising capital through a private placement, a QIP is identical to a PIPE except that it should be made only to QIBs. Therefore, all institutional investors who do not qualify as QIBs cannot participate in such private placement. For example, unregistered foreign venture capital or private equity funds are not eligible for a QIP. Similarly, NIIs are not permitted to participate in QIP offers. Since QIBs are involved, SEBI specifies a process of making a QIP offer though there are some relaxations as compared to PIPEs. A QIP is similar to a Rule 144A private placement offering that is available in the US capital market.

11.9.1 Rationale for a QIP

Qualified Institutional Placements are a very cost efficient and time saving method of raising capital for a listed company as compared to the alternative of a FPO or a rights issue. Since it is an institutional placement, the bidding happens only between a limited number of investors. Price discovery is efficient and allotments are discretionary based on the advice of the investment bankers managing the offer. Unlike in a public offer (FPO) where the company takes a market risk to receive minimum subscription of 90%, in a QIP the company may close the issue with whatever it receives. So, a QIP combines the advantage of reaching out to the wider institutional investors in the market for raising capital while avoiding the elaborate process, cost, compliance and risk taking associated with a public offer.

11.10 Institutional Private Placements

Institutional Private Placement (IPP) is a variation of QIP in a way that it is restricted only to institutional participation. However, the objective of an IPP is fundamentally different from that of a QIP. While PIPEs are mostly strategic in nature, QIPs are essentially fund raising transactions. On the other hand, IPPs are all about maintaining minimum public shareholding in listed companies. IPPs can be made either by the company through a new issue of shares or by an offer for sale by the promoters/ controlling shareholders of a listed company so as to bring down their shareholding within the maximum permissible limits specified under law.[9] As in the case of a QIP, an IPP is also an exclusive institutional placement made only to investors that qualify as QIBs under the ICDR Regulations.

11.10.1 Rationale for an IPP

Institutional Private Placement is a limited purpose window opened by SEBI in 2012 to enable listed companies to ensure increase in their free floats within a defined time frame. If and when all listed companies comply with the minimum requirements for free float, IPP will have limited relevance only to those promoters who wish to dilute voluntarily. The main utility of an IPP is that it enables block placement of secondary shares with institutional investors in an off-market mechanism. This is essential when controlling shareholders have to dilute significant stakes by selling off a huge quantity of stock in the company. Selling them in the secondary market would result in price aberrations due to a sudden over-supply and prove to be detrimental in the short term. On the other hand, an IPP will ensure that shares are placed directly with institutional investors who have the appetite for large holdings. Due to this facility, IPPs are almost without exception,

[9]Rule 19(2)(b) and 19A of the SCR Rules 1957 as applicable

transactions involving secondary shares. IPPs have been used very effectively in disinvestment of PSU shares by the government and dilution of stakes by promoters of large listed companies. IPP also serve a strategic purpose for realigning controlling stakes by holding companies through secondary placements. These are quite common in overseas markets and are known as Subsidiary Equity Redeployments or SERs.

11.11 Regulatory Overview of Private Placements by Listed Companies

Regulatory framework for private placements by listed companies is depicted in Exhibit 11.4.

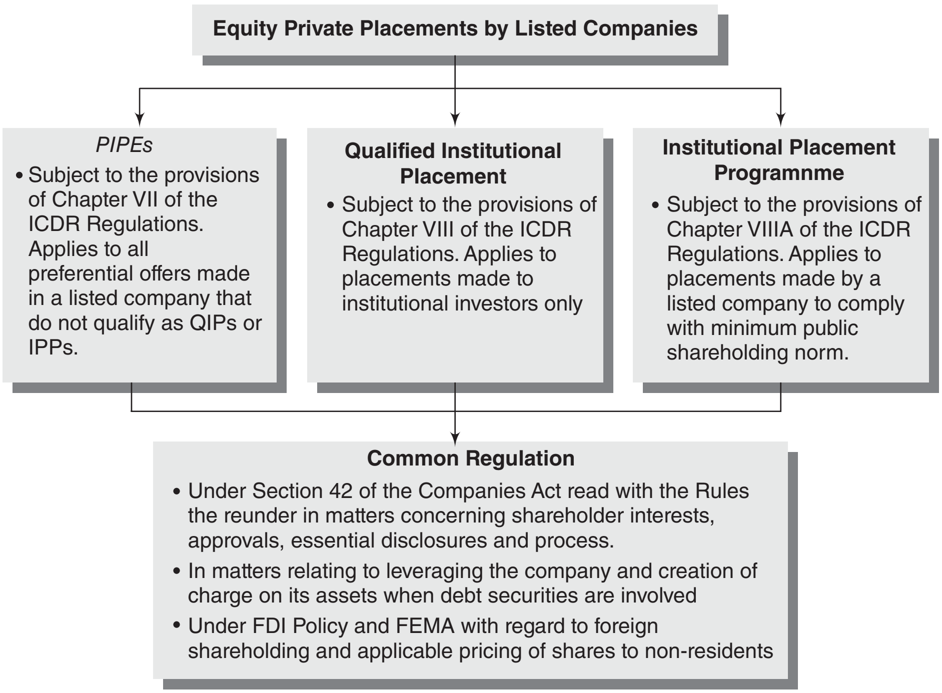


Exhibit 11.4 Regulatory Framework for Private Placements by Listed Companies

11.12 Regulatory Pricing for PIPEs

In the case of listed companies, any preferential allotment shall be subject to the provisions of the ICDR Regulations which prescribe the minimum pricing to be adopted in a transaction. The minimum price is determined as the *higher* of the following:

(i) The average of the weekly *high* and *low* of the closing prices of the related equity shares quoted on the recognised stock exchange during the *six months* preceding the relevant date

(ii) The average of the weekly *high* and *low* of the closing prices of the related equity shares quoted on a recognised stock exchange during the *two weeks* preceding the relevant date.

The relevant date is reckoned thirty days prior to the date on which the meeting of shareholders is held to consider the proposed preferential offer. In the case of a company with less than 6 months of listing, the price data under (i) above shall be for the entire period of listing. In case both the above prices are less than the IPO price, then the IPO price shall apply to determine the minimum price for such companies.

Any preferential offer of specified securities to QIBs not exceeding five in number, shall be made at a price not less than the average of the weekly high and low of the closing prices of the related equity shares during the two weeks preceding the relevant date.

It may be noted that the above provisions regulate the minimum pricing of a share under a PIPE transaction. The investment banker has to consider the actual pricing based on market valuation and the intrinsic value of the company. In PIPE transactions, the premium paid above the SEBI price and the prevailing market price (if it is higher) would not be very significant (usually around 10–15%). This is because most QIP investors are mutual funds and institutional treasuries who mark their portfolio to market. Paying a huge premium over market price will have an immediate adverse effect on their NAV. In exceptional cases, the premium could be significant at 20% or above based entirely on the fundamentals of the company and the market metrics at the time.

PIPEs to institutional investors, especially private equity funds are often laced with conditionality provisions on put options. SEBI issued a press note in 2013[10] permitting contracts for pre-emption including Right of First Refusal (ROFR), tag-along or drag-along rights contained in the shareholders' agreements or articles of association of companies. SEBI also permitted contracts containing an option for purchase or sale of securities subject to the following conditions:

- The title and ownership of the underlying securities are held continuously by the selling party to such a contract for a minimum period of 1 year from the date of entering into the contract.
- The price or consideration payable for the sale or purchase of the underlying securities pursuant to exercise of any option contained therein, is in compliance with all the laws for the time being in force. For non-residents, under FEMA, the exit price should not be at an assured return but determined at the market price determined on the floor of the stock exchange.
- The contract has to be settled by way of actual delivery of the underlying securities. No OTC derivative transaction is permitted.
- The contracts permitted shall be in accordance with the provisions of FEMA in the case of non-resident investors.

11.13 Regulatory Framework for QIPs

The important substantive provisions applicable to a QIP are listed as follows:

- The issue should be only for pure equity or non-convertible debt with warrants (combined or separate) or other convertible instruments except warrants.
- In the case of a QIP of equity shares, the company should have had a listing track record of at least one year prior to the placement on a nationwide electronic stock exchange.
- None of the QIBs allottees shall have any direct or indirect association with the promoter group. For this purpose, a QIB having rights under a shareholders' agreement, veto rights or a right to appoint any nominee director on the board of the issuer company shall be deemed to be related to the promoters.
- The total amount raised under the QIP shall not exceed five times the net worth of the company prior to the placement.
- Appointment of a merchant banker for the QIP is mandatory. The merchant banker shall conduct due diligence and issue necessary certificate to stock exchange on the compliance of the QIP guidelines and apply for listing of the QIP shares. In addition, the merchant banker shall be responsible for preparation

[10]PR No. 98/2013 dated October 3, 2013

of the QIP Placement Document which needs to have statutory and non-statutory disclosures as specified under the ICDR Regulations.

- There should be a cooling off period of at least 6 months between two successive QIPs.

11.13.1 Regulatory Pricing for QIPs

A QIP is also regulated by the minimum pricing regulation. The QIP shall be made at a price not less than the average of the weekly high and low of the closing prices of the equity shares of the same class quoted on the stock exchange during the *2 weeks* preceding the relevant date. The issuer may however offer a discount of not more than 5% on the price calculated for the QIP, subject to approval of shareholders. Where convertible instruments are issued, the issuer shall determine the price at which the conversion shall take place into equity shares by taking the relevant date as decided and disclosed by it while passing the special resolution. It may be noted that the QIP pricing regulation considers only the market price during the preceding two weeks and to that extent, it would be closer to the price prevailing on the relevant date. The normal practice in QIP transactions is that a floor price is fixed by the book running issue manager based on the statutory minimum price and other factors and investors are asked to bid at their offer price either at or above the floor price. This way, the company expects to discover a price which could be at a premium to the prevailing market price and the SEBI stipulated minimum price (Table 11.2).

Table 11.2 Sample Empirical Pricing Data in QIP Issues

Company	*Placement Floor Price ₹ per share*[11]	*Minimum Statutory Price ₹ per share*	*Prevailing Market Price ₹ per share*	*Floor Price Premium over Market Price %*
India Cements	120.20	120.20	140	(14%)
Exide Industries	107.90	107.86	110	(2%)
Shriram Transport Finance	500.80	NA	393	27%
Yes Bank	269.50	NA	261	(3%)
Gammon India	237.45	237.45	196	21%
Bajaj Electricals	785	NA	798	(1.7%)
Hindalco	130.90	NA	136	(3.7%)
Pantaloon Retail	316	NA	308	2.6%
Aban Offshore	1224.30	NA	1102	11%
HCL Infosystems	154.69	NA	125	23%
Larsen & Toubro	1659.30	NA	1497	11%
Educomp Solutions	3745	NA	3158	18.5%
Hindustan Construction Co.	102.15	NA	106	(3%)
Emami	310	NA	348	(11%)
Simplex Infrastructure	625	NA	587	6.4%
Suzlon Energy	1917	NA	1937	(1%)
Godrej Industries	215	NA	174	23.5%
GMR Infrastructure	240	NA	221	8.6%
United Phosphorus	350	NA	359	(2.50%)
Escorts	112	NA	119	(6%)

[11]Source: Company's Final Placement Document, NSE Official Website.

It may be observed from the above sample data on QIP issues that the prices of several issues were at a marginal discount to prevailing market price. In a QIP issue, the company has a time of 365 days to complete the issue after getting the approval of the shareholders. Therefore, considerable time elapses between the time the board of directors approves the issue and the placement is actually made. In the intervening period, there could be price movements which could either be beneficial or adverse to the company's QIP pricing. In the given table, the market price has been captured closer to the date of placement. Based on such price movements, the company may fine tune the price to be at a premium or at a discount to the market price. If the market sentiment about the issue is strong, the floor price could be fixed at a premium as was the case with Shriram, HCL, Educomp, Godrej, Aban, L&T, Gammon, Simplex and GMR in the above table. However, there are also several issues in the above table which were at marginal discount to market prices depending upon the conditions prevailing at that time and the judgement of the investment bankers associated with the issue. Notwithstanding the fine pricing that would happen closer to the issue, floor prices in QIP issues would generally tend to be closer to prevailing market price and the company expects to discover a better price due to the competitive bidding process.

11.14 Comparative Analysis of PIPE and QIP

- ***Currency of shareholders' resolution:*** Preferential issue has to be completed in 15 days while QIP can be executed within 12 months. This provides greater flexibility for the company in negotiating the terms and finding appropriate investors.
- ***Lock in*:** The shares issued to investors under a preferential offer are locked in for 1 year. There are also other lock-in restrictions. However, shares issued under QIP are free from lock-in for secondary market sales. This provides better flexibility for the investors and a premium pricing advantage to the issuer.
- ***Currency of convertibles*:** Convertibles issued under QIP have a currency of 60 months vis-à-vis 18 months in a preferential issue. This provides a staggered dilution and better investor perception and market capitalisation.
- ***Restrictive covenants*:** There are restrictive covenants on the number of investors and the maximum allotment per investor under QIP while no such restrictions exist under a PIPE preferential allotment.
- ***Cost of issue*:** The cost of a QIP would be higher since there is a requirement for appointment of a merchant banker and due diligence and preparation of QIP document.
- ***Disclosures:*** The level of disclosures in QIP is higher than in a PIPE transaction since a QIP requires the issuance of a regulatory QIP placement document.
- ***Appointment of merchant banker:*** In a QIP appointment of a merchant banker it is mandatory to conduct due diligence, prepare a placement document and conduct the placement. There is no such requirement for a PIPE placement.

11.15 Regulatory Framework for IPPs

The separate treatment of IPPs under law stems from the fact that while an IPP is considered as a FPO made only to institutional investors, a QIP is a private placement made to institutional investors. Accordingly, the necessary regulatory requirements have been prescribed. The important substantive regulatory provisions for IPP are as follows:

- An IPP shall be managed by a registered merchant banker who shall exercise due diligence and file a necessary certificate to that effect with SEBI.

- As in the case of a QIP, the IPP has to be made under an offer document containing the necessary particulars as prescribed under the regulations. Unlike in a QIP, the IPP offer document is considered as a prospectus.
- The promoter group or controlling shareholders who are offering their eligible securities should not have purchased and/or sold the eligible securities of the company in the 12 weeks period prior to the offer and they should undertake not to purchase and/or sell eligible securities of the company in the 12 weeks period after the offer.
- An IPP shall not result in increase in public shareholding by more than 10% or such lesser percent as is required to reach minimum public shareholding. Where the issue has been oversubscribed, the issuer may increase the issue size by not more than 10% of the offer size.
- As in the case of a QIP, shares or other convertible securities subscribed under an IPP shall not be sold by the allottee for a period of 1 year from the date of allotment, except on a recognised stock exchange.

11.16 Regulatory Pricing for IPPs

Unlike in a QIP, there are no pricing restrictions for an IPP transaction since it is treated as a FPO and not as a preferential offer under the ICDR Regulations. Accordingly, the issuer company has to set a floor price or a price band for the offer which will be determined in consultation with the merchant banker. The bids once made by the applicants in the IPP offer are not allowed to be revised downwards or withdrawn.

In an IPP, the issuer company shall have the option to make allocation/allotment as per any of the following methods:

- The '*proportionate basis method*' whereby all successful allottees will be allotted shares at the same price discovered through book building and the amount of shares allotted would be based on the bids received. This method is the same as applicable in a book-built public offer and is known as the Dutch Auction process.
- The '*price priority method*' wherein the company allots shares to successful bidders based on the highest price offered. Under this method, the company allots shares at multiple prices and is known as the French Auction method.
- The company may devise its own method of allotment and pricing which shall be disclosed in the offer document.

Case Study

ONGC IPP

The first ever IPP was an offer for sale by the Government of India in 2012 and not a new issue of shares by the company. The company in question was ONGC and the IPP offer for sale was made through an auction process comprising of 427.8 million shares at a floor price of ₹290 per share which was around the prevailing market price. Most of the market participants considered the pricing to be too aggressive. The market perceived that the share price would drop post issue due to additional floating stock and therefore, setting the floor price at prevailing market price was being investor unfriendly. Most market experts feel the auction would have gone through at levels around ₹275.

By the 3.30 pm deadline for bids, exchange data showed that the issue got subscribed for about 29.22 million shares. However, the LIC stated that its offer was rejected and the government also stated that more bids could not get accepted due to technical glitches in the system. However, LIC logged in a revised bid at 3.32 PM to complete the share sale by the government successfully. The government held a 74.14% stake in ONGC prior to the auction. The auction was meant to dilute the government stake to 69.14% thereby raising resources for the government to the tune of around ₹12,405 crore. Overall, the market perceived the IPP as a bail out by the LIC and not a successful offer for sale by the government.

11.17 International Private Placements

International capital market for private placement is widespread both for debt and equity securities. However, in the corporate bond market, except for the US and Britain, in the other markets, domestic bond issues through private placement have predominantly been restricted to local issuers and not so much for foreign issuers. However, in the Euro bond segment, several countries permit issuance of these bonds on private placement basis by foreign issuers subject to local regulations. In the United States, large insurance companies dominate the private placement market. Until the 1980s, all but the largest, most credit-worthy US corporations relied heavily on privately placed long-term debt securities with insurance companies for financing their corporate requirements. Fundamentally, the main distinction between private placements and public offers in the US market is that private placements are exempt from registration with the SEC. Therefore; there is no requirement for initial and continuous disclosures as well. The underlying rationale for such exemption is of course the fact that private placements are meant for informed institutional investors who have the necessary sophistication required for an assessment of the investment opportunity.

By the end of the 1980s, much of the water tight compartments separating the public and private markets had vanished and the public market was increasingly getting accessible to lesser known companies albeit investment grade. However, a new market had also opened up by then in the form of *Junk Bonds*, which were debt securities of less than investment grade. The distinction between public and private market was further blurred by the adoption in 1990 by the SEC of Rule 144A. The categories of private placement in US markets are discussed next.

11.17.1 Rule 144A Transactions

Rule 144A transactions *are* not considered PIPEs equity or equity-linked securities. These are private placements of debt and equity securities sold only to QIBs with the understanding that these buyers may resell the securities to other QIBs only. In effect, Rule 144A allows underwritten private placements and provides a *'safe-harbour'* for secondary trading of unregistered securities among QIBs. The vast majority of Rule 144A equity private placements are structured as either convertible debt or convertible equity. The rationale of Rule 144A was that it would increase liquidity in the private market and bring down the coupon rates of debt securities and pricing of equity. It was also hoped that when combined with lack of registration requirements, it would attract more non-US issuers to the US capital market. Rule 144A indeed spurred a boom in private placements by foreign issuers, mostly through the bond and GDR route. However, Rule 144A did not actually serve the traditional purpose of a private placement market, i.e. to enable smaller companies without access to the public market to raise funds. On the contrary, it perpetrated issues by rated companies who found it more efficient to use the private placement route under Rule 144A due to lack of registration requirements.

11.17.2 Non-Rule 144A Transactions

Non-rule 144A transactions are considered PIPEs as far as equity issues are concerned. These are private placements involving equity or equity-linked securities executed in compliance with certain exemptions provided for under the Securities Act of 1933. These issues are therefore subject to regulatory provisions from time-to-time. Representative deal structures associated with non-Rule 144A PIPEs include common equity, convertible preferred equity (preference shares), convertible debt securities, and straight debt with warrants.

11.17.3 Registered Direct Transactions

Registered direct transactions involve the issuance of equity and equity-linked securities. However, in contrast to non-Rule 144A PIPEs, the securities issued in a registered direct transaction are already registered for sale to investors through a primary registration statement declared effective by the SEC. Although such issuances have characteristics similar to public offerings, they are de facto PIPEs because of the negotiated nature of transactions and the limited distribution of securities. Included in this category are equity lines of credit, pre-registered common and preferred equity, pre-registered convertible debt and convertible preferred equity and warrants. Securities issued under this route are granted listing status in the US markets.

11.17.4 Regulation D Offerings

Keeping in view the onerous regulatory compliance for registered offers, the Securities Act permits small business companies with some exemptions under ‘Regulation D’ offerings. These issues are to be made only to ‘accredited investors’, who are similar to the QIBs in India. However, certain other categories such as HNIs, trusts, employee retirement funds, charitable institutions, directors and officers of the company are also included in the list of accredited investors. Regulation D offerings cannot be advertised or widely circulated through general solicitation. They can also not be traded on the stock exchange till they comply with full listing requirements.

11.17.5 Rule 144A Depository Receipts

A Rule 144A ADR program is similar to a Level III program (refer Chapter 7) in that the issuer is seeking to raise capital in the U.S. through the offering of ADRs that do not constitute a public offering within the meaning of the Securities Act. Therefore, no registration is required with the SEC by filing any forms. In addition, the issuer is not subject to any on-going reporting requirements. An issuer under a Rule 144A ADR program will need to obtain the Rule 12g3-2(b) exemption from the SEC. In Rule 144A security offerings, the investment banker acting as the arranger, purchases the shares on a firm commitment basis. In this respect, it is similar to a bought-out deal in India. Thus, a Rule 144A offering is quite different from a conventional private placement in which the investment banking firm acts solely as an arranger for a fee and has no fund obligation to take the securities on its books. The Rule 144A offer document is not filed with the SEC nor is it subject to SEC review. The Rule 144A route is generally very convenient for a global offer of GDRs.

The PORTAL market is the NASDAQ’s centralised market for Regulation D primary offers and privately placed securities and secondary sales thereof. It also provides clearance and settlement facilities through DTC. Participation in the PORTAL market is limited to NASD members and to QIBs who register with the NASD as PORTAL qualified investors. On the whole, the US market, the 144A route offers long tenors to issuers and access to huge fund base with the US investors, especially the QIBs. However, as already discussed above, this is primarily a market for high quality rated paper and the appetite for paper from foreign issuers in the emerging markets is relatively small.

11.18 Private Placements and Role of Investment Banks

As has been discussed in this chapter, the private placement market is quite large with several types of offers and investors with varying appetite for different securities. There are several investors in the QIB category such as mutual funds, insurance companies, banks, pension funds and DIIs. There are also registered FPIs and NIIs who form a part of the private placement market.

Private placements are mostly organised by investment banks acting as *'arrangers'*. Private placement of debt and equity is a major transaction advisory and intermediation service rendered by investment banks. It may also be noted that appointment of a merchant banker is mandatory for a QIP under the ICDR Regulations.

The investment bankers need to be more diligent while preparing information memoranda in PIPE deals since these involve listed companies and therefore attract the provisions of SEBI Regulations. The Information Memorandum along with other necessary documents such as Company Brochures, product catalogue and Profile, Press cuttings, Executive Summary and a Power Point presentation together form the preliminary offer materials.

In QIP transactions, the investment banker has to ensure that all material information is furnished to the investors. Material non-disclosures or partial disclosures could affect the outcome of the transaction and could also lead to regulatory non-compliance with its attendant consequences. There are statutory stipulations under the ICDR Regulations for the preparation of a regulated '*QIP Placement Document'*. The Placement Document shall set out *inter alia* the necessary disclosures as stipulated in Schedule XVIII of the ICDR Regulations. In a QIP, the merchant banking firm has added accountability since it has to perform a due diligence on the issuer company. A typical statutory disclaimer in a QIP document would be worded in the following lines:

"The issue and the distribution of this Placement Documents is being done in reliance upon Chapter VIII of the ICDR Regulations. This Placement Document is personal to each prospective investor and does not constitute an offer or invitation or solicitation of an offer to the public or to any other person or class of investors within or outside India."

The expertise required in private placements on the part of the investment banker is to determine the market sentiment to a proposed offer. PIPE transactions can fetch better premium to market than QIP. Therefore, pricing becomes key in a PIPE while getting good bidding support is key in QIPs. Since the concept of underwriting does not exist in private placements, investment banks would be in a position to secure mandates only on the basis of their institutional network and placement capabilities.

IMPORTANT TERMINOLOGY

Corporate Bond
Due Diligence
Institutional Bond
Institutional Placement Programme
IPP
Municipal Bonds
PIPE
Placement Document
Preferential Allotment
Price Priority Method
Private Placement
Proportionate Basis Method
PSU Bonds
Qualified Institutional Placement
Regulation D Offering
Rule 144A Bonds
Securitised Debt Instrument

TEST YOUR UNDERSTANDING

PART – A

I. Pick the right answer(s) or the alternative that best fits the description from the alternatives provided under each question.

1. A listed company just completed a buyback due to which the public shareholding stands at 25% and the promoters hold the rest. The promoters now announce a preferential allotment to themselves increasing their stake to 91%. The following is (are) the implications:
   (a) The proposed allotment is in violation of SEBI Regulations
   (b) The company has to be de-listed after the allotment
   (c) The promoters have to make an open offer
   (d) The company has to make a de-listing offer
   (e) The promoters have to make a simultaneous de-listing offer
2. Which of the following classify(ies) as a Preferential Issue (PIPE) under SEBI Regulations?
   (a) An unlisted company seeks creditors' consent to offer shares at a premium in its forthcoming IPO.
   (b) A listed company seeks shareholders' consent to raise equity from select categories of unidentified investors.
   (c) A listed company seeks shareholders' consent to raise equity from two large private equity funds.
   (d) An unlisted company seeks shareholders' consent to raise equity from select categories of identified investors.
   (e) A listed company seeks shareholders' consent to raise equity from select categories of institutional investors.
3. Which of the following classify(ies) as a Private Placement of Securities?
   (a) An unlisted company seeks creditors' consent to offer shares at a premium in its forthcoming IPO.
   (b) A listed company seeks shareholders' consent to raise equity from select categories of unidentified investors.
   (c) A listed company seeks shareholders' consent to raise equity from two large private equity funds.
   (d) An unlisted company seeks shareholders' consent to raise equity from select categories of identified investors.
   (e) A listed company seeks shareholders' consent to raise equity from select categories of institutional investors.
4. Which of the following classify(ies) as a Qualified Institutional Placement?
   (a) An unlisted company seeks shareholders' consent to raise equity from select categories of institutional investors.
   (b) A listed company seeks shareholders' consent to raise equity from select categories of unidentified investors.
   (c) A listed company seeks shareholders' consent to raise equity from select identified institutional investors.
   (d) A unlisted company seeks shareholders' consent to raise equity from select categories of identified investors.
   (e) A listed company seeks shareholders' consent to raise equity from select categories of unidentified institutional investors.
5. Which among the following would be would be an acceptable price for a PIPE issue by a listed company?
   (a) CMP of ₹82 per share
   (b) SEBI price of ₹67 per share

(c) Price negotiated with one big investor at ₹65 per share
(d) Price negotiated with rest of the investors at ₹80 per share
(e) Differential Pricing to investors
(f) Minimum of ₹82 per share
(g) Promoters' proposed subscription price of ₹75 per share.

6. Which among the following would be an acceptable price for a Private Institutional Placement by an unlisted company?
   (a) Shareholders' consent price of not less than ₹80 per share
   (b) Promoters' proposed subscription price of ₹75 per share.
   (c) Price negotiated with one big investor at ₹65 per share
   (d) Price negotiated with rest of the investors at ₹80 per share
   (e) Differential pricing to investors
7. In a QIP, the following are possible:
   (a) A large FPI negotiates to get shares at less than SEBI price but with lock-in.
   (b) The company fixes a Reserve Price less than the SEBI price but with a condition that the investor has to take a minimum of 20% of the offer.
   (c) The company proposes a convertible with a conversion price to be fixed at the time of conversion falling 72 months after the allotment.
   (d) The company proposes a convertible with a conversion price to be fixed on the conversion date falling 60 months after the allotment.
   (e) The company proposes a convertible with a conversion price to be fixed within 12 months from the date of the shareholders' consent.
8. In a private placement the due diligence is performed on behalf of:
   (a) The auditor
   (b) The private equity investors
   (c) QIBs
   (d) The underwriters
   (e) The Prime Lead Manager
   (f) The investors
   (g) The BRLM
   (h) The lead manager responsible for pre-issue process
   (i) The lead manager responsible for post-issue process
9. An unlisted company issues a Placement Memorandum to all eligible participants to appear in a quiz contest from which select winners would be allotted shares. This amounts to:
   (a) Private Placement (b) Public Issue (c) QIP (d) QIB
   (e) IPP (f) Rights Issue
10. If promoters increase their stake in a listed company through rights renunciation, it shall be:
    (a) Reckoned as preferential allotment
    (b) Held to be in violation of SEBI guidelines
    (c) Shall be valid though the pricing guideline is not followed
    (d) Shall be valid only if pricing regulations are followed.
11. In a PIPE deal, since the shares allotted to the investors are placed privately, these are eligible for trading on the OTC market.
    (a) True (b) False

12. A QIP in the Indian market resembles a Regulation 144A placement in the US since both the varieties of placements deal with unlisted securities.
    (a) True (b) False
13. In a QIP, in order to provide confidence to the investors, the investment banker can decide to have a component for the promoters on a preferential basis at a higher price with a lock-in for one year.
    (a) Yes (b) No
14. A listed company proposes to make a private placement of FCCBs in the overseas capital market that are convertible into domestic shares within one year of issue. This has the following implication(s):
    (a) The issue will be categorised as preferential allotment
    (b) The issue will be categorised as a public issue in India
    (c) The issue will be categorised as a private placement in Indian market
    (d) The shares will have to be listed in India
15. In a PIPE, the investment banker decides to have a dual pricing to improve its marketability by which, the promoters will subscribe at 25% higher than the QIB investors. Under the regulations, such higher differential pricing for promoters is allowed.
    (a) Yes (b) No
16. A listed company decides to do a QIP to raise funds. An i-banker is appointed as per the regulatory requirements. While preparing the QIP document, the i-banker realises that a PIPE transaction through a preferential issue makes better sense as the promoters are resourceful and can participate in the offer along with potential investors. Thereby the dilution for the promoters would be minimal. The board of directors dominated by the promoter directors feels that the company should keep its options open and try both the routes simultaneously. The i-banker is therefore asked to be the transaction adviser for both the proposed transactions. The i-banker prepares two different mandates to be appointed by the company for both the transactions. This amounts to violation of regulations and professional misconduct?
    (a) True (b) False
17. In a QIP offer, the company provides three options to the investor:
    (a) A debt instrument that can be converted into equity at the option of the investor after 84 months from the date of issue at a price to be fixed one month before the conversion date in accordance with SEBI pricing formula
    (b) A zero interest debenture that would be redeemed at a premium of 120% of its issue price at a date falling between the end of the sixth and seventh year from the date of issue. The company can exercise a call option anytime after the 6th year.
    (c) A NCD with an attached equity warrant that can be converted after a period of 56 months at a conversion price to be derived as per SEBI formula. The NCD will also be repaid on the conversion date.

    Which of the above complies with the regulations of a QIP issue?
18. A joint venture partner of a listed company decides to take a stake of 40% in a new venture being set up as a SPV of the listed company. This amounts to a private placement.
    (a) Yes (b) No

PART – B

19. What is a QIP? How is it different from private equity in unlisted companies? What are the regulatory requirements for a QIP?
20. What is an information memorandum? How is it different from an offer document for a public offer?
21. What are the requirements for a QIP memorandum?

22. What are the different types of raising capital through the private placement route? What should be the considerations for an issuer to decide on the appropriate route?
23. Explain the characteristics of PIPE investment.
24. What are the advantages of private placements over public offers? Explain in the context of listed companies.
25. Why are debt securities placed pre-dominantly in the institutional private placement market? What types of debt securities are preferred by institutional investors and retail investors respectively?

For answers to Part A, refer to Appendix B at the end of the book.

12 Private Equity Advisory

LEARNING OUTCOMES

- Role of private equity in different stages of fund raising in the private equity spectrum
- Investment banking services rendered in the context of private equity transaction advisory
- Distinguishing business and financial structure of PE backed enterprises
- Valuation in venture capital transactions, Conventional Venture Capitalist Method and variants
- Valuation approaches in private equity transactions with a comprehensive case study analysis involving buy side and sell side pitches and deal dynamics
- Process flow in a typical PE transaction—deal structuring, information memorandum and term sheets
- Regulatory framework for private equity transactions
- Exit mechanisms for PE investors
- Case studies on successful PE transactions

12.1 Introduction

Private Equity (PE) has not been specifically defined in financial literature as a distinct financial activity probably since it has evolved over the previous decades as a key source for corporate capital and is therefore referred to more in terms of a private placement. The term *'private equity'* is commonly associated with specialised institutional investments in companies that are not listed on the capital market. However, private equity has grown beyond the limited domain of off-market unlisted stock investment to become a premier global financial industry. This chapter discusses the broad spectrum of private equity and the nuances of private equity transactions. Private equity advisory is an important service in core investment banking and private equity investing is an integral part of asset management, which is an allied business for investment banks.

12.2 Domain of Private Equity

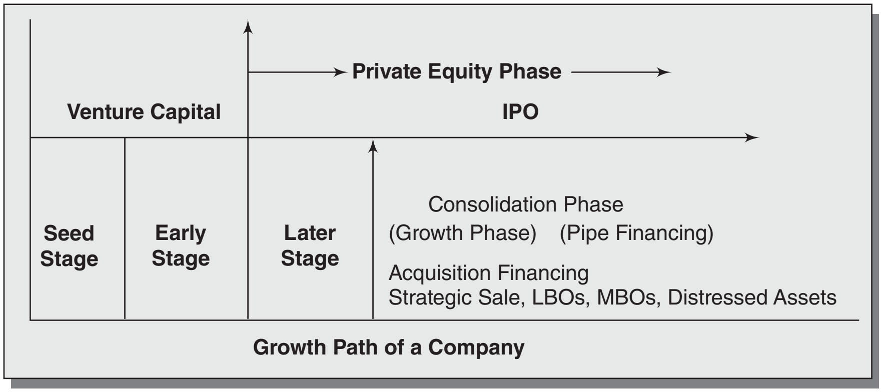


Exhibit 12.1 The Private Equity Spectrum

12.2.1 Venture Capital and Private Equity

The private equity spectrum ranges from early stage investments at one end to buy-outs and M&A activity on the other. Early stage financing entails considerable risk and is therefore identified separately as '*venture capital*'. Venture capital (discussed in a subsequent paragraph) is all about identifying early stage investment opportunities that entail high risk and high return. However, the spectrum of private equity is quite large and as companies grow and mature, they require more of equity capital through private sources. Thus, private equity is a term associated with financing companies that have crossed the venture stage in their life cycle. In other words, private equity can be termed as *'later stage financing'* as compared to venture capital, which is all about early stage financing. Private equity financing is thus a distinct model of making direct investments into good investment opportunities in well performing companies. The private equity spectrum is captured in Exhibit 12.1. It may be appreciated from this Exhibit that venture capital is a subset of the private equity universe.

Since private equity is about later stage financing, companies that are financed are those in the growth phase of their business graduating to the next level after being successful in the initial scale of operations. Therefore, the fund requirements of such companies would be fairly large. Keeping this in view, private equity funds cater to larger deal sizes and do not normally look at transaction values less than a minimum threshold. This is quite in contrast to venture capital wherein, since the risk is significantly higher, the venture capitalist looks at gradual infusion of capital to minimise risk. Private equity investors also have a relatively moderate return expectation as compared to venture capitalists who have exponential return expectations. Therefore, it may be said that private equity market is all about investors who invest later, invest more, prefer reasonable stakes and moderate risk-entailed returns.

12.2.2 PIPE, Buyout and Distressed Assets Funds

As may be appreciated from Exhibit 12.1, private equity not only plays a role in providing capital for unlisted companies, but in listed companies as well. Private equity investments in listed companies are channelled through PIPEs and QIPs.Furthermore, private equity extends its domain beyond providing growth capital. It plays a big role in acquisition financing or in buying and selling controlling stakes in companies. Such activity is known as '*buy-outs*' and PE funds that specialise in such activity are known as '*buy-out funds'*. One of the essential feature that differentiates a buy-out transaction is that the investor looks for a controlling stake unlike a pure play private equity investment wherein the investor merely looks for financial returns on its investment. Therefore, in most buy-out transactions, the investor acquires the founder's stake and provides him with an exit. Large institutional PE funds eventually graduate to doing buy-out transactions due to their fund raising and risk-taking capability. When the funds at their disposal are large, PE investors are in a position to take control and drive their return management in a company rather than being passive investors and depending on the management team to deliver their investment returns. KKR (Kohlberg, Kravis and Roberts) and Blackstone are two of the largest listed buy-out funds based in the US. Some private equity funds also specialise in nurturing a portfolio of companies in financial distress and provide turnaround financing. Therefore, distressed asset management also forms a part of the private equity spectrum.

Buyouts are discussed in the: context of acquisitions in Chapter 16 while PIPE and QIP investments by PE funds are discussed as a part of Private Placements in Chapter 11. This chapter focuses on pure play PE investments, i.e. private equity investments made in growth-oriented, closely held private or unlisted companies.

12.3 Investment Banking Services in Private Equity

The investment banker plays a key advisory role in formulating the transaction for raising private equity and intermediates the whole process till the transaction is closed successfully. More specifically, the role of the arranger can be broken down into the following components:

- ***Business advisory:*** Advise the company on the necessary steps to be taken to fine-tune the business model and make it investor friendly. Perform a study of the industry landscape and competitor analysis, product pricing strategy and SWOT analysis.
- ***Formulation of the transaction*:** Formulate the business plan incorporating the company's stated business objective along with detailed financial modelling that establishes the financial forecast of the company and the requirement of capital.
- ***Valuation:*** Conduct a valuation of the company for the purpose of assessment of its equity value and develop a deal structure.
- ***Deal structuring:*** Formulate the investment offering to be made by the company in line with the requirements of the company and the investment parameters that would find favour with targeted investors. Ensure that the deal structure complies with relevant regulatory framework.
- ***Offer literature:*** Prepare an *'Information Memorandum'* that incorporates the business plan, the transaction and the investment offering. The information memorandum should incorporate the necessary corporate disclosures that are required for investors to make an informed investment decision. Investment bankers are familiar with the information requirements of private equity investors.
- ***Transaction advisory:*** Identify suitable investors with related investment appetite, facilitate investor presentations, co-ordinate with agencies that would perform due diligence and valuation on behalf of the investor, negotiate on behalf of the client on the term sheet for the deal, work closely with legal advisers who would draft the documentation for the transaction and co-ordinate the steps to be achieved till the transaction is closed.

12.4 Venture Capital

Venture capital, rightly called as *'financing of innovation',* is the financing of start-up (young) businesses with a view to grow them into large commercially successful businesses. It is defined as *'capital for investment which may easily be lost in risky projects, but can also provide high returns, also called risk capital'*.[1] Bloomberg defines it as *'An investment in a start-up business that is perceived to have excellent growth prospects but does not have access to capital markets. Type of financing sought by early-stage companies seeking to grow rapidly'*. Some of the famous companies such as Apple Computer, Netscape Communications, Cisco Systems, Compaq (since merged with HP), Network General, Yahoo, eBay, etc., were all start-up companies financed through venture capital. The Indian examples of successful venture backed companies include Biocon, i-Flex Solutions, Avesthagen, Sasken, Geometric Software, Mastek Global, WNS Global, Firstsource and many others. The emergence of the start-up e-commerce sector saw the creation of some of the biggest and most valuable venture capital backed companies (known as '*unicorns*') in the new millennium.

The term '*start-up'* typically refers to the early stage in the life of a company that has been formed to set up a technology backed business venture or a technology development venture with an intent to commercialise the same. The tag of 'start-up' remains with a company till it has sufficiently advanced from a concept stage to being a business that has been sufficiently accepted by the market and its commercial feasibility has been proven. Venture financing involves significant risk-taking on the part of the venture capitalist since young businesses are subject to high rates of mortality and the venture investor could stand to lose the investment made in the company. Usually, venture financing is divided into several rounds of financing starting from the first round (or Series A) based on milestones to be achieved by the company in its business plan. Exhibit 12.2 captures the life cycle of a company financed through venture capital.

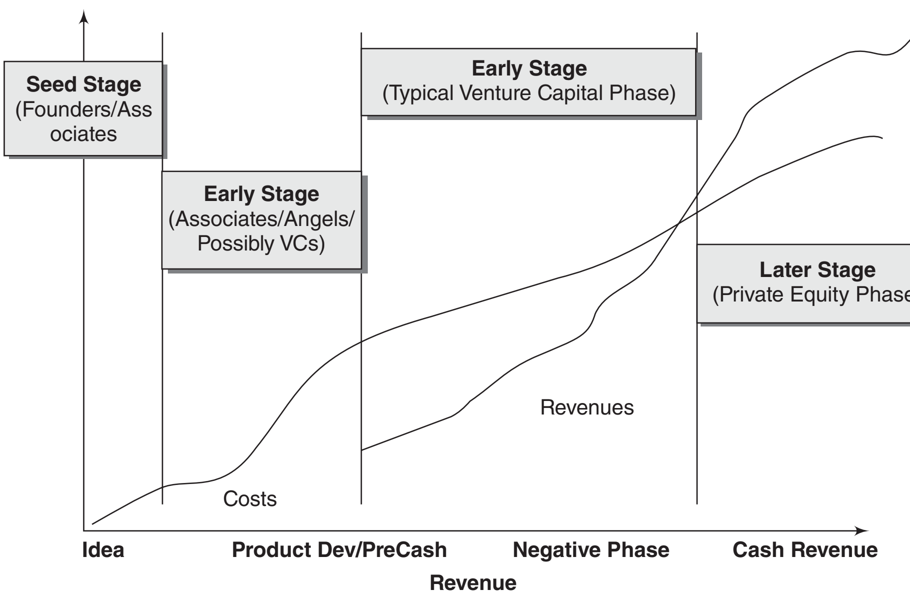


Exhibit 12.2 Prototype of a Venture Capital backed Start-Up Company Life Cycle

Venture capital is not meant for any type of a start-up business. A venture capital backed business requires certain characteristics in the business model and financing structure of the company. Some of the usual features are furnished in Table 12.1.

Table 12.1 Structure of a Venture Capital backed Start-up Business

Business Structure
1. Generally associated with a technology venture or a knowledge intensive or innovation driven business model.
2. Venture to be backed by technology that has been created or is to be created.
3. May require product development/technological and/or market validation.
4. Product or service has to be successful at pilot scale/prototype level (beta version) before it is commercially launched.
5. Test marketing or phased marketing is required since concept selling may be involved.
6. Revenue model requires to be established.
7. Business to be ramped up in phases.
8. Business risks are taken in phases. Investment monitoring by the VC is more of mentoring, with the VC appointing its nominees on the board of the company to bring in significant value addition apart from protecting its interests.

Financial Structure
1. Start-up firms go through rounds of financing starting from the seed stage to pre-IPO stage. Financing is generally linked to pre-set milestones either in terms of financial projections or strategic achievements.
2. Financial risk is taken in phases. The highest risk-reward relationship is at the seed stage and the risks and rewards go down progressively as the business gets de-risked in each subsequent round of financing.
3. Promoters may or may not have sufficient financial resources. Their technology or product idea is valued and allowed to be capitalised as stock. Alternatively, investors are prepared to pay a high premium on their stock. Promoters' equity is more in intellectual capital and stock options than in hard cash.
4. More suitable for financing through equity since the business model may not be able to support debt financing. Some part of the initial financing could be a convertible or venture debt to prevent excessive dilution of promoters' equity.
5. Tangible asset creation would be less since there is a high component of intellectual property creation. VCs are open to financing significant soft costs in the business plan that do not result in creating tangible assets. In other words, they are not security oriented in the financial structuring. No collateral security needs to be created for VC financing unlike in bank borrowing.
6. Involves significant amount of cash burn in terms of product or service development, hiring resources, marketing expenses and ramping up costs. No restrictions are placed on allocation of funds for working capital.
7. The business model should have the potential for very high returns to investors since the risk level is also very high. The business and financial risks and the management bandwidth are assessed through a Due Diligence process but mortality risk could be high.

12.4.1 Venture Capital Attributes

A venture capitalist normally looks for some of the following type of attributes in a business plan before deciding to invest:

- An industry or space that is currently a sunrise sector and promises to create a paradigm shift.
- An exciting concept that has the potential for an uninhibited market.
- A concept that significantly improves existing processes or applications and therefore find a vast replacement market.
- A business or idea that has potential for spin-off businesses or revenue streams or significant possibilities for future scale up.

- A start-up business that has the potential to become an attractive proposition for strategic acquisition in future by a market leader.
- A firm that has the calibre to become an industry leader in due course with the right inputs.
- A business that uses cutting-edge technology and could become an industry benchmark.
- A company that has sufficient technology and management bandwidth to reach and sustain the leadership position that it promises to attain.
- A business or technology that has a first mover advantage which can be harnessed adequately before competition catches up.
- A business that has significant entry barriers for the competition either in technology or in business variables that can largely be sustained.
- A firm that has an unfair advantage to begin with which could remain long enough before it is diluted by competition or regulation.
- A firm that offers possibilities for multiple exit options.

Looking at the above list of attributes, it is clear that not many firms would fit into them and that explains why venture financing should not to be construed as a source of business finance for everyone. Venture capitalists play a high-risk high-return game and are therefore very selective in their investments. Despite such stiff investment criteria, the mortality rate in VC funded firms is very high.

A good example of VC backed business is the e-commerce sector that had been classified as a disruptive business idea due to its potential to change the way products and services are marketed, distributed and sold. However, there are many other types of start-up firms that do not qualify for venture capital as they do satisfy the investment criteria of VC investors. These could be more of commercial ventures in manufacturing, trading and services that either address a commodity or mass market, small scale market, or engaged in the business of volumes with thin value addition or in a generic product or service market with little technology or innovation. Such businesses do not find favour with VC investors and would therefore need to be financed differently.

VCs place a lot of reliance on the management team of a company to realise the potential in the company and deliver the required financial returns. Many a times, when there are competitive deals in the market, the companies that get funded would be those that can project a better management capability and entrepreneurship.

12.5 Valuation in Venture Capital Transactions

One of the characteristic features found in the financial profile of start-up companies is negative earnings and cash flow in the early years and highly uncertain but potentially substantial future free cash flow. A DCF model weighing on terminal value of free cash flow is highly appropriate in such cases where there isno positive cash flow or earnings during the discrete period to value the company under any other method. In this context, it is necessary to comprehend the following terminology:

- ***Pre-money valuation:*** Pre-money valuation is equal to the post-money valuation of a company at a financing round minus the amount raised at that round. For example, a post money valuation of ₹500 million after raising ₹200 million implies a pre-money valuation of ₹300 million.
- ***Step-up in value*****:** Step-up in value refers to the increases in a company's pre-money valuation between two financing rounds. It is calculated as the pre-money valuation at a round divided by the pre-money valuation at a prior round. For example, a company with a valuation of ₹100 million in the fourth round and ₹25 million in the third round has achieved a step- up valuation of 4 times between the two rounds.

- ***Return on capitalisation***: The percentage annualised change in the pre-money valuation between two financing rounds is referred to as return on capitalisation. This, to some extent represents the annualised return on investment for the investors if the dilution in his stake from the previous round to the next round is not considered.

The most commonly used approach to structure a transaction for VC financing of start-up is known as the *'Conventional Venture Capitalist Method'*. Under this method, the following parameters are considered:

- The terminal value of the firm at a time of expected exit in the future. This is usually estimated using the expected projected earnings at the time of exit and the average P/E ratio of comparable firms. It can also be estimated using the DCF model.
- The present value of the firm using the DCF model based on the terminal value discounted at the VC's target required rate of return, typically 60–75%.
- The VC's required ownership stake based on the post-money value and the amount of financing being provided to the firm
- The possible dilution expected due to future fund raising by the company until the exit date. There has to be a suitable upward adjustment to the stake being offered to the VC to account for possible ownership dilution from a future round of financing.

The stake that an investor needs to hold is always calculated with reference to the post-money valuation by the following formula:

$$\text{Percentage stake} = \frac{\text{Investment proposed}}{\text{Pre-money valuation + Investment proposed}}$$

Therefore,

$$\text{Percentage stake} = \frac{\text{Investment proposed}}{\text{Post-money valuation}}$$

The post-money valuation has to be calculated in present value terms if the investment is proposed to yield returns to the investor over a given holding period.

Therefore,

$$\text{Percentage stake} = \frac{\text{Investment proposed}}{\text{Present value of the company's future valuation}}$$

which can be written as,

$$\text{Percentage stake} = \frac{\text{Investment proposed}}{\text{Future Valuation/Present Value Factor}}$$

which can be written as,

$$\text{Percentage stake} = \frac{\text{Investment proposed}}{\text{Future Valuation}/(1 + \text{Discount rate})^{\text{Number of years}}}$$

The discount rate to be considered in this case would be the expected rate of return that an investor would look for in the given circumstances.

A variation of the above method is the *'First Chicago Method'* wherein three scenarios, the best, the worst and the survival scenarios are plotted to get three different valuations. These are assigned appropriate weights to arrive at a weighted average valuation. This weighted valuation is discounted to arrive at the present value and the stake to be offered.

ILLUSTRATION 1

From the following details, the stake to be offered to a VC under the Conventional VC method is shown below.

1. The current level of earnings (R) = ₹2 million
2. The expected annual growth rate of revenue (*r*) = 50%
3. The required capital at present round = ₹2.5 million
4. Expected holding period = 5 years
5. Expected Profit after tax margin at liquidity event = 11%
6. Expected P/E ratio = 15
7. Expected rate of return (*d*) for the VC = 40%

The first step is to extrapolate the revenues at the end of five years at a CAGR of 50%. This comes to ₹15.19 million which forms the top line at the end of year 5.

- The PAT thereon @ 11% works out to ₹1.67 million.
- The PAT capitalised at a P/E ratio of 15 yields a valuation of ₹25.06 million
- The required present value factor = $(1+0.40)^5$ = 5.378
- The present value of the company = 25.06/5.378 = ₹4.66 million.
- The stake to be offered to the VC = 2.5/4.66 = 53.7%

The computations under the above method get complicated if there are proposed future rounds of financing wherein the investor in the current round may or may not participate. If the current investor does not participate in future rounds, to that extent, based on the valuations adopted in such future rounds, there would be a dilution of such investor's stake. Therefore, when a future valuation is being made under this method, it is difficult to estimate what would be the extent of future equity financing that may be required to achieve such valuation and the consequent dilution. The following illustration explains the point.

ILLUSTRATION 2

In the illustration below, the promoters float the business with a capital of ₹5 crore and support from a VC to the extent of a further amount of ₹5 crore. Thereafter, the company goes for two more rounds of financing and an IPO. The changing profile of investor returns is explained by the following table and the discussion thereafter.

Table 12.2

Year1	*Year2*	*Year3*	*Year4*
Series A	*Series B*	*Series C*	*Offer for Sale*
Pre-money value ₹5 crore	Pre-money value ₹20 crore	Pre-money value ₹60 crore	Pre-money value ₹100 crore
Capital invested ₹5 crore	Capital invested ₹10 crore	Capital invested ₹20 crore	
Post-money value ₹10 crore	Post-money value ₹30 crore	Post-money value ₹80 crore	Post-money value ₹100 crore
Investor VC_1	Investor VC_2	Investor VC_3	
Stake offered = 50% of post money valuation	Stake offered = 33.33% of post-money valuation	Stake offered = 25% of post money valuation	

(*Contd.*)

Post-money shareholding pattern Promoters – 50% VC_1 – 50%	Post-money shareholding pattern Promoters – 33.33% VC_1 –33.33% VC_2 –33.33%	Post-money shareholding pattern Promoters – 25% VC_1 –25% VC_2 –25% VC_3 – 25%	Post-issue shareholding pattern Promoters – 25% Public–75%
Annualised return to VC_1 = 133%	Annualised return to VC_2 = 75%	Annualised return to VC_3 = 25%	

The annualised return above has been computed on the basis of the period of holding. For example, VC_1 holds the investment of ₹5 crore for a period of 3 years before selling it off in the IPO for ₹25 crore. Therefore, VC_1 makes a return of ₹20 crore which works out to 400% in 3 years or an annualised return of 133% and so on.

It may be observed from the above illustration that the holding of VC_1 has diluted from 50% at Series A to 25% at the liquidity event. If this holding had remained at 50%, VC_1 would have earned an annualised return of 333%. However, this hypothesis may not be correct since the valuation of ₹100 crore after 3 years would not have been possible without the capital infusion of ₹40 crore in all. Therefore, the company has achieved a non-monetary value enhancement (step-up in value) of ₹60 crore (100 – 40) at the IPO stage. VC_1 actually gets a share on the step-up value of ₹60 crore. If one were to take a weighted average approach, the return profile can be worked out as shown in the Table 12.3.

Table 12.3 Return Profile of VCs

₹crore	*Investment*	*Number of years*	*Product*	*Share of step-up value*	*Annualised Return %*
Promoters	5	3	15	i.e. $15/70 \times 60 = 12.86$	$= 12.86 \times 100/5 \times 3 = 85.7\%$
VC_1	5	3	15	i.e. $15/70 \times 60 = 12.86$	$= 12.86 \times 100/5 \times 3 = 85.7\%$
VC_2	10	2	20	i.e. $20/70 \times 60 = 17.14$	$= 17.14 \times 100/10 \times 2 = 85.7\%$
VC_3	20	1	20	i.e. $20/70 \times 60 = 17.14$	$= 17.14 \times 100/20 \times 1 = 85.7\%$
Total	***40***		***70***	***60***	

The above calculation shows that the weighted average return for all the investors is the same at 85.7%. However, in reality, they do not get this return. They get returns that are either superior or inferior to the mean returns. For example, in the above case, the promoters and VC_1 end up getting superior returns by 47.6% each (133.33 – 85.73) while VC_2 gets a return that is inferior by 10.73% (85.73 – 75.00) and VC_3 gets an inferior return by 60.73% (85.73 – 25.00).

This phenomenon is due to the combined operation of several factors affecting the investor's interests. These are (a) the Valuation Effect (VE), (b) the Dilution Effect (DE) and (c) Future Capital Infusion. While DE and capital infusion act to the detriments of an investor, VE has to neutralise the adverse effect of these two factors. Though the DE is indirectly determined by the VE, if the business requires infusion of equity capital at regular intervals, the DE could surpass the VE and result in inferior returns. This entirely depends on the movement of VE and DE post-investment and the requirement of further capital during the investment time horizon.

The broad parameters that affect returns to investors over a time horizon are depicted in Exhibit 12.3.

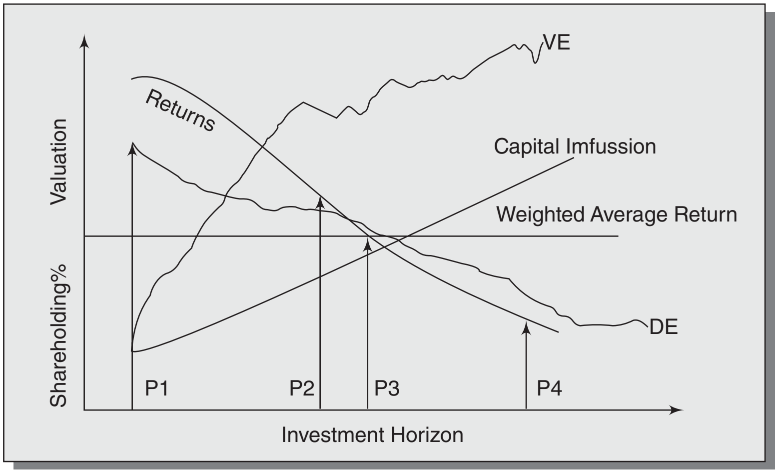


Exhibit 12.3 Returns to Investors and Determinants Thereof

In Exhibit 12.3,it has been assumed that valuation grows with the life of the firm and additional capital investment. It may be observed that for investments made at P1 and P2, the returns are superior. At P3, the investor makes average return since the VE has been balanced by the DE. Any investment made after P3 would yield inferior return.

The Conventional Venture Capitalist Method explained above takes into account the estimated dilution to the VC investors and accordingly adjusts upwards the present stake to be offered. Continuing with Illustration 1 above, let us consider the following additional information:

ILLUSTRATION 3

Present issued capital of the company = 10,000 shares
Stake to be offered to the VC = 53.7%
Residual stake with promoters = 46.3%
Numberof shares to be issued to the VC investor $= 10{,}000 \times 53.7/(1\text{-}53.7)$
$= 10{,}000 \times 53.7 / 46.3$
$= 11{,}598$
Total issued capital post financing = 21,598 shares.
Expected dilution in future rounds of financing till exit date = 40%
Upward Adjustment required in present round for the VC = Required current stake/retention ratio
The retention ratio is calculated by using the required current stake without dilution (i.e. 53.7%) and its equivalent if there is dilution of 40% (i.e. $53.7 \times (1\text{-}.40)) = 32.22\%$
The retention ratio to be used = 32.22/53.7 = 0.60
Therefore, the VC needs to maintain a retention ratio of 0.60 to offset the dilution effect on its present stake, i.e. 53.7/0.60 = 89.5%. In other words, if the VC presently takes 89.5% stake in the company, after getting diluted to the extent of 40% in future rounds, it will still remain at its target stake of 53.7% at exit date.
Number of shares to be issued after factoring in dilution $= 10{,}000 \times 89.5/(1\text{-}0.895) = 85{,}238$
Total issued capital post financing = 95,238 shares.

It may be observed from the above analysis that the key determinants of the return to a VC investor are (a) the exit valuation that would be achieved by the company and (b) the dilution in stake of the VC due to capital infusion in future rounds of financing till the exit date. However, it may be extremely difficult to envisage in earlier rounds how much future capital investment would be required to achieve a targeted valuation at the proposed time of exit. Therefore, investors usually keep a margin on their initial estimated return to factor in the possibility of future dilution. For example, if the ultimate return should be an annualised 25% per year or there about, the investor may discount the future valuation by 50% to factor in the dilution element depending on the facts of the case. The other way to accomplish this is to subscribe to a convertible instrument in the earlier rounds such as a convertible preference share, which would be converted just before the liquidity event takes place. Usually convertibles are converted in the ratio of 1:1. Therefore, it may be possible to arrive at a pre-liquidity event holding structure that becomes acceptable before the conversion takes place.

12.5.1 Valuation versus Pricing

At this stage, it is necessary to appreciate the subtle difference between valuation and pricing of a share. For unlisted companies raising capital, what is of relevance is the equity valuation of the company being arrived at and not what it translates into as price per share. Price per share becomes relevant only at the time the company proposes to make an IPO.Market considerations such as minimum application size, minimum investment, etc., become important at that stage. Such considerations do not matter to private equity investors as long as the equity valuation is in agreement. The following Table 12.4 illustrates the point.

Table 12.4 Valuation and Price per Share

Value in Rupees	*Company A*	*Company B*
Pre-VC Capital Shares with face value ₹10/- Fully are paid up	10,000	20,000
Current Earnings	25,000	25,000
Current EPS	25	12.5
Amount being raised	500,000	500,000
Equity Valuation	1,000,000	1,000,000
Number of new shares	500	1000
Equity dilution	50%	50%
Price per share	1000	500

It may be observed from the above workings that though the valuation of the two companies is the same, the price per share varies since the issued capital of both the companies at the pre-issue stage is different. Consequently, the new shares to be issued would also be different. The price per share is not a correct indicator of value as explained above. However, it becomes a relevant issue at the time of an IPO purely from a marketing and free float perspective. This is the reason why investment bankers apply their mind to strategize the capital structure and issue structure while managing an IPO, Details are furnished in the Chapter 8 on Domestic Issue Management. From a VC financing perspective, price per share is irrelevant and misleading.

12.6 Valuation in Private Equity Transactions

12.6.1 Valuation Considerations

- Since PE deals are about later stage companies, the valuation considerations are more conventional when the company in question is from an established industry. Usually at that stage, the revenue model and cash flow become more predictable, business model scalability is established and the financial forecast can be mapped with more reliable assumptions. The average growth rate, customer acquisition costs, cash burn rate and operating margins can be broken down in greater detail to understand how the cash flow model will pan out. If the company has been able to achieve previous milestones to a considerable extent, valuation metrics can be more aggressive and in the opposite case, a more conservative approach may be taken based on previous experience. In a tough situation, a '*down round valuation*' is possible whereby the valuation at the current round is less than that of the previous round.
- In a high-growth venture, the valuation model needs to factor in prospective growth rate rather than relying on immediate past as an indicator. Since the company is in the high growth phase, the top-line revenue, operating margins and cash flow are yet to reach their stable levels. So, more reliance can be placed on a high terminal growth rate to reflect considerable value creation in the future. Factors such as the nature of the industry, peer growth rates, intangible asset creation, market potential, human capital, customer acquisition and retention costs become relevant to determine the terminal cash flow. There is of course a lot of judgement and subjectivity to be used in this analysis and investment bankers have to draw upon their experience and their feel of investor perceptions in arriving at the valuation to be pitched to them. Since this is about sell-side banking, valuation pitching by transaction advisers is usually aggressive.
- PE valuations also use applicable industry metrics specific to the investee company in question. In certain industries such as telecom, commercial aviation, organised retail, hospitality, etc., there is strong emphasis on growth in market share and the valuation model is pegged to the average revenue per customer or the market share of the company. In the e-commerce sector, wherein billions of dollars of private equity was pumped in, valuations relied on business metrics such as Gross Merchandise Value (GMV) and its equivalents as a measure of business growth as distinguished from revenue growth and profitability. In such disruptive sectors, revenue stabilisation happens at a later stage when the market becomes more visible. The investors may not have a basis to estimate the topline with reasonable certainty. So, valuation based on earnings approach becomes extremely difficult. Investors therefore have to rely on metrics reflecting business growth rather than growth in earnings and profits.In this respect, the e-commerce sector rewrote many rules. It proved that when a sector is in high demand with the investors, it is a case of too much money chasing too few deals. Irrational exuberance takes over and investors become prepared to pay astronomical valuations just to be in the reckoning with the '*unicorns*' (market leaders with GMV of more than \$1 billion). As and when the potential of the sector becomes more visible, valuations sober down and get connected to conventional metrics such as revenues and profitability. The industry also reaches a consolidation phase whereby the probable market shares of those companies that will last out can be determined more accurately.
- In VC and PE deals, normally no strategic premium is paid since these are financial investors and do not have long-term business interests in the company. Moreover, the whole purpose of the transaction is to finance the company and not to acquire control. However, if there are specific instances where the investor is getting a strategic threshold of 26% or more, the investor may be willing to consider a *threshold premium* (known as '*acquisition premium'* which is discussed in Chapter 16). This is rarely seen in pure PE deals and is more of an exception than the rule.

12.6.2 Valuation Approaches

While the general approaches to corporate valuation remain the same, the methodologies are fine-tuned while applying them to particular transactions based on the considerations discussed above.

The valuations in private equity are based more on *Relative Valuation* using *Transaction Multiples* method but financial forecast becomes extremely important to arrive at the earnings, profits and cash flow. The financial results of the immediately preceding completed year of operations and current year's expected performance become the primary basis to arrive at the earnings. Forward multiples are used sometimes to arrive at the valuation when it is felt that the company is at the tipping point and past performance or current year do not adequately reflect future performance. Generally, forward multiples are not used beyond the next 12 months.

- The *Transaction Multiple* approach uses capitalisation factors based on Topline multiple (Revenue or Sales multiple), Operating profit (EBITDA multiple) or Net Profit after tax (PAT multiple) to arrive at the present value for the company. The ratios typically used are EV/Sales, EV/ EBITDA, EV/PAT or sometimes EV/ FCF (Free Cash Flow) and EV/ BV (Book Value). EV/EBITDA is the most common though it does not factor in the influence of leverage on free cash flow.
- The multiple to be used depends upon the type of industry and the stage of growth of the company. In companies that presently do not have a stabilised bottom line or there is a considerable element of future growth required to create a consistent financial forecast, top-line multiples are used. Sometimes companies have a negative cash flow due to high burn rates and customer acquisition costs. Since such companies at these stages have either negative profits or sub-optimal profit margins, it would be appropriate to look at top line rather than the bottom line.
- '*Transaction Comparables*' (also known as '*Deal Comps*') become extremely important in PE valuations for peer comparison and in judging if the valuation in a particular case is in tune with current PE market valuations. In doing so, certain subjectivity needs to be used to accommodate the distinctive elements of the company in question wherever necessary. For example, if a company has high potential intellectual property assets or better quality human capital, it may command a higher multiple than its peers. Similarly, if a company is close to an IPO as is the case in a pre-IPO mezzanine round financing, trading comps become more relevant than deal comps. Furthermore, when deal comps are pegged higher than usual, it may also be necessary to compare with the trading comps of similar listed companies to ensure that PE valuation is not out of tune with peer market valuation.

Case Study

PE Valuation

The following details are furnished in a PE transaction. Let us consider how the valuation needs to be arrived at.

Brief Facts About the Company

The company is in a high-growth industry and has been able to clock expected growth rates and revenues. However, cash burn has been extremely high and the company has been bleeding with losses until now. The gross margins are a healthy 46% but the EBITDA is negative at -12% since the company is yet to stabilise its manpower and customer acquisition costs which are reflected in the high SG&A expenses. The company expects to close its current year revenues at ₹220 crore (₹2.2 billion) but is expecting a

top-line growth of 22% next year due to the launch of new exciting product range. Similarly, costs are expected to be cut down drastically to build an efficient business model by reworking the operational strategies. Accordingly, based on the financial model, forward looking gross margin (sales – cost of production) is 52%, EBITDA is expected to be 24% and a positive PAT at 8%.
Prevailing Transaction comps are EV/EBITDA of 12, EV/Sales of 2.0 and EV/PAT of 20.
Other relevant data:

Issued and paid-up capital	
(Shares of ₹10 each)	₹25 crore
Reserves and surplus	
Securities premium	₹375 crore
Accumulated loss	₹162 crore
Long-term borrowings	₹.50 crore
Cash and bank	₹. 2 crore
Current Round Financing	₹100 crore

Sell-side Pitching

The company is yet to achieve its full potential and operating margins. Secondly, next year is the year of reckoning since the entire operating statement will be reinvented. So, it makes a good case to use forward multiples. Before doing so, the veracity of the claims made by the company has to be verified and accordingly, the financial forecast has to be firmed up for the next year. The strong growth attributed to the new product launches, cost optimisation, etc., need to be defended with adequate consumer data, marketing strategy and operational plan. The financial model should be extremely robust and backed with enough data on all important assumptions.

Assuming the company's estimates are defendable, the sell-side valuation pitch is worked out as follows:

Expected Revenues	₹268 crore
Forward EBITDA	₹64 crore
Forward PAT	₹22.7 crore

The multiple to be used depends upon a comparative analysis of the company with its peers. In sell-side pitching, it is necessary to establish why the company's multiple valuation should be based on higher than peer multiples. A detailed comparison of the business model, growth rates, margins, customer acquisition and retention costs, manpower and other critical elements of the business have to be established to justify giving the company a higher multiple than deal comps in the industry.

Assuming the industry deal comps are applied with EV/EBITDA multiple at 12 and EV/Sales multiple at 2.0, the EV works out to ₹773 crore and ₹537 crore respectively.The valuation range may thus be established around ₹627 crore. The price per share can accordingly be pitched as follows:

Enterprise value	₹627 crore
Less debt outstanding	₹50 crore
Less cash balance	₹2 crore
Equity value	₹575 crore
Price per share	₹230

Buy-side Analysis

The company is loss-making and the book value of share is ₹95. Though the growth is healthy, a lot of reliance in the valuation is being based on its next year transformation from a loss-making company into a profit-making company with a PAT margin of 8%. The scenario looks extremely optimistic and the pitching is highly aggressive. Though the company has a well-defended pitch, the valuation needs to be brought down to reflect the risk of investing in a loss-making company with the possibility of further losses and delay in turning around. In the event the company makes further losses, there is a high possibility of dilution in the investor's holdings due to the need to raise additional funding. As per the data available, the company has received an average valuation of ₹160 per share. It is therefore likely that the previous round was higher at ₹200 or ₹225 per share. Therefore, it is apparent that the company is anxious not to end up in a down round at this stage and is therefore pegging the asking price a notch above the price of the previous round.

Once the business analysis is done to ensure that the company is investment-worthy and it makes sense to scale up the operations to make it profitable, the buy side valuation needs to reflect the risk in the whole proposition. Accordingly, the financial forecast needs to be toned down to reflect a more likely scenario and the deal comps should also consider the size and profitability of the peers.

Assuming the buy-side has come up with the following analysis:

Expected Revenues	₹262 crore
Forward EBITDA	₹42 crore
Forward PAT	₹4 crore
Multiples to be considered	EV/EBITDA 10
EV/ Sales	1.80

Based on the above parameters, taking appropriate weightages, the EV range can be fixed between ₹400 crore and 450 crore at about ₹432 crore. The offer price therefore works out as follows:

Enterprise value	₹432 crore
Less debt outstanding	₹50 crore
Less cash balance	₹2 crore
Equity value	₹380 crore
Price per share	₹152

The offer price translates into Price/BV ratio of 1.60 translating into an EV/EBITDA multiple of 9 and EV/Sales of 1.45. Considering that the company is yet to generate profits, the valuation from a buy side perspective at ₹152 a share looks a reasonable offer. However, it amounts to a down round.

Deal Dynamics

Some of the important considerations that come into play are listed as follows:

1. The valuation gap is quite steep at 34% of the ask price. It requires a climb down by the sell-side and a more aggressive valuation by the buy-side. Is the buy side keen to do the deal?
2. How fancied is the sector and what are the comparable investment opportunities?
3. How important is this company in the portfolio of the investor?
4. Who are the other investors in the fray and what is their proposed offer?
5. The stake being offered on a post-money basis works out to about 21%. Does the investor wish to take the call of holding 21% in a loss-making company?
6. How strong is the call on future profitability and next year's performance?
7. What is the financial profile of the peers and are they profitable?
8. What is the expected exit valuation and mode of exit?
9. Does it satisfy the risk weighted cut-off rate for the investor?
10. How desperate is the company to raise funds and what are its other options?
11. Are the company and its existing investors prepared for a down round if necessary?

Assuming the deal is agreed to, the final valuation will depend upon the course of negotiations with all the investors and astuteness of the investment banker. It is likely that the deal might take place at the same valuation as in the previous round if it is not more than ₹200 per share. Given the predicament of the company, the investors will be cautious to ramp up the valuation aggressively before the company makes profits. In the worst-case scenario, if no new investor is interested, the existing investors may agree to a follow-on funding but at a reduced valuation of around ₹150–160 per share to cut their risk. There may also be a milestone based valuation agreed to with the management if the company does not agree to a down round.

Final Terms

In the final analysis, if the deal is closed at ₹180 a share, the deal parameters work out as follows:

Pre-money equity value	₹450 crore
Add debt outstanding	₹50 crore
Add cash balance	₹2 crore
Pre-money EV	₹502 crore
Offer Price/BV	1.90
EV/EBITDA	12
EV/SALES	1.92

The final deal valuation[1] serves well for both parties and strikes a balance. It is within the deal comps but based on the financial forecast of the investor. For the investee company, a price of ₹180 per share improves upon the average price of ₹160 but amounts to a marginal down round.

12.7 Process Flow in VC/PE Transactions

Pre-Deal

Mandate to investment banker
Preparation of Placement Document (Information Memorandum)
Vendor Due Diligence (if required)
Issue of Fliers to potential investors
Signing of Non-Disclosure Agreement with interested investors
Submission of Placement Document and other information
Investors process information

During Deal

Preliminary discussions
Visits by investors, further discussions
Term Sheet issued by investor
Term sheet negotiations
Signing of term sheet-commences
Due diligence by investor
Receipt of due diligence report by investor
Final discussions and deal terms
Drafting of documents
Negotiation on documents
Execution of Definitive agreements

Post-Deal

Completion of conditions precedent to investment by investee company Approvals if any required precedent to investment
Authorisations if any required for closing
Fix date for Closing
Closing date process
Funds transfer
Allotment/transfer of shares
Post-allotment company law and FEMA compliances as may be applicable
Board meeting to induct investor rominees
Amendment of articles of association

Exhibit 12.4 Process Flow Chart in Private Equity

[1]For the purpose of this case study, regulatory pricing applicable to private equity transactions involving non-resident investors has been ignored.

12.8 Transaction Perspectives in Private Equity

Based on the above role of an investment bank in private equity, we now discuss the key perspectives that go into the role of an arranger raising private equity for a company.

12.8.1 Offer Literature and Financial Model

Offer Literature

One of the initial tasks in a fund-raising programme would be to map the business model of the company and based on it, prepare a comprehensive business plan. The business plan preparation helps in understanding the business dynamics that shape the fortunes of the company. This understanding is fundamental to the investment banker as it lays the foundation for the transaction and also gives an insight into the likely perception of investors when the plan is presented to them for investment. The involvement in the business plan preparation helps the investment banker in the following ways:

- In understanding the business model so that it stands a test of scrutiny by the investors at a later date.
- In providing the key assumptions and inputs required to construct the financial model.
- To prepare the company for investor due diligence at a later date.
- The most important aspect of a business plan analysis is to make an assessment of the risks that are involved in the business and how well the business plan addresses the mitigation of such risks.
- Determination of fund requirement in the present round of fund raising and in successive rounds for at least a forecasted period of 3 to 5 years.

In later stage companies intending to attract private equity investment, since the disclosures would be many, it is customary to prepare a comprehensive Information Memorandum (IM). The difference between a business plan document and an IM is in the disclosures and length of the document. In early-stage companies, since there is not much of past business, the emphasis is on discussing the future of the company. In later-stage companies, disclosures of the past are as important as discussion about the future.

The business plan or IM forms the main part of the offer literature floated by the company in connection with the proposed deal. The IM would set out the statement that the company wishes to make to prospective investors, the detailed and complete information necessary for the investors to take informed investment decision, the offering summary and the deal structure. The IM goes out in the name of the investment banker but usually with disclaimers to protect the investment banker from third party liabilities.

Financial Model

The financial model follows the preparation of the business plan as all the key assumptions that go into its preparation directly flow from the business plan. The financial model helps in assessment of the following parameters:

- The investment plan envisaged by the company and its relevance and justification from a financial perspective.
- The generation capacity for operating cash flow based on the revenue and cost model and the positive and negative cash that the operating statement throws up. It is observed in many early-stage business plans, the company passes through an initial cash negative phase before its operations turn *'cash positive'*. It is critical to assess the cash negative period accurately as that much amount of external financing would be required to recapitalise the company. This would increase the fund requirement.
- Key financial parameters that define profitability and financial position such as EBITDA, ROCE, RONW, EPS, debt gearing and book value per share.

12.8.2 Transaction Structuring

Transaction formulation is another conceptually important aspect of raising private equity since it should meet the requirements of the company and be appropriately compliant with the regulatory framework. Structure of the transaction primarily stems from the following:

- The current status of the company in terms of its size, shareholding, listing status, etc.
- The amount of capital to be raised through the transaction after careful assessment of the company's requirements as per the financial model and finalisation of the financing plan.
- The type of instrument to be structured that would meet the requirements of the company and the investors.
- Prevailing market conditions and investment climate in the capital market and the private placement market, deal comparables, market valuations and trading comparables.
- The provisions of the Companies Act, Income Tax Act, FEMA.
- Target group of investors to be considered.

Based on the above parameters, the appropriate transaction, size and deal structure would be determined by the investment banker.

Choice of Transaction Structure

The transaction methodology has to be worked out carefully after assessment of the facts involved and looking at the different structures that may be available. The transaction structure determines the efficiency of the transaction, i.e. cost and time efficiency, regulatory optimisation and the quality of investors it would attract. The level of preparedness and growth of the company also determine the transaction structure. The more mature the company, institutional equity becomes preferable. However, institutional equity comes with a lot of responsibility and corporate governance requirements. From a transaction perspective, institutional private equity demands stringent due diligence and more time for execution of the transaction. The investment banker has to assess all these factors and determine the best transaction structure in a given situation. In addition, the transaction structure could also revolve around how many new shares to be issued, dilution aspects, exit to any previous investor through secondary sales to the new investor, regulatory pricing requirements and other deal specific requirements.

12.8.3 Valuation and Deal Structuring

The investment banker has to bear it in mind that no two venture or private equity investors have the same approach to valuing a company and therefore what is required is to arrive at a transaction valuation that could correspond to a fair valuation. The investment banker has to draw upon experience in similar deals and current market trends and arrive at a valuation that can be marketed to investors. Ultimately, the efficiency of the investment banker is judged by the valuation and terms negotiated for the client.

The deal structure normally evolves as the discussions with potential investors progress. However, many a time, if it is decided that the IM should be presented with the proposed deal structure, it would be necessary for the investment banker to formulate the same. To arrive at an appropriate deal structure, it is important to determine the following parameters:

- The pre-money valuation for the current round of financing.
- The approximate returns to the investors in that round based on the period of holding from the date of investment till the proposed date of a liquidity event such as an IPO or a strategic exit.
- The amount of funds being raised in the current round.
- The present value of the company's valuation at the date of liquidity event.

- The amount of further funds that may have to be infused through the equity route through subsequent rounds till the liquidity event happens.
- The stake that has to be offered to the investors in the current round so as to meet their return and dilution expectations.

The investment banker while structuring the deal has to keep ready a projected investor return model based on the criteria discussed above with suitable assumptions to back the model.

Apart from valuation and the stake proposed to be offered, the deal structure should importantly take into account the following as well:

- The company in which the stake is being offered, in case of a group of companies represented by the same promoters. It may be noted that investors normally attach a *'holding company'* discount if stakes are offered in holding companies rather than in the operative companies.
- The proposed exit route and the feasibility thereof. This is extremely important for deal negotiations.
- Type of instrument and staggered conversions if any depending upon the stage of the company's business, shareholding pattern and control issues. The conversion options and the basis of arriving at the conversion price keeping in mind regulations should be provided.
- Sweeteners such as equity warrants, '*earn-outs'* for promoters and '*equity claw back'* may be included in the deal structure.

12.8.4 Term Sheet

A *'term sheet'* is a broad expression of interest and statement of the deal structure that the investor proposes to make with the company for a given offering proposed by a company. It is not a binding offer on either side and both parties are free to terminate it if the deal is not proposed to be carried through at any stage during its validity. Only a few clauses in the term sheet such as confidentiality and indemnity clauses usually survive the termination of a term sheet. Generally, termination of a term sheet does not entail any right to claim damages to either party. The term sheet outlines the details of the investment together with the deal specific conditions.

The investment structure and other principal terms of the investment are outlined by the investors in this non-binding document known as the '*term sheet*' which forms the basis for the next steps to be taken to consummate the transaction. The term sheet is signed by both parties and it provides a window of exclusivity to both sides to complete the succeeding steps within an agreed time frame. It is also used as a basis document to draft the definitive agreements for the transaction. In addition to being subject to negotiation of the legal documentation, a term sheet will usually contain certain conditions which need to be met before the investment is completed and these are known as '*conditions precedent*'.

The principal aspects of a term sheet that are important from a deal perspective are discussed in the succeeding paragraphs. It may be noted that a term sheet does not give rise to any contractual rights whatsoever. It merely represents the understanding of the principal terms of investment agreed between both parties so as to engage in the deal process in good faith and in full agreement of the terms for the execution of binding agreements at a later date. It would be necessary to mention that the term sheet should not be viewed by a company as a case of the investor not trusting the company but more as a question of settling the mechanics of who the decision maker is, avoiding vagueness and injecting preciseness into the transaction. Nevertheless, term sheets can be contentious and the company will do well to hire expert investment bankers and legal advisers to advise them on negotiating and the legality of the various clauses therein. Apart from general stipulations, a term sheet would contain specific conditions that result from an understanding based on the due diligence carried out by the investor. Usually, investment bankers assist in the commercial negotiation of a contractual nature such as valuation and deal structure while legal counsel advise on terms of a legal nature.

Term Sheet in Private Equity

The following are the typical contents of a term sheet for raising private equity:

- Number of shares or other instrument proposed such as a convertible preference share and the issue price.
- Conversion price and conversion ratio in case of a convertible.
- '*Anti-dilution rights'* (known as *'ratchet clauses'*) such as '*equity claw backs'* or right to additional equity for the investors. These are contractual clauses that safeguard the investors against future dilution of investor's stake. For example, if the company does not achieve the stated financial performance, it could affect future valuation. Therefore, investors put in milestone conversion price mechanisms and if the milestones are not reached, they are entitled to additional equity so as to neutralise the reduction in valuation. Similarly, if in a subsequent round, new investors have to be allotted equity at a price lower than in the current round, the current investors have to compensate through issue of fresh equity to neutralise the dilution effect. Anti-dilution clauses also include suitable adjustment for stock splits, conversion of outstanding options, warrants, mergers and other such events that may lead to dilution.
- '*Investor protection rights'* such as '*right of first offer'* (ROFO) and '*right of first refusal*' (ROFR) for future stock issues by the company, dividend rights, etc.
- '*Equity Earn-outs'* or '*carve out'* for the promoters if they better the financial performance as projected. These are rights that will entitle the promoters to additional equity (usually in the form of sweat equity or concessional equity) as a reward for their performance.
- ESOP equity pool for other employees and working directors.
- '*Exit rights'* for investors such as '*liquidation preference*' and '*put option'* to compel the company or the promoters for a buyback of shares.
- *'Affirmative/veto rights'* on major corporate decisions such as sale or disposal of undertakings or substantial assets, dividends, capital issuance, long-term borrowings, managerial remuneration, technology transfers, etc. Although the VC/PE investor in partnership with the entrepreneur is interested in building a valuable company together, their interests are not always aligned. Promoters may have personal or intellectual satisfaction and private benefits of ownership which could be in conflict with that of investors. Therefore, in addition to negotiating the financial terms of the deal, the VCs also negotiate contracts with the promoters and the key management team and put in place control mechanisms, all designed to minimise the agency and information asymmetry problems between the parties. The presence of an affirmative right would mean that the company cannot implement such decisions even if there is a majority consensus among the shareholders without the express consent of the affirmative right holder. Other management representation rights include taking one or more board seats depending on the level of proposed investment, determination of management compensations, etc. The company has to seek expert legal advice to ensure that there is no transfer of 'control' of the company to the investors by virtue of these clauses.
- Provision of periodic financial information and requirements thereof.
- Provisions for proposed mode of exit and exit rights. Usually exit rights involve a '*tag along'* and/or '*drag along'* rights and '*put options'*. In the case of a 'co-sale' or 'tag along', if a shareholder wishes to dispose-off shares that are the subject of such a right, the other shareholders who benefit from the right can insist that the potential purchaser agrees to purchase an equivalent percentage of their shares, at the same price and under the same terms and conditions. Tag along rights are stipulated by investors so as to make it difficult for promoters to sell their stake to third parties and exit the company. A 'drag along' right (sometimes referred to as '*bring along'*), creates an obligation on the other shareholders of the company (subject to such right), to sell their shares to a potential purchaser if the shareholder with

such right chooses to sell to that buyer. For example, the VC investor may have a drag along right on the promoters. Therefore, if they wish to exit to a buyer, the promoters will be obliged to sell to the same buyer on the same terms. A drag along is usually insisted by an investor with minority stakes in the company to improve the prospects of stake sale and exit pricing.

- Conditions precedent to the proposed investment.
- Specific representations and warranties required from promoters and the company.
- Deal closing expenses.
- Due diligence requirements.
- Expected date of closing.
- Exclusivity period after signing the term sheet validity period thereof.
- Other terms specific to each case.

The investment banker has a crucial role to play in term sheet negotiations with the investors. While the investors usually try and peg down the valuation to their advantage, investment bankers start off with aggressive pricing to ensure that even if it is watered down during negotiations, they achieve an attractive pricing for their client. However, valuation is not the only negotiation point. The term sheet has to be read and understood completely in all its implications. Generally, term sheets tend to become restrictive as the investor looks for a strangle hold on the company for future adversities. The anti-dilution clauses, veto rights, tag along rights, non-disposal undertakings and right of first refusal on sale are major issues that need to be negotiated with the investors wherein the investment banker's expert knowledge and negotiation skills are put to test. The overall objective should be to achieve a reasonable term sheet that offers good valuation, enough leg room to the management in operational matters, flexibility on strategic issues and not too restrictive in exit mechanisms.

12.9 Regulatory Requirements in Private Equity Investments

Venture capital and private equity investments in unlisted companies qualify as preferential offers under law and though they do not involve a wider section of QIB and NII investors as in private placements, they require adhering to the regulatory requirements under Section 42 of the Companies Act. The following main conditions apply:

- The offer literature shall be circulated only to the intended investors. As per law, it should be numbered and addressed only to the intended parties. A suitable disclaimer on the following lines should be provided for additional safeguard:

  "*Strictly for private circulation only. No part of this Information Memorandum shall be construed to be a Prospectus or an Invitation to the Public within the meaning of Section 23 of the Companies Act 2013, for the purpose of subscription to the Investment Option detailed herein. This Information Memorandum is strictly meant for private investors and the information contained herein has been provided for the purpose of enabling the intended investors to make an informed investment decision*".

- The transaction should be supported by a valuation certificate from a registered valuer. For this purpose, a merchant banker registered with SEBI is an approved valuer.
- The certificate shall justify the pricing of the share based on the methodologies adopted by the valuer. The pricing shall be as per any internationally accepted methodology on arm's length basis as found appropriate by the valuer.
- In transactions involving non-resident investors, the requirements of the FDI policy and FEMA regulations should be complied to.

- All convertible instruments and warrants are allowed to be issued to non-residents subject to conditions on mandatory conversion and conversion price to be determined upfront at the time of issue.
- Put option on shares is allowed for non-resident investors after an initial lock-in period of 1 year. No assured return on exercise of put option is allowed. The exit price has to be determined as follows:
  - In case of unlisted equity shares, exit price is determined as a price not exceeding that arrived on the basis of Return on Equity (ROE) as per latest audited balance sheet. RoE is defined as the Profit after Tax divided by the net worth (defined to include all free reserves and paid up capital)
  - In case of preference shares or debentures, exit price is determined as a price determined by a Chartered Accountant or a SEBI registered Merchant Banker as per any internationally accepted methodology.
- The legality of shareholder agreements providing for pre-emptive rights on transfer of shares such as ROFO, ROFR, Drag Along and Tag Along as well as other disproportionate rights such as affirmative/veto rights have not been tested adequately. The Companies Act brought in a specific proviso under Section 58(2) which states that "*any contract or arrangement between two or more persons in respect of transfer of securities shall be enforceable as a contract*". The position stands as follows:
  - With respect to private companies, shareholder agreements are valid but need to be incorporated in the articles of association of the company. There are several decisions on this matter but the decision of the Supreme Court[2] is cited most often.
  - With respect to unlisted public companies, such agreements are enforceable only between the persons to the agreement under Section 58(2). However, for shareholders' agreement to be enforceable against the company and other shareholders, including those who are in minority, the provisions of the agreement have to be incorporated in the Articles of Association of the company, based on the SC judgement *(supra)*. In the event of a conflict in provisions, the articles shall prevail. However, the articles cannot supersede law.

12.10 Exit Mechanisms for PE Investors

At the end of a private equity investment cycle, the exit becomes the ultimate determinant of the outcome of a particular investment. Therefore, exit strategy is an integral and one of the most important aspects of private equity fund management. The exit cycle in which the investment is cashed out to provide returns to investors is arguably the most critical cycle that feeds back on both the investment cycle and the fund-raising cycle of the PE fund. The need for a successful exit impacts the investment choices in the investment cycle, and a successful exit provides high returns to the limited partners which furthers the prospects for the next fund raising cycle for the general partners. Successful exits at attractive valuations also provide top up returns to both the limited and the general partners and builds the track record for a private equity fund house. Most investment banks find it imperative to have a successfully running and reputed private equity fund house within their group interests.

One of the key determinants in the choice of the exit mode is the stage of the investment cycle. On an average, PE firms typically stay in an investment between 3 years and 5 years while VCs can stay longer upto 7 years. The PE funds need to sell out even if they see the value of their investment going up because the funds have a life period which stretches for about 10 years in general at the end of which the original investors are returned their money. This separates PE firms from other corporate or strategic investors, who usually acquire for perpetuity.

[2]*SC in V. B. Rangaraj v. V. B. Gopalakrishnan, AIR 1992 SC 453*

The common modes of exit in pure play VC/PE space which involves unlisted companies are any of the following:

- ***Taking the company public with an IPO:*** This is the most preferred and attractive exit option for PE investors and has historically yielded the best returns. Usually, the PE investors make an offer for sale (secondary offering) in the IPO and encash their stake. However, the PE fund need not make a complete exit at the time of the IPO. Since the IPO creates marketable wealth, the PE investor can also time its exit in phases going beyond the IPO. In some cases, the PE investors may use the IPO only to unlock value in the company but not offload any of their holdings in the IPO. This can happen when their investment cycle is not yet complete and they are in a position to wait for a better exit price in future.
- ***Secondary or trade sale/strategic sale:*** In this exit option, the investor exits through a stake sale to a third party. The third party could be another financial investor who takes out the selling investor and assumes his position in the company (known as a '*secondary sale' or 'secondaries' or a 'trade sale'*) or a strategic investor such as a larger competitor buying out the investee company in an acquisition thereby providing an exit to the private equity investor ('*strategic sale*'). Strategic investors usually acquire stakes of existing shareholders as part of a business acquisition or for other strategic purposes. They could either be competitors of the investee company or other business groups looking at the acquisition as an entry strategy. In a secondary sale, it is customary to find a VC fund being taken out by a later stage PE fund or an earlier PE being taken out by a later PE investor.
- ***Buyback:*** A buyback happens when the PE investor exercises a put option on the shares being held by it in the company. The buyback can be made by the company or the promoters depending upon whom the put option is exercisable. Buyback by the investee company works mostly in the case of unlisted companies since listed companies have a lot more regulatory hurdles in such a process. Even in the case of unlisted companies, there are provisions of law that need to be complied with. Buyback by promoters warrants huge personal resources of the promoters to be used in the process. In many VC backed companies, promoters are not resourceful enough for honouring a put option on them. Furthermore, PE investors stipulate a stiff put option exit price for a buyback to compensate for their loss of an IPO exit opportunity. These are the reasons why a buyback option may not be a feasible option for an investee company or the promoters to provide exit to the PE investors.
- ***Liquidation:*** This is the least preferred and worst case exit option for an investor. Liquidations are statutory processes that take a long time to complete and would only provide salvage value if any, to the investors. In most VC/PE backed unlisted companies that go in for liquidation, the companies in question would have become bankrupt and liquidation is only a statutory mechanism to dissolve the company. Normally a liquidation preference right could exist to protect the VC investor's first right of exit. Usually a liquidation preference clause might state that the investor has a right to recover the invested amount along with accumulated dividends in preference to other shareholders. Sometimes, it may provide for 1.5x or 2x right of preference meaning that in the distribution of the liquidation proceeds, the investor should be given twice its investment before any surplus can be distributed to other shareholders. A third way could be to provide a right to participate in the surplus remaining after taking out their money. Some investors decide to protect their right of first exit on liquidation by keeping the investment as venture debt or as cumulative convertible preference shares so as to have a preferred right of exit over equity shareholders.

12.10.1 Successful Private Equity Transactions

A successful private equity transaction is one that culminates in a successful and profitable exit. Though private equity in India is only about two decades old, there have been some success stories in this space backed by good exits made by PE investors. A few such transactions have been profiled below:

Case Study

Warburg Pincus

Private equity investor Warburg Pincus is arguably one of the successful private equity investors in India which made several profitable investments and exits. One of the highly successful investments made by Warburg was in the telecom major Bharti Airtel Ltd. At the time, it was the most valuable exit by any PE firm in the country. Warburg had invested ₹1,300 crore ($292 million) between 1999 and 2001 in the telecom company to acquire 18.5%.

Warburg began exiting Bharti in phases. In September 2004, it made $200 million from the sale of 3.35% equity. In just 6 months, Bharti's valuation jumped nearly 50% and Warburg walked away with $310 million from the sale of another 3.3% stake in February 2004. In March 2005, Warburg sold 6% more for $561 million and made its final exit in October the same year, selling 5.65% to Vodafone for $847.5 million. In all, it made a phenomenal ₹8,496 crore, or $1.9 billion, at the time of the final exit, taking home more than 6 times its original investment in about 7 years from the date of initial investment.

Warburg also made a successful exit from cement giant Gujarat Ambuja (now renamed as Ambuja Cements). The PE firm had invested nearly ₹270 crore in 2001 in the company and realised close to ₹827 crore through two separate transactions in late 2005. Warburg made many other successful investments in several other companies including Kotak Mahindra Bank in which it made its final exit in 2012 through a block deal on the stock exchange selling its residual stake of 3.6% for ₹1,400 crore (about $275m).

However, Warburg was criticised for making early exits from its profitable investments. Analysts pointed out that if it had stayed on, the returns would have been far higher than what Warburg made from its stake sales in those companies. Warburg's 18.5% stake was worth $8.14 billion in 2008 which would have meant a return of 28 times the original investment. In effect, Warburg lost $6.24 billion or more by virtue of a decision to exit its investment in Bharti in October 2005. Similarly, the value of the shares that Warburg Pincus held in Gujarat Ambuja was about ₹1,144 crore in 2008.

Case Study

Lodha Developers

Lodha Developers Ltd. bought out Deutsche Bank Private Equity (DBPE) in one of the largest PE exits in India through the buyback route by the company. The exit consideration was ₹2542 crore which was financed through internal accruals and issue of NCDs of ₹825 crore which were listed. For DBPE, it meant a 55% return on a holding period of 4 years. DBPE had made the investment in a group subsidiary, Cowtown Land Development which executed projects in Mumbai. In 2007, DBPE subscribed to FCDs in the company by investing ₹1640 crore in the single largest real estate FDI at the time. These FCDs carried a coupon and if Cowtown had defaulted, the PE had a right to convert the FCDs to get a 99% stake in the company and its downstream subsidiaries. The shares resulting from the conversion of the FCDs were bought back by the parent company Lodha Developers from DBPE thereby providing the exit. Lodha had earlier provided exits to other investors JP Morgan and HDFC Ventures from its other projects.[3]

[3]Based on reports in The Economic Times dated 10th February 2012.

Case Study

Matrix Laboratories

Newbridge Capital (created by TPG for Emerging Markets, now part of TPG) invested in Matrix Laboratories, Hyderabad in the largest PE deal at the time.Matrix was the largest API manufacturer in the world with presence in India, China and Africa. It also had a distribution subsidiary called DocPharma for the European markets.When TRG invested in 2004, it did not envisage any exit until 5 years, the usual time frame for a PE investment. It invested $200 million for a 40% stake in the company. Two years later, Mylan Pharmaceuticals USA proposed to acquire Matrix finding high synergies for global expansion.TPG decided to exit through strategic sale to Mylan which was buying out the promoters of Matrix as well.TPG exited through this transaction receiving 270 million for a 26% stake from Mylan which returned a 107% aggregate return.

Other Select Notable Cases of PE Exits

Company	*Details*	*Type of Exit*
i-Gate Global Solutions	Apax Partners was an investor which was provided an exit at 3x returns due to the global acquisition by Capgemini of France.	Strategic sale
CMS Infosystems	Blackstone exited by sale to Barings Asia	Secondary sale
Just Dial	Tiger global made returns of 13x	IPO
Freecharge	Sequoia Capital was a venture investor in the company. It was acquired by the e-com company Snapdeal	Strategic sale
Mankind Pharma	Chryscapital, a VC investor exited to PE investor Capital International. Returns made 13x	Secondary sale
Sasken, Firstsource, UFO Moviez, Mahanagar Gas, MCX Stock Exchange, Equitas Holdings, Dr. Lal Pathlabs, Ujjivan Financial, Narayana Hrudayalaya, Alkem Labs, Navkar Corp, Parag Milkfoods, Inox Wind and several other companies	Various PE investors	Offer for sale in IPO
Bhartiya Urban Infrastructure and Land Development Co.	IL&FS Investment Managers registered one of the biggest buyback exits in India in 2013 by offloading its stake in the company. IIML had invested $35.89 million in the real estate company in 2007 and exited the investment for $60.02 million.	Buyback

IMPORTANT TERMINOLOGY

Affirmative Rights
Arranger
Conditions Precedent to Investment
Conventional Venture Capitalist Method
Co-Sale Right
Down Round
Drag Along
Due Diligence
Early Stage
EBITDA Multiple

Equity Claw Back
Equity Earn Out
EV
Exit Rights
First Chicago Method
FV
Later Stage
Liquidity Preference
Post-money Valuation
Pre-money Valuation
Private Equity
Ratchet Clause
Return on Capitalisation
ROFO
ROFR
Seed Stage
Step-up in Value
Tag Along
Term Sheet
Venture Capital
Veto Rights

TEST YOUR UNDERSTANDING

PART – A

I. Pick the right answer(s) or the alternative that best fits the description from the alternatives provided under each question.

1. A company, with an issued capital of ₹1 million (of shares worth ₹10 each), negotiates with a VC for a stake in the company for a consideration of ₹500 million. The VC has to subscribe to a convertible that would entitle it to an equity share for every five convertible instruments issued to it. The face value of each convertible is ₹1000. The post-money valuation of the company works out to:
   (a) ₹50 billion (b) ₹5 billion (c) ₹2 billion (d) ₹1 billion
   (e) ₹500 million (f) ₹10 million
2. A company, with a post-money valuation of ₹1 billion has come out with an investment plan for ₹500 million involving the following: (i) Financing through promoters' equity ₹50 million, (ii) Financing through private equity ₹100 million, (iii) Financing through issue of convertibles ₹150 million and (iv) internal generation ₹200 million. The pre-money valuation of the company works out to:
   (a) ₹1.5 billion (b) ₹1 billion (c) ₹900 million (d) ₹800 million
   (e) ₹700 million (f) ₹600 million (g) ₹500 million
3. An unlisted company prefers to go in for a private equity transaction. One of the following conditions does not apply:
   (a) Promoters can be part of the preferential allotment
   (b) Warrants can be issued to the private equity investors
   (c) Convertibles shall have a maximum currency of 60 months
   (d) Entire money due on allotment shall be brought in as per the terms of allotment
4. An unlisted company is raising venture capital through a preferential issue of shares. The following are the implications:
   (a) Promoters cannot be part of the issue
   (b) Promoters can take warrants only if VC is also offered warrants
   (c) The post-money valuation shall not exceed five times the pre-issue valuation
   (d) VC cannot hold more than the promoters
   (e) None of the above
5. An unlisted company has proposed to make a private placement of the anchor investor portion in its upcoming IPO. It can be done in the following way(s):
   (a) To anchor investors at the issue price
   (b) To promoters at or more than the issue price
   (c) To venture capital funds as part of the offer for sale
   (d) To a strategic investor at a negotiated price

6. In a private equity transaction, the due diligence is performed by:
   (a) The private equity investors
   (b) QIBs
   (c) The underwriters
   (d) The prime lead manager
   (e) An independent agency
   (f) The BRLM
   (g) The lead manager responsible for pre-issue process
   (h) The lead manager responsible for post-issue process.
7. A company decides to go in for venture capital funding with the following condition, 'whenever the VC feels that its money is unsafe with the company, it can oblige the promoters of the company to buy back the shares from the VC'. This amounts to to:
   (a) Hedging
   (b) Arbitrage Trading
   (c) Security dealing
   (d) Counter Party Risk Mitigation
   (e) Full Recourse Investing
   (f) Simultaneous Offer
   (g) Put option
8. A PE fund (PE 1) enters into a term sheet with a company and simultaneously enters into a back-to-back term sheet with another PE fund (PE 2) to buy it out at the time it wishes to exit the company. This has the following implication(s):
   (a) The company can refuse such buy-out
   (b) The company can compel such buy-out
   (c) PE 1 can proceed against the company if it refuses to take cognisance of the buy-out
   (d) PE 2 can proceed against the company if it refuses to take cognisance of the buy-out
   (e) Both PE 1 and PE 2 can proceed against the company
   (f) The company is not obliged in any way unless it is a party to the second term sheet.
9. In a term sheet, a VC negotiates that if the company does not achieve the agreed levels of performance, the VC shall have an option to convert the equity shares into a loan and recover it from the company with interest at the rate of 20% from the date of investment till the date of recovery. This is:
   (a) Against the law and therefore illegal contract
   (b) Invalid contract since it is not possible
   (c) Invalid contract since company cannot consent to it
   (d) Valid only if there is no interest
   (e) Valid only if sanctioned by the Court/Tribunal
   (f) Valid only if prior permission is obtained from the Government
   (g) Valid only for public issue and not for a private placement
10. A VC seeks an investor protection right as follows: 'in the event there is a down round valuation in future, the promoters shall compensate the VC to the extent of the depreciation in their investment by sale of vendor shares from their holdings at an appropriate price'. This may have the following implication(s):
   (a) The promoters have no power to enter into such contract on behalf of the company
   (b) The contract is against law and therefore illegal
   (c) The sale of vendor shares should be in lieu of the issue of shares by the company and not in addition
   (d) Vendor shares can be sold only at the same price as the original issue
   (e) Vendor shares are always subject to lock-in and cannot be sold
   (f) The contract is valid and legal.
11. In a term sheet, one of the conditions states that if both the VC and the company find it necessary, the company can buyback the shares from the VC at the issue price and reissue them to the VC at a reduced price so as to compensate for down round valuation. This is:

(a) Against the law and therefore illegal contract
(b) Possible with the consent of the other shareholders
(c) Valid only when the pricing is decided beforehand for the new issue
(d) Valid only if the buyback and reissue are at the same price
(e) Valid only the buyback is at a lesser price than the new issue
(f) Valid only if prior permission is obtained from the RBI.

12. Private equity investors investing in PIPE deals have to be given pre-issue placements preceding the FPO.
(a) Yes (b) No
13. The term sheet in a private equity deal inter alia talks about the commitment of the investor to finance the investee company in future rounds of financing.
(a) Yes (b) No
14. The valuation in a private equity deal depends inter alia on the ability of the company to develop technologies that can shape future product trends.
(a) Yes (b) No
15. In an earn out structure, the private equity investor identifies certain milestones for the company, which if reached will result in the top management team being given an increase in their salaries coupled with handsome bonus payouts.
(a) Yes (b) No
16. A company's pre-money value is determined by the number of outstanding shares (pre-issue) while the post-money value is determined by the number of shares outstanding (post-issue).
(a) True (b) False
17. A PE fund wishes to buy a significant stake of 24% in a listed company and has been discussing with the company about the transaction as a combination of funding the company and acquiring secondary shares from a big institutional investor. The promoters already hold 62% of the company. The CFO of the company feels that post the proposed PE deal, the public shareholding in the company will fall below the minimum mandatory requirement of 25% and the company needs to apply for de-listing. The investment banker advising on the deal states that the company would have the minimum required 25% as the PE investor is reckoned as part of public investors. Who is right?
(a) The CFO (b) The Investment Banker
18. An investment banker negotiates a term sheet for his client with a PE investor based on post-money valuation for a 20% stake. Thereafter, based on due diligence, the pre-money valuation is re-negotiated to a lower level. In order to retain the PE investor's stake at 20%, the i-banker offers that the existing shareholders will bring in additional investment into the company so as to bring up the pre-money valuation to the pre-due diligence levels. The PE investor insists that such additional investment should be brought in at the same offer price per share as applicable to him since it is happening simultaneously. The i-banker says that such an argument is incorrect. Who is right?
(a) PE Investor (b) Investment Banker
19. A term sheet is negotiated with a particular PE fund by a company where after the due diligence is conducted. Post due diligence, the PE investor expresses inability to be able to go ahead with the transaction due to unexpected fund constraints. The company therefore approaches another investor and successfully completes term sheet and due diligence. When the company is about to execute definitive agreements with the second PE fund, the first PE fund comes back to do the deal stating that they now have the necessary funds and since their term sheet was signed prior to the second term sheet, they have precedence under law to do the transaction. The second PE investor states that the first transaction did not get consummated and is therefore not recognised under law. The company is

prepared to do the transaction with whichever investor offers a higher valuation. Will the company succeed in its objective?

(a) True (b) False

PART – B

20. What are the different types of private equity transactions? What is their relevance to in investment banking?
21. How does one arrive at a transaction structure for private equity?
22. What are the valuation techniques used in venture capital and private equity transactions? How does valuation affect pre-money valuation?
23. What are ratchet clauses? Illustrate.
24. What are the key issues in business and financial structuring of companies intending to raise venture capital?
25. What are the important stages in private equity investment? How do you say that venture capital is a subset in the universe of private equity?

For answers to Part A, refer to Appendix B at the end of the book.

13 Buybacks and De-Listing

LEARNING OUTCOMES

- Two types of exit offers, i.e. offers that provide exits to shareholders from investee companies otherwise than through secondary market exit. These are (i) a Share Repurchase or Buyback and (ii) De-listing offer.
- In both the above types of exit offers, shareholders get an exit but the principles, statutory and procedural aspects are vastly different. This Chapter provides a complete discussion on these aspects from an investment banking perspective.
- Concepts and financial implications of buyback, pricing methodologies, regulatory overview for buyback by unlisted and listed companies and buyback strategies.
- Scope and case for voluntary de-listing, regulatory framework, reverse book building, process and pricing for voluntary de-listing, unique cases on de-listing and comparative process with buyback.
- Minority squeeze out under de-listing with landmark case study.
- Both share repurchases and de-listing offers are a part of core investment banking and both these types of offers are to be managed by a merchant banker as per SEBI Regulations.

13.1 Introduction to Share Repurchase or Share Buyback

Stock repurchase or *share repurchase*, commonly known as *share buyback* refers to the process of a company buying back its own shares from its shareholders. In this sense, it is the reverse of an issue of shares and is, therefore, also one of the ways in which an *exit* may be provided to a shareholder. In the US and UK capital markets, companies are allowed to buy and hold their own shares from the secondary market as a part of their treasury operations. It implies that shares bought by a company as *treasury shares* can be sold back into the secondary market. However, there is a major difference between purchase of treasury stock by a company and a share repurchase programme. In the former, the shares are not extinguished, therefore, the transaction in balance sheet is neutral. In the latter case, the shares are extinguished and the company's issued capital gets reduced to that extent. Therefore, it is a process of capital reduction.

13.2 Conceptual Justification for Share Repurchase

Theoretically, it is said that shareholder wealth maximisation has to be the objective of every corporate enterprise. Therefore, if a company has a Return On Equity (ROE) that is better than the opportunity cost for the shareholder, his wealth is maximised by redeploying the profits back into the business. In other words, such a company should follow a no-dividend policy. But if a company is sufficiently mature and quite stable in its business model, two things would happen: (i) its annual growth rate reaches a more sustainable level and (ii) its investment needs become more modest. In such a company, there may not be a scope to redeploy all the internal accruals since the returns may not be as good as the opportunity cost of the shareholder and / or there is simply no requirement for so much extra cash in the business. Such companies would, therefore, need to make significant cash distributions as dividends or resort to stock repurchases to keep the capital employed in the business under control. In the US market, significant research was done about corporate share repurchases in the 1980s that led to the conclusion that the market does not value a company for its liquid cash balances or near to cash investments. Mature companies should look for maximising share value through a build-up of book value, earnings, dividends and return of surplus capital through share repurchases. Share repurchases tend to keep a company from becoming *over-capitalised*, i.e. having too much capital for the level of business being done. The concept of over-capitalisation is explained with a simple illustration.

ILLUSTRATION 1

Particulars (₹)	*Company A*	*Company B*	*Company C*
Sales	100,000	100,000	100,000
EBITA	24,000	24,000	24,000
EBITA %	24%	24%	24%
PAT	15,000	14,000	12,000
PAT %	15%	14%	12%
Share Capital (Shares of ₹10 each)	50,000	25,000	20,000
Reserves and Surplus (including profit)	100,000	10,000	(15,000)
Secured Borrowings	0	25,000	35,000
Capital Employed (share capital + reserves + long-term borrowings)	150,000	60,000	40,000
Capital Turnover Ratio (times)	0.66	1.67	2.50
ROCE (EBITA / Capital Employed)	16%	40%	60%
EPS	3.00	5.60	6.00
Debt-Equity Ratio (times)	0	0.71	7.00

It may be observed from the above data that though all the three companies have the same EBITA, the ROCE, EPS and debt-equity ratio vary widely. Looking at the ratios, it is possible to deduce that Company A is over-capitalised since it has large accumulated profits and a higher capital employed for the same level of operations as the other two companies. Due to this reason, it has the least ROCE. It also has a higher share capital which has depressed its EPS. Company B is more optimally capitalised both in terms of total capital and the debt-equity mix, while Company C appears to be grossly under-capitalised and is treading dangerously on a very small net worth. Company A has to look at higher distribution of capital back to its shareholders to improve its ROCE and EPS. Company B does not have to do significant distribution as of now since it has a healthy ROCE of 40% and has growth requirements for the future. The shareholders would be happy to keep the funds with the company as long as it shows a healthy trend of growth that is better than their opportunity cost. Company C requires immediate infusion of equity to refinance its losses and substitute debt as well so that it can bring down its debt-equity ratio and look for sustenance. The prolonging of this situation could lead the company into a very difficult situation and eventually into bankruptcy.

13.3 The Free Cash Flow Conundrum and Share Buyback

Based on the above discussion, it is necessary to appreciate the free cash flow conundrum of corporate managements. Free cash flow is the cash that is thrown up by the operations of a company year after year after meeting the reinvestment needs to sustain the business. Understanding and managing free cash flow is an extremely important part of strategic finance and investment bankers play a key advisory role in it. The cash that remains after meeting debt servicing requirements becomes *discretionary cash* available to the management. In a growing company, the discretionary cash is diverted to financing growth leaving very little to the discretion of the management. As pointed out in the previous paragraph, shareholders may not mind it so long as the company's ROE is more than their opportunity cost. But as free cash flow accumulates over time, the discretionary cash flow available to the management creates a moral hazard. Mike Jensen of the Harvard Business School termed this condition as *the agency costs of free cash flow.*[1]Due to global developments post the financial crisis in 2008, corporate managements are compelled to conduct far greater due diligence on new project investments so as to ensure that the deployment of free cash flow is in the intended direction of value enhancement. Therefore, in difficult business environment, the agency cost of free cash flow can increase if cash is left to idle on the balance sheet or put to inappropriate use by the management.

Share buybacks are among others, a means of squeezing out excess free cash flow from companies with few profitable growth opportunities, thereby reducing the agency cost.Keeping in view the significant impact it has on value creation, share buyback was legalised in India in 1997 by introducing Section 77A of the Companies Act 1956. It was legalised in USA in 1982 and in Japan in 1995.

13.4 Implications of Share Repurchase

Continuing the above discussion, the implications of a share purchase are not only about over-capitalisation. Share repurchase is a method of capital restructuring for a company whereby the equity component of capital employed is reduced. As a consequence, in companies that have debt in their capital structure, a shares repurchase programme increases leverage. There are also other important long-term implications which are discussed in following points:

- ***Correction of Over-Capitalisation:*** Well-performing companies that enjoy good margins and high recovery rates from customers are generally left with surplus liquid cash and cash equivalent assets that are in excess of their long-term requirements. The pitfalls of having excess liquidity are many; it could be misdirected into ill-conceived ventures and if not profitably employed, it would reduce the Return On

[1]The Agency Costs of Free Cash Flow: Corporate Finance and Takeovers – Mike Jensen, American Economic Review 1986.

Capital Employed (ROCE) generated by the company. The fall in such return has serious repercussions in terms of fall in the Return On Net Worth (RONW) and consequent adverse impact on the market price of the share.

In order to correct a condition of over-capitalisation, a company can resort to a repurchase of equity shares (and preference shares too if the terms of issue so permit) for payment in cash from the shareholders. Through this process, the company reduces its capital and excess liquidity in its business. As a result, the shareholders' funds are decreased and the equity capital is trimmed of the excess flab. The reduction in capital has a positive impact on the ROCE and RONW and the pruning down of equity share capital has a positive effect on the Earnings Per Share (EPS). This would lead to improved perception in the stock market and a consequent increase in market capitalisation.

However, buyback of equity is not advised for companies that have high growth rates and market capitalisation. In such companies, it would be advisable to retain the capital in business and reduce borrowings so as to bring down the current cost of capital and improve profitability and liquidity. Similarly, in companies that have high debt-equity ratios, excess capital should be used initially to repay existing borrowings rather than to buyback equity. Lastly, share buyback is also not recommended for companies with reasonable debt-equity ratios but with a long cash cycle or with unpredictable cash flow patterns. Such companies would do well to retain excess capital in liquid assets to meet contingencies or to retire debts and reduce financial leverage.

- ***Shoring up Promoters' Stakes:*** Equity buyback can also be used as an effective measure for increase of promoter stakes in a company. Company managements normally look out for such opportunities during times of depressed market conditions during which, buyback of shares from the public shareholders could be made at attractive price by the promoters. This would be a cost effective way of consolidation of promoter interest in a company.
- ***Exit Mechanism:*** Equity buyback is an investor-friendly measure in times of depressed markets wherein the retail investor is locked in the share due to its low market price. If the company can support a buyback with enough liquidity, the investor gets a respectable exit from the share during such times.
- ***Tax Efficient Distribution:*** A share buyback is specifically exempt from being taxed as dividend under the tax law of many countries including India. Instead, in the hands of the shareholder receiving the proceeds of the buyback, the gains arising would be taxed as capital gains (long term or short term as the case may be). For this purpose, the capital gain will be computed as the difference between the buyback price and the cost of acquisition of the shares. This way, a buyback is a tax friendly method of distribution of shareholder funds by the company.
- ***Shareholder Value Management:*** Equity buyback would be required in times when the company is not able to generate enough return on the surplus capital in its businesses to offset the opportunity cost to shareholders. If it continues to keep such funds in the business, it would destroy shareholder value. Therefore, a buyback at such times helps in unlocking the excess capital and the shareholders would be free to deploy such funds elsewhere. Therefore, buybacks do help long-term investors in a company by increasing its EPS and resurrecting its stock price.

Notwithstanding the above reasoning, it may also be noted that buybacks do not fundamentally change the business reality of a company. They are an ingenious way of improving EPS and ROE through capital restructuring without any fundamental change in business fortunes. To that extent, buybacks are deceptive. Furthermore, it is necessary to mention that pricing a buyback appropriately is extremely important so as not to erode value for the shareholders who are left behind after the buyback. This aspect has been discussed later on in the context of pricing of buybacks.

13.5 Buybacks in the US Context

Till buybacks were permitted in 1982 by the SEC, they were illegal in the USA as they were considered to be insider trading. This is because the management of a company has inside information on the company's affairs so as to time the buyback to its advantage. However, after buyback was made legal with several rules, companies were quick to latch on to it. The year 1984 saw US$ 27.3 billion in buyback spend (as compared to US$6.8b in 1983) and by the end of the century, it ramped upto US$ 250 billion. However, the bigger growth was to come in the years preceding the financial crisis upto 2007 touching almost US$ 500 billion per year. Numerous studies during this phase showed that companies that made buybacks outperformed the broader S&P 500 index. For example, IBM's shares grew at a CAGR of almost 50% between 1995 and 2000 while Coca Cola's shares grew at a CAGR of 24% between 1982 and 2000.

The years following the global financial crisis in 2008 exacerbated the buyback spends of US companies. The stagnant economy, low interest rates, the QE programme of the US Federal Reserve and increased business risk perception in USA prevented companies from considering new growth options and investing their cash wisely. Therefore, companies resorted to increased buyback programmes and an estimated US$2.1 trillion was returned to shareholders in the five years post 2011. Companies such as Apple, General Electric, Pfizer, McDonalds's, Exxon Mobil, Chevron and several others were notable during this time. Exxon Mobil alone accounted for US$ 210 billion of buybacks in ten years upto 2016. This was in addition to it being a company that had increased its dividend payout consecutively for 25 years until then. Companies in USA were sitting on an estimated US$1.35 trillion in cash at the time with very little treasury earnings due to low bond rates. Share buyback was a strategy to shore up the stock price in the midst of lacklustre business performance and dearth of diverse investment avenues.

At that time, since bond rates were very low, many companies resorting to bond issuances to finance their buybacks were reducing their cost of capital. This process left the US corporate sector heavily leveraged without substantial growth in operational cash flow. Investors were also not impressed with the high level of repurchases and analysis showed that such companies under-performed the broader index. Dutch auction method was introduced for the first time by investment bank Bear Sterns for their client Todd Shipyards' buyback programme in 1982.

Case Study

Apple Inc.

Apple's was the most valuable company in the world till early 2016. It indulged in billions of dollars of buybacks from 2013.Apple's buybacks were triggered by billionaire investor Carl Icahn, who wrote to Apple's CEO Tim Cook in 2013 stating that "it is our belief that a company's board has a responsibility to recognise opportunities to increase shareholder value, which includes allocating capital to execute large and well-timed buybacks."

Between 2013 and 2015, Apple bought back 760 million shares, lowering the count from 6.3 billion to 5.54 billion, a reduction of 12.1%. The program cost a total of $87.2 billion. Such massive repurchases did not help the intended objective of shoring up the stock price. Apple's shares continued to tumble and the company could have saved an estimated $15 billion if the buybacks had not been ill-timed. Apple continued its stock repurchases through 2016 providing an additional $30 billion for the programme.

Like in other US companies, buybacks for Apple did not produce the desired impact of propping up its stock price. The markets were more concerned about the fundamental direction of the company's future business and were not particularly influenced by the deception of share buyback on its financials.

The US regulations permit stock repurchases under four different methods: (i) Fixed Price or Tender Offers to shareholders, (ii) Dutch Auction method, (iii) Open Market Repurchases and (iv) Transferable Put Rights (TPRs). The first three methods are also available in India but TPRs are not allowed. TPRs are issued against existing shares with a fixed put option price. These are traded in the secondary market. If the ruling market price is below the put option price, the investor exercises the put option and the share is bought back by the company. TPR trades determine the expectation on the stock price in the lines of the F&O market.

13.6 Equity Repurchases in India

Exit offer is a relatively new concept in the Indian context. Till 1998, Indian companies were not allowed to buyback equity shares from their shareholders or from the secondary market. So, the only exit option for the common investor was to sell through the secondary market. With the amendments to the Companies Act, companies were allowed to buyback their shares subject to a lot of statutory restrictions. The basic theme of a share repurchase mechanism in India is to allow it as a step to be implemented from time to time by companies. Share repurchase can be used to meet strategic objectives including distribution of capital to shareholders but *not for treasury operations*. Accordingly, the statutory provisions governing share repurchases in India do not allow companies to retain the shares repurchased as *treasury stock* as is the international practice. They are supposed to be compulsorily cancelled and reduced from the equity capital of the company which amounts to *capital reduction*. In fact, under IFRS a specific accounting treatment for treasury stock is also specified stipulating that such stock should be presented as reduction from owners' equity and any gain or loss arising therefrom should be accounted for in the equity and not routed through the profit and loss account. Presently, in India, treasury stock is not allowed to arise from share repurchases and accordingly no separate accounting treatment is prescribed under I-GAAP.

Buybacks are being discussed in the context of investment banking since statutory regulations provide that appointment of a merchant banker as a manager to the offer is mandatory for listed companies intending to make a buyback offer to their shareholders. In such offers, the merchant banker plays a very significant role not only in pricing the issue but in ensuring compliance with law and in advising the company at every stage.

13.7 Regulatory Framework for Equity Re-purchase

Equity repurchase by a company was not allowed under the Indian law until 1999 when the Companies Act, 1956 was amended. Currently, Section 68 of the Companies Act, 2013 provides for the statutory framework for buyback by a company of its own securities. This section applies to all types of companies including listed companies. Unlisted companies should also comply with the rules prescribed for buyback.[2] On the same lines, listed companies should also comply with the provisions of SEBI Regulations in this behalf.[3]

13.7.1 General Conditions

The important general conditions applicable to all types of companies for buyback of securities in terms of the provisions of Sections 68 and 69 of the Companies Act are listed below:

- The buyback shall be approved by a special resolution passed in general meeting. In case the amount of the proposed buyback is only upto 10% of the paid-up capital and free reserves of the company, it can be

[2]Rule 17 of the Companies (Share Capital and Debentures Rules 2014)

[3]SEBI (Buyback of Securities) Regulations 1998

authorised through a board resolution. However, the board of directors of the company cannot authorise two buyback proposals within a period of 365 days under this provision.

- The buyback by the company has to be financed out of free reserves or securities premium account or from proceeds of earlier issue of dissimilar shares or other securities.
- The maximum time allowed for the completion of the buyback process is 12 months from the date of the relevant resolution.
- Buyback can be made from existing security holders on proportionate basis or from employees and directors out of the ESOP shares or sweat equity shares or through open market purchases.
- A declaration of solvency has to be filed with the ROC and the SEBI (where applicable) with a verification through an affidavit by the Board of Directors of the company that they believe that the company would remain solvent for a period of 12 months from the date of such declaration.
- All securities that are bought back have to be destroyed within seven days from the date of conclusion of the buyback programme.
- No company shall make a public issue of the same kind of securities that have been bought back within a period of six months from the conclusion of the buyback programme except through issue of bonus shares or through conversion of outstanding convertible instruments.
- The buyback should be a direct purchase by the company and not an indirect purchase through its subsidiaries or group investment companies.

13.7.2 Buyback by Listed Companies

Listed companies are governed in addition to the provisions of the Companies Act, by the SEBI (Buyback of Securities) Regulations, 1998 and the provisions of the SEBI LODR Regulations. Under the SEBI buyback Regulations, it is mandatory to engage a merchant banker to prepare the Letter of Offer and manage the buyback offer. The Regulations also do not fix any pricing mechanism, which has been left free to the Board or the company to determine on its own. Under the Regulations, a company can buyback securities under the methods described below.

Fixed Price Tender Offer

Under this method, the shareholders on record of the company, as of a record date, are invited to tender their shares for re-purchase by the company at a fixed price arrived at by the company and disclosed in the notice, public announcement and the Letter of Offer. This method is simpler to understand but may not realise the best price for the shareholders. As per the Buyback Regulations, 15% of the number of securities which the company proposes to buyback or number of securities entitled as per their shareholding, whichever is higher, shall be reserved for small shareholders. Small shareholders are defined as those whose portfolio of the shares or other securities in question does not exceed a value of ₹200,000 based on the closing market price on the record date.

Reverse Book Building Method (RBB)

This method prescribes a reverse book building to be applied for purchases from the open market whereby shareholders are invited to put in bids for re-purchase of their shares. The board resolution or the special resolution as the case may be, shall specify the maximum price at which the securities shall be bought back by the company. The company would make a public announcement based which shall specify the maximum price and quantity of securities as fixed by the Board and the method by which shareholders can put in bids for their securities to be bought back by the company. The company fixes the buyback price based on the highest price bid received from the shareholders. The bidders who bid at lower prices would also be eligible to receive the highest price. Therefore, this method is beneficial to the shareholder since it allows the highest bid price to be received by them instead of a price fixed by the company as in the Tender Offer method. However, as far as the company is concerned, it helps in making a more efficient pricing as compared to the Tender Offer, since this method allows for price discovery.

Open Market Repurchase (OMR)

Under this system, as in the case of the reverse book building method, the board resolution or the special resolution as the case may be, shall specify the maximum price at which the securities shall be bought back by the company. However, the method of re-purchase is different. In this method, the company buys back the shares directly from the secondary market using the electronic trading system and placing buy orders in its own name. Therefore, within a specified period, the company buys the shares from the market at varying prices based on the prevailing market price but subject to the maximum price and quantity already approved. This method is transparent and the company may actually end up buying the shares at an average price, which could be lesser than the maximum price approved. Under this method, the company cannot buyback shares belonging to the promoter group. This method is suitable when promoters wish to consolidate their stakes by letting the company to mop up shares for buyback from the secondary market. The drawbacks of this system are that the promoters cannot sell their own shares since the system is transparent. Secondly, if the company does not enjoy a good free float, the company may not be able to get sufficient quantities for buyback.

Apart from the above methods of buyback, the company is prohibited from any other modes of buyback such as through negotiated deals or through spot transactions or through off-market private deals.

Under the OMR method, there is no need to receive any tenders or bids from the investors. The company buys back securities directly from the market on an order driven system and settles the payment through the stock exchange clearing mechanism. *OMR is more appropriate for buying out non-controlling shareholders.*

Case Study

Open Market Repurchase

Several companies such as Hindustan Unilever, GlaxoSmithKline Consumer Healthcare, Reliance Industries, ICI India, Berger Paints, SRF Ltd., MRO-TEK, Great Offshore, Reliance Energy etc. used the open market purchase route for share buyback.

Reliance Industries Ltd. (RIL) conducted the largest buyback programme in India at the time (about US$2b) between 2012 and 2013 through the market route at a price not exceeding ₹870 per share. Its earlier buyback in 2004 was also through the market route. RIL concluded the buyback investing about ₹4000 crore instead of the ₹10,000 crore approved for the programme.

Dr. Reddy's Laboratories Ltd. commenced a market route buyback at a price not exceeding ₹3500 in Feb 2016 stating that it would buy over a period of six months. The total outflow was expected to be ₹1600 crore.

While structuring a share buyback, the company should do so in a manner that it does not infringe on the minimum public shareholding as prescribed under Rule 19(2) and Rule 19A of the SCR Rules.[4] It may be noted that as discussed in Chapter 8, Rule 19(2)(b) of the SCRA Rules read with the ICDR Regulations stipulates that the NPO to be made by a company at the time of listing should be 25% of the post-issue capital. Suitable relaxation has been provided to reduce the NPO to 10% in certain cases. Therefore, as per the buyback stipulation, a buyback of shares should not be made to reduce its public holding to less than 25% or 10% as the case may be. The company shall continue to remain listed after the completion of a buyback programme.

[4] Refer to Chapter 8

13.8 Investment Banking Perspectives in Share Buybacks

Under SEBI Regulations, investment bankers have to be associated as managers to all buyback offers by listed companies. The broad functions of the merchant banker appointed for the offer would be to advise on the transaction structure, size of the offer, method of buyback, pricing of the offer and manage the disclosures, offer document and other statutory compliances in connection with the offer. The merchant banker has to exercise due diligence and has to be responsible to SEBI with regard to satisfaction of requirements under SEBI Regulations. Some of the strategic aspects of buyback offer management are discussed in the following paragraphs.

13.8.1 Pricing a Buyback Offer

A formal model of the empirical findings of Ikenberry, Lakonishok and Vermaelen (1995) and Ikenberry and Vermaelen (1996) is suggested by Rappaport (1998). As per this model, if a company is presently undervalued in the market and its shares are repurchased through the open market repurchase method, the repurchase programme would result in earning for the continuing shareholders a return greater than the market cost of equity.

ILLUSTRATION 2

CMP of the company's share (CMP) = ₹500
Fundamental Value as per intrinsic valuation (FV) =₹750
Market cost of equity (K_e) = 20%
Rate of return earned by continuing shareholders (R_e) is computed as

$$R_e = \frac{K_e}{CMP/FV} = R_e = \frac{20\%}{500/750} = 30$$

Therefore, one of the merits in the OMR system is that the company can time the repurchases to its advantage based on price trends in the market. Since most repurchase programmes are initiated when stock is undervalued, it goes to show that a well-executed OMR will improve returns to continuing shareholders.

Price Discovery in a RBB Buyback Offer

Under the reverse book building offer, shareholders bid at various prices subject to a maximum price fixed by the company but a single price is finally determined after evaluation of offers received. Those who have bid for lesser than the determined price would also be eligible to the offer. Several studies were done in the past in the US context which agreed that to discover the reverse book-built price, two fundamental pre-requisites are relevant: (i) shareholders should have different assessment of the present worth of the company's share and therefore, have respective valuation schedules (ii) there should be information asymmetry, i.e. the management of the company does not know the valuation schedules of shareholders.

In India, under both the SEBI Regulations and the Companies Act and Rules framed there under, the pricing aspect for the buyback has been left open and it is for the company in consultation with the merchant banker to fix the price. In the case of listed companies, while the fixed price has to be decided beforehand by the company under the tender offer method, the maximum price has to be determined under the book building and the stock market purchase method. As has been mentioned above, the pricing for a book-built buyback shall specify the maximum price for a shareholder to bid at. Therefore, the management has to specify a price that reasonably covers the valuation schedule of every shareholder.

Principles for a Tender Offer Pricing

In tender offers, the company has to specify the price of the offer beforehand. This brings us to the discussion on pricing of securities for buyback. Tender offer price is different from pricing a share issue because it is the exit price paid by the company to its shareholders unlike in a share issue wherein the task is to determine entry pricing.

The following are some of the general principles that would be useful in determining the buyback price:

- Price is to be fixed at a premium over the CMP to prevent fall in CMP after the buyback.
- Lower the current P/E multiple, the higher the company can pay.
- Lower the future Return On Net Worth (RONW), higher can be the premium over CMP.
- Price should not be lower than original issue price.
- If a company does not have too long a history of listing (for example, not more than ten years), it is better to work out a decent IRR for the shareholder based on original issue price at the time of the IPO after averaging it with the bonuses and rights given in the intervening period.

It is evident that there is a relationship between the current RONW and consequent EPS and the current Price to Earnings Ratio (PER) in determining the premium that can be paid by the company over its ruling market price. Therefore, let us consider the main determinants for buyback premium to be (i) the present RONW before buyback and (ii) Current PER. Let us also assume that there would not be any change in the PER ratio before and after the buyback.

The relationship between RONW, PER and the buyback price is, lower the RONW or the current PER, higher is the necessity for a buyback and therefore, the justification to price the buyback higher. It is therefore, an inverse relationship between the premium, on one side and the RONW and PER, on the other. We could then correlate these variables through a useful computation that can be expressed as follows:

$P \leq \left\{ \left(\frac{1}{\text{RONW} \times \text{PER}} \right) - 1 \right\}$ where P is the premium that can be paid over the ruling market price.[5]

Though the above way of determining the buyback premium is not a sacrosanct approach, it is a useful way of setting a price range for the investment banker. It may be noted that under this approach, the premium to be paid would remain positive only if the company earns on an incremental basis, less than the inverse of the PER. The inference, thereof, is explained below with an illustration.

ILLUSTRATION 3

If the current EPS is ₹5 per share and the current P/E multiple is 8, the current market price would be ₹40. If the present RONW is 10%, the premium that can be paid would be,

$$P = (1/(0.10 \times 8)) - 1 = 25\%$$

Thus, the premium that can be paid according to the above calculation is ₹10 over the current market price of ₹40, i.e. an offer price of ₹50.

Under the above approach, it would be clear that if either of the two variables, the RONW or the PER is healthy, the premium to be paid would be negative. In other words, if the RONW is healthy, the shareholder would be better off retaining the share since it protects the opportunity cost. Similarly, if the PER is healthy, it means that the shareholder has a good exit mechanism with the current market price. However, under the above formula, if the premium has to be negative, both the RONW and the PER need to be reasonably good enough; otherwise, one could be pulled down by the other. For example, in the above illustration, if the RONW is 20% and the PER is 4, the company would still be required to pay a premium of 25% on ₹40.

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[5]Buyback of Shares: What it is, What it is not and How it Works: Legal and Financial Implications, NJN Vazifdar, Chartered Secretary, March 1999.

In fixing the premium over market price for the buyback, it should also be kept in mind that equity buybacks are normally associated with companies of good quality and therefore, serve as a positive signal to the market. The higher the premium, the stronger is the signal of expected future earnings and the confidence level of the management. Some of the early studies on this aspect in the US revealed that, *"The larger the premium offered over current market price, the larger the increase in the value of the firm upon the announcement. Moreover, such increases in share values were relatively permanent in the sense that the stock prices stayed high even after the distributions to shareholders."*[6]

Having said that a higher premium acts as a strong signal for price reaction in the market, it is important to know that pricing of a buyback is a trade-off between value distribution to exiting shareholders vis-à-vis value preservation to continuing shareholders. Therefore, let us now consider the impact of buyback pricing on post buyback P/E. Normally, the trend in post buyback P/E is an increase due to the increase in the EPS on the reduced capital base. However, this has to be weighed in together with the reduced returns on account of capital reduction. The capital reduction in turn would depend on the exit price paid to shareholders. If the exit is over-priced, the capital reduction would be substantial. This could lead to a fall in EPS even on a reduced capital base.

Therefore, if the shareholders find that the loss of returns is more than off-set by the reduction in the capital base, the post buyback P/E would increase. On the contrary, if the EPS is expected to fall, it would have a compounding effect since the P/E would also tend to fall. The issue of whether the RONW would remain constant or vary would depend upon the efficiency of capital utilisation post buyback.

ILLUSTRATION 4

Given: current P/E = 5, current EPS = ₹10, RONW = 10%, capital employed = ₹100 million, paid-up capital = ₹10 million consisting of 1 million shares of ₹10 each. The company proposes to buyback 25% of its paid-up capital. The other requirements of the law have not been considered for this illustration such as residual debt-equity etc. Based on the suggested pricing formula, the maximum price that can be paid for the buyback works out to be 100% of the existing price, i.e. ₹50.

The impact of the exit price on the post-issue EPS and P/E is shown below:

Buyback price = ₹50		*Buyback price = ₹75*		*Buyback price = ₹100*	
Number of shares bought back	250,000	Number of shares bought back	250,000	Number of shares bought back	250,000
Capital reduction amount ₹	12,500,000	Capital reduction amount ₹	18,750,000	Capital reduction amount ₹	25,000,000
Reduced capital base ₹	7,500,000	Reduced capital base ₹	7,500,000	Reduced capital base ₹	7,500,000
Reduced number of shares	750,000	Reduced number of shares	750,000	Reduced number of shares	750,000

(*Contd.*)

[6]Dutch Auction Share Repurchases: Theory and Evidence by Donald B. Hausch, University of Wisconsin-Madison and Dennis E. Logue and James K.Seward, Darmouth College, page 244, The New Corporate Finance – Where Theory Meets Practice, McGraw-Hill International Editions, Second Edition 1999.

SCENARIO – I (RONW remaining constant)					
Post buyback RONW %	10	Post buyback RONW %	10	Post buyback RONW %	10
Post buyback Return to shareholders ₹	8,750,000	Post buyback Return to shareholders ₹	8,125,000	Post buyback Return to shareholders ₹	7,500,000
Post buyback EPS ₹	11.66	Post buyback EPS ₹	10.83	Post buyback EPS ₹	10.00
Post buyback P/E	5	Post buyback P/E	5	Post buyback P/E	5
Post buyback market price	58.30	Post buyback market price	54.15	Post buyback market price	50
SCENARIO –II (RONW increasing)					
Post buyback RONW %	12	Post buyback RONW %	12	Post buyback RONW %	12
Post buyback Return to shareholders ₹	10,500,000	Post buyback Return to shareholders ₹	9,750,000	Post buyback Return to shareholders ₹	9,000,000
Post buyback EPS ₹	14.00	Post buyback EPS ₹	13.00	Post buyback EPS ₹	12.00
Post buyback P/E	7	Post buyback P/E	6	Post buyback P/E	5
Post buyback market price	84.00	Post buyback market price	78.00	Post buyback market price	60.00
SCENARIO – III (RONW falling)					
Post buyback RONW %	8	Post buyback RONW %	8	Post buyback RONW %	8
Post buyback Return to shareholders ₹	7,000,000	Post buyback Return to shareholders ₹	8,125,000	Post buyback Return to shareholders ₹	7,500,000
Post buyback EPS ₹	9.33	Post buyback EPS ₹	10.83	Post buyback EPS ₹	10.00
Post buyback P/E	5	Post buyback P/E	4	Post buyback P/E	3
Post buyback market price	46.65	Post buyback market price	43.32	Post buyback market price	30.00

In the above table, in scenario I, since the RONW is expected to be constant, the P/E is also assumed to be constant. It may, thus, be observed that the maximum premium that can be paid is 100% on the existing price so as not to impact the prices post buyback. If the premium paid is less than the maximum allowable, the market reacts favourably by pricing the share above its existing price. Therefore, it may be observed that if the buyback price is fixed at ₹75 instead of ₹100, the expected market price post buyback would be ₹54.

In scenario II, the RONW is expected to rise, the P/E is also assumed to have an increase, if the buyback price is favourable. Therefore, even if the premium paid is 100% over the existing market price, the post buyback price is expected to be more than the existing market price.

In scenario III, since the RONW is expected to fall, the P/E is also considered at lower levels than the existing 5. Therefore, it may be observed that the market price is expected to be lower than the existing market price under all the pricing alternatives. It amounts to mean that when the RONW is expected to fall post buyback, the company should not resort to a buyback; otherwise the market would react adversely.

The above analysis supports the point stated earlier as well as empirical evidence that a buyback cannot salvage a company, if its business fortunes and earning potential are not favourable. Resorting to buybacks in a falling scenario will destroy shareholder value by adverse movement in the market cap of the company.

Table 13.1 Sample Empirical Data on Buyback Pricing

Company	*Buy Back Price ₹ per share*	*Average Market Price ₹ per share*	*Premium over Market Price*
Akzo Nobel India	920	595	55%
Amrutanjan Health Care	900	728	24%
Lakshmi Machine Works	2045	2092	(2.25%)
Binani Cement	90	84	7%
Eicher Motors	691.68	222	211%
Zensar Technologies	165	143	15%
Apollo Finvest	15	11.50	23%
Abbot	650	554	17%
GTL	300	187	60%
GlaxoSmithKline Consumer Healthcare	370	316	17%

It may be observed from the above sample date that buyback pricing does not follow a particular pattern but is a function of prevailing market conditions and the strategic objectives behind the offer. While undervalued companies prefer to price their offers higher (Eicher Motors in the above table), well valued companies (Binani Cement above) are very modest in their pricing. The main objective for Binani Cement was to use its idle cash of around ₹650 crore at a time when business prospects were under strain and the company was expecting to reduce pressure on EPS through the buyback.

In the above table is included Lakshmi Machine Works which made a buyback offer at less than the market price for about 9% of its issued capital. The market reacted adversely on the next day after the board meeting considering the buyback offer. However, the company received valid applications for 99% of its offer. The promoters/promoter group/persons in control of the Company did not offer any equity shares under the buyback. As a result, the promoters had the opportunity to increase their stake from 25.81% to 28.34% which was the targeted increase as per the objectives of the offer. The company's indicated objectives of the offer included utilisation of surplus cash but did not mention about consolidation of promoters' stakes. The company's valuation at that time was 2.8 times its book value and at a P/E ratio of 25. Apparently, this is not a case of under-valuation of stock. Therefore, the primary objective was to return excess capital and consolidate promoters' stakes in the process. At the time of the public announcement for the buyback, the company's share price rose impressively and was around ₹2350.

Since pricing a tender offer can be tricky, several companies prefer the open market purchase route in order to overcome the problem. It is, however, quite interesting to note that though the Buyback Regulations allow for reverse book building, no company seems to have used this route to buyback pricing since the option of open market purchases is available.

13.8.2 Fixing the Quantum of Buyback

In the US markets, at the initial stages, companies used to resort to questionable mechanisms such as sale of assets and business undertakings, long-term borrowings etc. to finance buyback programmes. This is because, when companies found their capital base high and did not find enough liquid resources to return capital to shareholders, the only option was to liquidate fixed capital or resort to substitution of equity with debt capital. Even in the years following the financial crisis in 2008, companies resorted to bond issue programmes to finance their buybacks since bond coupons were attractive. In the process, they reduced their cost of capital but increased leverage.

Keeping in view such experience, the regulatory provisions in India specify not only the allowable resources that can be used to fund buyback programmes but also put a cap on the quantum of permissible buyback. The quantum of securities that a company can buyback is governed by the provisions of Section 68 of the Companies Act. In terms of those provisions, there are three essential conditions determining the quantum of buyback, which are given below:

- The buyback in value terms of shares or any other securities shall not exceed 25% of the total paid-up capital and free reserves of the company. Free reserves for this purpose shall mean all reserves that are available for distribution as dividend as per the latest audited balance sheet of the company and shall also include the securities premium account but not any share application money pending allotment.
- Buyback of equity shares shall not exceed 25% of the paid-up equity capital in any given financial year.[7]
- The residual debt-equity ratio shall not exceed 2:1 after the buyback. The equity for this purpose has to be reckoned as paid-up capital and free reserves. Debt includes both secured and unsecured debt.

As per the above provisions, it would be necessary to work out the quantum of a buyback through the following steps:

1. Work out the aggregate paid-up capital and free reserves of the company as on the date of the balance sheet that is within six months preceding the proposed buyback offer.
2. One-fourth of the aggregate of such paid-up capital and free reserves arrived at forms the absolute limit on the quantum of the buyback that has to be maintained at all times irrespective of the number of buybacks made by the company. This absolute limit applies cumulatively to all types of shares – preference, equity and others.
3. The third step would be to determine whether the application of the entire available limit as arrived at in (2) above in the buyback would result in the residual debt-equity ratio exceeding 2:1. If it so increase, the quantum available under (2) above should be restricted to the amount that would not allow the residual debt-equity ratio to exceed 2:1.
4. In the case of a buyback of equity shares, the next step would be to ensure that the buybackdoes not exceed 25% of the paid-up capital in nominal terms in the relevant financial year. In case it so exceeds, it has to be limited to 25%.
5. The next step would be to divide the absolute limit available under (3) above with the total quantity of shares to be bought back under (5) above in order to arrive at the maximum price payable per share under the buyback.

[7]Proviso to Section 68(2)(c)

6. In the case of a Tender Offer, the next step would be to arrive at the pricing for the buyback offer using the principles stated above and determine whether the desirable price falls within the price arrived at under (5) above.
7. In case the desirable price exceeds the maximum price arrived at under (5) above, the company has to scale down the size of the offer so as to arrive at the desirable pricing within the given parameters.
8. In the case of open market and book-built offers, the company can decide based on the available funds if it wishes to buyback the entire allowable limit. In such a case, it has to quote the price arrived at under (5) above as the maximum price and take necessary approvals for the same.

ILLUSTRATION 5

Buyback Ltd. has the following financials as per the recent audited balance sheet.

Particulars	*Amount ₹*
Paid-up equity capital	200,000
20,000 shares of ₹10/- each	20,000
Share application money pending allotment	
Reserves and Surplus	
General Reserve	500,000
Securities Premium Account	1,000,000
Capital Redemption Reserve Account	250,000
Profit and Loss Account	100,000
Debenture Redemption Reserve	150,000
Total Debt	3,000,000

The company's current EPS is ₹20 and the market price is ₹40. The company earned a profit after tax of ₹4 lakh for the relevant financial year.

On the basis of the above information, keeping in view the norms on quantum of buyback and the principles of pricing as discussed above, the quantum can be computed as follows:

Particulars		*Amount ₹*
Aggregate amount of Paid-up equity capital and Free Reserves		
Paid-up capital	200,000	
(share application money not considered)		
Reserves and Surplus	500,000	
General Reserve	1,000,000	
Securities Premium Account	100,000	
Profit and Loss Account		
(Capital Redemption Reserve and Debenture Redemption Reserve are		
not considered since they are not available for distribution as dividend)		1,800,000
Total aggregate (T)		450,000
25% of the above (A)		
	5,000	
Total amount of shares that can be bought back		
(25% of the total number of shares) (B)		
	90	
The maximum price per share that can be offered for the buyback (in ₹per share) - (A)/(B)		

(*Contd.*)

The residual debt-equity ratio if the total quantum is bought back =	
	3,000,000
Residual Debt (C)	1,350,000
Residual Equity (1,800,000 – 450,000)	2.22
Residual DER = (C) / (D)	
Since the residual DER cannot exceed 2:1, the residual equity cannot be less than 1,500,000.	
Therefore, the maximum aggregate that can be utilised for the buyback out of (T) above = (1,800,000 – 1,500,000) (M)	300,000
Therefore, the maximum price per share that can be paid if all the permissible shares have to be bought back in ₹per share = (M) / (B)	60
The company earned a PAT of ₹4 lakh for the previous year.	
The balance sheet net worth including all reserves but excluding the P&L account is ₹21 lakh. By including the PAT for the current year, the total shareholders' funds (prior to dividend distribution) works out to ₹25 lakh yielding a RONW of 16%.	212.5%
Therefore, the maximum premium that can be paid as per the suggested formula on pricing = (1 / .16 × 2) – 1	
Since the current market price is ₹40, conceptually speaking, the company can offer up to a price of ₹125 per share. If the company wants to pay ₹125 per share, it can buyback only 2,400 shares forming 12% of the paid-up capital.	
However, the company can also pay ₹60 per share and buyback the entire allowable quantity of 5,000 shares.	
Between the above two extremes, the company can decide on a suitable price and accordingly fix the quantum of buyback within the maximum permissible limit of (M) above.	

13.8.3 Offer Strategy

Pricing Strategy

While fixed price offers are easier to understand, the book-built system using the Dutch auction pricing process increases the complexity for the shareholder. This is the reason several companies prefer to use the fixed price tender offer method for buybacks as that makes the offer straight forward. Companies can also have an exact estimate of fund requirement prior to the offer basing on the maximum size of the offer.

Buyback pricing also has its merits as it may actually bring down the cost of the buyback transaction, if the management's estimate of the shareholders' expectations is over-stated. In other words, if shareholders are undervaluing the present value of the company's future worth, due to asymmetry of information, the management may be over-pricing the buyback, thereby jeopardising the interests of continuing shareholders. In such situations, a Dutch auction pricing provides a more efficient discovery of price.

Most buyback pricing decisions are eventually triggered by strategic requirements. It has to be remembered that a buyback is made using the company's funds. Therefore, if the objective is to shore up the promoters' stakes, it becomes imperative to make the buyback offer succeed. This would be a very efficient way of achieving such objective without use of promoters' resources. Similarly, if the objective is to ward off potential takeovers or to reduce free float, the management may find it necessary to make the buyback offer succeed. In such situations, wherein the strategic objectives ride over financial considerations, buybacks are priced aggressively to ensure success. In any case, if a buyback is priced aggressively and the consequent drain on the company's resources predominantly affects the promoter group (being residual shareholders), they may be willing to pay such price to achieve the stated objectives.

Offer Methodology

Under the regulations, buybacks can be made by listed companies either through direct offers to shareholders or through open market purchases. Direct offers to shareholders evoke better price reaction since they directly concern shareholders. Open market purchases are an indirect mechanism whereby the company purchases from the secondary market. However, the open market method may provide cost efficiency since the company assesses market conditions and buyback shares more efficiently. It will also provide short-term buoyancy in the market without a steep price reaction, upward or downward.

13.9 Additional Case Discussions on Share Buyback

Case Study

Controversial Buyback by Sterlite Industries (now part of Vedanta)

Sterlite Industries conducted a controversial buyback programme which had raised several eyebrows due to the manner and price at which it was conducted. The objectives for the buyback were to restructure its capita and to attain an appropriate valuation in order to tap the overseas markets for which an optimal capital structure would be of substantial benefit.

Sterlite which intended to repurchase 50% of its equity, offered to pay ₹150 per share of a face value of ₹5 under the buyback offer. This included a cash component of ₹100 and a non-convertible debenture of ₹50. The debenture portion of ₹50 carried a coupon rate of 10% and was redeemable at the rate of 35%, 35% and 30% in the third fourth and fifth years respectively. The buyback price was at a premium of around 43% over the average prevailing price of the past six months. The price was, however, at a steep discount of around 50% to its book value which was around ₹300 at that point of time. The company considered the offer a good exit opportunity for the retail investors, if they wished to exit the company, since the risk profile of Sterlite had changed after the acquisition of BALCO and Hindustan Zinc Ltd. which were disinvested by the Government of India. Sterlite intended to de-list from the bourses as well, if the retail shareholding fell below the 10% mark after the buyback.

Unlike going through the buyback route as stipulated under Section 77A of the Companies Act 1956 and the SEBI guidelines, Sterlite decided to buyback shares much in excess of the 25% allowed under Section 77A. Therefore, the company had to take the route of a court order for the buyback since it amounted to a capital reduction. Therefore, Sterlite filed an application under Sections 100, 391 (arrangement) and Section 394 of the Companies Act, 1956. The scheme was approved in a court convened meeting and court order was received for the capital reduction. The Department of Company Affairs also approved the buyback offer.

However, the offer raised a controversy due to the manner in which the whole process of the buyback was conducted. Under normal circumstances, any company would first send out the buyback offer and request the shareholders to tender their shares for buyback if they so desire, to the Registrar. The Registrar would sort out all the applications, arrive at the over-subscription ratio and then send out the cheques to individual investors based on their entitlement. Therefore, the investors would receive payment only for the number of shares that have been bought back by the company. In the case of

Sterlite, the company sent out cheques for the cash component of ₹100/- per share along with the offer letter to the shareholders. The shareholder had only to fill up a form of non-acceptance that was enclosed along with the cheque and return the cheque along with such form in case the offer was being refused. Otherwise, if the cheque was encashed, it would be presumed that the shareholder accepted the offer. This left the investors with no option but to tender their shares for the buyback since the entire onus of non-acceptance was on the shareholder. At the same time, by sending out the cheques in advance, the offer was confusing to the investors since it could be presumed that they had no choice but to encash the cheques. In addition, the short time given to the investors was one of the factors which also raised the controversy.

The Investors Grievances Forum filed a complaint with the Department of Company Affairs that the scheme was coercive and against the interests of the shareholders and was also against the Depositories Act. Objection was also raised on the offer price of ₹150 which was way below the book value. The SEBI also referred the matter to the DCA. Later on, the SEBI moved the Bombay High Court to quash the scheme citing the interests of shareholders. Sterlite in its defence cited several other buyback offers as precedents such as Century Enka, Mather & Platt India, Hindustan Dorr-Oliver, Sierra Optima, Jai Corp. Ltd., Hardcastle & Waud Manufacturing Company, P & G Distribution Company and Mahindra-Gesco for the procedure followed in sending the cheques in advance. It also quoted about twenty other issues wherein the buyback price was less than the book value of the share. The Bombay High Court ruled in favour of the company and dismissed the petition.

The buyback offer was successful and 25% of the equity had been accepted for buyback with about 4000 retail investors rejecting the offer. However, the rejection represented only a meagre 1.5% of the ₹28 crore of equity capital. The financial institutions, which held about 7.7% of the equity, decided not to take part in the buyback since they did not approve of the buyback per se. These included the LIC, UTI and the GIC. The company however, could not achieve its objective of de-listing since the promoter holding remained below 90%.

Case Study

Indian Rayon (Presently Aditya Birla Nuvo in Merger with Grasim)

With the need to earn money on invested capital, if you have too much cash, you can't do it. Ultimately, you're responsible to the shareholder. For a company, the possible way out is a share buyback. Companies burdened with having so much cash but very few options are the probable candidates for buybacks. Companies operating under sectors like cement, textiles, steel, etc., which were grappling with recession and overcapacity, had the option of going for share buyback. But they had to satisfy their shareholders that there were no other promising investment avenues left. And also that sitting on the cash pile was not going to result in any addition to shareholder wealth. Indian Rayon is a case in point.

Indian Rayon, an A.V. Birla group company, during September 1999, implemented a share buyback program through the book-building method. The holding of the promoters in Indian Rayon after the buyback had possibly risen to around 29% of the total equity, from the pre-buyback level of around 21.5 percent. The bids were invited from shareholders in range of ₹75 to 85 a share through this process. The offer price range was at a premium over the average traded prices of the company's shares on stock exchanges in the past. As per the share's closing price of ₹72.65 on September 17, 1999, it was at a premium of 3.2 percent at the minimum offer price of ₹75 per share and 17 percent at the maximum offer price of ₹85 per share. The two-week average price was ₹72 per share, which was at a discount of 4.2 to 18.1 percent to the indicated price range for buyback. The 26-week average price of ₹58.20 was at a discount of 28.9 to 46 percent and the 52-week average of ₹54.50 was at a discount of 37.6 to 56 percent to the range of ₹75 to 85 per share. The outflow from the company to buyback 25 percent of the equity was expected to be ₹127 crore at the minimum price of ₹75 per share and ₹144 crore at the maximum price of ₹85 per share.

In view of the under-utilised plant capacities and no major capital investments envisaged in the next two to three years, share buyback offered a good option to return money to the shareholders. The company's move was also influenced by the fact that it expected to continue enjoying a healthy cash flow from its current businesses. The company felt it feasible to return up to ₹144 crore to its shareholders through the buyback process. Further it hoped that the buyback would push up the earnings per share of the company in the future and create long-term shareholder value. The buyback is unlikely to cause any material impact on the profitability of Indian Rayon, except to the extent of loss of interest income on the amount to be utilised for the buyback. However, the market was not happy over the deal between Indian Rayon and Grasim, regarding the transfer of some of the assets including cement division. This to a considerable extent affected the buyback program. However, given that no growth opportunities were available which could justify investments, it was a correct decision on the part of Indian Rayon to go for share buyback.

Case Study

Bajaj Auto

Sometimes, complicated cross holdings of the ownership in a company make it difficult for the market to value the true worth of the company. Share buyback provides good opportunities for those companies, which are having such problems, to unlock true worth of the company. The buyback announced by Bajaj Auto Ltd. is a case in point.

Bajaj Auto, in a bid to clear up cross-holdings, approached the promoters of Bajaj Tempo to transfer its 9 percent stake in Bajaj Auto, valued at around ₹400 crore at current prices. In return, Bajaj Auto would transfer its 23 percent holding in Bajaj Tempo to the Firodias. The Bajaj Auto management was keen that the Bajaj Tempo promoters subscribe to the buyback offer of Bajaj Auto.

The company has given the Bajaj Tempo promoters a proposal to clear up the cross-holdings. However, there were some contentious issues. Firstly, the two parties were to agree on the transfer price. Bajaj Auto's transfer of its holding in Bajaj Tempo would give the latter's promoters the crucial majority control. However, the same was not true for the transfer of the Bajaj Auto shares. While the Bajaj Tempo promoters were the largest shareholders in Bajaj Tempo with a 40 percent stake, the shareholding of the promoters in Bajaj Auto aggregated to 23 percent. A second problem area was that the holding of the Firodias in Bajaj Auto, at current market price, was valued at around ₹400 crore, which was close to seven times the valuation of Bajaj Auto's holding in Bajaj Tempo. The possibility of the settlement of the issue through a stock swap, however, did not seem to be possible. It was a good move on part of Bajaj Auto to propose the clearance of cross-holdings. This could help improve the valuation of the stock which had languished for a long for several reasons, important among them have been the sluggish sales, lack of attractive investment avenues, huge reserves, etc. However, the buyback was meant only for 1.8 crore shares of its existing equity base of 119 crore shares. Whether such a token gesture of buyback would help improve returns to shareholders was a matter of doubt.

The company's announcement to buyback its shares at a price of ₹400 plus helped the stock price move up from its six-year low of ₹257 to around ₹370. The share buyback was perceived to improve the market sentiment in the stock on several counts. Firstly, it would reduce the capital base. Secondly, the expense incurred on buyback could have some positive impact in terms of reducing the enormous amount of cash available with it. Bajaj Auto was estimated to hold about ₹1,800 crore in the form of loans & advances, debt/equity investments and cash in hand. In sheer size, this portfolio would match the core business investment of the company. On the other hand, this component, which was partly invested in low-yielding instruments, resulted in an estimated pre-tax earnings of 12.5 percent, which became a drag on the 40 percent pre-tax return of the core-business, thereby restricting overall pre-tax earning to a weighted average of 21–22%. The company once even mulled the idea of starting a portfolio management to manage its excess cash reserves but the idea was later dropped due to the prevailing unstable interest rate regime and low earnings profile for gilt securities.

Case Study

Reliance Industries Ltd.

RIL's share buyback program was triggered off due to the under-valuation of the company's stock vis-á-vis the BSE Sensex, which was one of the reasons cited by the RIL management to initiate steps to correct the pricing anomaly. As per the statistics for the past five years, the stock had been trading at a discount to the Sensex's P/E, which the company thought was unfair given its consistent financial performance over this period. The company generated a compounded annual growth of 15 percent on EPS (Earnings Per Share) during the last five years. RIL's P/E relative to the Sensex had ranged between 43 percent on March 31, 1996 to 85 percent on March 31, 2000. The Sensex's P/Es was based on the old BSE Sensex. RIL's current P/E at the time of the buyback announcement was 66 percent of the recast Sensex. The stock outperformed the Sensex by 38 percent between January 1, 2000 and April 11, 2000. The stock outperformed the Sensex by 135 percent in one-year time frame, by 21 percent in two-year time frame, by 105 percent in 3-year time, by 90 percent in 5-year timeframe and by 409 percent in ten-year time frame. Hence, despite consistently outperforming the Sensex over these timeframes, the stock had been trading below its perceived intrinsic value.

The buyback move aimed to achieve certain objectives including supporting the stock price in the face of under-valuation. The company wanted to return the money to shareholders in large measures in a tax efficient and investor friendly manner without sacrificing growth opportunities and within the overall capital allocation framework. The company proposed to buyback its shares up to a price of ₹303 aggregating ₹1100 crore, which was 25 percent of its free reserves as per the legal provisions on share buybacks. According to the company, the share buyback would help to optimise its weighted average cost of capital, thereby enhancing its overall global competitiveness, improve financial parameters such as return on equity, reduce floating stock and enhance overall long-term price performance. As per the share buyback regulations, shares that were bought back, had to be compulsorily written down and cancelled immediately. This reduced the floating stock. The company expected that the buyback would help improve valuation to a considerable extent and enable it to use its stock as currency for any M&A activities in the future. The company aimed to achieve a re-rating for the RIL stock by sending a powerful signal on the perceived under-valuation from time to time. In addition, this could also help increase the RIL's market capitalisation, thereby adding to the shareholder wealth. These were some of the key objectives that RIL aimed to achieve through its share buyback plan. The buyback was also meant to give a signal to the speculators that if the stock gets hammered below the floor price, which the company had set at ₹303, it would enter the market to push it up by mopping up the excess floating stock from the market.

Case Study

ONGC

The Oil and Natural Gas Corporation considered buying back its shares held by Indian Oil and the Gas Authority of India. The deal was expected to improve ONGC's fundamental valuation, though it would further reduce liquidity in the stock. The buyback was also being looked at as a way to use the roughly ₹8,000 crore surplus funds that the cash-rich company was sitting on.

IOC and Gail together held 12% of ONGC shares, 84% equity was with the government and the remaining 4% was with the public and the institutional shareholders. SEBI's buyback norms did not allow negotiated deals between companies. But Government companies could do negotiated deals, without making an open offer to general shareholders through requisite government approvals.

The two options considered for the buyback were either for IOC and GAIL to sell their stake in the market or for ONGC to buyback its shares from them. The net effect would be a reduction in the market float and an increase in market capitalisation. ONGC would be required to extinguish its shares to the extent of the buyback.

Earlier, ONGC had written to the ministry of petroleum, opposing IOC's and GAIL's move to offload their respective stakes in the market. The company management said there was a danger of creeping acquisition by players, who could use the float to corner shares in a company that has been declared *strategic* by the government. It could have led to the acquirer having a seat on the ONGC board as well. The company was also concerned about such a move leading to excess liquidity and the ONGC stock taking a beating on the bourses. The ministry had subsequently said that IOC could only sell half of its ONGC holding.

The buyback did not seem appropriate at that time because ONGC shares were trading at a high price of around ₹350. The price was moving in tandem with the global crude prices that were touching new heights because of an imminent war in the Gulf on the Iraq issue.

The buyback, however, was a positive development for IOC, which has been waiting to offload its ONGC holding. The oil refining company has a majority of its receivables tied up in seven-year government bonds and with refinery margins slipping, it is facing a bit of a cash crunch. IOC stood to gain roughly ₹4,800 crore, if it sold its entire stake at the ruling market price. The company had, in ₹99, acquired 9.6% in ONGC for ₹2,225.2 crore and 4.8% in GAIL for ₹245 crore as part of a cross-holding scheme drawn up to shore up the government kitty. In return, ONGC picked up 10% in IOC for around ₹1,700 crore and 5% in GAIL for ₹245 crore.

Case Study

Multinational Companies

MNCs in India have used the buyback route with an objective to de-list themselves from the Indian stock exchanges. This superseded the primary objective of a buyback which was to enhance shareholder value. Some examples include buyback plans of Cadbury, Phillips and Carrier Aircon which shelled down ₹875 crore, ₹234 crore and ₹115 crore respectively. Otis Elevators and Industrial Oxygen also spent ₹104 crore and ₹109 crore respectively. The depressed markets provided the perfect environment for such buybacks by MNCs. They preferred the listing of only their holding or parent companies to avoid the cumbersome disclosure and regulatory norms.

After the de-listing guidelines were issued in 2003, companies were not allowed to de-list pursuant to a buyback offer. In later years, buybacks by MNCs were mainly targeted at consolidation of promoters' stakes. ABB Ltd. made a buyback announcement in 2010 after a dismal financial performance in the previous year in order to increase the stake of its Swiss parent company. Hindustan Unilever made a buyback through the open market route in 2010 primarily to return its free cash flow to shareholders and thereby consolidate the stake of its parent company from 52% to 53%. The company was generating free cash flow in excess of ₹2000 annually crore at that time.

Case Study

The Curious Case of Wipro

Wipro Ltd. announced a buyback amounting to ₹2500 crore (approx $) to purchase through a tender offer 4 crore outstanding shares amounting to 1.62% of its paid-up capital. The tender offer price was ₹625 per share with face value of ₹2.

As per the disclosures made by the company, its justifications for the buyback as per the offer document were as follows:

- The buyback was being undertaken by the Company to return surplus funds to the equity shareholders, which are over and above its ordinary capital requirements and in excess of any current investment plans,
- The buyback would help in improving financial ratios like earnings per share and return on equity.
- Gives an option to eligible sellers to either choose to participate in the buyback and receive cash, or
- Choose not to participate in the buyback and get a resultant increase in their percentage shareholding in the company post the buyback, without additional investment.

The controlling shareholders held 73% as of that date and offered to tender almost their entire shareholding (72%) of the company.

Basis for the buyback price:

- The buyback price represents a premium of 14.79%over the volume weighted average market price for the past 3 months and 11.81% over the volume weighted average market price of the equity shares on the NSE for the 2 preceding weeks.
- The buyback price was higher by 277.51% of the book value.

The pre and post-buyback financial indicators of the company:

	Pre Buyback	*Post Buyback*
Net Worth (₹Lakh)	40,90,520	38,40,520
Return on Net Worth (%)	19.80%	21.09%
Earnings Per Share (₹)	32.97	33.51
Book Value per Equity Share (₹)	165.56	158.00
P/E as per latest audited results	16.91	16.63
Total Debt/Equity Ratio	0.16	0.17

The promoters justified their participation in the buyback by stating that the funds were required for philanthropic purposes. For this purpose, two promoter entities sought approval from SEBI to offer more shares than their entitlement under the buyback.

The buyback offer came at a time when the company had been consistently losing market share in the preceding three years. Its annualised revenue growth was 6.1% against its peers' average of 11.1%.

Margins declined from 24% two years earlier to 17.8% for the preceding year. However, its share performance matched its peers primarily because of a lower free float. The company also increased its shareholder payouts in preceding years.

Pertinent questions:

- Was the buyback necessary when the company's stock performance was satisfactory?
- Was the buyback justified when the promoters have a huge vested interest in its participation?
- What was the sanctity for the buyback pricing when promoters were huge beneficiaries?
- Could the management justify sufficiently the application of surplus funds to finance the buyback?

13.10 De-listing of a Listed Company

13.10.1 Introduction to De-listing

De-listing is a process by which a company whose shares are listed on a stock exchange is taken private once again by getting its publicly held shares bought over by private shareholders and terminating the listing agreement with the stock exchange. This process of a buy-out of the minority by the majority to make the company privately owned once again is known as *going private.*

As a result of a company going private, there can be no public shareholding and the shares will not be traded on a stock exchange after the de-listing process is completed. In the US market, going private has traditionally been a phenomenon associated with the LBO era. Going private transactions are often undertaken by or at the direction of controlling shareholders or third party acquirers and require extensive board consideration, disclosure, fairness opinions, SEC filings and often a shareholder vote. Even in present times, listed companies going private are quite a frequent phenomenon in the US and other markets.

In India, this process is known as *voluntary de-listing*. De-listing is an important strategic advisory and issue management function of investment banks. In India, all de-listing offers are to be mandatorily managed by a registered merchant bank.

13.10.2 Evolution of De-listing in India

There was quite a concern for the policy makers as regards de-listing and its legitimacy in India considering that it would deprive the capital market of depth, if well-performing companies opted to de-list. There was also no provision in the Companies Act, 1956 or the SCRA that provided for de-listing by companies. The Dr. K.R. Chandratre Committee set up in 1997 prescribed criteria for de-listing of loss-making companies and other provisions. Later on, further examination was made of this issue, which led to the framing of the SEBI (De-listing of Securities) Guidelines, 2003. These Guidelines were overhauled based on their working and were converted into Regulations by SEBI. The Securities and Exchange Board of India (De-listing of Equity Shares) Regulations, 2009 (De-listing Regulations) form the statutory framework for voluntary de-listing by listed companies.

The current thinking is to allow de-listing as a natural process since the listing agreement is primarily a contractual relationship between the issuer and the stock exchange and therefore, it should have an exit option subject to adequate protection to investors' interests. De-listing also offers a right balance for companies to look at the capital market as a source of capital as and when necessary and not as an obligation that becomes counter-productive in times of adverse market conditions. Furthermore, companies need to protect themselves from unwanted intrusions through the secondary market route, especially when their market capitalisation is unduly depressed. In such times, voluntary de-listing offers a strategic alternative.

13.11 De-listings in India

De-listing in the Indian context, it can either be compulsory or voluntary. Compulsory de-listing happens when the stock exchange penalises a company through de-listing its shares for non-payment of listing fee, violation of the listing agreement or for other statutory violations such as non-filing of accounts etc. Voluntary de-listing is a process initiated through a minority buy-out by a promoter or an acquirer or any other person other than the stock exchange.

Over the years since its introduction, voluntary de-listing has become a common occurrence in India whenever there is a depressed market condition. Most MNCs, which prefer 100% subsidiaries to listed ones, have been active in de-listing their Indian subsidiaries. In the initial phase of liberalisation, the government's FDI policies prevented 100% foreign ownership but with subsequent opening up of 100% FDI in many sectors, most MNCs started to prefer a wholly owned subsidiary in India. This led to a spate of voluntary de-listings. Examples of this nature are Carrier Aircon, Otis India, Philips India, Coates Viyella, Castrol India, ITW Signode, Wartsila India, Atlas Copco, Bausch & Lomb, Alfa Laval, Electrolux Kelvinator, Astra Zeneca, Cadbury's etc. Several others such as Thomas Cook, Oracle Financial Services, 3M, Blue Dart, Novartis, Kennametal, Timken etc.have been or will likely be candidates for voluntary de-listing.

Case Study

MNC Subsidiary De-listing

Bausch & Lomb Eyecare India, a subsidiary of the US based Bausch & Lomb Opticare bought over the 20 shares of its resident shareholders to convert itself into a 100% subsidiary. The shares were bought by Bausch & Lomb South Asia. In 1999, as part of a global acquisition, the Luxottica group had acquired the sunglasses business of Bausch & Lomb USA, for $ 640 million. The takeover of the Indian operations was part of this deal. So, while the eyewear business went to Luxottica, the eyecare business remained with Bausch & Lomb.

Apart from MNC subsidiaries, several other Indian companies opted for voluntary de-listing from domestic stock exchanges over the years and these companies were taken private. Examples are Essar Steel, Essar Oil, Binani Cement, Chemplast Sanmar, Eicher, FACT, India Gypsum, Kitply, Kothari Sugars, Madras Aluminium, Arch Pharmalabs, Nirma, Oswal Chemicals and Fertilisers, Pantaloon, TVS Finance, WIMCO and several others.

13.11.1 Voluntary De-listing

The validity of the concept of going private has to be examined on the same grounds on which the company goes for listing. These have been discussed earlier in Chapter 8 under the heads of strategic, financial and investment banking considerations. If the costs of remaining listed outweigh the benefits sought to be received, it would not make sense for the company to remain listed.

According to a study conducted by Scott Larson, professor at the National – Louis University in Chicago at the time[8], there are two components of cost for a company to stay listed: (i) the cost of regulatory compliance and (ii) the cost of equity which is higher than the cost of risk-free debt. Together, these two elements constitute the cost of public equity. In order to decide on de-listing, this cost of public equity should be compared to the return demanded by private equity investors. In good market conditions, private equity investors have to shell out more to acquire stakes in companies which constrains spread of their portfolio for a given size of the fund. Since the same fund has to be allocated to less number of portfolio companies, their risk concentration is higher. This in turn increases their return expectation. Secondly, private equity is illiquid which also increases return expectations. However, the return expected by public equity investors would be lower since it entails liquidity. To sum up, in a good market, cost of private equity is higher than that of public equity and therefore, the company should remain listed.

However, in a weak market, the argument is reversed. The return expectations of public equity increase due to the absence of an exit route in the secondary market. In addition, if the cost of regulatory compliance increases, it adds to the increased cost of servicing public equity. On the other hand, the return expectations of private equity investors get moderated since they can acquire good stakes in larger number of portfolio companies at attractive valuations. Secondly, they would also be privy to inside information and decision making which can guide them on their investments. For example, if the company has been approached for a strategic merger or a stake, the private equity investors by virtue of being on the board, would participate in the decision making. Therefore, in a weak and highly regulated market, the cost of public equity overtakes that of private equity. This makes the case for going private.

A company should also consider the fact that due to the weak market conditions, it may not be able to raise further funds through new issuances in the near future. Due to the prevailing low market cap, the company may even find it difficult to raise private equity on reasonable terms. In such situations, de-listing could be the way out. There is always an option for the company to return to the market when conditions improve.

Case Study

Dell MBO

Dell Inc. called on shareholders to approve a $24.4 billion buy-out offer by founder and CEO Michael Dell and private equity firm Silver Lake, saying the bid was superior to other strategic options. Under the terms, Dell stockholders were to receive $13.65 in cash for each share of Dell common stock they held, in a transaction valued at approximately $24.4 billion. The buyers were to acquire for cash all of the outstanding shares of Dell not held by Mr. Dell and certain other members of management.

The price represented a premium of 25% over Dell's closing share price of $10.88 on Jan. 11, 2013, the last trading day before rumours of a possible going-private transaction were first published; a premium of approximately 35% over Dell's enterprise value as of Jan. 11, 2013; and a premium of approximately 37% over the average closing share price during the previous 90 calendar days ending Jan. 11, 2013.

[8]As *reported in the 'Economist'*

The transaction was to be financed through a combination of cash and equity contributed by Mr. Dell, cash from investment funds affiliated with Silver Lake and investment by an investment fund affiliated with MSDC Management, L.P., a $2 billion loan from Microsoft, rollover of existing debt as well as debt financing that had been committed by BofA ML, Barclays, Credit Suisse and RBC Capital Markets and cash on hand.

Activist investor Carl Icahn and Southeastern Asset Management, Dell's biggest independent shareholder launched a US$21 billion counter offer for Dell. The alternative plan allowed shareholders to keep their shares and get an additional $12 per share in cash or additional shares and keep the company listed.

In May 2013,Dell posted a 79 percent decline in earnings for the most recent quarter. A special committee setup by Dell's Board found in favour of Michael Dell's MBO offer. Subsequently, the company was successfully taken private.

13.12 Regulatory Requirements for Voluntary De-listing

Unlike in the US markets wherein going private was mainly fuelled as a part of LBO strategy, voluntary de-listing mechanism in India was thought necessary mainly to address the problem of illiquidity for investors in under-performing scrips and to provide an off-market exit. Initially, de-listing through a share buyback was allowed in India whereby public shares would be bought back by a company and thereafter it could apply for de-listing citing lack of minimum public shareholding. This was a common occurrence with subsidiaries of MNCs. In 2003, this route to de-list a company was removed. Presently, a company cannot be de-listed unless a specific de-listing offer is made through the *reverse book building* route under the De-listing Regulations. The main change that has been brought about is that companies cannot de-list using the fixed price tender offer either though buyback or a takeover. Instead, they need to go necessarily go through a process of reverse book building and exit price discovery.

13.12.1 Main Provisions

Since de-listing applies only to listed companies, it is governed by the SEBI De-listing Regulations 2009. The De-listing Regulations 2009 apply to all kinds of de-listing mechanisms but more specifically to the following:

- Voluntary de-listing sought by the promoters of a company (complete de-listing).
- De-listing by operation of law due to winding up of a company or any scheme of arrangement for a sick company consequent to which the public shareholding falls below the minimum limit required for the company to stay listed.
- Promoters seeking to de-list a company from some of the stock exchanges (partial de-listing).
- Compulsory de-listing of companies by the stock exchange.

Not included in the above are the following situations:

- When a company makes a buyback of shares in such a way that the public shareholding falls below the minimum limit required for the company to stay listed. Current regulation is that a company has to limit its buyback such that it retains the minimum required public shareholding.
- An open offer made by an acquirer pursuant to the Takeover Code due to which the public shareholding falls below the minimum limit required for the company to stay listed. This process is dealt with under the Takeover Code.
- When a preferential offer is made under Section 62(1)(c) of the Companies Act.

In all the above cases, the company would not be allowed to use these routes in order to de-list the company. In other words, the company cannot use its own funds through the buyback route for de-listing itself. Similarly, a fixed price open offer under the Takeover Code cannot also be used to de-list a company because the objective of the De-listing Regulations 2009 is to provide the shareholders a fair exit opportunity through a discovered price. In this respect, Indian regulations differ from the US law wherein a company may go private after a buy-out of the existing shareholders through a fixed price offer. On the same grounds, a company cannot be delisted as a consequence of a preferential offer.

13.12.2 Process for Voluntary De-listing

The purchasers of shares from the public in a voluntary de-listing offer shall be the promoters or substantial shareholders of the company. A company would be allowed to de-list voluntarily, if not less than 3 years have elapsed since the listing of the company or that particular class of shares that are proposed to be delisted. However, de-listing will not be permitted if a company has any convertibles outstanding, unless the conversion process is completed or the exercise period of the conversion option has lapsed. A voluntary de-listing essentially requires the promoters of the company to provide an exit opportunity to public shareholders as provided in the De-listing Regulations. However, such exit opportunity need not be provided in the case of a partial de-listing. The difference is that in a partial de-listing, the company will continue to remain listed in at least one nationwide stock exchange. For this purpose, presently the BSE, NSE and Metropolitan Stock Exchange are reckoned.

Voluntary de-listing would be permitted by obtaining approval of the board of directors followed by a special resolution of the shareholders in general meeting and making a public announcement of a de-listing offer. The special resolution shall be acted upon if and only if the votes cast by public shareholders infavour of the proposal amount to at least two times the number of votes cast by public shareholders against it. In other words, through the company may procure the requisite majority of 75% to approve the special resolution for de-listing, it shall also get the approval of two-thirds of the minority public shareholders counted separately. For this purpose, public shareholders are defined as holders of equity shares other than the following:

- Promoters
- Holders of depository receipts issued overseas against equity shares held with a custodian and such custodian.

It may, thus, be noted that GDR / ADR holders are not entitled to any direct voting on the resolution for de-listing. However, if the company gets delisted in domestic market, it will be simultaneously delisted from the overseas markets for its depository receipts. In other words, the company cannot keep its depository receipts listed while the underlying shares in India are delisted. The holders of depository receipts will be paid the equivalent exit price as is arrived at for the domestic shareholders under the reverse book building route.

The company is also obligated to complete the de-listing offer and make the final application to the stock exchange for de-listing within one year from the date of passing of the special resolution stated above.

Before the de-listing happens, the merchant banker appointed for the de-listing offer has to conduct due diligence on prescribed matters and certify them apart from managing the offer and ensuring regulatory compliance.

An offer is deemed to have failed if it has not received the requisite minimum number of shares under the reverse book building process. The minimum bids required for this purpose shall be the *higher* of the following:

- Upto 90% of the issued capital of the company excluding shares held by custodian that are underlying depository receipts; or
- The promoter holding prior to the offer + 50% of the offer quantity.

If the quantity eligible for acquiring shares at the final price does not result in public shareholding falling below the required level for continuous listing, the company shall continue to remain listed.

13.12.3 Pricing a Voluntary De-listing

De-listing could also be an expensive affair since the retail investors would want to make the best of an exit opportunity that comes their way after a long time. According to Professor Larson's study, US companies that de-listed in 2003 had to pay on an average about 40% to 80% premium on the prevailing market prices of their shares to buy them back. In another empirical study by Lowenstein (1985), of all the 28 MBO proposals that happened during 1979 to 1984 revealed an average premium to prevailing market price of 56%. However, an a larger scale it has been found in various studies that companies taken private pursuant to a buy-out deal in the US markets prior to 1990 paid on an average a premium of around 35% to the prevailing market price.

Unlike in the US market wherein pricing was aggressive due to a buy-out by investors, in India wherein de-listing is more of a voluntary mechanism financed by controlling shareholder group, the price can neither be too aggressive nor too low since it has to elicit investor response. Moreover, the retail investor needs to be a part of the price determination for an exit. Therefore, the De-listing Regulations 2009 provide for the mechanism of *reverse book building* in case of de-listing offers.

For the purpose of the reverse book building, the public announcement made for the de-listing offer has to specify a *floor price*. The *floor price* of the offer has to be determined as the higher of the following:

- The average of the opening and closing 26 weeks traded price quoted on the stock exchange where the shares of the company are most frequently traded during such period; or
- The average of the preceding 2 weeks opening and closing traded price.

There would be no maximum price or *cap* for the offer. In the case of infrequently traded shares, the floor price shall be arrived by the promoters in consultation with the merchant banker taking into account the price paid by the promoters for any acquisition of shares in the company in the preceding 26 weeks and parameters including return on net worth, book value of the shares of the company, earning per share, price-earnings multiple vis-à-vis the industry average, etc., and this may also require independent certification by a merchant banker, if SEBI requires so.

The final price of the offer would be discovered through a reverse book building process as the price at which the maximum number of shares have been offered by the shareholders for sale. The promoters or acquirers shall have the option to accept the price or not. If the final price is accepted, the promoter or acquirer shall be bound to accept all the offers upto and including the final price but may not accept the higher priced offers, if so desired. If the final price is not accepted, the offer stands cancelled and no final de-listing application should be made.

The following illustration provides a perspective on the reverse book building price and the minimum quantity stipulation under the De-listing Regulations:

ILLUSTRATION 6

Existing Promoters' Stake = 32%

Therefore, minimum quantity to be acquired is 58%

Let us assume the offer has been made for the entire 68% of public shareholding. The bidding details are furnished below.

Offer quantity bid as % of the Paid-up Capital	*Bid Price*	*Remarks*
12%	120	Floor Price
26%	125	
12%	130	
11%	135	Final Price (as quantity offered reaches 90%)
11%	140	

13.13 Minority Squeeze Out

Minority squeeze out is a process whereby the controlling shareholders (in concert with outsiders or acting in isolation) buy-out the minority interests in a company. Under law, this can happen in three ways: (i) by a scheme of amalgamation or arrangement, (ii) through capital reduction under the directives of the court or tribunal and (iii) compulsory acquisition as prescribed under law. A de-listing (going private) offer amounts to a compulsory acquisition under law.

In a squeeze out, should the minority have a right in to decide on the squeeze out itself or only decide on the exit price? This becomes a matter of conjecture on which opinion could be divided. Therefore, under law, a threshold is prescribed whereby if the majority reaches a prescribed percentage of holding, it is given a right to squeeze out the minority. This threshold in many countries such as the UK, Singapore and others is 90%. Even under the De-listing Regulations of SEBI, the prescribed threshold is 90% of the outstanding shares. If the majority shareholders garner the required minimum of 90%, they can force the minority to sell to them at the RBB price for a year after the closure of the de-listing offer. This provision is mutual in the sense that it casts an obligation on the majority as well to buy out the minority, if it is willing.

A complication may arise if the minority is unwilling to sell either in whole or in part the residual shareholding in the company even after the stipulated period of one year. The company would by then have delisted and the shares would have become non-tradable, thereby taking them out of the purview of SEBI Regulations. Then, the residual minority can only exit through a private negotiation with the majority. In the past, this situation has led to protracted litigation and frustrated both parties due to the lack of a suitable squeeze out provision under law. The courts have held that as long as a fair price is offered to the minority, a squeeze out is permissible.[9]

The Companies Act, 2013 for the first time introduced a squeeze out provision to address such situations. This provision applies to any case wherein the majority has acquired 90% or more of the issued capital by way of a scheme of amalgamation, share exchange, conversion of securities or by any other means. Therefore, it applies to a delisted company and unlisted company acquisitions as well. Under these provisions[10], the majority upon acquiring 90% or more shall notify the company of its intention to buy the remaining shares. The price to be offered for this purpose shall be determined on the following basis by a registered valuer.

- In the case of a listed company, it shall be as per pricing formula under SEBI Regulations.
- In the case of unlisted companies and private companies, the value to be determined by the valuer based on fundamental valuation and the highest price paid by the acquirers.

The squeeze out process under this provision is valid for one year during which time, the minority may offer to sell their shares. In the event the minority does not come forward, their shares will be deemed to have been sold or cancelled and the consideration would be despatched to them by the company.

Overall, it is perceived that the law supports fairness in exit price for the minority but does not address the aspect of choice of exit for the minority. Internationally, squeeze out laws in US, UK, Singapore, Canada and other countries prescribe more or less the same rights for minority squeeze out but courts do examine the fairness of the exit on a case to case basis.

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[9] Sandvik Asia Limited v. Bharat Kumar Padamsi, (2009) 3 BomCR 57.11 [1976] 1 WLR 123

[10] Section 236 of the Companies Act read with Rule 27 of the Companies (Compromises, Arrangements and Amalgamations) Rules, 2016.

Case Study

Cadbury India

Cadbury's India (now Mondelez) was a listed subsidiary of Cadbury's Plc UK. The parent made several open offers and buyback offers to increase its holding to 97.583%.It petitioned the High Court for a reduction of capital to squeeze out the minority of 2.417% through compulsory acquisition.

The Company's scheme proposed a price of ₹1340 per share. The scheme was passed by the shareholders including the majority of the minority. However, the Court appointed an independent valuer who determined the squeeze out price at ₹1743 and then revised it to ₹2014.50**.** The Court confirmed the squeeze out at this price justifying it to be fair, just and reasonable using the principles enunciated by the Supreme Court in [Miheer H. Mafatlal v. Mafatlal Industries Ltd., AIR 1997 SC 506]. The minority had a victory in the decision since the revised price was more than 150% of the offered price. Two shareholders who were still disgruntled with the verdict appealed to a higher bench of the High Court.

The High Court observed in this case,"The Court's duty lies in ensuring that the scheme is not against the public interest, is fair and just and not unreasonable, does not unfairly discriminate against or prejudice a class of shareholders ..... The term 'prejudice' in relation to valuation of a scheme would mean something more than just receiving less than what a shareholder desires, being a concerted attempt to force a class of shareholders to divest themselves of their holdings at a rate far below what is reasonable, fair and just."

13.14 Unique Cases on Voluntary De-listing

Case Study

Digital GlobalSoft

In the first ever case of voluntary de-listing under the reverse book building guidelines, Digital GlobalSoft India was de-listed using the reverse book building under the de-listing guidelines. Digital India, which began in 1988 as a joint venture between Digital Equipment Corporation of USA (DEC) and Hinditron, later became a subsidiary of Compaq when the latter acquired DEC in a global acquisition. After Hewlett Packard (HP) took over Compaq, Digital India (renamed Digital GlobalSoft) became the subsidiary of HP. HP announced a voluntary de-listing so that Digital India could become a 100% subsidiary of the parent company.

The de-listing offer was made at a price of ₹750 per share, which nearly worked out to a 50% premium on the 26-week average price formula. The reverse book-building offer opened in the month of January 2004. The response from the investors was good but the most number of offers were received at ₹850 a share which amounted to almost 21% of the total shareholding in the company. This meant that HP had to increase its offer price to ₹850, thereby incurring an additional cost. The final deal size worked out to about ₹1418 crore as opposed to the earlier size of around ₹1000 crore at ₹750 per share. This made it the largest exit offer at the time in India.

Case Study

Patni Computer Systems

i-Gate Corporation, a company that was listed on NASDAQ at the time, acquired Patni Computer Systems Ltd., a company listed on BSE and NSE in January 2011. i-Gate had acquired the company paying a consideration of ₹503 per share. As a consequence of the takeover offer, i-Gate ended up holding 83% of Patni and sought to de-list the company from domestic stock exchanges in 2012. This was clearly against the provisions of the de-listing regulations.

SEBI intervened when the company applied to stock exchange for in-principle approval for de-listing based on investor complaints about the irregularity. The investment banker and the company claimed that the acquisition was done with an open offer document that had clearly mentioned about de-listing and that there was a precedent in the de-listing of Camlin Ltd. Camlin was acquired by the Kokuyo Group of Japan in 2011. SEBI examined the case and finally gave the approval for the takeover offer only after the acquirer sold back shares in the open market and the company satisfied the minimum public shareholding norm condition.

i-Gate, therefore, launched a separate de-listing offer subsequently at a floor price of ₹356 per share. The RBB resulted in a discovered price of ₹520 which i-Gate accepted. The company completed the de-listing in 2012 under the De-listing Regulations.

Case Study

Essar Oil

Essar Oil, subsidiary of Essar Energy that listed in London, considered the proposal to delist itself from both the BSE and the NSE. Essar Oil was a stressed asset from 2004 to 2014 having gone through a debt restructuring plan to help cover the construction of its grassroot Vadinar refinery in Gujarat.The company's total debt was in excess of ₹21,000 crore and its DER was very high at 8.5 times. However, its profitability started to improve substantially from 2014 due to the large capex programme that was fully completed. The company never paid any dividend.

After board approval, Essar Oil made a de-listing offer to buyback 137 million shares or a 27.53% stake held by the public and other non-promoters at a floor price of ₹108.18. At this floor price, the Group would have had to spend ₹1,480 crore to acquire all outstanding shares. Promoters had to also ensure that their share holding crossed a minimum 90 percent for the de-listing to be successful. The promoter firm, Essar Energy held 71.22% in Essar Oil through a Mauritian Holding company.

The stock price doubled to ₹113 on the news of de-listing. Essar Oil's board of directors approved the de-listing in a meeting on June 22, 2014. On August 6, the company announced the shareholders of the company had approved the de-listing proposal through a postal ballot. However, later in August 2014, SEBI put the process on hold, seeking clarifications following shareholder complaints. On 7 November, SEBI stated that Essar Oil would require to offer the same price per share for de-listing at which Russian oil and gas giant OAO Rosneft had bought 49% stake in Essar Oil. As a result, the floor price was revised to ₹146.05 per share.

The offer provided a RBB price of ₹262.80, an 80% premium to the floor price of ₹146.05 per share. The promoter accepted the discovered price which pegged the equity valuation of the company at ₹38,000 crore. The company stated that out of the 142.5 million shares held by public shareholders, the promoters acquired 101 million shares through the de-listing offer, as against the minimum requirement of 92.6 million shares to reach 90%. The promoter company paid out ₹3,745 crore to complete the de-listing process which according to the company was the largest payout for taking a listed company private in India at the time.

Thus, India's second biggest private sector refinery company was successfully de-listed. Eventually, the promoter company sold 98% of Essar Oil to Rosneft at an enterprise valuation of ₹78,000 crore. However, as per SEBI's order the company had to pay the final price given by Rosneft to its minority shareholders even after the de-listing offer had closed.

Case Study

Astra Zeneca

Astra Zeneca India (Astra Zeneca) is a 90% subsidiary of Astra Zeneca Pharmaceuticals AB (Astra AB) Sweden. In December 2001, the parent Astra AB held 56.51% shares in it which was increased to 90% in 2003. In July 2004, it came out with a de-listing offer at a floor price of ₹825. The exit price discovered was ₹3,000 which was rejected by the parent company.

Pursuant to SEBI's mandatory public shareholding requirement of 25%, the parent came out with another de-listing offer in 2010 with a floor price of ₹576.10 and set a maximum acceptable price of ₹1,152 (paid-up shares of₹2 each now). The offer was rejected by the public shareholders through postal ballot.

The company then worked on a market cap reduction plan through suspension of production and write off of deferred tax assets. The price of the share fell by about 50%.

Finally, in order to comply with SEBI rules Astra reduced its stake from 90% to minimum 75 % through OFS route to institutional investors at ₹620 per share in May, 2013.In 2014,the parent announced another de-listing offer and managed to creep back above 90%. The minority shareholders alleged that is was achieved through a warehousing transaction. However, the matter did not get litigated and in March, 2014, Astra Zeneca got SEBI approval to delist its shares from BSE and NSE. After 13 years, the de-listing plan was successful after multiple attempts.

Case Study

Select Cases of Failed De-Listing Offers

I-flex Solutions (presently Oracle Financial Services Software Ltd.)

I-flex Solutions was acquired by Oracle Corporation USA and was proposed to be de-listed in 2006 under the reverse book building method. The floor price was fixed at ₹1486 a share. The public response was lukewarm due to which Oracle decided to increase the offer floor price to ₹2100 per share (a 42% increase).However, the expectation of the shareholders was much more due to which the offer failed to garner enough support. The de-listing offer, thus, failed regulatory clearance. Oracle decided not to hike the price further and to keep the company listed. At that time Oracle owned 83% of I-Flex. By the end of 2012, the share price quoted around ₹2,900. Oracle held 90% which needed to be diluted to 75% by June 2013. It was, thus, a failed de-listing offer.

Ricoh India

Japanese-multinational Ricoh's offer to delist its Indian arm Ricoh India in 2014 was not successful. The price discovered in the reverse book building offer was ₹225 per share to repurchase the minimum required by the parent. However, the promoter could manage to garner bids for only around 40 lakh shares, or around 62% of the required quantity to successfully at ₹200. The price of ₹225 was rejected by the parent and the offer was declared unsuccessful. The offer was made to acquire the entire public shareholding of 26.4%.

BOC India (presently Linde India)

BOC India, a part of the German Linde group which is in the industrial gas business, unveiled an offer to acquire 10.52% of the paid-up capital or 89.75 lakh equity shares through its holding company. BOC India was listed on the BSE, the NSE and the Calcutta Stock Exchange. The company had set ₹225.29 as the floor price to buy out public shareholders. The offer made in 2011 received poor public response due to which BOC was unable to acquire a minimum of 44.88 lakh shares from the public being content with just 39.3 lakh shares. Since the promoter holding was close to 89.5% in BOC India, it was incumbent upon the promoters to buy out at least 50% of the shares from minority shareholders. According to BSE data, 15.85 lakh shares were tendered at ₹600 per share while BOC shares were trading at around ₹264. Investment bankers complained that public shareholders were selling off the stock in the market rather than surrender them in the offer with an expectation that when the offer failed, they could pick them up again.

Saint-Gobain Sekurit India

French building materials company Saint Sekurit Gobain S A France along with Saint Gobain Glass India owned 85.77% stake in Saint-Gobain Sekurit Indiaat the end of March 2012. The promoters of the company announced a de-listing offer in 2012. The response was poor and the company received bids for 4.9 million shares, about a third needed to be submitted by shareholders to complete the de-listing. The offer manager announced that "the de-listing offer is deemed to have failed as the total number of equity shares tendered by the public shareholders in the de-listing offer at or below the discovered price of ₹90 per share is 4.9 million, which is less than the minimum number of equity shares required to be acquired by the company in order for the de-listing offer to be successful. Accordingly, the company will not acquire any equity shares tendered by the public shareholders in the de-listing offer and the equity shares of the company will continue to remain listed on the BSE." After the announcement, the company's share price fell abruptly to ₹45 on the BSE indicating disappointment of speculators who had built up positions in anticipation of a high exit price.

Other MNC Companies

In 2010, tyremaker, Goodyear India's plans to delist from domestic stock exchanges was unsuccessful due to poor response from shareholders. The de-listing plans of MNCs such as AstraZeneca (read the full case in this Chapter) and Kennametal, also failed earlier, after minority shareholders rejected their share buyback proposals. Both companies had to drop their plans, after shareholders turned down the proposal in a postal ballot. Investment bankers stated that given the growing importance of Indian operations, shareholders were expecting better returns over the long run and were loath to exit at prevailing valuations. Such tendencies were noticed in all MNC de-listing offers and the expectation of the public was very high. Whilst some promoters like Alfa Laval and i-Gate succumbed to higher expectations from shareholders, others such as Oracle did not. For instance, in case of Alfa Laval, while the parent gave a floor price of ₹2,045 and also indicated a revised price of ₹2,850, the price that was determined based on the reverse book-building stood at around ₹3,850, as per BSE, which was almost 35% higher than the company expected. In many other cases as mentioned herein, the offers did not elicit the minimum response required.

In all such companies, the promoter holding companies were holding much higher stakes than the compulsory maximum of 75% which was to become effective from June 2013. Therefore, such companies needed to make another de-listing offer before that date or increase the pubic shareholding to 25% to stay listed. Therefore, there was a desperate urgency for the parent companies which was capitalised by the public shareholders in the successful offers.

13.15 Comparative Scheme of Buyback and De-listing as Exit Offers

Exit Offers

Share Buyback	*De-listing Offer*
Applies to equity shares, preference shares and other specified securities.	Applies to equity shares, preference shares and other specified securities.
Governed by Section 77A/77B and respective guidelines by MCA / SEBI.	Applicable for listed companies alone. Governed by De-listing Regulations 2009 of SEBI and stock exchange requirements.
Pricing determined by the company as Fixed Price Book-built Price/Open Market Price. There is no concept of a minimum price.	Price to be determined only through Reverse Book Building using Dutch Auction process.
Quantum of buyback restricted to specified amounts.	Quantum of shares bought back shall be the residual public shareholding to enable the company to de-list.
Company uses its own funds to buyback.	Acquirers (including promoters) use their personal sources of funds to buy shares.
Company cannot use proceeds generated from earlier issues to finance buybacks.	No restrictions on sources of funds since these are brought from outside the books of the company whose shares are being de-listed.
Buyback cannot be used for de-listing a company.	To be used only if de-listing is contemplated.

Exhibit 13.1 Comparative Scheme of Buyback and De-listing as Exit Offers

13.16 Compulsory De-listing

Stock exchanges may de-list companies which have been suspended for non-compliance with the listing agreement or matters connected therewith. The de-listing decision shall be taken by a specially constituted panel of the stock exchange and notice of the termination of the listing agreement needs to be given to the company. The de-listing should also be publicised and displayed on the trading systems.

Where a company has been compulsorily de-listed, the stock exchange shall appoint independent valuers to assess the valuation of the company and fix the price for repurchase. The independent valuer shall be a merchant banker or a chartered accountant. The shareholders of the company have an option to sell their shares to the promoters at the stated valuation. If they exercise this option, the promoters shall buyback the shares from the public at the fair price to be determined by the valuer. The consideration for the shares should be settled in cash. Where a company has been compulsorily delisted, the company, its whole-time directors, its promoters and the companies which are promoted by any of them shall not directly or indirectly access the securities market or seek listing for any equity shares for a period of ten years from the date of such de-listing.

In the US market parlance, compulsory de-listing is known as *going dark* which means de-registration of a company from the stock exchange. Going dark happens when a company finds that it is unable to meet the continuous listing requirements of minimum shareholders or financial criteria such as minimum market capitalisation or revenues. Such companies need to make necessary filings to get their shares de-registered under the Securities Exchange Act. Such deregistered companies are traded on OTC market (such as the OTCQX) through information made available on what are known as *Pink Sheets*. Pink sheets are limited information records furnished by a deregistered company to market makers in the OTC market.

13.17 Re-listing

In cases pertaining to voluntary de-listing, re-listing of the same securities can be permitted by a stock exchange after a cooling period of ten years. In cases involving compulsory de-listing, it is possible to re-list after a period of five years. However, re-listing shall be as per the terms and conditions applicable at the time of re-listing and further subject to the clearance from the relevant stock exchange. Considering the long cooling off period stipulated under law, voluntary de-listing should be a carefully thought out decision with a well-planned strategy for which investment bankers provide valuable guidance and professional advice.

IMPORTANT TERMINOLOGY

Compulsory De-listing
Declaration of Solvency
De-listing Offer
Dutch Auction
Fixed Price Tender Offer
Going Private
Letter of Offer
Open Market Purchase
Over-Capitalisation
Re-listing
Reverse Book-Building(RBB)
Share Repurchases
Treasury Shares
Voluntary De-listing

TEST YOUR UNDERSTANDING

PART – A

I. Pick the right answer(s) or the alternative that best fits the description from the alternatives provided under each question.

1. One of the reasons why a company would resort to equity repurchase is that its assets are overvalued and to that extent the capital is unrepresented by assets.
   (a) True (b) False
2. A share repurchase programme does not amount to capital reduction if the company is able to buyback the shares at less than their issue price.
   (a) True (b) False

3. A share buyback programme amounts to capital restructuring even when the buyback is financed through internal accruals.
   (a) True (b) False
4. An unlisted company may use the share buyback route to provide exit to venture capitalists.
   (a) True (b) False
5. A listed Indian company that is also listed in Casablanca proposes to de-list its GDRs. It has the following implication(s):
   (a) The de-listing of the GDRs is not possible without de-listing the domestic shares
   (b) The Indian de-listing should precede the overseas de-listing
   (c) There has to be simultaneous reverse book-built offer at both places
   (d) The cut-off price in the de-listing offer in India has to be applied to the overseas de-listing offer
   (e) The overseas de-listing offer can be independent of the domestic listing
6. A company decides to make a share buyback through reverse book building since it is of the view that it can return more capital to shareholders than through a fixed price tender offer. The following is (are) the implications:
   (a) The proposed buyback is illegal
   (b) The has to make a de-listing offer since it is a reverse book-built offer
   (c) Shares bought back have to be sold back through book building
   (d) The company has to provide a floor price for the reverse book building
   (e) The company has to make a simultaneous de-listing offer.
7. A share buyback is different from de-listing a company in the following way:
   (a) Buyback increases RONW while de-listing decreases floating stock
   (b) De-listing privatises the company while buyback promotes the Company
   (c) Buyback increases RONW while de-listing decreases issued capital
   (d) Buyback increases RONW and decreases issued capital while de-listing decreases RONW and increases the EPS
   (e) Both RONW and EPS are increased in a buyback while in de-listing both remain unchanged.
   (f) RONW and EPS are increased and issued capital is decreased in a buyback while in de-listing it is the opposite.
8. Which of the following amount(s) to capital reduction?
   (a) The company decides to cancel unissued capital
   (b) The company buys back shares and re-issues them
   (c) The company sub-divides ₹10/- share into five shares of ₹2/- each
   (d) The company consolidates a ₹1 share into a ₹5 share
   (e) The company decides to reduce the face value of existing shares from ₹10 to ₹5
   (f) Makes a buyback of ₹10 share at ₹25 per share
   (g) Makes a buyback of ₹10 share at ₹5 per share
9. In a share buyback, the shareholders are given an option to surrender their shares either in part or in full depending upon the price discovery that is done prior to the opening of the offer.
   (a) Yes (b) No
10. In a de-listing offer, if the public have not responded in full, the left-out shares can be acquired through a negotiated price after 1 year.
    (a) Yes (b) No

11. A company has a debt-equity ratio of 1.8:1. It is now considering an equity buyback such that the residual debt-equity ratio is not more than 2:1. For this purpose, the company considers repayment of an existing debt using its debenture redemption reserve so as to conserve cash for the buyback. The company is therefore compliant with the regulations.
(a) Yes (b) No
12. In a de-listing offer, the company fixes a floor price which is subsequently increased after some of the shareholders have tendered their shares. The revised price has to be mandatorily made applicable even to such shareholders.
(a) Yes (b) No
13 In a share buyback, the shareholders are given an option to surrender their shares either in part or in full at their option but the pricing will depend upon how much they offer.
(a) Yes (b) No
14. In a de-listing offer, if the public have not responded in full, the left-out shares need not be acquired at all if the promoters' holding has already reached 90%.
(a) Yes (b) No
15. In a share buyback, the company cannot be de-listed if the public shareholding falls below the statutory minimum even if the share buyback regulations have been complied with.
(a) Yes (b) No
16. A company has a debt-equity ratio of 1.5:1. It is now considering an equity buyback such that the residual debt-equity ratio is not more than 2:1. For this purpose, the company considers transfer of a long-term liability to the current liability category in consultation with the auditors. The auditors object to this step stating that it is not in compliance with accounting principles. The company maintains that compliance with statutory provisions takes precedence over accounting principles. Who is right?
(a) Company (b) Auditors
17. In a share buyback, a company decides to buyback 30% of the issued capital at a price that would be within 25% of the share capital and free reserves of the company. The board and shareholders have approved the proposal. However, since the company proposes to buy more than the allowable 25% of issued capital, the Company Secretary decides to approach SEBI for a special permission in this case. The CFO is of the view that since the company is within the permissible value of the buyback, no approval is required from any authority. Resolve the issue from the following alternatives:
(a) The Company Secretary is right
(b) The CFO is right
(c) The Company Secretary is right but SEBI is not the authority to approach
(d) Both are wrong since there is no approval mechanism.
18. In a de-listing offer, the company has offered a floor price of ₹275 per share. The CMP is ₹282. The 6-month weighted average price is ₹273. The last two weeks weighted average is ₹287. The price at which the controlling shareholders bought shares from the open market in the past 15-day averages on volume weighted basis at ₹286. The minority shareholders representing 12.20% of the voting capital petition the court against the offer stating that the offer is below the SEBI price. Analyse the situation from the given alternatives.
(a) The SEBI price has been followed correctly in this case
(b) The minority has no right to invoke any action
(c) The minority have misunderstood the applicability of the pricing formula
(d) The company should have applied only the last acquisition price and nothing else.

19. A company proposes a buyback of its shares in exchange for 3-year inflation-indexed bonds that would carry a convertible option. The conversion option entitles a bond holder to accept the buyback in terms of repayment proceeds of the bond or in terms of two equity shares for every bond held. The investment banker is hailed by the market as a brilliant banker and the offer is over-subscribed. The CFO is unhappy and cites a huge regulatory liability on the company but is not sure about it. Is the offer valid?
    (a) Yes (b) No
20. In a buyback of shares, a company wants to buyback 25% of its issued capital at a price per share by which the total value of the transaction will be less than 25% of it paid-up capital and free reserves. The CFO says that the buyback is invalid. The investment banker says the buyback is valid. Who is right?
    (a) CFO (b) Investment Banker
21. In a share buyback scheme, the residual DER of a company is 2:1 if outstanding FCDs are not considered as debt. If the FCDs are included, the DER amounts to 2.8:1. The company's CFO and the i-banker are confused as to which is the right approach. How do you determine?
    (a) FCDs to be included (b) FCDs to be excluded
22. In a de-listing offer of a company, the principal shareholders succeed in procuring 98% of the shares. The residual 2% is in the hands of some public shareholders who have not responded to the offer. The principal shareholders now have the following alternatives for a squeeze out:
    (a) They can compel the residual shareholders to sell at the discovered price.
    (b) They can offer to buy them out upto 1 year from the close of the offer at the discovered price.
    (c) They can buy them out through a negotiated price.
    (d) They can compel them to sell through a court proceeding.
    (e) They can de-register them as shareholders by striking off their name from the register of members.
    (f) They can make another de-listing offer for them.
    (g) They can cancel the offer and go for a new offer.
    (h) They can increase the price of the offer and wait for them to surrender their shares.
23. A company that was incorporated two years ago and taken public wishes to de-list since its shares are not traded at all in the market and the price has remained stagnant below the offer price. The promoters propose to offer a handsome exit price. The offer is valid.
    (a) Yes (b) No
24. In a compulsory de-listing, the stock exchange has stipulated that the promoters of a company shall offer to buy the public shareholders at a P/E multiple of 25 when the current trading multiple is 18. The stock exchange is going by the opinion of the valuer. The promoters feel the valuation is unjustified and wish to go in for arbitration. The promoters will succeed.
    (a) Yes (b) No
25. In a share buyback, a company offers a fixed price tender offer to shareholders that is 12% below the CMP. A shareholder questions the validity of the proposal and files a case stating that the controlling shareholders are trying to squeeze out the minority in the pretext of a share buyback at an unfair price. The shareholder is right.
    (a) Yes (b) No
26. In a de-listing offer concluded a month ago, the company has obtained 92% stake. 3% of the shareholders are willing to exit at a higher price of 2x. The balance 5% shareholders are willing to exit at 2.5x. The company can buy them out at the higher prices or insist on paying the same price as in the de-listing offer.
    (a) Yes (b) No

PART - B

27. What is a share buyback? How is it different from de-listing?
28. How does a company decide between a buyback and a de-listing offer to the shareholders? How do they compare?
29. How is the pricing determined under a buyback and a de-listing offer? From the purchaser's point of view, what are the implications?
30. What are the requirements as regards the quantum of a buyback offer? What is the rationale for such quantitative restriction?
31. What are the methods of making a buyback and a de-listing offer? Are the procedural requirements different and if so, in what respect?
32. What is a squeeze-out mechanism? How does it work in the context of a de-listing and a share repurchase programme?

For answers to Part A, refer to Appendix B at the end of the book.

Corporate Restructuring

14

LEARNING OUTCOMES

- Various modes for corporate restructuring as a spilt-up strategy including business activities in subsidiaries and associate companies.
- Role and methods for asset based Split-ups—Demerger, Hive-off, Reconstruction, Slump Sale and Asset Disposition.
- Types of demergers including Structured Demerger, comparative analysis of demerger vis-à-vis hive-off.
- Methods for Split-ups under the equity approach—Spin-off, Equity Carve Out and Divestiture.
- Subsidiarisation and De-subsidiarisation.
- Statutory framework for asset based split-ups and equity based split-ups.
- Valuation approaches in corporate restructuring.
- Investment Banking perspectives in corporate restructuring.
- Case studies of well-known companies in corporate restructuring.

14.1 Overview of Corporate Re-organisations

14.1.1 Introduction

Corporate re-organisation is a wide term that encompasses changes confined to a particular company or to more than one company in a single transaction. These are done from time to time in response to business environment and changing business dynamics. As it may be appreciated, preservation and enhancement of shareholder value is the primary driver for corporate performance and therefore, companies are frequently in the process of re-organising their business structure to grow and enhance value. The discussion in this chapter is centered around corporate reorganisations associated with (i) split-up of an existing company's balance sheet through asset sale, subsidiarisation or other methods involving transfer of assets or transfer of equity, popularly known as *corporate restructuring*. The other methods of corporate re-organisation are

(ii) integration of two or more corporate balance sheets, popularly known as *mergers and amalgamations* and (iii) change in the shareholding pattern of a company resulting in a change in control or ownership, known as *acquisitions or takeovers*. Mergers and Acquisitions are discussed in detail in Chapters 15 and 16.

Corporate re-organisation forms the core of M&A business portfolio in investment banking. The entire spectrum of corporate re-organisation is mapped in Exhibit 14.1.

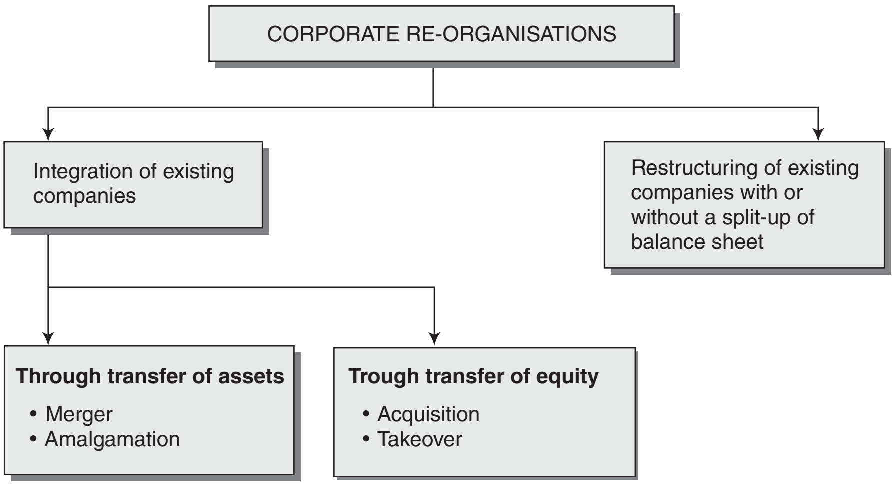

Exhibit 14.1 Types of Corporate Re-organisation

14.1.2 Rationale for Corporate Re-organisations

Mergers, acquisitions and corporate restructuring are a part of business portfolio re-organisation by companies that happens on a continuous basis to handle business dynamics. Restructuring is the process by which companies respond to changes in the operating environment and is often a tool for change management. The objectives of corporate re-organisations and restructuring could be many and based on the objective, the method of restructuring varies. Given below is an illustrative list of some corporate objectives that trigger corporate restructuring and related examples in the Indian context. The rationale for corporate re-organisation through mergers and acquisitions is discussed separately in Chapter 15.

1. ***To create long-term holding structures:*** The Tata Group conducted a group restructuring in the mid-nineties to build cohesiveness in group structure and corporate objectives. The Future group created a very complex scheme of arrangement to restructure group holdings so as to create long-term holding structures in 2013.

Case Study

Aditya Birla Group

The Aditya Birla Group decided to transfer Indo Gulf Corporation's investments and cross-holdings in group firms to Hindalco Industries. This was aimed at rationalising cross-holdings in the manufacturing companies of the group. Indo Gulf held 3% in Indian Rayon, 0.6% in Grasim, 1.26% in MRPL and some shares in Idea Cellular, the mobile telephony JV with the Tatas and AT&T. Hindalco held lot many shares in group companies. With the recasting of shareholdings, the holdings in the manufacturing companies remained mainly with Hindalco and Grasim, while Indian Rayon was to spearhead the new businesses such as insurance (Birla Sunlife) and IT (PSI Data Systems)—(Business Standard 23/07/2002). Indo Gulf was, thereafter, merged with Indian Rayon to give rise to Aditya Birla Nuvo Ltd.

2. ***To realise better business focus and valuations for individual businesses:*** In diversified companies that have several independent business divisions, a restructuring helps in repositioning them as independent businesses in separate subsidiary or group entities so as to unlock their independent valuation. Such a restructuring could help in better business focus, fund raising, taking such subsidiaries companies public or getting them listed without an IPO and to induct strategic or financial partners. It could also help in bringing down the financial burden on the parent company to fund the growth of all the divisions within its own balance sheet. Creating independent businesses out of a divisionalised structure is one of the main reasons for restructuring a diversified company.

Case Study

Case of Wipro Restructuring

IT bellwether Wipro Ltd. announced in late 2012 its plan to demerge its three non-IT business divisions, including consumer products segment, into a privately-held company to be named Wipro Enterprises Ltd. Wipro Ltd. would continue to remain a publicly listed company that would focus exclusively on information technology business, while Wipro Enterprises will be an unlisted company engaging in all the non-IT businesses. The objective of the restructuring was explained by the executive chairman of the company in a statement, "I am confident that the demerger will enhance value for our shareholders and provide fresh momentum for growth. Each of our distinct businesses is best of breed in its respective industry and we are committed to both the businesses." Similar explanation was provided by the executive director who said, "Creating a technology-focused company will allow us to better serve the needs of our customers and accelerate investments necessary to capitalise on market growth opportunities." A detailed analysis of the restructuring as proposed by the company is furnished in Annexure 4 of this chapter.

Several other demerger schemes mostly fall under this category wherein a conglomerate is formed out of a diversified company through corporate restructuring scheme to enable better focus on individual businesses. The scheme of arrangement of Bajaj Auto Ltd. (2008) and Adani Enterprises Ltd. (2015) are a few other cases in point.

3. ***To attain or better utilise tax shields and tax write-offs:*** Harnessing tax efficiencies through hive-off of profit-making and loss-making undertakings has been an age-old technique of tax planning which continues to thrive. The tax law provides for writing-off business losses and unabsorbed depreciation against future profits. However, these benefits cannot be availed if there are insufficient or no future profits. In such situations, these companies are merged with other companies or reverse merged so that the merging or merged company as the case may be, could benefit from such deferred tax assets.
4. ***To restructure balance sheets:*** Restructure balance sheets with a view to reflect the asset and liability profile better or to increase the asset base or fund base.

Case Study

Mahindra & Mahindra Ltd.

Mahindra and Mahindra (M&M) undertook a financial restructuring by amalgamating three of its subsidiaries and writing-off deferred revenue expenses up to a maximum of ₹500 crore against the share premium account. The balance in the Share Premium Account (SPA) stood at 819 crore at that time that would have come down to ₹319 crore after the write-off. The write-off is on account of product development, VRS schemes and minor software expenditure, to the extent of 374 crore as on September 30, 2001. The remaining was the likely expenditure to be incurred on account of product development and VRS schemes up to March 2002.

As a result of the amalgamation of group companies, M&M wrote-off the value of investments of its shares in these subsidiaries. This write-off, which was about ₹500 crore, was in addition to the write-off mentioned earlier. The company's net worth stood at ₹2069 crore as on March 31st 2001. The company was expected to earn a profit on revaluation of the shares of M-BT (Mahindra–British Telecom) in which one of its merging subsidiaries had a 31.9 % stake. As a result of all these measures, the balance sheet of M&M reflected a better picture of its net worth. It also benefited by capturing directly into its balance sheet the appreciation in the value of M-BT.

5. ***To facilitate distribution of assets and family settlements:*** Restructuring of companies through splitting existing companies is necessitated due to family splits or settlements. Indian industry goes through such phases whenever there is a succession in a group. Recent examples include the Reliance Group, Bajaj Group, Thapar group, etc. Some of these result in acrimonious battles such as those in the Chhabria group, the Modis, the Apollo Tyres Group etc. A case study of the Reliance demerger is provided in Annexure 3 of this chapter.
6. ***To exit non-core businesses:*** In times of increased competition and business volatility, companies look for sustenance in areas of core competence. This could mean increased investments in such areas for which funds are raised through divestiture of non-core businesses. Examples are the sale of TOMCO by the Tatas, Times Bank by Bennett Coleman, Tata Steel's cement business, etc.
7. ***Strategic divestitures and exiting loss making businesses:*** There are instances where a company is nurtured with a strategic sale in mind. Many a time, venture backed companies are looked at as good exit vehicles for venture capitalists, if they make good candidates for strategic sale at a later date. Sale of CustomerAsset to ICICI, Spectramind to Wipro and India World to Satyam Infoway are examples. Similarly, Flextronics was bought out by venture capitalists with an intention to make a strategic sale. This was accomplished when KKR, a buy-out firm bought Flextronics in a MBO for US$ 760 million. Earlier Flextronics which was controlled by Hughes was sold to the Star Group that subsequently sold it to the buy-out fund. In later years, the strategic divestitures made by the promoters of American Remedies to Dr. Reddy's Laboratories, Nutrine Confectionery to Godrej Foods and Beverages, BFL Software to Mphasis, Mphasis to Electronic Data Systems, Ranbaxy to Daiichi, MTR Foods to Orkla, Patni Computer Systems to i-Gate, Paras Pharma to Reckitt Benckiser, Ispat Industries to JSW Steel, Sesa Goa to Vedanta Resources, Pantaloon Retail to Aditya Birla Group are examples of exits made by promoters in strategic transactions. A divestiture decision may also be triggered due to a loss-making business in a group. In order to cut losses and improve the valuation of a diversified company, a loss-making division or businesses may be divested. Similarly, in a conglomerate structure, the parent company may divest a loss-making subsidiary. The sale of Kelvinator to Whirlpool India and TOMCO to Hindustan Unilever were divestitures of this kind. Similarly, BPL exited its loss making white goods business in 2007 after its financial restructuring and joint venture efforts with Sanyo of Japan failed to take off.

8. ***To facilitate the entry or exit of business partners:*** Corporate restructuring may be necessary when there is an entry or exit of a JV partner. Businesses may have to be hived off into separate entities to accommodate the partners in such ventures as distinct from the other businesses in the group.

Case Study

UB Group

The United Breweries Group hived off its beer division into a separate SPV, which inducted Scottish & Newcastle (S&N) as a strategic partner. The UB Group holds 40%, S&N holds 40% and the balance is held by private persons in the SPV. S&N invested ₹250 crore into the SPV for a 40% stake apart from investing another ₹175 crore into other UB group companies. The investment was used to wipe off UB group's debt burden of ₹350 crore. The investment in the SPV of ₹250 crore came in the form of ₹200 crore of redeemable optionally convertible preference shares and ₹50 crore of debt funds. UB intended to convert the entire funds into equity within two to five years at an appropriate valuation. The understanding was to cap S&N's shareholding at 26% at the time of such conversion.

9. ***To capture forward and backward linkages in the value chain:*** Often group company restructurings are triggered off to provide efficiencies in the product value chain.

Case Study

RPG Group

The RPG group embarked on a restructuring of its tyre and rubber business in late 2002. The rubber business would be consolidated in Ceat Ltd., which would merge the rubber division of group company Harrison Malayalam with itself. The objective was to strengthen the business of Ceat by providing it with backward integration for sourcing rubber for its tyre manufacturing and also to provide synergistic effect. In order to focus on its core business, Ceat would de-merge its ₹180 crore investment portfolio to its subsidiary company Meteoric Industrial Finance Company following which, it would cease to be a subsidiary. Besides, Harrison Malayalam, the second largest tea producer in south India would merge its wholly owned subsidiaries with itself and concentrate on core business of tea.

10. ***By operation of law or order of a judicial or quasi-judicial authority:*** When companies become too large or diversified for effective regulation, statutory authorities (known as anti-trust regulators) intervene to break up such companies into smaller and manageable entities that are at arm's length with each other. In India, after the repeal of the MRTP Act, the Competition Act, 2002 was passed which regulates business combinations. Similarly, under the Companies Act, the central government has powers which are in the nature of splitting up companies that are being run in a manner prejudicial to public interest. In such situations, albeit quite rare in the Indian scenario, a splitting of a company becomes necessary and the company has to abide by law. Again, as part of a rehabilitation scheme for a sick company, the erstwhile BIFR[1] used to sanction a split up of a loss making division of the company as a part of the rehabilitation scheme. Being a quasi-judicial authority, the BIFR's orders were binding on the company in terms of the provisions of SICA.[2]

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[1]These powers have since been instituted with the Bankruptcy and the Insolvency Board of India under the Insolvency and Bankruptcy Code 2016 which came into effect from May 28, 2016.

[2]The SICA was repealed in 2003 and a new law was passed to addresscorporate bankruptcy (ibid).

14.2 Overview of Corporate Restructuring

The term *corporate restructuring* connotes the entire process through which an existing company re-orients itself as a response to changing business environment and operational dynamics. Therefore, corporate restructuring encompasses several facets of change according to the circumstances and different methods are adopted for such change to achieve different objectives. Corporate restructuring can be internal to a company without a change in its legal entity. It can be an external process as well with the creation of one or more new entities or by a process known as a *split-up* of an existing balance sheet. The different types of corporate restructuring can be depicted, as shown in Exhibit 14.2.

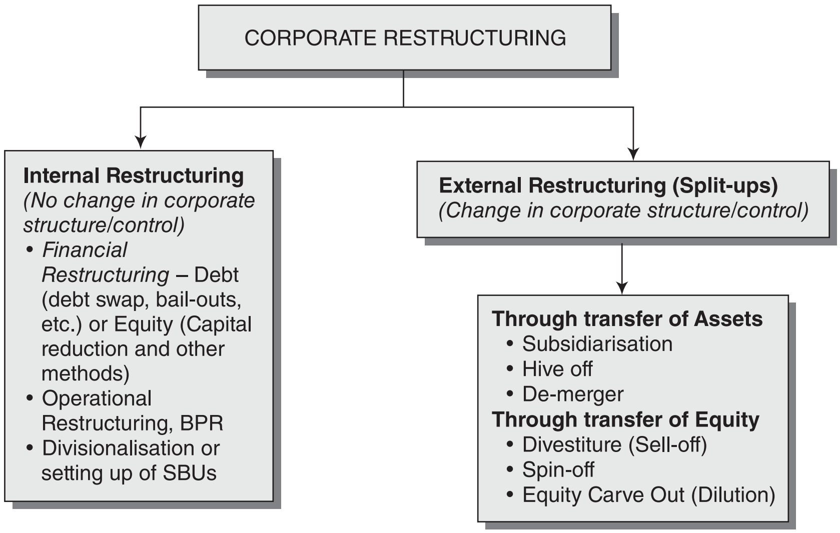


Exhibit 14.2 Types of Corporate Restructuring

Internal restructuring consists of (i) operational restructuring, (ii) divisionalisation and (iii) financial restructuring. Operational restructuring is either a technical exercise such as a business process re-engineering or a managerial initiative such as a change in the organisational structure. Therefore, operational restructuring is a change brought about to the organisation and/or its processes. Divisionalisation refers to setting up separate divisions within the same company for better operational and financial control and accountability. Detailed discussion regarding operational restructuring and divisionalisation is outside the scope of this book.

Case Study

Godrej & Boyce

Godrej & Boyce Manufacturing, the closely held flagship of the Adi Godrej group, revamped its operations in 2001 by merging some of its divisions, which were operating as separate SBUs. This also involved relocating some of its divisions out of Mumbai to cheaper locations such as Chennai, Goa and Pune in a bid to trim operating costs.

Financial restructuring entails a change in the capital structure of a company. This might be required from time to time to increase the efficiency of the capital base, to reduce leverage and financial costs, to rationalise equity base and to deal with over or under-capitalisation. Financial restructuring can be broadly classified as equity restructuring and debt restructuring. Equity restructuring can again be looked at as (i) involving capital reduction and (ii) not involving capital reduction. Those that involve capital reduction need to go through an elaborate process prescribed under law since they affect the interests of shareholders in particular. Detailed discussion on financial restructuring is outside the scope of this book except for equity repurchase which has been discussed in a different chapter since it forms part of merchant banking.

External restructuring entails a change in the asset and liability structure of the company or sometimes only in the asset portfolio. This is achieved through split-up of the balance sheet of the company using several methods. The choice of a particular method would depend upon the facts of a given case, statutory provisions, tax considerations and strategic objectives underlying the split-up. A *split-up* is generally defined as a process by which a single company splits into two or more separately run companies. The shareholders of the company being split up are often given shares in the newly formed entities into which the split-up businesses are transferred. Very often, the split-up company is dissolved but that is more of a matter to be decided on the facts of a case than a pre-requisite. However, the term split-up is construed more in a generic sense to denote corporate actions involving the division of an existing company.

Let us now move on to examine the whole process of split-up in detail in the Indian context. Exhibit 14.3 explores the different types of split-up that are possible in India. It may be noted that included therein are methods that even involve separation of ownerships in a conglomerate structure. In a conglomerate structure, the parent company is often faced with the predicament of unlocking the value of its subsidiary or to encash its value for the benefit of its own shareholders. Such processes are known as *Subsidiary Equity Redeployments (SERs)*. SERs are methodologies available for a parent company to relinquish control, raise cash, reduce leverage or de-subsidiarise its subsidiary companies within a group. SERs play a major role in corporate restructuring processes in the US market. SER IPOs account for a significant chunk of the IPO market as well. Other SER methods such as spin-offs also account for many of the corporate restructurings in developed markets. In the Indian context, one needs to discuss these available options within the framework of Indian law and corporate practices. The following discussion takes into account these aspects. Accordingly, corporate restructuring in the context of split-up is discussed herein to include even methods that are deployed to separate control and/or ownership so as to make two group companies standalone or at arm's length distance from each other. A study of all these methods is relevant from an investment banking point of view so as to enable the formulation of the best possible transaction strategy in a given situation.

As may be observed from Exhibit 14.3, there are several methods of a split-up both under the asset route and the equity route. In addition to the methods mentioned therein, based on statutory provisions and industry practices, it is possible to distinguish additional terms that are used to describe split-ups and variants thereof.

In larger schemes of corporate restructuring, a combination of internal and external restructuring methods is used to arrive at optimal solutions. In particular, schemes involving rehabilitation of financially distressed companies have complex modes of restructuring to address conflicting goals. In order to bring down the liabilities of the company, settlements are arrived at with creditors. To help the company to pay up its outstanding dues to employees and statutory authorities and to restart operations, suitable recapitalisation is provided for in the scheme along with financial restructuring. In order to improve business viability, a loss m1aking undertaking may be hived-off as a part of the same scheme. Such schemes which entail financial restructuring of a company by re-organising its capital structure are known as *arrangement* and *compromises* under the Companies Act. The word *arrangement* also includes a split-up. In cases where a split-up entails transfer of the entire business undertaking and consequent liquidation of the transferor company, such a

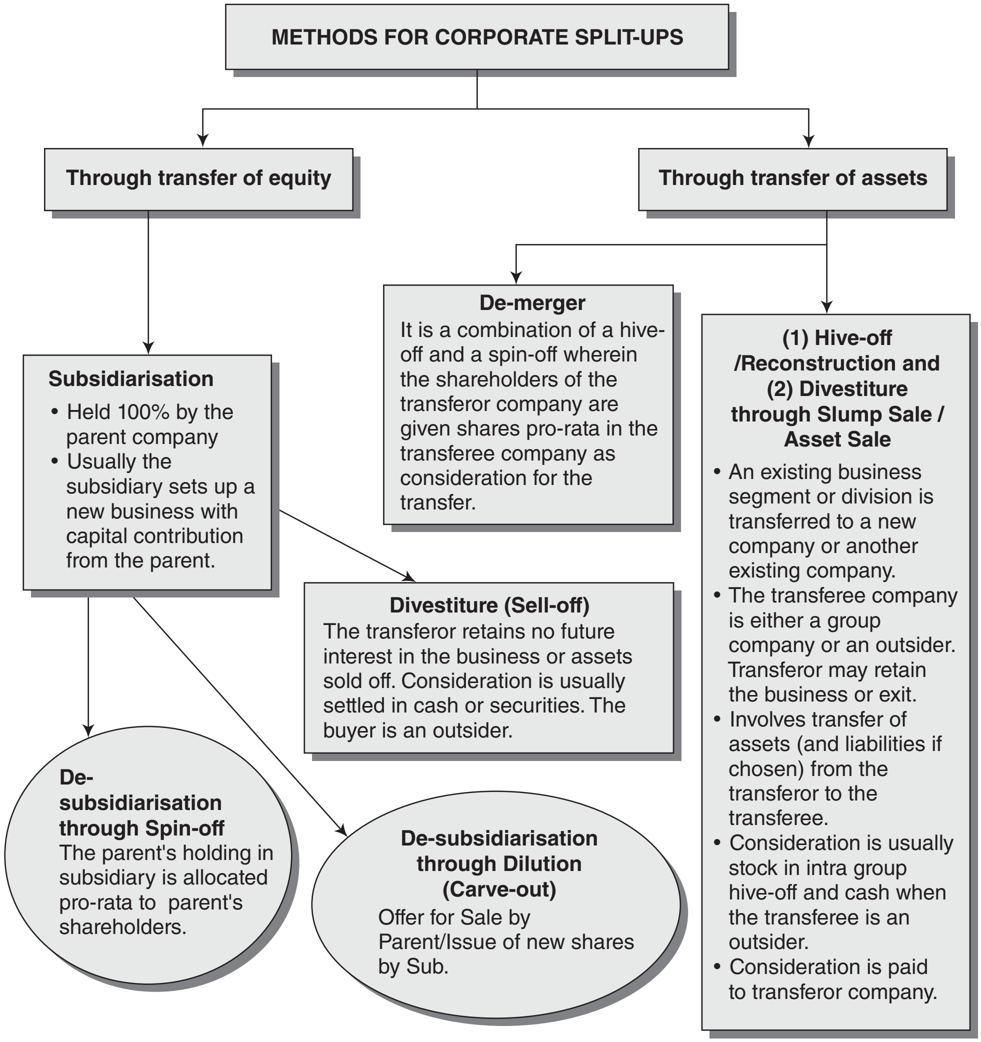


Exhibit 14.3 Types of Split-ups

scheme is known as *reconstruction* under the Companies Act. There could also be other variants such as a combination of restructuring and amalgamation of two or more companies. In such schemes of arrangement, reconstruction or amalgamation, a split-up strategy may even be used even in conjunction with an integration of companies.

Pure compromises with creditors or capital reduction relate only to financial restructuring which as stated earlier, are outside the scope of this discussion. This discussion is only in relation to schemes relating to external restructuring of a company. Therefore, for the purpose of clarity of thought, split-ups are being discussed presently in isolation and not in the context of a larger scheme of complex arrangement, reconstruction or amalgamation of a company. Accordingly, the methods for split-up are discussed in the subsequent paragraphs of this chapter while detailed discussion on amalgamations is provided in a subsequent chapter.

14.3 Split-up through Transfer of Assets

When a company begins to grow and diversify its business portfolio, structuring such diversifications is possible in two ways: (i) by setting up each business segment (vertical) as a separate division or SBU within the same company and (ii) by setting up each vertical in separate companies either as WOSs of the parent or as JVs, associates or strategic investments as may be appropriate. Conducting the business as a division of the parent would mean that it still remains a composite legal entity and gets integrated into a single balance sheet. However, corporatising a diversification would house the new business in a separate legal entity. Generally speaking, the natural choice is to grow organically within the same corporate structure rather than in separate subsidiary companies. This is due to the convenience of allocating capital among various business undertakings in the same balance sheet. It also obviates taking approvals from the board or the shareholders for such capital allocation under Section 186 of the Companies Act as well as related party transactions and disclosures which are necessary in a conglomerate structure. There are other onerous provisions such as Section 188 which can be avoided by adopting a diversified company structure instead of a conglomerate structure involving a holding company and its wholly owned subsidiaries.

However, at a later date, it is possible that a diversified balance sheet may act as a drag on the company due to various strategic, financial and operating reasons. It may then be necessary for a diversified company to restructure its businesses through an organic separation of its balance sheet. Therefore, at the outset, a split-up through transfer of a business undertaking or block of assets is required only in the context of a diversified company restructuring its balance sheet to facilitate: (i) conversion into a conglomerate structure on a going concern basis or (ii) exiting a particular business through a sale of business or a block of assets. In both the situations, a break-up of the existing balance sheet becomes necessary. This method of corporate restructuring is not necessary when a corporate business is already structured as a conglomerate.

Thus, the main objective of a split-up through transfer of assets and liabilities of a company is the break-up of the balance sheet of a company into two or more such balance sheets. However, the underlying objective for such a split-up can be understood in two broad contexts: (i) whether the split-up is envisaged on a *going concern basis* or (ii) on a *break up or liquidation basis*. A going concern split-up would be necessary to convert a diversified company into a conglomerate structure. A break-up or liquidation would be necessary only in the case of a divestiture of a business undertaking or a sale of a block of assets. In the former case, it is necessary to ensure that the split-up balance sheet gives rise to one or more independent balance sheets that are individual businesses that can be continued thereafter on a going concern basis. In the latter case, the business may be divested or the parent company's assets may be sold off by breaking up the business. This would lead to a liquidation of the company. It is, therefore, extremely important to contextualise a restructuring process at the initial stage itself so that the methodology to be applied is determined accordingly in a most transaction efficient manner.

Keeping in view the statutory framework in India and industry practices, split-up through transfer of assets can be divided into three broad methods: (i) *demerger*, (b) *hive-off*(reconstruction) and (c) *divestiture* through *slump sale* or anitemised *asset sale*. There are discussed in the following paragraphs.

14.4 Demerger of a Company

A demerger is a method of split-up of the balance sheet of a diversified company in the context of allowing the different businesses to continue to exist after the split-up on a going concern basis. Under a demerger, the balance sheet of a diversified company is split-up into two or more balance sheets representing the businesses that existed under the common balance sheet of the diversified company as separate SBUs. The process would give rise to independent companies representing the SBUs as separate legal entities. However, it is manner in which these independent companies are created and owned that differentiates a demerger from other similar methods.

As a result of the demerger, the shareholders of the diversified company are given direct representation in the business(es) that has been de-merged in the same proportion in which they hold shares in the parent. Therefore, instead of the consideration for the transfer of assets (being shares in the transferee company) being passed on to the parent (transferor) company, it is given as an issue of shares directly to the shareholders of the parent company. Effectively, this process would mean that a mirror image of the shareholding pattern that exists in the parent would be created for the business that has been de-merged. The business that has been transferred can be a new company or an existing company, which would be called the *resulting company.* The parent company thereby shrinks in size and is called the *demerged company*. The demerged company retains the same shareholding pattern but with a contracted balance sheet of its own. Demerger can be summed as an anti-thesis to a merger.

14.4.1 Definition of Demerger

Under the Indian law, demerger has statutory recognition both under the Companies Act and the IT Act. The IT Act, however, defines it more specifically under Section 2(19AA). As per this provision, a demerger should conform to *all* of the following conditions:[3]

- The demerger should be a scheme of arrangement under Sections 391-394 of the Companies Act (Section 230–232 of the Companies Act 2013). Essentially, these sections prescribe a process by which such schemes are sanctioned through the NCLT.
- All the property of the undertaking, being transferred by the demerged company, immediately before the demerger, becomes the property of the resulting company by virtue of the demerger.
- All the liabilities relatable to the undertaking, being transferred by the demerged company, immediately before the demerger, become the property of the resulting company by virtue of the demerger.
- The property and the liabilities of the undertaking or undertakings being transferred by the demerged company are transferred at values appearing in its books of account immediately before the demerger.
- The resultant company issues, in consideration of the demerger, its shares to the shareholders of the demerged company on a proportionate basis.
- The shareholders holding not less than three-fourths in value of the shares in the demerged company become shareholders of the resulting company by virtue of the demerger.
- The transfer of the undertaking is on a *going concern basis*.

De-merger is depicted in Exhibit 14.4. From the above definition and depiction, four important requirements have to be met for a transaction (reconstruction/arrangement/hive-off) to be designated as a demerger:

- It should be a scheme of arrangement under Sections 230–232 of the Companies Act to be sanctioned by the NCLT.
- It requires ratification by shareholders representing 75% of the paid-up capital of the company.
- It should be made at book value of assets and liabilities.
- Consideration should be through the issue of shares to shareholders of the transferor company. This issuance is based on a *share entitlement ratio*, i.e. the number of shares that a shareholder of the demerged

[3]In a 2012 judgement in the case of Indo Rama Textile Ltd., In re., the Hon'ble Delhi High Court held that satisfaction of all the conditions including transfer of all relatable assets and liabilities of the demerged undertaking was only a matter under IT law to ascertain the tax neutrality of the demerger but it shall not in any manner whatsoever, invalidate the scheme of arrangement as a demerger under company law.

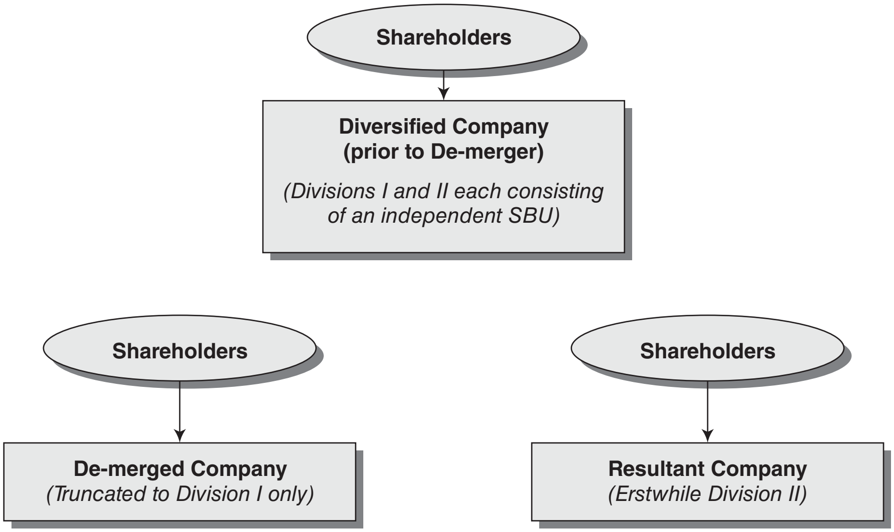


Exhibit 14.4 Anatomy of a Demerger

company is entitled to in the resultant company based on the shareholding held in the demerged company. It may be noted that the shareholder gets to keep shares in both companies.

14.4.2 Working of a Demerger

ILLUSTRATION 1

The following is the balance sheet of Brake Liners Limited, which has two divisions: (i) Brake division and (ii) Brake Liner Division. The company has to be broken up and the brake division is proposed to be demerged into a separate company by name Brake Up Limited. Brakeup Ltd. proposes to issue 1400 shares of ₹10 each as consideration for the demerger to the shareholders of Brake Liners Ltd. Immediately prior to the demerger, the balance sheet of Brake Liners Limited is as follows:

Liabilities	*Amt. ₹*	*Assets*	*Amt. ₹*
Share Capital Equity shares of ₹10 each	10,000	Net Fixed Assets	20,500
Reserves and Surplus		Investments	5,000
Capital Reserve	2,100		
Share Premium	2,500		
General Reserve	10,000		
P&L Account	1,900		
Long-term Borrowings	9,500	Current Assets	15,000
Current Liabilities	6,000	Miscellaneous Expenditure	1,500
Total	**42,000**	**Total**	**42,000**

The assets and liabilities specifically attributable to the brake division are as follows:

Liabilities	*Amt. ₹*	*Assets*	*Amt. ₹*
		Net Fixed Assets	14,800
		Investments	1,200
		Current Assets	8,600
Current Liabilities	2800	Miscellaneous Expenditure	0
Total	**2,800**	**Total**	**24,600**

Prepare the demerged balance sheets of both the companies taking into consideration that Brakeup Ltd. would be issuing shares of ₹10 each fully paid as consideration for the demerger.

Solution

Since the respective assets and specific liabilities of Brakeup Ltd. have been identified, the task is to look at those liabilities that are not specifically attributable to the demerging brake division. These are long-term borrowings and reserves. The reserves contain accumulated profits of the entire company. It is obvious that the company does not maintain divisional accounts and cannot, therefore, ascertain divisional profits. Even if divisional reserves are ascertainable, the reserves of the company are never demerged.

As far as other general external liabilities are concerned, according to the provisions of the IT Act, the non-specific liabilities shall as such be apportioned in the ratio of assets being demerged.

The share of Brakeup Ltd. in the non-specific liabilities is:

Long-term Borrowings (in the ratio of fixed assets) – $(14800/20500 \times 9500) = 6859$

Based on the above computations, the balance sheet of Brake up Ltd. would appear as follows immediately after the demerger.

Liabilities	*Amt. ₹*	*Assets*	*Amt. ₹*
Share Capital Equity shares of ₹10 each	14,000	Net Fixed Assets	14,800
Reserves and Surplus Capital Reserve*	941	Investments	1,200
Long Term Borrowings	6859	Current Assets	8,600
Current Liabilities	2800		
Total	**24,600**	**Total**	**24,600**

**Note: Capital Reserve in Brake Up Limited's balance sheet represents the Net Asset Value of the assets and liabilities demerged. This has been arrived at after proportionate allocation of the long-term borrowings by treating it as a general liability. It is also possible that the entire long-term borrowings may be assumed by Brake Liners Ltd. which is normally the case when lenders do not agree to be moved from the original balance sheet. The scheme of demerger would normally provide for the liabilities being demerged and the balance sheet is worked out accordingly.*

The demerged balance sheet of Brake Liners Ltd. would appear as follows:

Liabilities	*Amt. ₹*	*Assets*	*Amt. ₹*
Share Capital** Equity shares of ₹10 each	10,000	Net Fixed Assets	5,700
Reserves and Surplus P&L Account***	 1,559	Investments	3,800
Long-term Borrowings	2,641	Current Assets	6,400
Current Liabilities	3,200	Miscellaneous Expenditure	1,500
Total	**17,400**	**Total**	**17,400**

***Note: Usually, the share capital of the demerged company is not reduced to reflect the truncated balance sheet. However, if such adjustment is envisaged it must be provided for in the scheme and sanctioned by the NCLT as it amounts to a capital reduction. In the absence of any information with regard to the same, the share capital of the demerged company is kept intact and the difference in assets and liabilities transferred to Brakeup Ltd. has been adjusted against the reserves. It may be noted that there is no separate accounting treatment prescribed for demergers under I-GAAP presently. Therefore, the scheme of demerger usually prescribes the elaborate accounting treatment envisaged both in the demerged and the resultant companies.In future, if a specific treatment emerges under I-GAAP for demergers, the above illustration should be construed accordingly.*

****Note: The P&L Account balance represents the residual reserve after adjustment of the NAV of assets remaining with the demerged company. The manner and order of such set-off is usually specified in the scheme of demerger. It may be noted that securities premium account may also be debited as provided in the scheme read with Sections 52 and 66 of the Companies Act and as further confirmed by the NCLT.*

14.4.3 Further Conceptual Aspects of Demergers

- A demerger may be made of a business undertaking of an existing company either to a new company formed for this purpose or to another existing company. In the former case, the resultant company would be a new company formed for the specific purpose of receiving the demerged division. For example, Wipro proposed to demerge its non-IT business undertakings into a shell company which was proposed to be renamed as Wipro Enterprises. Similarly, the demerger of the cement division of L&T was made to a new company called Ultra Tech Cement. GESCO Corporation was formed out of the demerger of the real estate division of Great Eastern Shipping. Such demergers which involve transfer of business undertakings to a new company are known as *plain vanilla demergers*. Share swap ratio in a plain vanilla merger is inconsequential since the resultant company is a new company and can as such be organised to the convenience of the parties. In several demergers of this kind, the scheme specifically provides that there shall be no purchase consideration payable by the resultant company to the demerged company.

Case Study

Demerger of Tower Business by IVRCL to its Wholly Owned Subsidiary

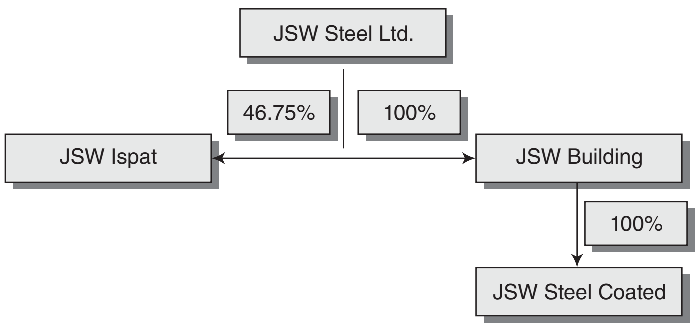
IVRCL Ltd., a listed company proposed a composite scheme of demerger whereby it would restructure its business segments in separate group entities so as to make the company unattractive for hostile bids. As a part of the scheme, it was envisaged that the tower manufacturing business undertaking of the company be demerged to its WOS. Therefore, this part of the scheme was a plain vanilla demerger. Accordingly, the scheme specified no issue of shares by the resultant company to the demerged company (IVRCL) in these words, "The resulting company 2 is a wholly owned subsidiary company of the Amalgamated Company (IVRCL). The scheme is intended to restructure the Tower Undertaking within the Group controlled by the Amalgamated Company in a more efficient manner consistent with the diverse needs of business and does not involve any movement of assets or liabilities to any company outside the Group controlled by the Amalgamated Company. Hence, the resulting company 2 shall not issue any shares or pay any consideration to the Amalgamated Company or to its shareholders."

- In contrast to the above, a demerger may also be made of a business undertaking wherein the resultant company is an existing company. This may be necessary in two contexts: (i) when the business portfolios within existing group companies need to be realigned and (ii) when there is a divestiture proposed to a third party. In such demergers, the resultant company already has a business activity of its own and the demerger will result in adding to its balance sheet. Such demergers are known as *composite demergers*. Composite demergers are more complex to accomplish as the process of valuation of the transferee company is involved in order to fix the share swap ratio.

Case Study

JSW Group

JSW group of companies presented a composite intra group scheme of arrangement that involved two demergers and a merger.



The scheme involved transfer of business undertakings from JSW Ispat Steel Ltd. to JSW Steel Ltd. and from JSW Steel to JSW Steel Coated Products Ltd. In the same scheme, JSW Ispat Steel and JSW Building Systems were proposed to be merged with JSW Steel. Thereafter, JSW Steel would be the flagship company with JSW Steel coated as its 100% subsidiary.

In the demerger of undertakings, no consideration was proposed from the transferee companies to the transferor company. This is because the scheme also envisaged a simultaneous merger of one of the transferor companies with the transferee and the second transferor company was becoming a 100% subsidiary of the transferee.A share swap was proposed only for the merger of JSW Ispat with JSW Steel.

- From an ownership perspective, demergers may be accomplished in full or in a structured manner, in that the shareholding of the resultant company may entirely be identical to that of the demerged company or otherwise. If both the demerged company and the resultant company become identical in their ownership structure, it would be known as a *vertical demerger*. However, if the demerger of ownership is not done in its entirety, the shareholding pattern of the resultant company will not be identical to that of the demerged company. Such demergers are also known as *structured demergers*. These demergers are discussed further in the subsequent paragraph.

- Demergers may also be differentiated in terms of the extent of business undertakings being demerged. If only a particular business/division or SBU is being demerged and the rest of the demerged company proposes to continue its operations as before, it is known as a *partial demerger*. In a partial demerger, the demerged company continues to exist and only the demerged business undertaking is transferred to the resultant company. Unlike a partial demerger, it is also possible in a scheme of demerger to demerge the entire business of a company to the resultant company. This type of a demerger is known as a *complete demerger*. In a complete demerger, the demerged company is reduced to a shell which could then be wound up without dissolution by the High Court as a part of the scheme itself or separately through a shareholders' resolution to that effect for its voluntary winding up. However, a complete demerger is more in the nature of a *reconstruction* of a company and does not exactly resemble the context of a demerger. A demerger is resorted to when businesses have to be realigned or divested. A reconstruction is necessary to give a struggling business a new lease of life in a separate balance sheet. The birth of New General Motors from the bankruptcy proceedings of the erstwhile General Motors is a classic example of a reconstruction or complete demerger. Reconstruction is discussed further in Section 14.5.
- Demergers may be accomplished either through a scheme of arrangement under Sections 391–394 of the Companies Act or through an agreement of slump sale with the resultant company (known as a *business transfer agreement or BTA*). A company may enter into a BTA by passing a resolution under Section 180(1)(a) of the Companies Act. A BTA may provide for all the terms that are identical to a scheme of demerger comprising of: (i) transfer of all the assets of the business undertaking being envisaged for demerger, (ii) transfer of relatable liabilities of such business undertaking and (iii) issue of shares by the resultant company to the shareholders of the demerged company as consideration. The implications of a slump sale vis-a-vis a scheme of demerger are discussed in Section 14.6.
- With the introduction of provisions relating to demergers in the IT Act, demergers became the most preferred way of corporate restructuring involving a split-up through transfer of assets. Demergers provide *tax neutrality* for such split-ups and, therefore, became the most common method of corporate restructuring involving transfer of business undertakings. Several large demergers in the Indian corporate sector such as that of Great Eastern Shipping Limited, Reliance Industries Ltd., Indian Rayon's cement division, Grasim's cement division, TV 18 group, Pantaloon Retail, Wipro etc. were conducted in recent years. One of the most elaborate demergers in terms of value and diversity was done by Reliance Industries Ltd. when it made a four-way de-merger of its strategic businesses in telecommunications, finance and energy sectors. A summary of Reliance Industries Ltd.'s scheme of demerger is provided at the end of this chapter in Annexure 3.

Structured Demerger

A '*structured demerger'* occurs when a demerger is not done in its entirety as in the case of a vertical demerger. It may be appreciated from the definition provided under Section 2(19AA) of the IT Act *(supra)* that the definition provides a leeway of upto 25% for the resultant company to bring in shareholders other than those of the demerged company. Therefore, a demerger can be made in such a way that it is possible for the parent company to directly hold upto 25% of the share capital in the resultant company. The balance of 75% may be held by the shareholders of the demerged company in proportion to their holdings in the demerged company.

It may be noted that a structured demerger can also be made in any other combination of shareholding in the resultant company between the demerged company and its shareholders. However, if such ratio results in the direct stake of the demerged company being more than 25%, the demerger would not be treated as a demerger under the IT Act. A well-publicised case on a structured demerger is that of L&T's demerger of its cement division to a new company called UltraTech Cement. An analysis of this case is provided at the end of this chapter in Annexure 1.

Case Study

ILLUSTRATION 2

Carrying forward the example furnished in Illustration 1, as per the scheme envisaged therein, Brakeup Ltd. would issue 1400 shares of ₹10 each to the shareholders of Brake Liners Ltd.

However, if this were a structured demerger wherein 50% of the resulting company would be held directly by the shareholders of Brake Liners Ltd. and Brake Liners Ltd. would hold the balance, the following picture would emerge. The shareholders will receive 7000 shares in Brakeup on a proportionate basis and the rest would be allotted to Brake Liners as the corporate shareholder of Brakeup.

Brake Liners has to record investment in Brakeup Ltd. to the extent of its 50% shareholding therein. The balance sheet of Brake Liners Ltd. after the demerger would also undergo a change and will appear as follows:

Liabilities	*Amt. ₹*	*Assets*	*Amt. ₹*
Share Capital Equity shares of ₹10 each	10,000	Net Fixed Assets	5,700
Reserves and Surplus		Investments	3,800
Capital Reserve	2100	Shares in Brake-up Ltd.	
Share Premium	2500		7,000
General Reserve	2,059		
P&L Account	1,900		
Long-term Borrowings	2,641	Current Assets	6,400
Current Liabilities	3,200	Miscellaneous Expenditure	1,500
Total	24,400	Total	24,400

14.5 Other Business Hive-Offs/Reconstruction

A hive-off of a business undertaking is also possible without complying fully with the conditions of a demerger as stipulated under the IT law. This would amount to a *hive-off not amounting to demerger*. The basic objective in such a hive-off is to separate businesses that are distinct from other businesses in the company and wherein a new strategic interest needs to be created or existing interest has to be removed. Generally, in such hive-offs, strategic intent is more important than tax neutrality. The following could be some of such strategic objectives:

- Sometimes, a hive-off may be made to an existing group company in order to realign business interests within the group or to refocus the business portfolio of the parent (transferor) company.
- A hive-off into a new company may be initiated to introduce new strategic interests such as a JV or a technology partner into the separated business undertaking.
- A hive-off into a newly created WOS could result in subsidiarisation of the transferred business undertaking. In other words, the diversified structure of the parent company is converted into a

conglomerate structure with a holding company and its wholly owned subsidiary. This type of a hive-off is discussed further in Section 14.5.3.

- Hive-offs may also be used as the first step towards a *divestiture.* A divestiture is a sell-off or exit from a business activity that is no longer considered core to the business along with its business undertaking. In such a case, the hive-off could be a direct sale from the transferor company to the transferee company whereby the divested division is hived-off into an existing or new company belonging to the acquirer. In other cases, it could be a two-stage process wherein at the first stage, the hive-off is made to a new company belonging to the seller. At the second stage, the equity in the transferee company is divested in favour of the acquirer. Divestitures are usually settled in cash consideration by the acquirer to the transferor company since there is not intent to continue the business or to have any relationship with the transferee company or the purchaser of the divested business and its assets.

Case Study

Demerger of Tower Business by IVRCL (Contd.)

In the IVRCL demerger scheme (supra), it has already been mentioned that no issue of shares was envisaged by the resultant company to the demerged company. In addition, the scheme also provided for the accounting treatment to be done differently from what was prescribed in the IT Act. The scheme stated that in the books of the resulting company, the assets and liabilities being transferred would be recorded at their respective fair values, as may be determined by the Board. The net asset value (being the difference) would be credited to a *Business Restructuring Reserve*. In the books of the demerged company, the assets and liabilities being transferred under the scheme would be recorded at their book values and the difference thereof (the net book value of assets) would be debited to *Capital Reserve Account*. Obviously, this treatment was resorted to since the book value of the net assets being transferred was negative and the resultant company did not wish to record them that way.

Since this demerger did not satisfy the requirements of the IT Act on demerger, the scheme was silent on the compliance aspect. It was a composite scheme involving two demergers and an amalgamation. While the scheme specifically commented on the tax compliance of one demerger and the amalgamation, it was silent on the compliance aspect of the demerger of the tower manufacturing undertaking. Therefore, this part of the transaction was a hive-off accomplished under Sections 391-394 of the erstwhile Companies Act 1956 and since it did not comply with the requirements of a demerger, the benefits envisaged under the IT Act would not have been applicable to it.

Case Study

Jaiprakash Associates Ltd.

Jaiprakash Associates Ltd. (JAL) is a diversified listed company with varied business interests in construction, cement, heavy engineering, castings, hospitality, real estate etc. It had cement plants across the country in various locations. As a part of a restructuring strategy to improve the financial performance of the company, deleverage and grow, a demerger scheme was envisaged to transfer its western and southern India cement plants, heavy engineering business and asbestos business to a group company named Jaypee Cement Corporation Ltd. (JCCL) which was a non-operational company used for this purpose And JCCL was setting up its first cement plant in Karnataka. According to the disclosures provided by the company, the demerger was intended to benefit both the companies with focused management, better penetration of cement market in western and southern India and make it flexible to tap opportunities, raise funds and grow.

The consideration for the demerger was structured entirely in cash of ₹4030.98 crore to be paid within six months of the sanction of the scheme or such other extended periods of time as agreed to. Till such time the consideration was unpaid, it was to be treated as an unsecured loan from the demerged company to the resultant company. It was also provided in the scheme that the resultant company would record the assets and liabilities received from the demerger at their fair market value. There was no share allotment contemplated under the scheme from the resultant company. The net result of the demerger was to be recognised as goodwill or capital reserve in the books of the resultant company. The demerged company was to reduce assets and liabilities at book values and the net result was to be recorded as *demerger reserve account*. The business valuation of the demerged undertakings was conducted by an independent chartered accountant and a fairness opinion on it was obtained from a SEBI registered merchant banker. The auditors of the company certified the accounting treatment to be in compliance with accounting standards prescribed under law. There was no mention in the scheme about tax benefits as it was not compliant with the provisions of a demerger under Section 2(19AA) of the IT Act.

It appears that the scheme was meant to generate cash for the heavily leveraged JAL to help it to reduce some of its debt burden. However, it was not evident wherefrom the cash to be paid by JCCL was proposed to be generated. The recording of transferred assets and liabilities in the books of the resultant company at their fair market value and not at book value was also intentional to provide a bankable balance sheet to JCCL so that it could raise funds. Since JCCL was implementing a big project, it was necessary to improve its net worth through the scheme. This was a scheme of a business hive-off through a scheme of arrangement not amounting to a demerger.

A similar case study on hive-off of a business undertaking under Sections 391-394 of the erstwhile Companies Act, 1956 involving Indian Rayon and Industries Limited (renamed as Aditya Birla Nuvo Ltd.) is provided at the end of this chapter in Annexure 2.

14.5.1 Reconstruction

If a hive-off is made in such a way that the transferor company transfers all its business undertaking(s) to a new company formed for this purpose and in the process, the transferor company is dissolved, it amounts to a *reconstruction*. A reconstruction is possible in two ways: (i) the transferor company is dissolved by passing a special resolution for members' voluntary winding up and authorising the Company liquidator under Section 319 of the Companies Act to transfer the business undertaking of the transferor company to the transferee company or (ii) a scheme of arrangement under Sections 230–231 of the Companies Act (Sections 391–394 of the erstwhile Companies Act 1956) whereby the business undertaking(s) of the transferor company is completely transferred to the transferee company and the transferor company is dissolved by the Court without winding up. In practice, however, reconstructions under Section 319 are extremely rare and reconstructions under a scheme of arrangement under Sections 230–231 are more commonly used. A reconstruction is resorted to in the context of a company under financial distress or for continuing an existing business in a new corporate entity to avoid legal disputes that could arise in the existing legal entity. It is also possible that a reconstruction is formulated under a scheme of rehabilitation by the IBBI.[4]

[4]Insolvency and Bankruptcy Board of India.

14.5.2 Demerger and Other Business Hive-Offs Distinguished

At this time, it is essential to appreciate the transactional and legal nuances of a demerger vis-a-vis a hive-off not amounting to a demerger of a business undertaking.

- Firstly, all corporate restructuring transactions involving transfer of a business undertaking from one company to another are essentially hive-off transactions. However, a hive-off is not statutorily defined anywhere in the Companies Act and is a generic corporate finance term that connotes the above said meaning. A demerger is merely a special form of hive-off specifically envisaged under the IT Act for the purpose of providing tax neutrality in corporate restructuring transactions. It requires continuance of the demerged business without change in ownership structure to the extent of at least 75%. In short, *shareholder carry* is a must under the IT Act as the transaction should preserve ownership of the transferred undertaking. It should not amount to a transfer. Therefore, all hive-offs of business undertakings that satisfy the conditions prescribed under the IT Act are demergers. It goes to say that while all demergers are essentially hive-offs of business undertakings, all such hive-offs do not amount to demergers.
- Normally, in a hive-off, the transferor company is paid the purchase consideration by way of shares of the transferee company or in cash or other consideration as mutually agreed to between the parties. Generally, in intra group hive-offs since the transferee company is a group company, the transaction is made cash neutral and the purchase consideration is settled through shares of the transferee company or in some cases no consideration is stipulated as in the JSW case *(supra)*. In the event the hive-off is a divestiture, the purchase consideration is generally cash or cash equivalent securities. In either case, the shareholders of the transferor company are not made the recipient of the purchase consideration. However, demerger is characteristically different from a regular hive-off in this respect. As envisaged under the IT Act, a demerger is essentially in the nature of *de-pooling of interests* to facilitate continuance of the respective businesses in separate legal entities within the same majority ownership structure. Therefore, the IT Act envisages that in a demerger the majority ownership should be preserved by making the shareholders of the transferor company directly the shareholders of the resultant company. Accordingly, the purchase consideration is settled with the shareholders of the transferor company and not the transferor company per se.
- A demerger has to necessarily be carried out only as per a scheme of arrangement under Sections 230–231 of the Companies Act due to the express provisions of the IT Act. In contrast, a business hive-off can be carried out in any of the three ways: (i) Under a scheme of arrangement under Sections 230–231 of the Companies Act, (ii) through a resolution passed by the members under Section 180(1)(a) of the Companies Act and (iii) by empowering the official liquidator under Section 319 in a members' voluntary winding up. It may, thus, be observed that hive-offs and reconstructions need not always be judicial or quasi-judicial processes since they can also follow the routes provided under (2) above. However, demergers within the meaning of the IT Act require confirmation of the NCLT under Sections 230–231 of the Companies Act without exception.
- Under the express provisions of the IT Act, a demerger has to be necessarily carried out at book values appearing in the books of the demerged company immediately before the demerger. Revaluation reserves, if any, in the books prior to the demerger have to be ignored for this purpose. However, a hive-off of a business undertaking using any of the routes available under the Companies Act (*ibid*) does not have to necessarily follow such stipulation. Accordingly, a hive-off can be structured at negotiated values for assets and liabilities or through a lumpsum consideration. It can be settled in cash or other securities as found feasible.
- A demerger is bestowed with tax neutrality due to the specific exemptions provided under the IT Act. This includes the benefit of carry forward of losses and unabsorbed depreciation of the demerged

company by the resulting company (Section 72A), capital gain exemptions for the demerged company and its shareholders (Section 45 read with Section 47). Special tax holidays, if any, enjoyed by the demerged company will be allowed to the resultant company. These benefits would not be available to other schemes of hive-offs not amounting to demergers or those envisaged under the other available statutory mechanisms as explained above. Due to this reason, it is found that if tax considerations such as carry forward of losses or avoidance of capital gains tax are the primary drivers to the transaction, hive-offs are structured as demergers. If strategic issues are more important, a hive-off may be structured as acceptable to both parties and in a legal mechanism not involving a court process.

14.5.3 Subsidiarisation through Demerger/Hive-off

Under this method, the demerger/hive-off happens into a wholly owned subsidiary of the transferor company. Such subsidiary could be an existing company with or without any business activity or a new company formed exclusively for this purpose. Essentially, subsidiarisation through a hive-off entails transfer of business undertaking from the holding company to its subsidiary. This method is usually resorted to for the purpose separation of a business activity or for inviting strategic or financial partners into the divisional activity.

A subsidiarisation through a demerger/hive-off also serves another important purpose, i.e. to provide an efficient platform for an eventual exit from a business. At the first stage, the hive-off is made into a WOS and thereafter, the shares of the subsidiary are divested. Alternatively, the parent's holding in the subsidiary is diluted to bring in the acquirer. This type of a mechanism is efficient from a tax, stamp duty and corporate law perspective. The subsidiarisation by transfer of undertaking can be made in a scheme of arrangement under Sections 230–231 of the Companies Act or through a slump sale by passing necessary resolution under Section 180(1)(a) as already discussed in preceding paragraphs. This is possible because of the immunity available under Section 47 of the IT Act for transfers made by a holding company to its wholly owned subsidiary. Therefore, the hive-off need not comply with the provisions of a demerger.

In the past several restructurings, included a process of subsidiarisation through hive-off such as the Voltas restructuring or Ponds India's hive-off to Ponds Exports Ltd. In the Axis Bank acquisition of Enam Securities, the investment banking arm of Enam being acquired by Axis bank was simultaneously demerged to its subsidiary (Axis Capital) in a composite scheme (for details refer to Chapter 5).

Case Study

TCS

When Tata Sons Limited, the owner of TCS division, wanted to subsidiarise the division, it acquired along with its group shareholders, the entire shareholding of an existing company called RR Donnelley (India) Private Limited and changed its name to Tata Consultancy Services Limited (TCS Ltd.) and made it a subsidiary wherein Tata Sons held 90% and the rest by the promoter group. Thereafter, Tata Sons Limited filed a scheme of hive-offunder Sections 391–394 of the Companies Act 1956 for the transfer of the TCS Division to TCS Limited with the High Court of Judicature at Bombay on December 17, 2002. Thereby the entire IT services undertaking of Tata Sons became the property of TCS Limited. The consideration for the hive-off was to be settled in cash. In order to raise cash, TCS Ltd. was taken public. In order to ensure payment to Tata Sons, it was provided that the scheme of hive-off would not be effective until the underwriting agreements for the IPO were executed.

Prior to the subsidiarisation of the TCS division, it was also essential for Tata Sons to consolidate all its IT services into the TCS division, so as to realise maximum value for the subsidiary. Therefore, Tata Sons' entire holding of 51.12% of the equity share capital of CMC Limited was also transferred to TCS Limited. The total consideration paid by TCS Limited to the TCS Division for this transfer was ₹3,799.0 million. The TCS Division made a loan of ₹3,750.0 million to TCS Limited. This loan was utilised by TCS Limited for acquiring the CMC shares. This loan was extinguished upon the hive-off of the TCS division to TCS Ltd.

Case Study

Jindal Group

Jindal Strips Ltd. (JSL) put forward a plan to hiveoff its investments in group companies, Jindal Steel and Alloys, Jindal Holdings and the US firm Massilon into a separate company. The move for de-subsidiarisation was to create a capital structure that would help JSL in its future plans. JSL had a total debt of ₹750 crore and the efforts were to bring down the cost of capital to below 10% from 13.7%. The company's earlier plan of selling off its subsidiary Jindal Steel and Alloys to its group company Jindal Iron and Steel did not meet the favour of the lenders. (Economic Times 9th Jan 2003). Jindal Strips also announced a restructuring whereby its stainless steel business would be demerged into a new company Jindal Stainless while Jindal Strips would be made a holding company to manage the company's businesses and investments. Jindal Stainless would make a bonus issue to help its shareholders to regain their previous level of holdings.

Case Study

Marico Ltd.

Marico Ltd. subsidiarised its skin care division that operated under the Kaya brand into its wholly owned subsidiary Marico Kaya Enterprises Ltd. in a scheme of arrangement on a going concern basis. The subsidiarisation was done with the strategic objectives of providing better focus, value unlocking and extraction and fund raising. The skin care division had grown considerably and was becoming an important vertical for group interests distinct from the FMCG business of Marico.

The subsidiarisation was structured as a tax compliant vertical demerger and Marico Kaya issued shares in consideration for the demerger. Once the demerger was effective, the shareholding structure of Marico Kaya mirrored the shareholding structure of Marico.In the process, Marico Kaya was listed without an IPO by virtue of the scheme of arrangement under the provisions of SEBI Regulations for such backdoor listing.

By opting to subsidiarise the skin care business through a demerger, Marico achieved tax neutrality and also made the subsidiary compliant with minimum public shareholding norm so as to be eligible for listing. Though these objectives could have also been achieved through a hive-off under a scheme of arrangement, there was no such necessity as the situation was perfect for a tax compliant demerger. The market reacted very positively to the proposal to demerge the skin care business.

Case Study

Welspun Corp (WCL) Subsidiarisation

WCL is the flagship Company of the B.K. Goenka promoted Welspun Group. The Company before its demerger was a diversified company for businesses ranging from pipes, steel, oil and gas and energy to several others. The other businesses were mainly EPC contracts conducted through subsidiaries and joint ventures. WCL was listed on both NSE and BSE, its GDRs and FCCBs were traded in Singapore. It had a wholly owned subsidiary by name Welspun Infra Enterprises Ltd. (WIEL) which was incorporated to facilitate the demerger with the main object of providing infrastructure related services.

The scheme of demerger envisaged the split of the Demerged Company (ECL) by transferring its Other Business Division to WIEL (resultant company) which included transfer of WEL's investments in its other business subsidiaries also to WIEL. The scheme which was designed as a tax compliant demerger, was envisaged to provide better focus and independent growth for the Other Business Division as also to enable each company to focus on its own fund requirements and growth.

As per the terms of the scheme, a share entitlement ratio was fixed for allotment of shares by the resultant company to the shareholders of the demerged company. To facilitate this share issue, the scheme provided for the automatic increase in the authorised share capital of the resultant company. The share entitlement included GDR holders as well who were to be allotted additional GDRs as per the same entitlement ratio. The scheme also provided that in the event the FCCB holders opted for the share entitlement, the FCCBs would at first be converted into shares and thereafter additional shares would be issued as per the entitlement ratio. In the event of non-conversion, the FCCBs were to be redeemed by the demerged company. The scheme disallowed any liability for the resultant company on account of the FCCBs.

A subsidiarisation is also possible through a slump sale by a holding company to its subsidiary. A slump sale is discussed in the next paragraph.

14.6 Slump Sale/Asset Sale

In certain cases of restructuring that involve hive-off or divestiture of a business undertaking, the seller usually disposes off the entire business undertaking through a *slump sale*. A slump sale is a concept associated with the IT Act. As per the definition provided by Section 2(42C) of the IT Act, *slump sale means the transfer of one or more undertakings as a result of the sale for a lump sum consideration without values being assigned to the individual assets and liabilities in such sales.* As the definition connotes, a lumpsum consideration is fixed for the entire block of assets and liabilities of the business undertaking being divested including sometimes its intangible assets such as brands, patents and licences without fixing individual values to each asset or block of assets. Such a transaction is known as *slump sale*. Slump sales facilitate easier determination of tax and accounting issues unlike assignment of individual values to assets and liabilities to arrive at the net value being transferred. It also facilitates easier negotiation between parties. If a divestiture is made through a hive-off with a slump sale consideration, the purchase consideration received by the transferor company would be reckoned as the sale value and the net asset value of the business undertaking divested is considered as the cost of acquisition under the IT Act for determination of capital gain tax liability. A slump sale is, therefore, a convenient method of arriving at purchase consideration in a restructuring in the nature of a divestiture. However, a slump sale need not be the only method to arrive at the purchase consideration.A divestiture may also be structured based on individual assets and liabilities and valuation thereof to determine the purchase consideration though such a process could be cumbersome and tax unfriendly. A slump sale is accomplished through a resolution passed under Section 180(1)(a) of the Companies Act. It is not a quasi-judicial process. It is accomplished through the execution of a Business Transfer Agreement (BTA) by the concerned companies. A slump sale made by a holding company to its 100% subsidiary would be tax neutral under Section 47 of the IT Act. A slump sale made to any other person including a non-100% subsidiary is taxable as a slump sale.

Case Study

Piramal's Slump Sale to Abbot

Piramal Healthcare Ltd. is a listed company and had 47.9% public shareholding at the time of this transaction.It divested its domestic formulations division to Abbott Healthcare Pvt. Ltd., the Indian subsidiary of Abbott Labs USA structured through a slump sale by way of a business transfer agreement in 2010. The deal consideration was agreed at USD 3.72 billion including a fee of ₹350 crore for non-compete obligation for eight years. It was an all cash deal with a staggered payment structure to be financed entirely with cash on the balance sheet. The deal price translated into a premium of 70% over the ruling market price. The demerged division constituted about 55% of the company. Piramal envisaged using the cash to retire debt and increase R&D spend for its own business.

The slump sale was accomplished by virtue of a resolution passed under Section 293(1)(a) of the Companies Act, 1956. The alternative structure would have been to use the demerger route to separate the divested business into Abbot India or into a separate Abbot group company. Demerger would have meant tax neutrality for Piramal. Slump sale meant long term capital gain tax (estimated at ₹3800 crore) and any distribution of the cash received from Abbot to its shareholders would have attracted Dividend Distribution Tax (DDT)as well. Furthermore, slump sale also attracted stamp duty on the BTA. Therefore, the question emerges as to why the demerger route was not used in this case. The following reasons can be pointed out in justification of a slump sale though it meant a steep tax liability for Piramal:

- Demerger is a time consuming judicial process. Usually in an M&A context, time is of essence. Demergers are more appropriate for internal reorganisations without tax implication.
- In all cash deals involving divestitures, demergers are inappropriate as they involve shareholder carry.
- Since the consideration is received in cash, it does not require additional liquidity on the balance sheet of the seller to pay tax.
- Since the seller is listed in this case, either the demerged business would have required listing under the scheme or the public had to be provided a cash exit by the buyer.

Another remote possibility would have been for Abbot to acquire Piramal Healthcare. This would have been unworkable in this case since it meant a takeover of the seller:

- Piramal would have had to completely exit the healthcare business.
- Abbot would have had to make an open offer to the public.
- The character of the transaction would have got transformed which may not have aligned with the strategic objectives of the deal and the intentions of the buyer and seller.

Numeric Power's sale of its UPS division to Legrand for ₹837 crore was done for a valuation purely attributable to this division, as it contributed almost the whole of the company's turnover of ₹530 crore. The deal also included a non-compete fee. Other such companies following the slump sale route included Kanoria Chemicals and Laffans Pharmaceuticals among others.[5]

[5]As reported by The Economic Times dated 11th and 14th Feb 2012

14.6.1 Asset Sale

Companies, sometimes, resort to disposal of redundant or surplus assets. Such transactions amount to an *'asset sale*. While divestitures through hive-offs/slump sale are larger strategic transactions involving entire business undertakings, itemised asset sales can be for more ordinary purposes such as providing liquidity to the company or for the repayment of debts. Several companies that are in a financial distress often resort to asset sales to generate liquidity and reduce leverage. Recent examples included the UB group, Future group, Suzlon, Wockhardt group, Nokia, etc. Companies may also resort to asset sales to unlock value in their surplus assets. For example, the sale of surplus office properties by Britannia, development of surplus land by the Godrej group, monetisation of land parcels through development of construction projects by L&T Realty etc.

14.7 Listing of Resultant (Transferee) Company

Consequent to the demerger of a listed company under Sections 230–232 of the Companies Act, it is possible that the transferee company gets listed since the public shareholding of the transferor company may have to be replicated in the transferee company. In such a case, Section 232(3) of the Companies Act provides that the transferee company shall remain an unlisted company until it becomes a listed company by seeking SEBI approval and complying with SEBI (LODR) Regulations. Dissenting shareholders need to be given exit in cash or other terms as decided by the adjudicating authority according to SEBI pricing regulations.[6]

On the contrary, if the scheme specifies that the resultant company shall be listed, after the confirmation of the scheme by the NCLT, the resultant company should apply to SEBI to get itself listed without there being an IPO. This type of back door listing is possible for an unlisted company to get listed in compliance with clause (b) to sub-rule (2) of Rule 19 of the Securities Contracts (Regulation) Rules, 1957 by making a suitable listing application to the designated stock exchange and complying with other requirements for listing in terms of the listing agreement.[7] The following are some of the important provisions:

- Shares have been allotted by the unlisted company (transferee company) to the holders of securities of a listed company (transferor company) pursuant to a scheme of arrangement/reconstruction under the provisions of Section 230–234 of the Companies Act, 2013 and such scheme has been sanctioned by the NCLT.
- The listing of the shares of the unlisted transferee company is in terms of scheme of arrangement sanctioned by the NCLT.
- Atleast 25% of the paid-up share capital, post scheme, of the unlisted transferee company seeking listing comprises shares are allotted to the public holders of shares in the listed transferor company.
- The unlisted company has not issued/reissued any shares, not covered under the scheme.
- A valuation report from an independent chartered accountant will be required except in schemes wherein the resultant company mirrors the shareholding of the demerged company. A scheme of hive-off that does not fulfill this requirement in preservation of shareholding pattern will require independent valuation report. A fairness opinion from another independent chartered accountant or merchant banker will also be required.
- An auditors' certificate shall be filed to the effect that the accounting treatment contained in the scheme is in compliance with all the Accounting Standards specified by the Central Government under Section 133 of the Companies Act, 2013 or as stipulated by the ICAI.

[6]National Company Law Tribunal constituted under the Companies Act 2013.
[7]SEBI circular CIR/CFD/CMD/16/2015 dated November 30, 2015

Based on the above provisions, several unlisted companies formed out of demergers such as the GESCO Corporation, four Reliance group companies (formed out of the demerger of RIL), UltraTech Cement and several others were listed in the past without IPOs. It may, however, be noted that listing of a resultant company in a demerger or the transferee company in a scheme of arrangement is not automatic. It has to be *inter alia*, specifically provided for in the scheme. In the Wipro demerger case, the scheme specifically provided that the resultant company (Wipro Enterprises) shall be unlisted (Annexure 4 provides the necessary details). In the scheme of demerger of Pantaloon Retail, the proposal was to demerge some of the business undertakings of the listed company Pantaloon Retail India into its group companies that would be listed separately. This case is discussed in Annexure 5.

14.8 Comparative Analysis of Split-up through Transfer of Assets

Based on the discussions above, it is now possible to draw a comparison of the relative features under each method of asset-based split-up of companies. A strategic and statutory analysis is given in Table 14.1.

Table 14.1 Comparative Analysis of Split-up through Transfer of Assets

Issue	*Demerger*	*Hive-off not amounting to demerger*	*Reconstruction*	*Slump Sale*
1. Provision of applicable law	Sections 230-231 of the Companies Act. 2013 and rules issued there under[8] read with Section 2(19AA) of the IT Act	Sections 230-231 of the Companies Act, 2013 and rules issued there under[5]	Section 319 of the Companies Act,, 2013 read with relevant rules issued under Chapter XX	Section 180(1)(a) of the Companies Act and Section 2(42C) of the IT Act
1. Procedure	Involves a scheme of arrangement to be sanctioned by the NCLT under Sections 230–231 of the Companies Act.	Can be approved either by a NCLT order or by shareholders under Section 180(1)(a) of the Companies Act. Consent of creditors would also be required.	Requires a special resolution and authority of the AOA. Official liquidator would be involved in voluntary winding up of the transferor company.	Can be completed at corporate level by entering into a BTA under the authority of a resolution passed under Section 180(1)(a). Can also be used for determination of purchase consideration either under a hive-off or a reconstruction. Procedure is determined by the relevant transaction.
2. Efficiency in transfer of assets and liabilities of the transferred undertaking.	Most efficient. Blanket transfer under NCLT order.	Most efficient. Blanket transfer under NCLT order.	Most efficient. Blanket transfer under NCLT order.	Most inefficient. No blanket transfer of ownership. Individual transfer required for immovable assets, contracts, licences etc.

(*Contd.*)

[8]Companies (Compromises, Arrangements and Amalgamations) Rules, 2016.

2. Tax neutrality, i.e. avoidance of capital gain tax, reduction of stamp duty etc.	Best method for tax neutrality as it is recognised under the IT Act.	Does not provide tax neutrality unless under a revival scheme sanctioned under law. Stamp duty and registration charges on conveyance would arise unless scheme is approved by NCLT.	Does not provide tax neutrality unless under a revival scheme sanctioned by law. Tax on dividend distribution *in specie* may also arise. Stamp duty and registration charges on conveyance could also arise.	Does not provide tax neutrality unless under a revival scheme sanctioned under law. Stamp duty and registration charges on conveyance would arise.
3. Flow of Consideration	To shareholders of transferor company	To transferor company	To transferor company	To transferor company
4. Purchase Consideration	Exists in shares	Exists in cash/ securities/both	Exists in cash/ securities/both	Exists in cash/ securities/both
3. Tax efficiency, i.e. benefit of carry forward of losses, unabsorbed depreciation, current depreciation, tax holiday benefits, etc.	Most efficient.	Carry forward benefits are not available unless it is a revival scheme sanctioned under law.	Carry forward benefits are not available unless it is a revival scheme sanctioned under law.	Carry forward benefits are not available unless it is a revival scheme sanctioned under law.
4. Option of using for Strategic Divestiture	Does not provide an exit since consideration has to be settled only through shares of the transferee company.	Can be used for a divestiture.	Not meant for exit though technically possible.	Provides exit since consideration is settled in cash.
5. Induction of strategic partner/ financial investors	Enables induction separately into the demerged company or the resultant company as desired.	Enables induction separately into the parent company or the hived-off company as desired.	Enables induction into the new company since parent is dissolved.	Not applicable since this method is meant for exit.
6. Diversification of business	Diversified activity would have direct shareholder representation.	Subsidiarisation through hive-off is a good method as it does not have direct shareholder representation.	Not meant for this purpose.	Not applicable since this method is meant for exit.
7. Representation of shareholders	Yes	No	No	No
8. Disposal of assets unrelated to the demerged undertaking.	No	Possible	Possible	Yes

(*Contd.*)

9. Simplified process of split-up	No	No	Yes	Yes
10. Open to contest in court	Order can be appealed to appellate tribunal	Order can be appealed to appellate tribunal	Order can be appealed to appellate tribunal	Minority relief under company law

14.9 Split-up through Transfer or Dilution of Ownership/Control

The split-up of a company through the equity route is one of the most often used strategic options to create value by corporate managements. In the US markets, these mechanisms are known as *Subsidiary Equity Redeployments* (*SERs*). SER either by transfer of shares or by dilution of ownership is less cumbersome as compared to the asset-based route. Under this category of split-up, there is no alienation of assets and liabilities from one company to another. Neither is there a need to dissolve the transferor company pursuant to the split-up. This is because the objective of split-up is achieved through alienation of ownership or control without disturbing the operative assets and liabilities in the balance sheet. This approach basically involves subsidiarisation of a particular business undertaking of the company followed by a de-subsidiarisation at a later date.

14.9.1 Subsidiarisation of a Business Undertaking

This is one of the most common methods used under the equity route. Under this method, at the initial stage, a future business envisaged by the parent company is kept out of its own balance sheet from inception by forming it in a 100% subsidiary (WOS) formed for this purpose. This might be necessary since the business has a different growth path and risk profile. Such subsidiaries are also required when the parent wishes to operate in different jurisdictions and limit its liability in each jurisdiction.

The start-up capital for the subsidiary's business in such cases is entirely subscribed to by the parent company. Therefore, though the subsidiary is a separate company, its ownership at the first stage of subsidiarisation remains with the parent company. At a later date, if it is felt that the parent company needs to let the subsidiary grow independently, the parent company de-subsidiarises the business using a split-up strategy through the transfer of equity route.

14.9.2 Considerations for Subsidiarisation

Subsidiarisation is also used in cases where a hive-off of an existing business undertaking is made to a WOS with an intention to divest it or to dilute the parent's interests at a later date. Such a hive-off has already been explained in preceding paragraphs.

The decision to form a subsidiary at the inception of a business as distinguished from forming it as a division within the parent company is based on strategic, financial and legal considerations. Some of these important considerations are discussed below:

- The aspect of possible separation of the existing and new business at a later date cannot be overlooked at the time of setting up. If such a possibility exists, it may be advisable to keep them apart from inception at a balance sheet level and if necessary, keep them linked only at the shareholding level either as holding-subsidiary companies or as associates as may be applicable. This is because the cost of a balance sheet level separation at a later date involves significant time, laborious court approval mechanism, transaction costs and stamp duty through the split-up methods discussed above under the asset route.

- The valuation of the existing company will take a hit if the new project has a long gestation and high capital cost. This is because the existing balance sheet would show high amount of fund infusion (predominantly debt) to finance the new project without corresponding accrual of returns in the medium term. Such a situation leads to distortion of ratios, credit rating downgrade and fall in its valuation during that term. The situation could get accentuated, if the project is not implemented as per envisaged cost and time parameters. The implications of such an eventuality on the fund-raising capability of the company and continuing viability of its existing operations can be disastrous. Therefore, there could be a strong case to keep the parent company bankruptcy remote from the existing operations in a wholly owned subsidiary or a SPV formed exclusively for the project.
- If the proposed activity requires a new set of investors or lenders, it may be complicated and perhaps not feasible to implement the project within the same balance sheet. If a strategic partner or a new consortium is being inducted for the proposed activity, such third partiescannot be inducted into parent company due to its existing operations. Similarly, the existing members may not wish to dilute their equity by bringing in new shareholders on the same balance sheet for an unrelated activity. In such situations, a separate company is recommended as a SPV or WOS to implement the new project or JV.
- If the project is set up in the same balance sheet, it creates the additional burden of divisional accounting and segmental reporting in the financial statements. It will also impact the company's profitability and balance sheet based due to amortisation costs for the new assets and setting up costs. Setting up of the proposed activity in a different company would lead to disclosures on related party transactions in the books of both the companies. If there are too many such transactions between the two companies, it does not go to comfort external investors, especially PE investors.
- From a taxation perspective, having the new investment in the same balance sheet provides significant tax shield on existing profits so that the company may reasonably be expected to avoid a tax liability higher than MAT[9] for several years. This is possible due to higher interest costs and depreciation accruing on the new investment. This will increase earnings on equity and cash flow. In addition, if the position is that there could be considerable inter-se transactions between the parent and the subsidiary, it may be necessary to set up the new business as a division in the existing parent company. This could obviate the need to satisfy the revenue authorities on inter-firm *transfer pricing* issues. Thirdly, if the new activity is expected to generate losses in the initial years, these can be set-off against the profits of the existing operations, if both the businesses are in the same company under Section 72 of the IT Act. In all, from a tax perspective, setting up of a new business as a division of an existing company makes better sense at inception though a subsequent separation would be cumbersome.

Let us now discuss the methods available for a parent company to separate from its subsidiary, thereby accomplishing a split-up through the equity method.

14.10 De-Subsidiarisation through Spin-off

A spin-off is one of the most popular ways to achieve a SER in developed markets. It is similar to a demerger under the IT Act insofar, as the aspect of issue of shares directly to the shareholders of the transferor company is concerned. Under this method, the shareholders of the parent company are offered direct holding in the subsidiary and the parent company ceases to hold any shares in the subsidiary. This is achieved by substituting the shares held by the parent in the subsidiary with distribution of those shares directly to the shareholders of the parent company. This process does not increase the share capital of the subsidiary, since no new shares are being issued. The names of the respective shareholders are recorded in the place of the parent company in the Register of Members of the subsidiary.

[9]As may be applicable based on the tax law in force

For example, if A is the 100% holding company of B, the exchange of shares held by A in B for shares to be held by the shareholders of A in B in the same proportion as they hold shares in A is known as a *spin-off* of B from A. The effect of a spin-off is to provide direct representation to the shareholders of A in B as compared to an indirect representation through the holding company. This has several advantages: (i) It provides the shareholders of A with two securities representing their shareholding in each company as compared to a single security in A. This gives them an opportunity to liquidate one while keeping the other. (ii) It provides them direct control on the affairs of the subsidiary. (iii) It provides the subsidiary an independent identity with its own set of shareholders as distinct from having A as its corporate shareholder. This helps the subsidiary to raise its own funds and grow independently.

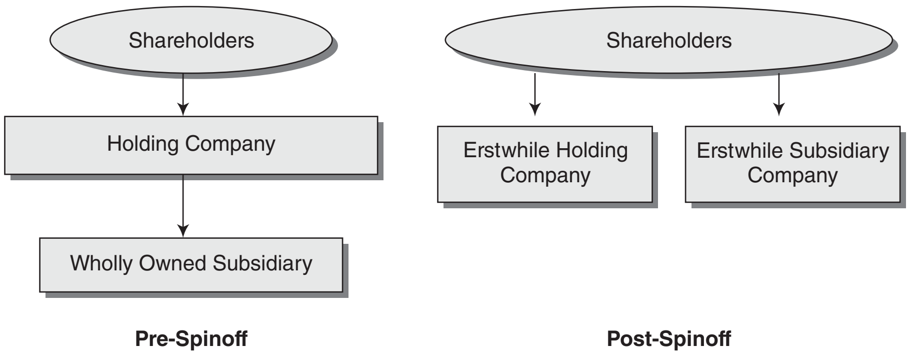


Exhibit 14.5 Equity Spin-off

14.10.1 Notable Features of a Spin-off

There are various features of a spin-off, some of them are given below:

- Spin-offs are cashless transactions and there is no purchase consideration recorded in either balance sheet. The investment held by the parent company in the subsidiary is written down in its books and to that extent, there has to be a write-down to its reserves. This can be accomplished through a special resolution passed by the shareholders. However, if the write-down has to be against the equity capital of the parent company, it amounts to a reduction of capital. Complying with the requirements of Section 66 of the Companies Act, this process requires the approval of the NCLT. Therefore, in the latter case, a special resolution passed by the shareholders approving the spin-off will alone not be sufficient without a court order approving it. As per the order of the NCLT, the share capital of the parent company will be reduced to the extent of the diminution in its assets representing the value of its investment held in the subsidiary. As part of the same scheme, the subsidiary issues new shares to the shareholders of the parent substituting its existing shares held by the parent company. At the conclusion of the process, the shareholders of the parent company end up holding separate shares of the parent and the subsidiary in identical percentages.
- In the spin-off of a subsidiary, if the holding company is already listed, it can result in a back-door listing for the unlisted subsidiary without an IPO. In the case of a pure equity spin-off, the scheme should also be accorded NCLT approval under Sections 230–234 so as to be eligible to seek listing without an IPO even though there may be no envisaged transfer of assets and liabilities. The other necessary conditions to be fulfilled for listing are identical to those for any company going for its IPO which are prescribed by the SCRA and the SEBI (LODR) Regulations. In the Indian context, pure equity spin-offs are extremely rare. Schemes are mostly in the nature of financial restructuring or demergers as defined in the IT Act.

- In overseas markets, equity spin-offs are very common though many a time they could be combined with transfer of assets and liabilities or business undertakings as well (known as *split-offs* in US, wherein parent company shares are exchanged for that of the spun-off company). The difference between a *spin-off* and a *split-off* lies in the capital structure of the parent company. In a spin-off, the number of issued shares of the parent remains constant though there is a diminution in value. In a split-off, there is a capital reduction for the parent company and the number of issued shares comes down. In either case, there is a downward impact on the balance sheet of the parent to reflect the alienation of the value of the subsidiary. Some of the well-known spin-offs include Eastman Chemical from Eastman Kodak,Leap Wireless from Qualcomm, Idearc split-off from Verizon and spin-offs made by parents such as Marriott, Kimberley Clark, Allergan and Peoplesoft (since merged with Oracle). The year 2011 proved to be a watershed year for spin-offs and split-offs in the US. Companies ranging from Sears to Sara Lee, Netflix, Tyco, McGraw Hill, Kraft and AMR announced such transactions.

Case Study

Idearc Split-off from Verizon[10]

Verizon Communications Inc., a listed US company made a split-off of the companies that represented its domestic print and internet yellow pages directories publishing operations. As part of this scheme, Verizon transferred to Idearc Inc. all of its ownership interest in Idearc Information Services LLC and other assets, liabilities, businesses and employees primarily related to Verizon's domestic print and Internet yellow pages directories publishing operations. The equity spin-off was accomplished by making a pro-rata distribution to Verizon's shareholders of all of the outstanding shares of common stock of Idearc.

As a part of the scheme and in consideration of the transfer of business undertakings by Verizon, Idearc issued to Verizon (i) additional shares of its common stock, (ii) debt obligations of itself consisting of $2.85 billion aggregate principal amount of Idearc's 8% senior notes due after 10 years and $4.3 billion aggregate principal amount of loans under Idearc's tranche B term loan facility and (iii) transferred to Verizon approximately $2.4 billion in cash from its cash balances as on date as well as from cash raised through issue of its debt obligations to third parties.

- It is not necessary that a spin-off unlisted subsidiary of a listed parent company should be listed automatically. If the resolution or the scheme provides that the subsidiary shall stay unlisted, the shareholders of the parent company would become the owners of unlisted shares of the subsidiary. At a later date, the subsidiary may be taken public either through new issue of shares or through an offer for sale by the existing shareholders (a process known as *equity carve out* discussed below). Seen in this context, a spin-off is a precursor to equity carve out.
- Equity spin-offs are tax neutral since they are sanctioned through a NCLT order and are most often cashless transactions. So, there would be no tax impact on the shareholders due to a write-down in the reserves or capital reduction by the parent company. However, since an equity spin off would not satisfy the requirements of a demerger, to the extent such write-down can be attributable to the distributable profits of the company, it could be considered as dividend distribution under Section 2(22)(a) read with (d) and there would be an implication of dividend distribution tax thereon on the parent company. In the US, equity spin-offs are usually tax neutral, if the spin-off is to a minimum extent of 80% and subject to other conditions under the *Anti-Morris Trust Rule* as per Section 355 of the Internal Revenue Code

[10]As per its 8-K filing with the SEC and Stock Exchange in November 2006.

(the income tax law of US).Due to this rule, in a divestiture, usually a *Reverse Morris Structure* is used for the split-off and eventual divestiture of a subsidiary by the parent in a tax neutral manner.Under this structure, the parent splits off the business it wishes to divest to its subsidiary. Thereby the subsidiary becomes de-subsidiarised and is held directly by the shareholders of the parent. The subsidiary is then merged with the target company of the acquirer. The transaction would be tax free only if the original shareholders of the parent company own more than 50% of the merged entity, i.e. the purchaser of the subsidiary should be a minority shareholder in the merged entity. This stipulation is basically to ensure that tax neutrality is not given to a divestiture transaction. Therefore, the reverse Morris Trust structure can be used for tax neutrality only in certain cases. Verizon's divestment of its access lines business to Fairpoint and P&G sale of Pringles snack food business to Kellogsare cases in point.

Readers may refer to Annexure 4 on the Wipro demerger scheme that provides interesting details on how an innovative scheme was structured in the Indian context involving a demerger with features of a reverse split-off.

14.10.2 De-subsidiarisation through Equity Carve-out

This is the other most popular method of a SER. Equity carve-out is the process by which the parent company's stake in the subsidiary is diluted either in one step or through a gradual process. In this sense, equity carve-out lays the roadmap for a possible de-subsidiarisation eventually.

Equity carve-out can be achieved through the following routes:

- The parent company could relinquish control through induction of a strategic partner and therefore, convert the 100% subsidiary into a JV company. This is usually accomplished through a new issue of equity by the subsidiary to the JV partner so that the funds can be used for its business.

Case Study

IL & FS De-subsidiarisation

IL&FS de-subsidiarised its trusteeship services company IL&FS Trust Company. This was achieved by a preferential allotment made by the trust company at a price of ₹500 per share to other subsidiaries and affiliates of IL&FS. Post restructuring, IL&FS held 40% while 25% was held by Investsmart India and IL&FS Venture Corporation. The balance 10% was held by IL&FS Merchant Banking Services Ltd. The de-subsidiarisation was done to leverage the synergies between the other companies and the trust company. Investsmart was subsequently merged with IL&FS.[11]

- If no strategic partner is envisaged, the subsidiary can make an IPO by issue of new shares and start diluting the stake of the parent. This would also help the subsidiary to raise funds for its business. Equity carve-out results in fund raising and listing for the subsidiary and opens up a route for its independent growth. It also obviates the need for the parent company to keep funding the growth of the subsidiary through infusion of its own equity. Equity carve-out can also result in a substantial increase in the market capitalisation of the parent company and the group as such. It would also provide the parent company several options for fund raising for its own objectives and provides additional currency in the form of listed shares of its subsidiary for strategic acquisitions through the subsidiary. The listing of Tata Consultancy Services Ltd. falls under this category.

[11]The Economic Times dated 17th August 2001.

Case Study

TCS

One of the most successful and high value equity carve-outs in recent times in Indian corporate scenario has been the listing of Tata Consultancy Services Ltd., a subsidiary of Tata Sons, the group holding company. TCS was an extremely profitable IT services division of Tata Sons Ltd. and it was decided to unlock its value to its parent by taking it public through a carve-out by existing shareholders including Tata Sons. For this purpose, TCS had to be corporatised before taking it public. This was achieved through a hive-off. The details of the subsidiarisation of TCS have been discussed earlier in this chapter.

In order to enable an equity carve-out, Tata Sons wrote to all the other shareholders in April 2004 inviting them to participate in the offer for sale. The number of shares agreed to be offered by these selling shareholders, except Tata Sons, aggregated to 18,220,484. The total offer for sale including that of Tata Sons was 32,677,600 shares. In addition, there was a fresh public issue of shares by TCS Ltd. to the extent of 22,775,000. Almost the whole of the funds raised by the issuer company were used for paying off Tata Sons for its hive-off of the TCS division. Therefore, as a result of the carve-out, Tata Sons and other group shareholders encashed a sum of around ₹50 billion. The carve out resulted in the dilution of the shareholding of Tata Sons and its group in TCS Ltd. to around 85%.

- The parent company can make an offer for sale of its stake either fully or partly in the subsidiary to make an IPO so as to take the subsidiary public. This is also known as a *split-off IPO*. This is a way of recovering the investment made in the capital of the subsidiary in cash. The idea in a split-off IPO is to ensure that the subsidiary benefits from listing, while the control on its business, is still with the parent. Usually, at the IPO stage, the parent does not offer for sale more than the minimum necessary for listing. A split-off IPO may be combined with certain amount of new issue of shares by the subsidiary, if the IPO has to be made larger or if the subsidiary requires finance. Split-off IPOs are appropriate if the intention is for the parent to exit the subsidiary.

Case Study

Syngene International Ltd.

Syngene International Ltd. is a subsidiary of Biocon Limited which is also its promoter. It is a contract research organisation offering a suite of integrated, end-to-end discovery and development services for novel molecular entities for many industrial sectors. Syngene was taken public in 2015 through an IPO consisting entirely of an OFS of secondary shares by existing shareholders. The main objects of the issue were to achieve the benefits of listing, enhance visibility and provide liquidity to existing shareholders.The dilution in the OFS was to the extent of 11% of the post-issue paid up capital of the company. The listing requirements mandated a minimum of 10% public shareholding. Biocon Ltd. held 85.5% of its subsidiary at the time of its IPO. The rest was held by employee trust, institutional investors and NIIs.Post IPO of Syngene, Biocon's stake was diluted to 76.10%, just enough to remain in control of special resolution power in the company. It may, therefore, be appreciated that the net offer to the public was fixed strategically higher than the statutory minimum so as to reach the maximum possible dilution without relinquishment of control.

- If the intention is to exit the business, the parent can relinquish ownership of the subsidiary through strategic sale of its equity holdings. By this process, the parent can encash its efforts in growing the subsidiary till that stage. This is a cost-effective method of exit as compared to the asset-based route. In the process of an exit of this sort (known as *divestiture*), the sale of equity is done to an outsider and the parent company relinquishes both ownership and control on the subsidiary.

Case Study

US Cases

The classic US cases concerning spin-off are that of GM-Delphi (a carveout followed by a spin-off) and Dupont's spin-off of Conoco. In the GM-Delphi case, Delphi, which was a division of GM, was hived-off into a separate wholly owned subsidiary of GM. Thereafter, Delphi went public through a carve-out by GM to the extent of around 20%. Delphi, thus, became a listed subsidiary of GM wherein it still held 80%. Thereafter, both the companies approved a spin-off scheme whereby the share swap ratio was fixed at 7 shares of Delphi to the shareholders of GM for every 10 shares held by GM in Delphi. The spin-off was made to the extent of 78% and the balance 2% was transferred to the employee trust. Delphi, thus, became an independent listed company.

In the Conoco case, it was a 100% subsidiary of Dupont which was acquired in 1981. Dupont made plans to take Conoco public through an equity carve-out of 20% of its equity and subsequently make a spin-off for the balance. The spin-off was structured innovatively through a share exchange programme whereby the shareholder of Dupont was given an option to exchange shares held in Dupont for shares in Conoco (a split-off structure). This was because, Dupont was concerned that a regular spin-off could depress the stock price of Conoco, if there was a selling pressure from shareholders who did not see value in staying invested in the oil industry. Through the share exchange programme, a choice was given to Dupont shareholders to invest either in the chemical or the oil industry. Readers may be reminded that split-off structures are not expressly provided for in Indian law and therefore, require detailed examination of the facts of the case and the relevant provisions of the Companies Act and the IT Act to understand their feasibility in India and tax implications thereon.

14.11 Statutory Framework for Split-up through Transfer of Equity

The process of a split-up using the transfer/dilution of equity route does not enjoy any special privileges under the IT Act. Nor does it require any special treatment under the Companies Act since transfer of shares between different shareholders is a matter of mutual contract between the two parties. However, the following provisions need to be kept in mind with regard to these kinds of transactions:

- A split-up through the equity route by a parent company does not require separate shareholder approvals or a confirmation through NCLT at the parent company level. The board of directors of the parent company is normally empowered to take such decisions. However, the loan agreements entered into with banks and financial institutions either at the parent level or the subsidiary level usually provide for prior approvals for such transfer of ownership by the parent company or its promoting group. In addition, if the carve out is in the nature of a divestment by the parent in a listed subsidiary, the transaction could become a *substantial acquisition* for the acquirer under the Takeover Code and the provisions therein shall apply.
- If the transferee in these transactions is a company, it has to consider the provisions of Section 186 of the Companies Act and the Takeover Code before making such acquisition and comply with the law. Under Section 186, shareholder approvals would be required, if the proposed investment is in excess of 60% of the pai-up equity capital and free reserves or 100% of free reserves (whichever is higher).

- Normal stamp duty on transfer of shares has to be paid.
- The provisions of FEMA and the notifications issued there under by the RBI with regard to acquisition and transfer of shares by non-resident pursuant to the FDI policy need to be followed. The relevant notifications issued by the Ministry of Industry and the Ministry of Finance, insofar as they may be applicable also need to be followed.
- There are no specific benefits under the IT Act from exemption of capital gain tax for split-ups made under the equity route even if they are made under a scheme of arrangement sanctioned by the court. Therefore, if such split-ups involve a share swap, there can be incidence of capital gain for the recipient shareholders or dividend distribution tax on the parent company as already discussed above.

14.12 Investment Banking Perspectives in Corporate Restructuring

Investment banks are retained as advisers by bodies corporate that wish to restructure themselves to hand hold the entire process of conceptualising and execution of restructuring plans from a financial perspective. Of course, restructuring plans require the collective effort of several other professionals including accountants, legal advisers and attorneys, company secretaries, management and HR experts. Investment banks have to coordinate with all these professionals in executing restructuring transactions for their clients. Complex restructuring transactions require expert advice and assessment of the issues involved from strategic, financial, transaction, statutory, accounting and tax perspectives. The investment banker's role in corporate restructuring is to give shape to the restructuring proposal as a transaction that meets all requirements. In addition, the investment banker also plays a distinct role in the execution of the transaction along with other professionals.

Based on the above functionality of an investment bank, the significant conceptual elements of corporate restructuring that embody its advisory role are discussed below:

14.12.1 Choice of Split-up Strategy

Investment bankers have to consider the following factors while devising a split-up strategy for a stand-alone diversified company or a conglomerate. Going by the discussion so far in this chapter, it is possible to list out all the alternative routes that are available to a company. For the purpose of facilitating the analysis of a split-up strategy, the various alternatives can be mapped as shown in Exhibit 14.6.

Since the routes available are many, the optimum solution would emerge in a given case only after a consideration of the requirements and their implications. Let us examine these in some detail to understand the role of the investment banker.

Strategic Objectives

The strategic objectives of a restructuring transaction are the primary driver to the choice of the split-up methodology. Some of these are listed out below:

- Better capture of value for an existing line of operations.
- Strategic exit from a line of business.
- Disposal of surplus assets to provide liquidity for the company.
- Induction of a strategic partner for a particular division.
- Unlock value of an investment made in another company.
- List one division while keeping the rest of the company unlisted.
- Invite private equity investment into a particular business activity and not the company as a whole.
- Conversion of an existing division into a joint venture.

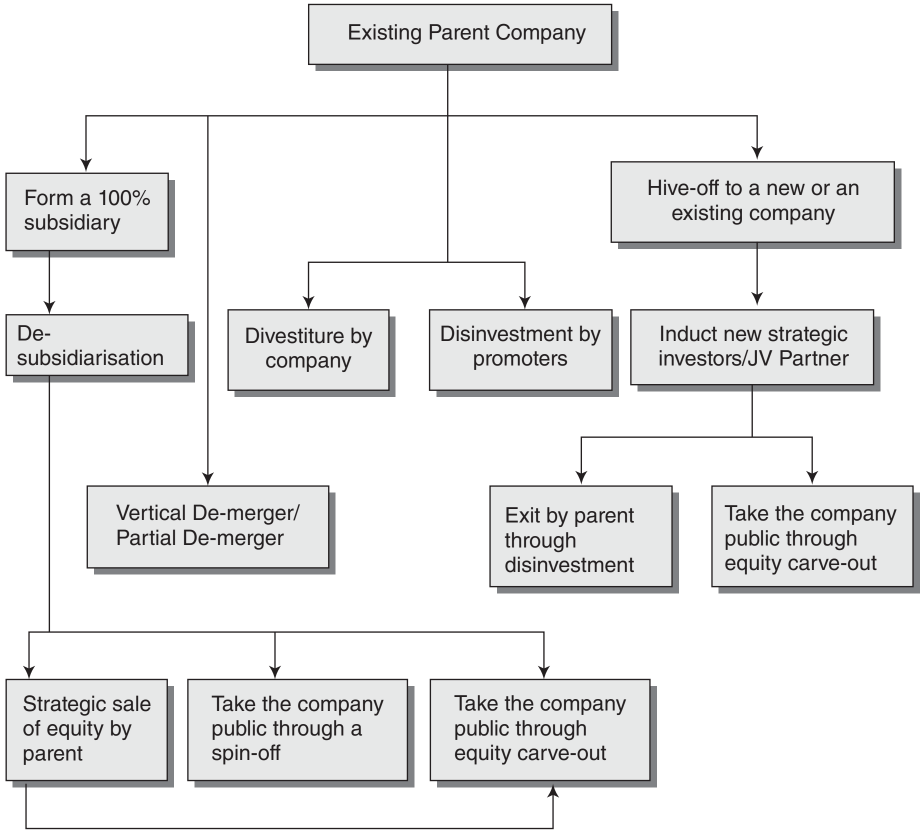


Exhibit 14.6 Alternative Split-up and Exit Strategies for a Company

- Hive-off an activity that has distinct risk profile as compared to the other businesses.
- Set up a new business in a bankruptcy remote manner using some of the existing assets or cash and outside investment.
- Increase leverage through non-recourse financing for a particular line of business.
- Hive-off a profit-making division from a loss-making division to capture its value better.
- To split a multi-divisional company for better identification with the market.
- Family settlements between promoters or principal shareholders.

Contractual and Statutory Requirements

- *To meet specific regulatory requirements for individual businesses:* For example, under the Competition Act, the CCI is empowered to make orders on companies that are in the nature of anti-trust measures.
- *To facilitate licensing requirements:* For example, bank sponsored financial businesses that cannot be housed within the parent bank's balance sheet (such as merchant banking or broking) need to be housed in subsidiaries which at a later date may be spin-off or carved-out. The situation is similar for NBFCs conducting merchant banking operations or taking on underwriting obligations under SEBI Regulations. Other sectors also have such requirements based on sectoral regulatory requirements.
- Provisions of the Companies Act relating to arrangement and reconstruction under Sections 230–234 and 319 of the Companies Act.

- Approval from members under Section 180(1)(a) of the Companies Act.
- The necessity to list or de-list the company or the division to be hivedoff under the ICDR Regulations.
- The implications of the Takeover Code in the case of transfer of equity/ issue of equity by listed companies.
- Necessity for capital reduction, if any.
- FDI policy and proposed foreign investment.
- Listing guidelines and SCRA requirements where applicable.
- Need for dissolution of a company.
- Intellectual property or contractual rights to be hived–off, if any and the terms of such rights that may constrain such hive-off.

Tax Implications

- Benefit to be derived from deferred tax assets in the balance sheet.
- Incidence of capital gains tax on the company or shareholders.
- Stamp duty and registration fee for transfer of assets.
- Written down value of assets transferred by the transferor company for tax purposes.
- Provisions of Section 79 of the IT Act which denies the benefit of carry forward and set-off of business losses by the transferee company in certain cases and exemptions available therefrom.
- Admissibility of current depreciation on brought forward assets from the transferor company.
- Admissibility of brought forward tax deductions such as unabsorbed losses and depreciation as well as unexpired tax holiday benefits.
- Admissibility of the expenses of the restructuring scheme.
- Amortisations that can be continued in the books of the transferee company.

Financial and Accounting Implications

- The structure of the balance sheet before and after the proposed scheme is implemented.
- Business viability and projected financial forecast after restructuring.
- Revaluation of assets and liabilities, if any.
- Capital reduction and its impact on market capitalisation, ROE, EPS and other financial indicators.
- Debt servicing capability after the restructuring and acceptance thereof by lenders.
- Accounting treatment under GAAP and disclosure requirements.
- Prior period adjustments, if any required prior to the restructuring.
- Appointed date for the scheme and accounting feasibility thereof.

14.12.2 Transaction Structure

The transaction structure has to finally emerge after taking into account all the requirements of the restructuring under different heads listed above. Though this depends on the facts of a given case, some guiding principles can, however, be drawn:

- Firstly, it has to be determined whether the transaction involves a split-up or a strategic exit.
- If the restructuring is a split-up, it has to be determined whether it requires split-up under the asset route or the equity route. Generally speaking, the asset route is more cumbersome and involves multiple approvals. Therefore, this route should be preferred only if it cannot be avoided or if the rewards justify. Having said that, asset-based split-ups are unavoidable if existing undertakings in a company have to be hived-off.
- If an asset-based split-up is necessary, the demerger route is the best available option that has necessary tax efficiency.

- If a demerger cannot be adopted for any reason, a hive-off to a 100% subsidiary is the next best option since it can be used at a later date for a split-up through transfer of equity.
- A demerger through a scheme of arrangement under Sections 230–231 is a very convenient option for corporate restructuring for several reasons. This is because of several facilitating provisions that are embodied therein for such restructuring. Firstly, if the scheme of arrangement has the concurrence of 75% in value of the creditors and members, the NCLT can direct that it will be binding on all of them if it finds merit in the scheme. This facility makes it easier for companies to deal with dissenting creditors or members in such schemes. Secondly, it is tax efficient since a non-judicial route attracts full stamp duties and registration charges on conveyance of immovable property between companies. This would make the transaction prohibitively expensive and financially unviable. Thirdly, where a restructuring requires a transfer of the entire undertaking of a company to another company, an NCLT order under Section 319 can provide for dissolution of the transferor company without the process of winding up. This is an extremely convenient provision otherwise; a long voluntary winding up procedure should be complied with. Fourthly, if a reduction of capital of the transferor company is envisaged, no separate approval under Section 66 of the Companies Act is required if the scheme is already with the NCLT. Due to all these advantages, corporate split-ups involving hive-offs and reconstructions are generally preferred under a scheme of arrangement.
- The route available under Sections 230–231 is the only option if the demerged/hived-off entity requires to be listed without an IPO.
- The route available under Section 180(1)(a) is more convenient since it does not involve sanction of any adjudicating authority. However, this route has a pitfall. If approval is not unanimous, dissenting members may petition the NCLT praying for relief under Chapter XVI of the Companies Act or otherwise litigate on the matter. This could bring the whole transaction under cloud with severe uncertainty. Therefore, if there is a possibility of dissenting members or creditors, the route prescribed under a scheme of arrangement is preferable since it is binding on the minority.
- Demerger is the most preferred option for split-up of a loss-making business undertaking.
- In the Indian context, divestitures involving divisions of a diversified company are usually accomplished either through a demerger/hive-off or a slump sale/stake sale. In some cases, it is accomplished in a two-stage process whereby a demerger/hive-off of the disposable business undertaking is made into another new or existing company at the first stage. At the second stage, the ownership of the transferee company is divested to the acquirer. If a slump sale approach is used, the business undertaking to be divested is sold to the acquirer on a consolidated basis for cash or equivalent consideration.
- Getting a 75% majority approval of shareholders and creditors is a pre-requisite for asset-based split-ups. Otherwise, it may be necessary to transfer the existing promoter stakes to a holding company and divest through the holding company at a later date. The Takeover Code, however, applies in such cases, if the operative company is listed.

Case Study

Bharti Group

The FIPB rejected in early 2002, the proposal of Bharti Global, a holding company which held shares in Bharti Telecom and Bharti Healthcare to transfer its entire shareholding in these two companies to its Mauritius based wholly owned subsidiary, Indian Continental Investments. The ground for the rejection was that it did not fit into the guidelines though the question of *round tripping* was not raised. Bharti Televentures re-organised its group structure under four linear subsidiaries for its four business segments: cellular, basic, long distance and broadband. Bharti Cellular was to be the subsidiary for all the cellular operations, which would own 100% of the two companies Bharti Mobile and Bharti Mobinet, which operated cellular networks in AP and Karnataka and Chennai respectively.

Case Study

Jumbo Group

The Jumbo group of Late Manu Chhabria restructured its equity holdings in Indian group companies. The company decided to transfer its holding in Gordon Woodroffe from its domestic holding companies to Jumbo's non-resident holding company, Jumbo World Holdings. Earlier, the Jumbo group tried the same thing with its other two major companies in India, Shaw Wallace and Falcon Tyres which was turned down by the Government. The Government gave the approval for the transfer of holdings after FIPB verified whether Jumbo World Holdings was under the status of an OCB or not. This was necessary since Gordon Woodroffe was engaged in property development and management services which was restricted for foreign investment.

- The Takeover Code is a major constraint for restructuring of listed companies. In such cases, it may be necessary to float a 100% unlisted subsidiary and transfer the business undertaking to be divested into it at the first stage so as to enable the transaction without triggering the Code at the second stage.
- In many transactions, restructuring is an enabler for fresh fund raising either to recapitalise the transferor company or to raise fresh financing for the hived-off business. In such cases, it would be necessary to examine the feasibility of the fund raising, debt-equity ratio, dilution of stakes of existing shareholders, pricing guidelines of SEBI, mode of fund raising, feasibility of IPO/FPO, structure of the financing instruments etc.
- In a restructuring through transfer of equity route, the essential feature is to maximise value for the buyers or the sellers as the case may be. A case in point is CMC Ltd. which was acquired by Tata Sons Ltd. through disinvestments made by the Government of India. TCS held 51.12% of CMC Ltd. This entire stake was transferred to TCS Ltd., another subsidiary of Tata Sons Ltd. Subsequently, TCS was taken public to encash a part of the parent company's interests therein. Through this method, Tata Sons not only realised value for its holding in TCS Ltd., but also in CMC Ltd.
- The overall scheme should be reasonably straight-forward. If the transaction is too complicated for regulatory scrutiny, it could consume more time in getting approvals. Since time is of essence in most restructuring transactions, the investment banker has to devise the transaction that can be executable in reasonable time and lesser procedures.
- The overall cost of the transaction and efficiency thereof should be kept in mind.
- The transaction should allow least operational strain or dislocation on the company's operations.

14.12.3 Valuation Approaches in Restructuring

The other main investment banking issue in corporate restructuring relates to valuation in restructuring transactions. Valuation is extremely important in such transactions not only in terms of corporate governance but in terms of statutory requirements as well. Both listed and unlisted companies should obtain independent valuation reports establishing the value of the transaction and the fairness of the terms of consideration.

Valuation of the hived-off division or undertaking or share valuation for split-ups involving transfer of equity is a complex task for the investment banker. While the general methodologies available for valuation are common, the investment banker has to consider the appropriateness of a particular method in the application thereof to the given case. The following general guidelines may be useful:

- Business valuation would be required for all transactions involving transfer of a complete undertaking or divestment through transfer of equity. This is because an undertaking constitutes an economic vehicle capable of producing economic return and its value should, therefore, incorporate its future economic value. Therefore, business valuation would call for ascertaining its future earning capacity value either through the accountant's profit approach or through the DCF methodology. Business valuation cannot be adopted for hive-offs that do not transfer undertakings on a going concern basis. In such cases, asset-based valuation methodologies are relevant. On similar lines, valuation of businesses under the DCF methodology may require incorporation of some peculiar characteristics of the business such as concession rights for a particular period. The exceptions to this general statement could be plain vanilla demergers wherein the demerger happens to a newly constituted wholly owned subsidiary.
- Valuation of brand and other intangible assets is normally not done in a business valuation made for a hive-off wherein a share issue is made by the transferee company. But in cases where cash consideration is paid in an asset sale or divestiture, these may be valued as per established norms.
- Revaluation of assets would be required for hive-offs not amounting to demergers/reconstructions and divestitures. The assets will need to be revalued at current costs to reflect their current values based on an assessment of their economic life and the present depreciated value. Sometimes, the technical assessment of an expert would be required to arrive at the value of customised plant and machinery and other equipment. Similarly, some special types of buildings or structures and land may require expert valuation by civil engineers or surveyors.
- Revaluation of liabilities may be required in cases involving compromises and settlements with creditors.
- Valuation for a slump sale is made to fix a lumpsum value to the entire undertaking or block of assets rather than to assign individual values. In such a case, a complete undertaking may be valued using business valuation techniques. A block of assets not constituting an undertaking may be valued as per its net realisable value as a whole unit or its replacement value, as may be found desirable. A sum of parts valuation may also be looked at to arrive at a price for different blocks of assets being sold on a slump sale basis.
- Valuation for the purpose of composite demergers would be on similar lines as those adopted for mergers which are discussed in a subsequent chapter. The essential feature for demerger valuation is to be able to value the demerged division separately on a going concern basis so as to fix the ratio of split of the existing shares of the combined company between the shares of the resulting company and reduced shares of the demerged company. For example, for every 10 shares in the combined company, the shareholder would be issued 7 shares of the demerged company and 4 shares of the resulting company. It may be noted that in a demerger, there is a *share-issue ratio*, not a *share swap ratio* as in a merger.
- Valuation of business undertakings that do not have a case for future viability cannot be made on going concern basis since there is no expectation of future economic return. Asset-based valuation is appropriate. However, if the undertaking does not have a value as a whole, the *break-up value* needs to be estimated based on the net realisable values of each of the saleable assets of the undertaking.
- Restructuring for the purpose of induction of strategic or financial investors and joint venture partners would require business valuation to arrive at the value per share. The pricing formula of SEBI has to

be kept in mind while working with listed companies. Similarly, for induction of non-resident investors through FDI route or transfers of equity, pricing guidelines of RBI have to be considered.

The above are only indicative guidelines to help the reader appreciate the task of the investment banker in valuation for restructurings. In transactions involving outside interests, since the investment banker also helps in deal negotiations, valuation helps to set a benchmark price so as to be able to realise the best valuation for the client.

IMPORTANT TERMINOLOGY

Anti-Morris Trust Rule
Asset Sale
Business Transfer Agreement (BTA)
Composite Demerger
Demerger
Divestiture
Equity Carve Out
External Restructuring
Hive-off
Internal Restructuring
Partial Demerger
Plain Vanilla Demerger
Reconstruction
Reverse Morris Trust Structure
Scheme of Arrangement
Share Entitlement Ratio
Slump Sale
Spin-off
Split-off
Split-off IPO
Split-up
Structured Demerger
Subsidiary Equity Redeployment (SER)
Vertical Demerger

TEST YOUR UNDERSTANDING

PART - A

I. Pick the right answer(s) or the alternative that best fits the description from the alternatives provided under each question.

1. The following falls under the category of internal restructuring:
   (a) Capital Reduction by the company
   (b) Creation of a new SBU
   (c) Reducing the face value of the equity shares of the company
   (d) Consolidation of share capital
   (e) Stock-split
   (f) Issue of sweat equity
   (g) Issue of ESOP
2. The following falls under the category of external restructuring:
   (a) Capital Reduction by the company
   (b) Creation of a new SBU
   (c) Reducing the face value of the equity shares of the company
   (d) Consolidation of share capital
   (e) Stock-split
   (f) Issue of sweat equity
   (g) Issue of ESOP
3. The following is an essential pre-requisite for a transaction to constitute a demerger under Indian law:
   (a) The entire assets and property of the demerged company, immediately before the demerger, becomes the property of the resulting company by virtue of the demerger.

(b) All the liabilities of the demerged company, immediately before the demerger, becomes the property of the resulting company by virtue of the demerger.
(c) The transfer of assets and liabilities is at values appearing in its books of account immediately before the demerger.
(d) The resultant company issues, in consideration of the demerger, its shares to the shareholders of the demerged company on a proportionate basis.
(e) The shareholders holding not less than three-fourths in value of the shares in the demerged company become shareholders of the resulting company by virtue of the demerger.

4. A company decides to give up a sea-face guest house valued at $ 2 million to the bank for the settlement of a loan which was overdue. This amounts to:
(a) Internal restructuring
(b) External restructuring
(c) Demerger
(d) Hive-off
(e) Spin-off
(f) Asset sale
(g) Asset carve out
5. A company decides to suspend operations in a loss-making manufacturing division and transfer all the assets of that division to another profit-making division. This amounts to:
(a) Internal restructuring
(b) External restructuring
(c) Demerger
(d) Hive-off
(e) Spin-off
(f) Asset sale
(g) Asset carve out
6. A company proposes to start a new business activity with bankruptcy remoteness in a separate 100% subsidiary and grow it. This process would amount to:
(a) Formation of a subsidiary
(b) Subsidiarisation through hive-off
(c) Spin-off of a subsidiary
(d) Subsidiarisation through split-off
(e) Demerger of business
(f) Demerger through subsidiarisation
(g) Restructuring through subsidiarisation
7. A company proposes to separate one of its existing business activities with bankruptcy remoteness and grow it. This can be achieved through:
(a) Sale of business to a newly formed 100% subsidiary
(b) Hive-off of the business to another existing company
(c) Demerger into another existing company
(d) Demerger into a new company
(e) Converting the existing company into a joint venture
(f) Bringing in a strategic investor.
8. A company decides to suspend operations in a loss-making manufacturing division and transfer all the assets of that division to its group company at the values appearing in the balance sheet as of the date of transfer at a share issuance ratio of 2.5:1. The group company issues its own shares as purchase consideration to the transferring company. This amounts to:
(a) Demerger
(b) Hive-off not amounting to demerger
(c) Asset sale
(d) Spin-off
(e) Purchase in the nature of demerger
(f) Spin-off in the nature of hive-off
(g) Asset carve out in the nature of demerger
(h) Spin-off in the nature of a demerger

9. A listed company proposes to invest into a new business, grow it and then look to unlock the value. This can be achieved through:
   (a) Investing in a subsidiary and spinning it off at a later date
   (b) Growing the business as a division and demerging it
   (c) Investing in a subsidiary and rolling it back at a later date
   (d) Growing the business as a division and invite private equity investment
   (e) Growing the business as a division and convert itself into a JV
   (f) Investing in a subsidiary and go for equity carve out.
10. If a holding company spins off its subsidiary and then merges it with itself, the share swap is made between:
   (a) The holding and the subsidiary companies.
   (b) The shareholders of the holding company and the subsidiary company.
   (c) The holding company and the shareholders of the subsidiary company.
   (d) The shares held in the subsidiary with additional shares in the holding company.
   (e) The shares in the holding company are exchanged for shares in the subsidiary company.
11. A listed company has two subsidiaries, one that is also listed and the other unlisted. It wishes to do a spin-off of the unlisted subsidiary and subsequently a merger between the two subsidiaries. The merger has to be accomplished through:
   (a) Exchange of parent company's share with that of the listed subsidiary.
   (b) Exchange of shares between shareholders of the parent company and that of the listed subsidiary.
   (c) Exchange of shares between shareholders of the parent company and that of the unlisted subsidiary.
   (d) Issue of shares by listed subsidiary in exchange for shares held in unlisted subsidiary.
   (e) Issue of shares by listed subsidiary in exchange for shares held in parent company.
   (f) Issue of shares by listed subsidiary in exchange for shares held by shareholders of parent company in the unlisted subsidiary.
12. In a spin-off, if the purchase consideration has to be settled in cash, it is paid to the shareholders of the company that has been spun off.
   (a) True (b) False
13. The difference between a demerger and a spin-off is that the former entails an asset transfer along with an equity transfer while the latter is just an equity transfer.
   (a) Yes (b) No
14. A company wishes to relinquish control of its 100% subsidiary in favour of its own promoters. This is possible through a spin-off.
   (a) Yes (b) No
15. In a three-way split of a company, it is decided that at the first stage, a demerger would be done to create the second company. At the second stage, the resultant company will do a second demerger so as to create a third company. In this case, the share-swap can be done on a combined basis for both the demergers.
   (a) Yes (b) No
16. If a division of an existing company has to be spun-off into a subsidiary, it is necessary to pay a purchase consideration to the transferor company either by way of securities or cash or both.
   (a) True (b) False
17. In the spin-off of a subsidiary, the shareholders of the spun-off company are the shareholders of the parent.
   (a) Yes (b) No

18. In a demerger scheme, a division of Company A is proposed to be demerged into Company B and another division of Company B is proposed to be demerged into Company A. The mutual consideration is proposed to be set-off against each other such that both the companies do not propose any share issue. For the scheme to be fair and reasonable, it needs to be shown that:
    (a) The number of shares to be issued by Company A is identical to that of Company B
    (b) The book value of assets and liabilities to be transferred by Company B to Company A is identical to those of Company B to be transferred to Company A.
    (c) There is approval by 75% of the shareholders of both companies to the scheme.
    (d) The valuation of Company A and B are almost identical.
19. A listed company has two unlisted subsidiaries. In one of the subsidiaries a carve out is proposed while in the other its a divestiture. Will this be the right strategy if in the former subsidiary, the parent wishes to monetise its holding while in the latter, it proposes to cut losses.
    (a) Yes (b) No
20. A listed parent company has two subsidiaries, one of which is also listed. It wishes to do a demerger of a business from the listed subsidiary into the unlisted subsidiary. The investment banker advises that under the scheme, the unlisted subsidiary would be subject to backdoor listing. In order to prevent such a situation, the parent company proposes to issue its own shares in exchange for the shares of the unlisted subsidiary. Such a scheme would be invalid as the parent company has no *locus standi* under the demerger.
    (a) Yes (b) No
21. A company proposes to hive-off its loss-making division into a wholly owned subsidiary through a BTA at an agreed value. This could lead to tax liability for the holding company even though its an internal reorganisation.
    (a) True (b) False
22. In a demerger, a loss-making division is separated from a listed company into a newly formed resultant company. The resultant company proposes to issue shares to the shareholders of the demerged company. This will amount to a backdoor listing for the loss making resultant company. The investment banker states that this is not possible since a loss-making company cannot get backdoor listing. The banker is right:
    (a) Yes (b) No
23. American Auto Ltd. has two divisions: auto manufacture and auto ancillaries. It decides to hive off the auto ancillary division to its OEM supplier Indian Auto Ltd. Indian Auto wishes to pay the purchase consideration in the form of 10% royalty to the American company over the next 20 years. The purchase agreement also provides for a guaranteed 20-year lock-in for payment of royalties by the Indian company. A shareholder of the Indian company alleges that this is a fraud on the company as the value of the assets being acquired is far less than the royalty agreed to be paid. The I-banker advising on the deal states that independent valuation has been conducted and the royalty to be paid is justified by the valuation. Are shareholders within their right to reject the scheme or are they bound by the conclusions of the independent valuation?
    (a) Shareholders can veto the scheme (b) Shareholders are bound by the scheme

PART - B

25. What corporate re-organisations? Why do they happen? What are the types of corporate re-organisations?
26. What are the methods for splitting up a company? What are the strategic and other considerations that go to decide the method adopted in a given situation?
27. How is a demerger tax efficient? What are the disadvantages of a demerger in comparison with a subsidiarisation through a hive-off?

28. How does a de-subsidiarisation through a spin-off compare with that through an equity carve-out?
29. What are the considerations to be kept in mind while determining the appropriate transaction structure for a corporate split-up strategy?
30. In a split-up strategy involving transfer of shares, is it possible to create tax neutrality and if so how?

For answers to Part A, refer to Appendix B at the end of the book.

Annexure 1 Larsen & Toubro Cement Division into Ultra Tech Cement

Larsen & Toubro Cement Division (A scheme of Structured Demerger)

The Aditya Birla group through Grasim Ltd. acquired the stake of Reliance Industries Ltd. in Larsen & Toubro Ltd. (L&T) in 2001 amounting to 10.05%. Subsequently, it adopted the creeping acquisition route and since the stake of Grasim in L&T was nearing the trigger point of 15%, as per the Takeover Code, Grasim made an open offer in late 2002 to acquire 20% of L&T at an offer price of ₹190 per share. The management of L&T on the other hand, felt that the valuation was too low against a fair value of around ₹300. Therefore, they approached the Financial Institutions (FI) to oppose the Grasim open offer. The FIs had in the past thwarted the attempt by Reliance to enter L&T. The strategy of Grasim, on the other hand, appeared to be to get over with the open offer and then go for the creeping acquisition route to get controlling stake in L&T. This was the strategy adopted by Reliance in BSES. Though Grasim had been maintaining that L&T was a strategic investment and that it did not seek to control day-to-day operations, the open offer was a move to pre-empt L&T from demerging its cement division and inviting a strategic MNC partner therein.

The SEBI issued a direction to the merchant banker JM Morgan Stanley to hold Grasim's open offer till its investigation in Gujarat Ambuja ACC case was completed. In that case, Gujarat Ambuja Cements bought over the Tatas from ACC acquiring in the bargain 14.4% of ACC in two stages. It maintained that its investment was strategic and not to seek operational control. However, SEBI has been investigating whether Gujarat Ambuja had management control on ACC and therefore, if it had violated the Takeover Code by not making an open offer. In its order to Grasim, SEBI wanted to investigate the same aspect in the L&T case as well. It also indicated that it would look into the pricing aspect, which the other shareholders felt was low. Grasim had paid ₹306 per share to Reliance. The Financial Institutions (FIs), which were holding 36% in L&T, were the single largest shareholder group. Grasim immediately filed an appeal on the SEBI order with the Securities Appellate Tribunal (SAT). Grasim's contention was that they had followed the rule book in making the open offer. As far as the price was concerned, Grasim felt that it was a fair price considering that it had paid an entry premium to Reliance. Any upward revision would have affected the interests of the shareholders of Grasim in which incidentally, the FIs held 24%. The open offer was only optional to L&T shareholders and therefore, they did not have the necessity to opt for the indicated pricing.

The Stand-off between Grasim and L&T Management

The L&T management had been striving to restructure L&T by hiving-off the cement division (which is now the largest in India) and inducting a strategic partner. Initially, three global cement majors Lafarge, Cemex and Holcim evinced interest in it. In the meantime, the Reliance shareholding changed hands and Grasim came in with two Board seats. This gave an indication to the market that the cement demerger would never happen. In the meantime, the foreign suitors lost momentum due to the emergence of Grasim in the picture. Under the circumstances, there were no other serious contenders to bid for L&T as a whole.

The L&T management felt that eventually Grasim wanted all its cement business under one company and would, therefore, work towards the interests of Grasim to the detriment of the shareholders of L&T. This issue of *conflict of interest* had surfaced and the management put up stiff resistance to Grasim at the board level. The suggestion by Grasim to have cross manufacturing arrangement between the two companies would have benefitted Grasim at the cost of L&T since the latter had better brands. The management felt protecting L&T's interests in future and still remaining in control would be tough for them. The management, therefore, resisted the open offer and sought institutional support.

As far as the Birlas were concerned, they needed majority control eventually to steer their investments in L&T to safety and derive value.

The Demerger Proposal by L&T and the Counter Demerger Proposal by Grasim

Since the proposed open offer by Grasim was stalled by SEBI, in the intervening period, the L&T management sought to revive its demerger plan and seek support for it from the FIs. Looking at the turn of events, Grasim came up with an alternative demerger plan and made its case with the FIs. Before either of the plans could go forward, SEBI in the interim gave a green signal for the original open offer of Grasim at ₹190 per share. This offer opened for the public in May 2003. Grasim had said in March that in the event of the FIs agreeing to its version of the demerger plan, it would go ahead with the open offer at the first stage and then go for the demerger and acquire a majority stake in the cement company by offering a value of $ 75 a tonne, which was the value a strategic investor was willing to give. However, if the FIs were to decline the demerger, Grasim intended to increase its open offer price by 20% to the range of around ₹225-240 per share. The outcome was dependent upon the decision of the FIs and the success of the open offer.

The Valuation of L&T Based on Sum of Parts[12]

	₹ *(crore)*
Engineering division valued at 5 times EBITDA	2347
Cement division valued at $ 80 per tonne	6600
Electrical division valued at one time revenue	705
Diversified businesses valued at one time revenue	425
Software division valued at 10 times net profit	420
Total gross valuation	10497
Less total debt	–3543
Value of Equity	6954
Outstanding equity shares (no. in crore)	24.86
Value per share (₹)	280

[12]Source: Business Standard (Smart Investor) dated 18th November, 2002.

L&T's Structured Demerger Proposal

The L&T management's plan was as follows:

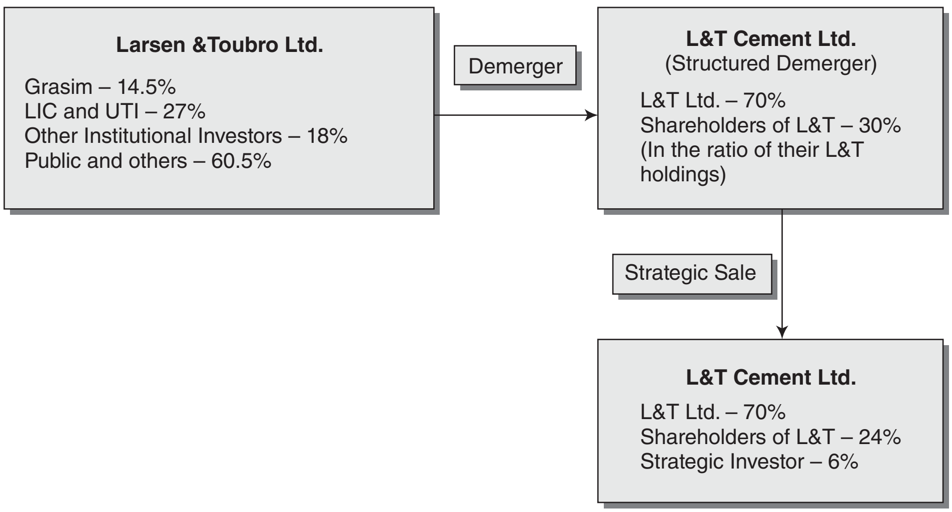


Exhibit 14.7 L&T Management Plan

The L&T management through this route wanted to maintain the say for L&T in the cement company, thereby preventing the AB group from exercising control. The dilution to strategic investor could happen either through fresh issue of shares (in which case the original 70:30 ratio between L&T and its shareholders interse would have remained static after the strategic sale) with the funds being received by the company or through disinvestment by the shareholders of L&T or a combination of both. The strategic partner was CDC Partners, a private equity investor. The management felt that its proposal would result in greater gains for the shareholders of L&T. This was because the strategic investor would pay a higher price than the Birlas for a stake in the cement business. Secondly, by keeping 70% with itself, L&T could offload a part of it at a future date to strategic investors at higher valuations looking at the good long-term prospects of the cement industry.

CDC agreed to pick up 6.8% in L&T Cement but put in a lot of restrictive conditions such as:

- Right to nominate a board seat.
- Fully convertible FCDs which can be converted before December 2004.
- If not converted, the debentures would be redeemed in three tranches between 2004 and 2007.
- Can exit the company, full exit possible after 2007.
- Conditions on operational issues.
- Drag along right to insist on L&T to sell 51% in all including its 6.8% in case it plans to exit the company. This is to get a better valuation from a strategic investor.
- Veto power on declaration of dividends, sale of assets and appointment of key executives. The alternative suggested by the L&T management was to allow exercise put option if it disagrees on major issues without being able to block decisions.
- Price offered translated to $ 76 per tonne.

- Co-sale – if L&T makes secondary market sales between 2004 and 2007, CDC has the right to sell alongside.

As an alternative to the CDC proposal, the L&T management suggested a competitive bidding route whereby a strategic partner would be selected out of several bidders. Under this plan, L&T would have 75% stake in the demerged company and the balance would be with L&T shareholders. At a later date, it would offer a strategic stake to an investor out of the 75%. It was open to the idea of having Grasim as a strategic partner to offload a stake of 47.5% at a valuation of $ 100 per tonne. Through this route, Grasim would get 47.5% from L&T in addition to the 3.5% it would be holding as part of the 25% with the L&T shareholders, thus, making it a cumulative holding of 51%. In addition, it would then make an open offer for an additional 20% as per the Takeover Code. The L&T management held that this plan would result in the best deal for the L&T shareholders. The valuation of $100 per tonne was justified by maintaining that it was in line with other valuations in the industry. Vishnu Cements was acquired for $ 82 per tonne by Zuari Cements. As compared to it, L&T had multi-locational plants, larger capacity of over 16 million tonnes, captive power facilities, premium brand and a jetty for the export of clinker. Therefore, the expectation of $ 100–105 per tonne was justified.

Grasim's Vertical Demerger Proposal I

The Grasim management's plan was as follows:

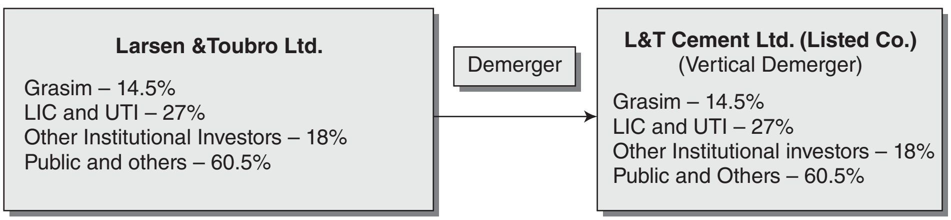


Exhibit 14.8 Grasim's Management Plan

Under the vertical split structure as above, L&T Ltd. as a company would not hold anything in L&T Cement. This structure, according to the Birlas, favoured the shareholders than the company itself. This also meant that Grasim at a later date could look at an open offer in L&T Cement thereby gaining control. Grasim opposed the competitive bidding route suggested by the L&T management on the ground that L&T Cement already had a candidate for the same in Grasim which had agreed to pay ₹130 per share ($65 per tonne) after the vertical demerger for its additional stake in the demerged company.

The L&T management analysed that under the vertical split, since Grasim would hold 14.5% of the cement company, it would need to acquire an additional 36% through an open offer to gain majority control. At the price offered by Grasim, this was much lower in investment than what was envisaged by the L&T management under its structured demerger plan.

Grasim's Demerger Proposal II

Since the L&T management and the FIs were of the view that the subsidiarisation plan would realise better shareholder value than the vertical split suggested by Grasim, an alternative plan was put forth by Grasim.

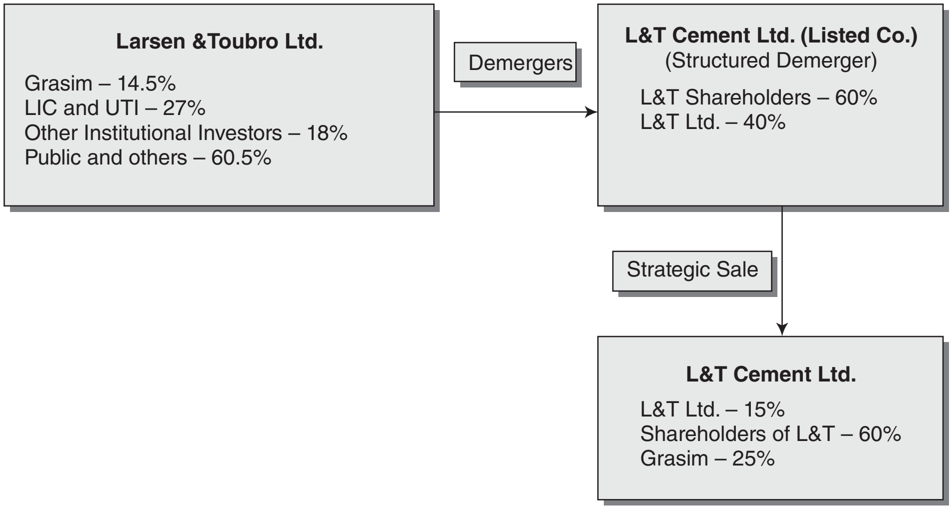


Exhibit 14.9 Grasim's Demerger Plan

Under this plan, the company would, at first stage, be demerged with L&T Ltd. holding 40% and the rest by the shareholders of L&T in their existing ratio. This would mean that Grasim would hold about 9% out of the 60% held by all shareholders. At the second stage, Grasim would buy a strategic stake of 25% from L&T Ltd. out of its 40% at a price of $76 per tonne matching the price offered by CDC. After the acquisition, Grasim would have around 34%. In addition, it would have had to acquire an additional 20% through an open offer, thereby gaining majority control of about 54%.

The open offer made by Grasim was eventually allowed by SEBI after clearing charges against Grasim in its earlier buy from Reliance. The open offer made at ₹190 a share for L&T evoked poor response from the public and Grasim managed to increase its stake by only 1%.

Thereafter, Grasim's second proposal found favour with ICRA, the rating agency that was appointed by the L&T management to examine both the proposals and make suitable recommendations. ICRA favoured the vertical demerger plan of Grasim stating that it would give the existing shareholders of L&T a representation in the cement business. However, ICRA recommended a higher price of $85 per tonne as the valuation for the cement business.

Taking note of ICRA's recommendations, Grasim hiked the price of its offer for the vertical demerger to $76 per tonne in order to impress upon the financial institutions to part with their 36% stake in L&T. This translated into a price of ₹170 per share for the cement business.

L&T's Viewpoint

Overall the L&T management's view was to have a structure, whereby L&T Ltd. would realise a strategic premium for parting with controlling interest in the cement business. They were opposed to the vertical split for two reasons: (i) with a 15% stake in the cement company to start with, Grasim can go for an open offer for 20% at market price and thereafter, adopt the creeping acquisition route to gain majority control without having to pay any strategic premium. This would be to the detriment of L&T shareholders. (ii) L&T management did not want Grasim to have controlling say in the cement business to safeguard its own interests. So it wanted L&T to have majority control in the demerged company. The management felt that if at all Grasim were to take a controlling interest, it should fork out a strategic premium for it in line with competitive valuation.

The Deal Closure

The final deal that was entered into by Grasim and with L&T in June 2003 paved the way for the largest M&A transaction in the country then valued at ₹2200 crore. The deal structure was as follows:

- L&T would hive-off its cement business into a new company, which would be christened UltraTech Cement Ltd. through a structured demerger. L&T in its corporate capacity would hold 20% and the rest would be in the nature of a demerger to the existing shareholders of L&T.
- As a result of the above, Grasim by virtue of its existing 15.7% stake in L&T would get a representation of around 12.6% in UltraTech Cement. Grasim would then acquire 8.5% of Cemco from L&T (out of its 20%) at a price of ₹171 per share amounting to ₹360 crore. Through this process, Grasim' stake increases to more than 20% with a corresponding fall in L&T's stake to 11.5%. Consequently, the Takeover Code would be triggered off.
- Grasim would then make an open offer for 30% in UltraTech Cement at ₹171 per share with a total open offer size of ₹1280 crore. Therefore, the total outflow for Grasim would be ₹1640 crore for a stake of 51% in UltraTech Cement. Thereby Grasim gets controlling interest in the cement business of L&T post-demerger.
- Since Grasim's strategic interest was only in L&T's cement business and not in its engineering business, it would sell off its 15.7% in the parent company to the employee trusts of L&T.

The above final structure brought the curtains down on one of the longest board room manoeuvers for a takeover in corporate India spanning more than 18 months. It was a personal triumph for the young Kumara Mangalam Birla, the Chairman of the then ₹300 billion Aditya Birla group.

The Final Take

The L&T deal catapulted Grasim into the global league with the largest manufacturing capacity for cement in Asia going upto 31 mtpa. Grasim would account for a 42% market share and would also save on costs. The company's estimated a future cost saving of ₹100 crore per annum. The markets cheered the deal and Grasim' shares went upto a 52-week high of ₹414 on its announcement. L&T scrip also rose to ₹239. L&T was to get a cash generation of ₹360 crore from the deal immediately. In addition, more than 50% of its outstanding debt of ₹3000 crore was to be transferred to Cemco upon the demerger, thereby cutting down its interest cost and debt-equity ratio.

However, in the final deal structure, UltraTech Cement was not going to get the benefit of certain assets, which were included in the initial demerger proposal. These were the L&T brand name, its ready mixed concrete plants, a power gas plant in Andhra Pradesh and some buildings. These were to remain with L&T. Therefore, in the final take, it was a win-win situation both for Grasim and L&T.

Post-Deal Developments

As per the final deal structure, L&T continued to hold 11.5% in UltraTech Cement after the proposed transaction was completed. At the end of 2007, L&T held 11.3% in UltraTech while Grasim continued to hold 0.63% in L&T. Under the arrangement sanctioned by the Bombay High Court, Grasim sold its 14% stake to L&T Employees Welfare Foundation at ₹120 a share and had retained 0.8%.

Both parties could not reach an agreement on the pricing to buy out each other's cross holdings. Grasim wanted to sell its stake in L&T at the then prevailing market price of ₹3,061.15 per share. But L&T wanted to buy the shares at ₹120, the price when the arrangement was drawn up between the two companies in 2004. The matter was referred by L&T to the High Court of Bombay which was dismissed by a lower bench. Similarly, L&T wanted to sell its stake in the open market which required a no-objection from the Birlas who had the right of first refusal. Under the terms of the agreement, in case the Birlas did not exercise their right of purchase, L&T was free to sell its shares to financial investors through open market operations. L&T was, however, not allowed to sell to strategic investors. After the Birlas finally gave their no-objection clearance to L&T in June 2009, it mandated Citibank as the sole arranger to its divestment through the open market. Finally, L&T completed the entire stake sale in 2009 for ₹1036 crore. Its stake was picked up by a number of institutional investors such as Citigroup Global Markets Mauritius, LIC, Pru India Equity Open, Reliance Capital Trustee and MasterTrust Bank. The Birla Group, which had the first right of refusal to buy the shares, did not participate in the open market sale. As a result of the exit, L&T saw UltraTech shares appreciate over 330 percent from about ₹171 to ₹735 in about 5 years of its holding.

L&T also divested its ready mix concrete business (which was not parted to UltraTech Cement in the original deal) to French major Lafarge in 2008 as a part of its exit from non-core businesses. The deal, which was valued for ₹1,480 crore ($349 million), gave Lafarge a 25% market share in the ready mix concrete business in India.

In the later part of 2009, Grasim announced the sale of its cement business undertaking to UltraTech in a deal worth more than $2 billion as the Aditya Birla Group's attempted to consolidate its cement business under one single roof after 11 long years of restructuring efforts. At the time of this announcement, Grasim held 55% in UltraTech. The transaction created India's single-largest entity in the cement industry. Swiss giant Holcim's Indian subsidiaries, Ambuja Cement and ACC, had a combined higher capacity but did not form one corporate entity. The restructuring of the cement portfolio within the Birla Group was a part of the overall effort to create flagship entities for each of their mainstream businesses such as cement, copper and aluminum. The restructuring efforts for the cement vertical were delayed post 2004 due to the significant stake held by L&T in UltraTech until 2009. It was reported that Grasim was contemplating its options between a slump sale and a demerger though the former meant a tax implication on the company. Ultimately, the deal was structured in such a way that Grasim demerged its cement business undertaking into its wholly owned subsidiary Samruddhi Cements. Immediately after that, the demerged entity was proposed to be listed and merged with UltraTech in a separate scheme of amalgamation. The entire transaction was accomplished by 2010 and UltraTech became the then largest cement company in India with a capacity of 49 mtpa or 20 percent of the country's cement production and also the 10th largest in the world at that time.

Annexure 2 Extracts from the Scheme of Arrangement

(A Scheme of Hive-off not Amounting to Demerger)

Between

Indian Rayon and Industries Limited Transferor Company Vikram Insulators Private Limited Transferee Company and their Respective Shareholders and Creditors

This scheme of Arrangement (hereinafter referred to as the **Scheme)** provides for the reconstruction of the Transferor Company consequential upon the transfer of the Transferred Business (as defined hereinafter) of the Transferor Company to the Transferee Company and consequent issue of shares and debentures by the Transferee Company to the Transferor Company pursuant to the relevant provisions of the Act.

(J) **Transferred Business** means all the business, undertakings, properties and liabilities, of whatsoever nature and kind and wheresoever situate, as on 11th August, 2002 of the Transferor Company pertaining to its Jaya Shree Insulator Division, on a going concern basis, together with all their assets and liabilities and shall mean and include (without limitation):

(i) all assets, moveable and immoveable, real or personal, in possession or reversion, corporeal or incorporeal, tangible or intangible of whatsoever nature ……. together with all present and future liabilities (including contingent liabilities pertaining to the Transferred Business) as appearing in the books of the Jaya Shree Insulator Division of the Transferor Company as on 31st July, 2002 a summary of which is annexed hereto as Schedule 1

(ii) all permits, quotas, rights, entitlements, industrial and other licences, approvals, consents, tenancies, offices, trade marks, patents, copyrights, all other intellectual property rights, bank accounts….. contracts and arrangements and all other interests in connection with or relating to the Transferred Business

(iii) all earnest moneys and/or security deposits paid by the Transferor Company in connection with or relating to the Transferred Business

(iv) all Employees of the Transferor Company engaged in or in relation to the Transferred Business as on the Effective Date

(v) All debts, liabilities, duties, responsibilities and obligations of the Transferor Company relating to the Transferred Business as appearing in the certified Balance Sheet of Jaya Shree Insulator Division as on 31st July, 2002

(vi) all necessary records, files, papers, engineering and process information, computer programmes, manuals, data, catalogues, quotations, sales and advertising materials, list of present and former customers and suppliers, customer credit information, customer pricing information and other records in connection with or relating to the Transferred Business.

Part II - Transferred Business

3. (a) With effect from the Appointed Date, all the estates, assets, properties, liabilities, obligations, rights, title and interest of the Transferred Business shall, pursuant to Section 394 of the Act and without any further act or deed, be transferred to and vested in or be deemed to have been transferred to and vested in the Transferee Company so as to become as and from the Appointed Date, the estates, assets, properties, liabilities, obligations, rights, title and interest of the Transferee Company. The entire Transferred Business shall be managed by the Transferee Company as a joint venture of the Transferor Company with NGK Insulators Ltd., Japan (NGK). NGK will infuse further capital and provide the technical know-how to the Transferee Company.

(b) In respect of such of the assets of the Transferred Business as are movable in nature or are otherwise capable of transfer by delivery or by endorsement and delivery, the same shall pursuant to the provisions of Section 394 of the Act stand transferred without requiring any further deed or instrument of conveyance for transfer of the same, and shall become the property of the Transferee Company as an integral part of the Business/undertakings hereby transferred.

(c) In respect of such of the assets of the Transferred Business other than those referred to in sub-clause (b) above, the same shall, as more particularly provided in sub-clause (a) above, without any further act, instrument or deed, be transferred to and vested in and/or be deemed to be transferred to and vested in the Transferee Company on the Appointed Date pursuant to the provisions of Section 394 of the Act.

(d) Any statutory licences, permissions, approvals or consents to carry on the operations of the Transferred Business shall stand vested in or transferred to the Transferee Company without any further act or deed and shall be appropriately mutated by the Statutory Authorities concerned in favour of the Transferee Company upon the vesting and transfer of the Transferred Business pursuant to this scheme.

4. (a) Upon coming into the effect of the scheme, the debts, liabilities and obligations of the Transferor Company relating to its Transferred Business shall without any further act or deed be and stand transferred to the Transferee Company and shall thereupon become the debts, liabilities and obligations of the Transferee Company.

(b) All loans raised and used and all liabilities and obligations incurred by the Transferor Company after the Appointed Date and prior to the Effective Date for operations of the Transferred Business shall also stand transferred to and vested in the Transferee Company upon the coming into effect of the scheme.

(c) All liabilities and obligations arising out of guarantees executed by the Transferor Company, relating to the Transferred Business in favour of third party shall become liability/obligation of the Transferee Company which it undertakes to meet, discharge and satisfy.

6. (a) Upon the coming into effect of the scheme, all legal or other proceedings by or against the Transferor Company under any statute, whether pending on the Appointed Date or which may be instituted in future (whether before or after the Effective Date) in respect of any matter arising before or after the Effective Date and relating to the Transferred Business shall be continued and be enforced by or against the Transferee Company after the Effective Date.

7. With effect from the Appointed Date and up to and including the Effective Date,

(a) the Transferor Company shall be deemed to have been carrying on and to be carrying on all business and activities relating to the Transferred Business and stand possessed of all the assets, properties, liabilities, obligations, rights, title and interest of the Transferred Business for and on account of, and in trust for, the Transferee Company; and

(b) all profits accruing to the Transferor Company, or losses arising or incurred by it (including the effect of taxes if any thereon), relating to the Transferred Business shall for all purposes, be treated as the profits, taxes or losses, as the case may be, of the Transferee Company.

8. (b) The Transferor Company has agreed that it shall run the business in such a manner that the net book value of the Transferred Business, i.e. the book value of the assets of the Transferred Business less the book value of the liabilities thereof on Effective Date shall not fall below US Dollar equivalent of ₹103.95 crore (Rupees one hundred and three crores ninety five lakhs only) without taking into account any value for goodwill (the Agreed Amount). In case the net book value is lower than the Agreed Amount, the Transferor Company shall remit to the Transferee Company, the difference between the Agreed Amount and the net book value of the Transferred Business on the Effective Date.

Part III - Remaining Business

11. With effect from the Appointed Date and upto and including the Effective Date,
    (a) the Transferor Company shall be deemed to have been carrying on and to be carrying on all business and activities relating to the Remaining Business for and on its own behalf;
    (b) all profits accruing to the Transferor Company thereon or losses arising or incurred by it (including the effect of taxes, if any, thereon) relating to the Remaining Business shall, for all purposes, be treated as the profits, taxes or losses, as the case may be, of the Transferor Company.

The Remaining Business and all the assets, liabilities and obligations pertaining thereto shall continue to belong to and remain vested in and be managed by the Transferor Company.

Part IV - Consideration

14. In consideration for the Transferred Business, the Transferee Company shall allot to the Transferor Company:
    (a) 1,24,90,000 equity shares of the face value of ₹10/- each at par; and
    (b) Debentures of an amount being the rupee equivalent of U.S. Dollars 2,50,00,000, being the amount received by the Transferee Company in Rupees on subscription to the shares of the Transferee Company by NGK, on such terms and conditions and in such form, as may be acceptable to the Transferor Company. However, the Transferor Company shall not transfer these Debentures and the Debentures will be redeemed by the Transferee Company as decided by its Board of Directors and agreed to by the Transferor Company.
15. There shall be no reduction of share capital of the Transferor Company under this scheme.

Part V - General Terms & Conditions

28. All taxes, costs, charges, levies and expenses which are statutorily the liability of the Transferee Company including stamp duty for the transfer shall be borne by the Transferee Company. All other taxes, costs, charges, levies and expenses in relation to or in connection with or incidental to this Scheme or the implementation thereof shall be borne and paid for by the Transferor Company.

Annexure 3 Reliance Industries Limited

(A Combination of Demerger and Spin-off)

The split-up of Reliance Industries Ltd. (RIL) was necessitated due to two primary reasons: (i) to grow the diversified and emerging businesses of RIL (demerged businesses) independently and (ii) to facilitate a family settlement between Mukesh Ambani and Anil Ambani, sons of late Dhirubhai Ambani, the patriarch and founder of RIL. In line with the family settlement, it had to be ensured that RIL would not have any cross holdings in the demerged businesses and that there would not be any kind of conflict of interests for the two groups. Therefore, the scheme also provided for a non-compete agreement and for a support agreement from RIL to supply gas, a feedstock for power generation.

I. The scheme is a combination of a demerger and a spin-off due to the following reasons:
  - RIL has diversified its interests in other businesses distinct from its own through a combination of use of its own balance sheet and strategic investments made in other companies. As a part of the scheme, the assets and liabilities of such businesses had to be demerged such that the demerged balance sheet of RIL did not have any assets or liabilities pertaining to such businesses. This was the demerger part of the scheme.
  - As far as the strategic investments were concerned, these had to be spin-off directly to the shareholders of RIL such that after the scheme was executed, there would be no direct shareholding for RIL in those companies in its balance sheet. Similarly, there had to be no cross-holdings between the two-family groups after the implementation of the scheme. This was the spin-off part of the scheme.
  - Both the above considerations formed the core of the whole split-up scheme of RIL. In effect, this was more of a spin-off than a demerger.

II. In order to bring into effect the above objectives, the following stages had to be accomplished:
  1. Demerger of the business undertakings from the balance sheet of RIL.
  2. Spin-off of the direct investments held by RIL in other companies that needed to be removed from its fold.
  3. Ensure that as a result of the scheme, the shareholders of RIL had listed shares in respective businesses that constituted a part of the combined RIL share held by them. This was necessary since RIL's share was listed and shareholders should be able to have the same liquidity as before.

III. The scheme addressed the above objectives and processes in the following manner:

Demerger Scheme

The scheme identified the business undertakings to be demerged (demerged undertakings) as follows:

- Coal Based Energy Undertaking consisting of a component of RIL's balance sheet and its strategic investments in Reliance Energy Limited (formerly BSES Ltd.) and other coal based power generation companies. RIL held 45% of Reliance Energy at the time of the scheme.
- Gas Based Energy Undertaking consisting of a component of RIL's balance sheet and its strategic investments in Reliance Patalganga Power Limited, a gas based power generation company.
- Financial Services Undertaking consisting of a component of RIL's balance sheet and its strategic investments in Reliance Capital Limited, Reliance Life Insurance Company Limited and Reliance General Insurance Company Limited. RIL held 29% of Reliance Capital at the time of the scheme.
- Telecommunication Undertaking consisting of a component of RIL's balance sheet and its strategic investments in Reliance Infocomm Limited, Reliance Communications Infrastructure Limited, Reliance Telecom Limited and World Tel Holdings Limited. RIL held 65.9% of Reliance Infocomm at the time of the scheme.

It may be noted from the above structure that the demerger provided for the business undertakings as well as the strategic investments to be removed on a combined basis. Presumably, this was done so that the spin-off of the subsidiaries and strategic investments would not give rise to tax implications and other legal complications, if made separately. In addition, a spin-off on a stand-alone basis would cause reduction in the shareholders' funds of RIL through a scheme under Section 391 of the Companies Act. The demerger scheme addresses this issue as well.

In order to achieve the spin-off with least structural changes to RIL's balance sheet and shareholding, the scheme addressed the issue in two phases.

First Phase

- At the first stage, four shell companies belonging to RIL were identified and their names were changed appropriately to reflect the demerged undertakings. These were companies floated by RIL in the past for various purposes but did not have any operations. Presumably in order to prevent cross-holdings, the ownership of these companies was alienated from RIL before using them for the purposes of the scheme. These companies were Reliance Communication Ventures Limited (RCoVL), Global Fuel Management Services Ltd. (GFML), Reliance Capital Ventures Ltd. (RCVL) and Reliance Energy Ventures Ltd. (REVL). Each of these companies became the resulting company for its respective demerged undertaking under the terms of the scheme.
- As a consideration for the transfer of the demerged undertakings, each of the resulting companies issued one new share of itself against one existing share of RIL to the shareholders of RIL as per the following formula:
  - One share of RCoVL of face value of ₹5 each fully paid.
  - One share of REVL of face value of ₹10 each fully paid.
  - One share of RCVL of face value ₹10 each fully paid.
  - One share of GFML of face value of ₹5 each fully paid.
- The issue of shares as above was envisaged for all existing shareholders except a group of shareholders who were called specified shareholders in the scheme. The specified shareholders collectively held 12.2% of RIL's shareholding. The issue of shares to the specified shareholders would have caused a conflict with the main objectives of the scheme mentioned above. Therefore, the scheme specifies that the specified shareholders waived their right to receive shares in the resulting companies. The scheme goes on to state that this would benefit the other shareholders of RIL since that many shares would be issued less by the resulting companies. As a result of this measure, the total number of shares issued by the resulting companies was 1223 million as against 1394 million equity shares of RIL. Understandably, the scheme does not elucidate the accounting treatment given in the books of the specified shareholders.
- Since all the resulting companies were unlisted, the scheme provided for listing them under the relevant DIP Guidelines so that the shareholders of RIL would have four new listed shares along with the original RIL share that represented the truncated demerged RIL.

Second Phase

- After the scheme became effective in December 2005, all the demerged undertakings became part of the Anil Dhirubhai Ambani Group (ADAG). The four resulting companies were listed on the BSE and NSE in the months of February and March 2006. The shares of RIL began trading again on January 18, 2006 post-demerger.
- In order to execute the remainder of the plan, REVL was merged with Reliance Energy Ltd. and RCVL was merged with Reliance Capital Ltd., thereby completing the spin-off process of these two companies from RIL. The shareholders of RIL now have a direct representation in these two listed companies.
- RCVL was structured as the holding company for ADAG's telecom ventures including CDMA operator Reliance Infocomm, GSM phone services firm Reliance Telecom, bandwidth company Flag Telecom

and Reliance Communication Infrastructure. Therefore, the spin-off process from RIL was completed and RCVL's entity was retained. Its name was since changed to Reliance Communication Ltd.

- GFML was renamed Reliance Natural Resources Ltd. (RNRL), a part of the ADAG's energy ventures business. It continues to trade on the NSE and the BSE. Interestingly, none of the RIL group shareholders own any shares in RNRL since it was part of the understanding for the demerger.

The RIL demerger had a positive effect on the market capitalisation and individual shareholder's portfolio. The markets cheered the proposal and heaved a sigh of relief that the bitter battle for the family settlement had been resolved. The RIL scrip which was quoting at around ₹800 prior to the demerger, went up in post demerger trading but settled down again at ₹800 by end of March 2006. However, the other four entities that got listed also had good response. Reliance Communications, REVL, RCVL and RNRL was quoting at around ₹300, ₹40, ₹25 and ₹30 respectively. Therefore, a shareholder of RIL holding one share of RIL valued at ₹800 prior to the demerger would have had five shares valued at around ₹1200. This meant a 50% increase in value over a few months, primarily triggered by the unlocking of value of Reliance Communications. What is interesting to note though, is the fact that RIL's truncated business commanded the same market capitalisation as that of the combined business a few months ago prior to the demerger.

Annexure 4 Wipro Limited

(Restructuring through a Scheme of Demerger Compliant with the IT Act)

In late 2012, Wipro Ltd., a Bangalore based diversified company announced a scheme of restructuring aimed at "enhancing value to our shareholders and provide fresh momentum for growth", according to the Chairman Mr. Azim Premji. The objective as stated in the Scheme was that the demerger was perceived to unlock value of the diversified non-IT businesses of the company and allow them to grow independently while enjoying the benefit of the Wipro brand.

Under the scheme, Wipro as the transferor company proposed to demerge three non-IT business divisions, including consumer products segment, into a privately-held company to be named Wipro Enterprises Ltd. The demerged company Wipro Ltd. would thereafter be an IT company exclusively. According to the filings made with the BSE by Wipro, the demerger to Wipro Enterprises consisted of its Wipro Consumer Care & Lighting division (including furniture business), Wipro Infrastructure Engineering division (hydraulics and water businesses) and Medical Diagnostic Product & Services division. According to the company, there was no proposal to change the leadership of any of Wipro Enterprises' constituent businesses and the Wipro brand was to be jointly owned by both the companies. The appointed date for the demerger was April 1, 2012.

Salient Features of the Scheme

1. The demerger was proposed pursuant to Sections 391–394 of the Companies Act read with Sections 78, 100 to 103. The scheme expressly provided that it shall be compliant with provisions of a demerger as provided in Section 2(19AA) of the IT Act.
2. Wipro Ltd. was the transferor company (demerged company) and Wipro Enterprises was the transferee (resultant company). The original name of the resultant company was Azim Premji Custodial Services Ltd. which was proposed to be changed pursuant to the scheme.
3. The scheme also envisaged transfer of ownership and usage rights, all brands and intellectual property rights of the various businesses of Wipro from a third company called Wipro Trademarks Holdings Ltd. Wipro Trademarks was a wholly owned subsidiary of Wipro. The scheme provided for the use of trademarks and intellectual property rights to both the demerged and the resultant companies.
4. The demerger consisted of the following:
   Demerger of non-IT businesses (supra) by demerged company to resultant company as a going concern. The value of the business undertakings being demerged was provided in the scheme as per the balance sheet of those undertakings on March 31, 2012. The book value of assets being transferred was ₹49.316 billionand the book value of corresponding liabilities was ₹7.017 billion resulting in a net asset value of ₹42.299 billion.
5. In consideration of the demerger, the resultant company proposed to issue to all shareholders holding domestic listed shares, for every 5 shares held in the demerged company:
   (a) One share in the resultant company (i.e. a ratio of 1:5) or
   (b) One 7% redeemable preference share in the resultant company as per terms specified.
6. In consideration of the demerger, the resultant company proposed to issue to all non-resident shareholders holding domestic listed shares, and all ADR holders (represented by the Custodian) for every 5 shares held in the demerged company, one share in the resulting company (the same ratio as for domestic shareholders). The option of redeemable preference shares was not available to non-resident shareholders since it would not have been compliant with FDI policy and FEMA Regulations.

7. All equity shares received from the resultant company by domestic shareholders (who opted for 5(a) above) and all non-resident/ADR holders were meant to be compulsorily exchanged for shares in the demerged company in the ratio of 1:1.65, i.e. for every 1.65 shares held in the resultant company, one share of the demerged company will be issued.
8. The shares to be issued by the demerged company to the holders of shares in the resultant company pursuant to the exchange scheme (supra) was not proposed through a new issue of shares by the demerged company. Instead, these were proposed to be issued by a Special Trust to be set up by the promoters. The promoters were required to transfer the requisite amount of their shares held in the demerged company to an escrow account to be set up by the Trust with all the eligible shareholders and the Custodian as beneficiaries.
9. The share exchange was proposed to be completed in 5 working days and the shares in the resultant company that would be received into the escrow account were to be transferred to the credit of the promoters. The Trust proposed to incur all the costs of such exchange including stamp duty and legal costs. The Trust also took responsibility for withholding tax obligations that could arise from such share distribution to non-residents and the Custodian. The Trust was proposed to be dissolved after the completion of the transaction in all respects.
10. All allotment of securities pursuant to the scheme in respect of ADR holders were proposed to be made to the Custodian.
11. The securities issued to the Custodian were not proposed to be registered in USA by availing the exemption provided under Section 3(a)(10) of the Securities Act 1933.
12. The allotment of securities by the resultant company to non-resident shareholders and to the Custodian as well as the share exchange, thereafter, with shares in the demerged company were subject to extant FDI policy and FEMA Regulations and necessary approvals as might have been required thereunder.
13. The scheme also proposed that with respect to the shares of the demerged company received by the Custodian from the Special Trust pursuant to the share exchange, the demerged company shall enter into appropriate agreements with the Custodian and Overseas Depository for issue of additional ADRs to eligible ADR holders as per their entitlement ratio. Such issue of additional ADRs was subject to necessary approvals under the Securities Act, 1933. It was also provided that in case such approvals were not to be received, the Custodian may sell the shares in the domestic secondary market and appropriate the proceeds thereof to the benefit of the ADR holders or deal with them in any other manner, as may be arrived at by both the companies in the interests of the ADR holders.
14. The resultant company proposed to increase its authorised capital of equity and preference capital to accommodate the new issue of securities once the scheme became effective.
15. All securities issued by the resultant company were not proposed for listing anywhere. Therefore, the resultant company was proposed to remain unlisted.
16. All share entitlement ratios for the scheme were fixed based on independent valuations conducted by N.M.Raiji &Co., Chartered Accountants and Deloitte Touche Tohmatsu India Pvt. Ltd. along with independent fairness opinions received from JM Financial Institutional Securities Pvt. Ltd. and Citigroup Global Markets India Pvt. Ltd.

Evaluation of the Scheme

1. This scheme was unique in many respects. Firstly, it proposed to keep the resultant company that arose from the demerger of a listed company, unlisted. Normally, the demerger of a listed company results in the listing of the resultant company as well as was the case with the demerger of Reliance Industries Ltd. and many other such companies. Secondly, Wipro Ltd. as the demerged company was already

listed in the US and had ADR holders in its portfolio. Therefore, the company had to find a way to accomplish two things: (i) keep the resultant company unlisted but provide a way to compensate its shareholders with listed shares and (ii) enable its ADR holders to a similar benefit of listed ADRs as consideration.

2. In order to achieve both the above objectives, the demerger scheme had two interesting features: (i) The share exchange scheme using promoters' shares in Wipro Ltd. and (ii) The proposal to provide additional ADRs to its investors against underlying shares received by the Custodian from the Special Trust. In short, as per the proposal, the scheme would have resulted in the promoters paying a purchase consideration by way of the stock of Wipro Ltd. to the shareholders of Wipro Ltd. for transferring the non-IT businesses to an unlisted entity owned by them. If this had to be done directly by the promoters with Wipro Ltd., there would have been two problems: (i) Wipro would have had to resort to a hive-off or a slump sale both of which would have given rise to tax implications for Wipro Ltd. (ii) Since the promoters had planned to settle the transaction through shares that they owned in Wipro, the transaction would have given rise to treasury shares on Wipro balance sheet.
3. The very unique demerger scheme devised by the company obviates both the above issues by making the transaction compliant with the demerger law and thereby providing the necessary tax neutrality. At the same time, it enables the promoters to do a cashless transaction to get complete control of the non-IT businesses of Wipro Ltd. To a lesser extent, it also enabled them to keep the non-IT businesses unlisted and wholly owned by the promoters for pursuing every possible growth strategy thereafter. The scheme also took care to ensure that the promoters had the continued benefit of using the Wipro trademark and brand name which was built by Wipro Ltd. in businesses that would entirely belong to them thereafter. In the author's view, this does not measure upto satisfactory standards of corporate governance as no separate consideration was paid for the transfer of intellectual property rights by Wipro Trademarks Holdings Ltd. If this consideration was already built into the share entitlement ratio, the break-up thereof attributable to the transfer of intellectual property rights should have been disclosed in the scheme.
4. The proposal of share exchange is quite innovative and this scheme is a rare example of such a spin-off happening in the Indian context and provides insights into how a reverse split-off can be accomplished in India. Similarly, the proposal for issue of additional ADR or open market sale of the additional shares in India is quite innovative.

Overall, the scheme is one of its kind in the Indian context and can become a precedent for more such innovative schemes to be structured in India in the years to come.

Annexure 5 Pantaloon Retail India Limited

(Financial Restructuring through a Composite Scheme of Demerger)

Pantaloon Retail (India) Ltd. (PRIL) is the flagship listed company of the Future Group led by Mr. Kishore Biyani, the promoter and principal shareholder of the group. Though it started off as a garment company, PRIL expanded rapidly post 2000 into several businesses and retail formats through business alliances and joint ventures. The group identity was changed to Future Group in 2006. The group established itself as a market leader in organised retail and brand management with several formats and prestigious labels. In the course of its rapid expansion, PRIL and group companies accumulated mountains of debt which amounted to around ₹7600 crore by March 2012. Post the global recession, the group started looking out for various options to raise funds, restructure and pare its debt. The objective was to unlock value in its business assets held in various group companies and raise equity and cheaper debt. In 2010, the mall management and project management activities of PRIL were demerged into a separate company called Future mall Management in a bid to unlock value from its real estate assets. PRIL planned to carve out its equity by taking Future Mall Management public in future. PRIL also planned to create a step-down subsidiary of the demerged company which would hold all leasing business and food courts and restaurants run by the company. The plan was to induct a strategic partner into the step-down subsidiary.

Pantaloon Retail had entered into a lot of related businesses in the past. Some of them were incurring heavy losses. By demerging these businesses, PRIL hoped to ensure that its balance sheet remained trim so that it could focus on core retailing business. According to the company, the whole idea was to retain PRIL as a profitable retail entity and separate all loss making non-retail businesses from it so as to enhance its market capitalisation which was going down steadily under the weight of its mounting debt. In 2009, the company also explored fund raising through preferential allotment to promoters and PE investors. The group also created a company called Future Ventures India Ltd. (FVIL) subsequently and in 2012, it announced a major restructuring for PRIL. This restructuring move also coincided with the proposed investment by the Aditya Birla group company, Aditya Birla Nuvo (ABNL), in the garment business of the group. As per the investment agreement drawn up between both the parties, it was agreed that the fashion business of PRIL would be demerged into a separate company after ABNL infused ₹800 crore into the company in the form of Optionally Fully Convertible Debentures (OFCDs). Post demerger, the OFCDs were proposed to be converted into equity of the resultant company thereby giving ABNL a stake of around 25% to trigger the Takeover Code. ABNL would make an open offer for 26% of the resultant company so as to acquire majority stake. ABNL also agreed for the carryover of further debt from PRIL to the resultant company to help deleverage PRIL.

Based on the above investment, a scheme of demerger was announced to split up PRIL.

The scheme envisaged the following steps:

- Both PRIL and FVIL would demerge their fashion businesses into a new, to be listed, entity called Future Fashion Ltd. which would emerge as one of India's largest integrated fashion brands and retail company consolidating the entire retail fashion business of the group.
- Post the demerger, PRIL proposed to have as its core businesses the country's leading hypermarket and supermarket chain. In addition, the company will continue to own its existing investments in subsidiaries involved in supply chain solutions, sourcing, e-commerce, office supplies and joint ventures in insurance and textile mills in Mumbai.
- Future Fashion proposed to own and operate retail chains with domestic and global brands, an extensive distribution and retail network and manufacturing capabilities.

- FVIL proposed to be a company focused on the Food and FMCG sector with a portfolio of FMCG brands, its own rural distribution chains and convenience stores. It will focus on developing an integrated foods and FMCG business for the group. It, therefore, proposed to cease its NBFC activities. The financial services activities of the group were proposed to be consolidated under Future Capital Holdings.
- Post the realignment, shareholders of PRIL will hold 49.8% in Future Fashion, shareholders of FVIL will hold 30.5% and 19.7% will be held by PRIL as a corporate entity. As per the scheme, PRIL deleveraged itself with ₹1,226 crore of debt being transferred to Future Fashion. Future Fashion proposed to induct strategic/financial investors to explore possible monetisation of its value to further reduce leverage.
- The proposed scheme received the approvals of the shareholders and the Competition Commission of India and at the time of writing was awaiting confirmation from the High Court.

This scheme of demerger was more of a financial restructuring of the group to deleverage its expensive debt. However, the capital restructuring required hiving-off of assets that required to be grown as independent businesses, bring in strategic and financial equity and thereby monetise the parent company's investments in those assets. This restructuring was aimed at helping improve the company's market capitalisation and enable further fund raising by itself. All these objectives were fairly accomplished through the restructuring scheme.

15 Mergers and Amalgamations

LEARNING OUTCOMES

- Global and Indian perspective of M&A landscape and strategic objectives.
- Concept and definition of merger, amalgamation, absorption and reconstruction.
- Amalgamation structure and legal provisions, types of mergers—horizontal, vertical and conglomerate with case studies.
- Financial evaluation of a merger and M&A analysis with worked out illustrations, determinants of financial outcome.
- Valuation approaches and methodologies in mergers.
- Judicial Review of Schemes of Arrangements and Merger Valuation.
- Transaction Process in a scheme of arrangement involving a merger.
- Judicial pronouncements on schemes of arrangement involving mergers and amalgamations.
- M&A Advisory as a business portfolio of investment banks, investment banking perspective of M&A—identification of transaction structure, deal structuring, currency for the merger and merger MOU.
- Case Studies in Mergers and Amalgamations of well-known companies.

15.1 Introduction to the M&A Market

15.1.1 Global Industry Perspective

Corporate re-organisations consisting of restructuring, mergers, amalgamations, acquisitions and takeovers are by far, the most important business segment for investment bankers after management of public offers. Globally, in the traditional days of investment banking, this business segment, popularly known as *M&A*, contributed to significant share of the bottom line of investment banks, sometimes becoming the largest revenue stream. USA and Europe have traditionally been the favourite hunting grounds for mergers and acquisitions and over the decades, they influenced the growth and transition of corporate America and trans-national corporations. M&A segment received further boost with the popularity of the junk bonds and Leveraged Buy-outs, or LBOs in the US market in the 1980s. The biggest of them all in those days was the LBO of RJR Nabisco in 1988 estimated at $ 31.1 billion (more than $60 billion inflated adjusted in 2016). Between 1986 and 1989, LBOs had accounted for about 20% market share in the total M&A industry.

The M&A activity was further spurned on in the nineties by the increased global capital flows and it continued to grow and touched about $3.5 trillion per annum by the start of the new millennium. During this time, the LBO market went through a correction and by 1999, LBOs represented only 4% of the market. In addition, over the years, individual deal sizes went up considerably. Some of the biggest deals made towards the end of the nineties were all in excess of $50 billion such as MCI Worldcom—Sprint (US$ 115B), Exxon-Mobil (US$ 78.9B), Travelers Group—Citicorp (US$ 72.6B), Nations Bank-Bank of America (US$ 61.6B) and several others. The new millennium began with big-ticket deals such as AOL-Time Warner, HP-Compaq and Gillette-P&G. This pattern indicated that while the trend in the eighties was that of buying companies through cash deals financed considerably through leveraging, the trend in the nineties was more towards predominantly stock deals. The first eleven months of 2003 produced M&A deals worth $1,334 billion as compared to $ 1,271 billion in the whole of 2002. According to Dealogic, a global financial information provider, in the year 2006, a total of 149 M&A bids were received for US$ 507.7 billion in the global market and the US market accounted for 23% of it. This is in sharp contrast to the trends seen up till 2003 wherein acquisition bids were much smaller. Not only did the number of companies being chased by acquirers increases, the size of the bids saw exponential growth. The largest bid reported in 2006 was for the Spanish company Endesa for an amount of US$ 66.1 billion from Germany's E.ON. Out of the deals that were completed, cross border M&As showed significant increase in global capital market due to the increasing influence of globalisation. For example, in 2005 alone, cross border M&As amounted to US$ 716B.[1] Several such deals set the trend for big ticket M&A becoming common place in the years to come. One of the most talked about global deals in 2006 was the acquisition of Arcelor of France by UK based Mittal Steel for a deal value of Euro 26.9 billion.

The top global M&A transactions in value terms as ranked by Investment Week in 2012 were the following—Vodafone Group's acquisition of Mannesmann AG ($202.8 B in 1999), America Online (AOL)'s acquisition of Time Warner ($164.7 billion in 2000), Spin-off of Philips Morris International ($107.6 billion in 2008), RBS led consortium's acquisition of ABN AMRO Bank ($98.5 billion in 2007), Pfizer's acquisition of Pharmacia Corporation ($89.2 billion in 2003), Exxon Corporation's acquisition of Mobil Corp to form Exxon-Mobil ($78.9 billion in 1998), Glaxo Wellcome's acquisition of SmithKline Beecham ($76 billion in 2000), Royal Dutch Petroleum Corporation's buyout of Shell Transport and Trading Company (74.6 billion in 2004), AT&T's acquisition of BellSouth Corporation ($72.7 billion in 2006) and the merger of Traveler's Group with Citicorp ($ 72.6 billion in 1998).

The global financial crisis in 2008 proved to be a huge setback for the global M&A industry and in the next few years that followed, the size of the market shrunk on perceptions of economic slowdown, fiscal cliffs being faced by the Euro Zone and the US and lacklustre capital markets. One of the largest cross border M&A transactions around this time was the acquisition of Switzerland's Nycomed by Japan's Takeda Pharmaceuticals ($13 billion in 2011). Another notable international M&A deal was the takeover of UK's chocolate manufacturer Cadburys PLC by Kraft Foods in $19.5 billion, creating the world's largest confectionery company. Global cross border M&A recorded strong growth in 2011 to reach near to $400 billion. According to the Grant Thornton International Business Report 2012, the sentiment across the globe for M&A remained strong and had improved significantly as compared to 2010. While USA and Canada continue to be the top destinations for M&A, France and Germany from the Euro Zone, UK and Ireland and

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[1]As reported in the Economic Times, October 17, 2006

the BRIC economies are among the high growth M&A markets. Most corporate houses in these economies show increased penchant for inorganic growth through domestic M&A while a significant percentage of them in various markets believe in cross border M&A as well. One of the big cross border M&A deals of 2013 was the merger of Swiss commodity giant Glencore International and the mining major Xstrata PLC ($32 billion) forming the world's largest commodity trader and the fourth largest mining company. By 2015, global M&A activity peaked again at $4.9 trillion surpassing the levels witnessed in 2007. The merger of Pfizer and Allergan, Dow Chemical and DuPont, Heinz and Kraft Foods, AT&T and Time Warner, Dell's acquisition of EMC, Reynolds American by British American Tobacco, Monsanto by Bayer were some of the major global transaction announcements at the time.

Global M&A activity is further supported by the flow of capital to the M&A industry from financial investors. The increasing integration of private equity, buyout and sovereign wealth funds with the M&A space in recent times led to the availability of trillion dollar funds to the M&A industry that catapulted deal sizes and promoted aggressive deal making. The big acquisition and buy-out transactions led by funds such as Blackstone, KKR, TPG Capital, Warburg, Barings Capital, Temasek, Khazanah and others are evidence of increasing integration between the PE industry, M&A and investment banking.

The growth of the M&A industry is good news from investment banks that thrive on such deal making. Global bulge bracket investment banks and others compete in M&A deal making and are always at loggerheads to top the league tables. As discussed in an earlier chapter, league tables are very important for investment banks and M&A league tables are compiled separately as distinct from overall league tables. The rankings are done on the basis of the number of transactions handled and the value of those deals. An illustrative league table of investment banks in M&A activity is shown below.[2]

Table 15.1 Illustrative Global League Table of Investment Banks in M&A**

Name	*Volume in $ Mill*	*Number of deals*	*Market share %*
Goldman Sachs & Co.	606,134	217	25.3
Morgan Stanley	490,544	201	20.5
J.P.Morgan Chase & Co.	414,631	211	17.3
Credit Suisse Group AG	372,498	145	15.5
Bank of America Merrill Lynch	363,604	141	15.2
Barclays Capital Group	321,565	136	13.4
Citigroup Inc	268,370	148	11.2
Lazard Ltd.	219,891	145	9.2
UBS AG	210,332	109	8.8
Deutsche Bank AG	197,267	107	8.2

** The figures furnished in the table are illustrative and should not be construed as reflective of the position of these investment banks in the industry.

15.1.2 Indian M&A Industry

The Indian M&A scenario is much more modest both in terms of the size of the industry and the number of deals. Historically, prior to the reform era that began in 1991, the M&A market was small due to regulatory hurdles such as the MRTP Act (Chapter III) that curbed companies from growing both in terms of assets and

[2]As reported for 2016 by Bloomberg Financial Advisory

in terms of control. Though the *Licence Raj* and *Quota* system perpetrated a climate wherein setting up new business undertakings was extremely cumbersome and time-consuming, acquisition of existing companies was even more difficult due to the lack of a structured mechanism for takeovers in India. It can be said that while the MRTP Act was the main hurdle for mergers, acquisitions had several other hurdles. As far as mergers were concerned, these were mostly intra-group mergers either as part of bankruptcy restructuring (through IRBI or rehabilitation by a DFI and later by the BIFR) or tax mergers to avail tax shields available in loss-making entities. The sale of Hyderabad Allwyn to the Mahindras, Voltas takeover, Kelvinator, Nelco (by the Tatas), the Modi group restructuring were all related to financial distress. The group company mergers of Hindustan Lever Ltd. (Lakme's cosmetic division, Ponds, Brooke Bond and Lipton) are an example of intra-group mergers.

Historically, takeovers were sought to be regulated by the listing agreement of the stock exchanges. Clauses 40A and 40 B of the listing agreement with the BSE contained provisions to the effect that a person acquiring 25% or more of the voting rights of a listed company should make a public offer. This threshold limit was lowered to 10% in 1990. The first company that used this provision was Tata Tea Ltd. that made an open offer to acquire Consolidated Coffee in 1988. In addition, Section 111 of the Companies Act and provisions under the SCRA gave unfettered right to the board of directors of a company to refuse transfer of shares in favour of any person, if such transfer meant a change in management control that would be detrimental to public interest. In addition, there were restrictive provisions under the MRTP Act that restricted free transferability of shares to and from persons having substantial interest in companies. The restrictions in the MRTP Act, Companies Act and the SCRA were ominous to the extent of deterring any attempt for a corporate raid. In short, mergers and takeovers were more or less a pipe dream in that era. The government owned financial institutions, that held significant stakes in several companies, played a major part in change of management control, whether in the context of a takeover or not.

Takeovers battles are not alien to the Indian corporate landscape. There have been several takeover battles in the past, notably the famous but unsuccessful takeover bids by Lord Swaraj Paul on DCM and Escorts in the early eighties, and much later, the Ambanis' bid for Larsen & Toubro. Manu Chhabria's successful takeovers of Shaw Wallace, Genelec, Mather & Platt etc., the Hindujas taking over Ashok Leyland and much later Rajarathinam &Associates (Agni Group)'s acquisitions (Garware Paints, Deve Sugars) are some examples. Prior to the liberalisation era, such attempts were few and far between and therefore, made headlines.

M&A activity got a boost post-liberalisation due to the global imperative for consolidation as also the introduction of a structured code on takeovers. There were more than 400 open offers under the Takeover Code of SEBI in the five years after it was introduced in 1997. Cases of consolidation through mergers were quite a few such as the HLL mergers, TOMCO, Godrej group, AV Birla Group, Idea Cellular, India Cements-Raasi-Vishnu, Gujarat Ambuja-ACC, Nicholas Piramal group, Lafarge and several bank mergers, among others. In terms of market size, the Indian M&A market grew considerably in the late nineties and thereafter. In terms of number of deals, 2003 saw 978 acquisitions and 345 merger deals.[3] The notable M&A transactions were Flextronics's acquisition of Hughes Software (US$ 226M), HP's acquisition of Digital Global Soft (US$ 272M) and IBM's acquisition of BPO company Daksh (US$ 7B). The increasing consolidation in the domestic banking industry starting with the Centurion Bank-Bank of Punjab merger and ICICI Bank-Bank of Madura merger laid the roadmap for things to come.

The Indian M&A market saw a meteoric growth from 2004. According to another study, there were 237 M&A transactions recorded in 2004 for an aggregate deal value of US$ 9.5 billion. Some of the big acquisitions during this time were Bharat Petroleum acquiring Cochin Refineries, GlaxoSmithKline Pharma acquiring Burroughs Wellcome and Grasim's acquisition of L&T's cement division (UltraTech Cement).

[3]According to CMIE Data

The notable transactions in 2005 include Vodafone's 10% stake in Bharti Televentures for US$ 1.5 billion, Essar buying BPL's mobile business, Reliance Capital acquiring AMP Sanmar and IFFCO's purchase of Oswal's fertiliser business. The year 2006 was yet another watershed year for Indian M&A.

According to a study by Grant Thornton, there was an increasing trend of outbound acquisitions. India saw its share of cross border M&A too with the trend of Indian companies making significant overseas acquisitions. This trend was probably started by Tata Tea acquiring Tetley but the trend caught on in the years starting with 2003 with more Indian companies looking at cross border M&A. The year 2001–02 saw 45 such deals followed by 35 in 2002–03 and 39 in 2003–04 till November 2003. In 2003, ONGC Videsh, a subsidiary of ONGC Ltd., acquired a 50% stake in an offshore oil block in Angola. Tata Steel acquired Natsteel of Singapore for US$ 486 million. Videocon bought out the colour picture tube business of Thomson for US$ 290 million. Indian pharmaceutical companies such as Dr. Reddy's Laboratories, Wockhardt, Glenmark, Ranbaxy, Nicholas Piramal were front runners in M&A. Matrix Laboratories took over Explora Labs, Jubilant Organisys took over Target Research and Nicholas Piramal acquired Avectia Pharma. Among the inbound acquisitions, the notable were Oracle's acquisition of I-flex Solutions (US$ 593 million) and Holcim's acquisition in ACC, Ambuja Cement (US$ 208 million). The Tata-Corus deal and AV Birla Group-Novelis acquisition signalled the arrival of big ticket Indian M&A in the global arena.

In keeping with global trends, post-2008 M&A activity in India dampened across sectors and the continuance of economic concerns such as persistent high inflation, lower growth expectations, policy limbo and flight of foreign capital made the capital market lacklustre. With the reduced investment climate and higher risk perceptions, the flow of funding for big ticket M&A deals also dried up and there were few such deals between 2008 and 2012. The segment that remained active was the buyout funds that emerged as a significant M&A player in the domestic market in India around 2005. According to Dealogic, PE buyout deals were higher in 2011 at 125 than in previous years Though India continued to be a strong contender for inbound M&A from foreign players, the trends started to show encouraging signs only from 2012. Similarly, outbound M&A from India showed huge decline after 2007 and began to show signs of revival in 2012. Among the big inbound M&A transactions post-2008 were the Vedanta-Cairn acquisition ($8.6 billion) and British Petroleum's purchase of stake in the gas blocks of Reliance Industries. Among the outbound M&A transactions, some of the notable were the Tata Motors acquisition of Jaguar Land Rover (JLR) of UK ($2.3 billion in 2008), Adani Enterprises' acquisition of Abbot Point Coal Terminal in Australia ($2 billion), GVK group's acquisition of Hancock Coal ($1.26 billion) and the Mahindra & Mahindra acquisition of 70% majority stake in the auto company Ssangyong of South Korea ($463 million). The failed attempt by Indian Hotels of the Tata group to acquire Orient Express Hotels (US $ 1.2 billion in 2012) and Sahara group's successful acquisitions of Plaza Hotel and Dream New York in Manhattan ($ 800 million in 2012) and Grosvenor Hotel in London (GBP 470 million in 2010) were also made during this period.

Pure play domestic M&A and the buyout segments also saw some notable transactions such as i-Gate's buyout of promoters' stake in Patni Computers (2011), Daiichi's buyout of promoters in Ranbaxy (2008), divestiture of Matrix Laboratories to Mylan, sale of domestic formulations business by Nicholas Piramal to Abbot Laboratories (2010), divestiture by the promoters of Shantha Biotechnics (2009)and Aurobindo Pharma, divestiture by promoters of Wockhardt Hospitals to Fortis Healthcare, buy-out of unlisted Paras Pharma by Reckitt Benckiser, the bailout acquisition of the troubled Satyam Computers (renamed Mahindra Satyam) through an auction process by Tech Mahindra, buy-out of Nutrine Confectionery by Godrej Foods and Beverages, Blackstone's buy-out of Emcure Pharma, Orkla Foods' buy-out of MTR Foods, buy-out of Enam Securities by Axis Bank and JSW Steel's buy-out of the promoters' stake in Ispat Industries. Notable joint venture exits included the divestiture by Hutch of their telecom JV with Essar in favour of Vodafone and Honda's divestiture to Hero in their automotive joint venture. M&A activity continued to be robust and by 2016 driven by transactions in the e-commerce sector, pharma, healthcare, bio-technology, ITES and financial sector.

The merger of ING Vysya Bank with Kotak Mahindra Bank, Ranbaxy with Sun Pharmaceuticals, Cairn India with Vedanta India weresome of the larger transactions.

An illustrative league table of M&A investment bankers in India is provided in Table 15.2. One notable trend in the Indian M&A space has been the consolidation of their presence by global investment banks as compared to the league tables in 2004–07.

Table 15.2 Illustrative League Table of Investment Banks in M&A in India**

Name	*Volume in $ Mill*	*No. of deals*	*Market share %*
Morgan Stanley	9,662	10	23.8
Goldman Sachs & Co.	7,460	299	19.4
Standard Chartered Bank Plc	5,794	306	18.8
Bank of America Merrill Lynch	3,780	241	14.9
HSBC Bank Plc	3,676	161	14.0
Royal Bank of Scotland Group	2,837	230	13.8
Nomura Holdings Inc	2,540	201	12.5
Ernst & Young	2,345	203	10.5
SBI Capital Markets Ltd.	2,228	195	10.0
Avendus Capital Pvt.Ltd.	2,223	206	9.0

**The figures furnished are illustrative and should not be construed as their relative rank in the industry.[4]

15.2 Strategic Rationale for Mergers and Acquisitions

As explained in the previous chapter, mergers, acquisitions and corporate restructuring are a part of business portfolio re-organisation by companies that happens on a continuous basis as a response to business dynamics. Corporate re-organisations are a part of change management in business. Furthermore, mergers and acquisitions in particular, promote inorganic growth of a business enterprise that can help it to grow faster than through the organic route of asset creation. Furnished below are some of the strategic objectives relating to mergers and acquisitions with related examples in the Indian context. The list is not exhaustive.

- *To grow at a rate faster than an organic growth rate:* An acquisition strategy is often driven by the objective of attaining faster inorganic growth. Most M&A strategies are in this space. Companies either wish to grow faster in their own industry. The Nicholas Piramal group is an example of a business group that followed M&A as a growth strategy which started off buying out Sumitra Pharmaceuticals. Globally, Glaxo is a good example in the pharmaceutical space which acquired Burroughs Wellcome and SmithKline Beecham.
- *To enter a new market or grow beyond a saturated market:* Sometimes, mergers and acquisitions help in becoming an entry strategy. The acquisition of Tetley in UK by Tata Tea Ltd. is a good case in point. Several such acquisitions of brands and product lines were seen among FMCG companies such as Coca Cola's acquisition of Parle's soft drink business, Sara Lee's buy of Nutrine's biscuit business, Modern Foods by HUL, Kwality ice-cream by HLL (it became Kwality Walls) etc. Holcim's entry strategy into the Indian cement market was through the acquisition of Gujarat Ambuja Cement.

[4]All figures as reported for 2011 by Bloomberg Financial Advisory. The trend remained more or less the same in 2016 with foreign investment banks occupying the top positions. JM Financial and Ambit Capital also figured in this list among the top M&A investment banks in India in 2016.

- *To capture forward and backward linkages in the value chain:* Often group company mergers are triggered off to provide a complete value chain within the same company (known as vertical mergers). Similarly, such mergers are also possible in companies with complementary strengths. The group company mergers in the Reliance group (RIL-REPL, RPPL, RPL) and the mergers in the Hindustan Unilever Group (Brooke Bond, Ponds, Lipton) are examples.
- *To attain control on key resources, fund base, market share, intellectual property, technology, manufacturing capabilities, human resources or other such growth drivers:* Mergers are also triggered off for larger market shares or economies of scale (popularly known as horizontal mergers). At a time when the industry goes through the consolidation phase in several sectors, these mergers and acquisitions are many. Examples are those made by the cement industry, the telecom mergers, bank mergers, pharma mergers etc. The merger of AOL-Time Warner, Pfizer—Wyeth-Pharmacia-Warner Lambert, Exxon-Mobil, Worldcom-MCI, BP-Amoco, Dow Chemical-DuPont, AT&T-Time Warner, Bayer-Monsanto, Lafarge-Holcim, J.P. Morgan-Bank One- Chase Manhattan, Citi-Travelers, formation of Novartis with the merger of Sandoz and Ciba-Geigy, Glaxo-Burroughs Wellcome-SmithKline French-Beecham, UBS and Warburg, ICICI Ltd. -ICICI Bank, Times Bank and HDFC Bank, India Cements's acquisition of Raasi Cements and Vishnu Cements, Hindalco's acquisition of Indian Aluminium etc. are specific cases in point.ING Vysya-Kotak Bank, Sterlite-Sesa Goa, Facebook-Whatsapp, Flipkart-Myntra are some more examples.
- *Achieve synergies of operations:* Examples are Novartis, Glaxo-SKB, UBS-Warburg, ICICI-ICICI Bank. Several mergers cited in (4) above may also fall under this category as well.
- *Reverse Mergers:* Harnessing tax efficiencies through mergers of profit-making and loss-making companies (known in India as *Section 72A mergers/reverse mergers*) is a time-tested tool of tax planning. Another variant of a reverse merger is wherein an unlisted company is merged into a listed company so as to acquire listing without an IPO. This is also known as *backdoor listing*. A case in point is the merger of Kingfisher Airlines with Deccan Aviation which was a listed company. Though Kingfisher was the acquirer in the transaction, since it was unlisted at the time, it was merged with the smaller Deccan Aviation so that the combined entity obtained listing. The combined listed entity was renamed as Kingfisher Airlines.
- *Bail-out mergers* and acquisitions are common when a company is in trouble and seeks financial strength. For example, Centurion Bank's takeover by the Rana Talwar group, Oriental Bank of Commerce – Global Trust Bank, Tech Mahindra–Satyam Computer Services are cases in point.

15.2.1 Strategic Deal Drivers for M&A

At the first instance, it is very important to identify the strategic objectives of the management of a company (either seller or acquirer) behind a proposed M&A transaction. These mostly stem for business reasons and corporate strategy of the company. Some strategic objectives have already been outlined in the previous paragraph. Let us try to re-examine a few situations, to be able to appreciate their relevance to a transaction.

- The most common benefit that majority of acquirers in M&A market talk about is *synergy*. The synergy could be in terms of saving costs, improving processes, mutual exchange of know-how, rationalisation of manpower and facilities, improved utilisation of market infrastructure etc. Sometimes, there are revenue synergies as well, i.e. the additional sales that can be generated by being together instead of losing such sales to competitors. Some of the big integrations that fall under the *synergy* category are HP-Compaq, AT&T-Teleport, Chase Manhattan-Chemical Bank, etc.
- Access to key natural resources or intangible property can be major drivers for M&A such as oil reserves, mineral and metal reserves etc. The oil industry and steel industry M&A are examples for

accessing such resources. The pharmaceutical industry is replete with examples of companies accessing intellectual property using M&A to retain competitive edge.

- M&A is also used as a tool for managing changing business environment, especially if markets are getting saturated or extremely competitive. Industry consolidation has been the main driver for corporate India's M&A in the phase after the advent of reforms.
- Globalisation has become a key driver to M&A in recent times wherein a conglomerate structure is developed which de-risks its global businesses by spreading them across economies with varying risk profiles. The global business and financial model gives such corporations high leverage to stay competitive and dominate the industry landscape. Universal banks of the world such as Citibank, J.P.Morgan, UBS and others are examples. Similarly, multi-national corporations such as Pfizer, Glaxo-SKB, GE, GM, Ford, Toyota, Sony are good examples. Indian corporate sector initiated a spate of outbound acquisitions from 2004 onwards in order to position itself with a scale of operations suitable for global competitiveness.
- As pointed out earlier, utilisation of tax shelters is a driver in itself, especially, if the profitable businesses are paying taxes and are not able to off-set the losses of other divisions. This is the main driver for *reverse mergers* (wherein a profit-making company is merged into a loss making company) as also for mergers under bankruptcy proceedings.
- Undervalued companies are always targeted by buyers. According to Thomas Liaw, this has three aspects. First is what he calls *kick-in-the-pants* explanation, in which the acquirer is stimulated to adopt a higher valued operating strategy. The second is the *sitting-on-a-goldmine* hypothesis that basically argues that the market will revalue the target in the light of information about an impending deal. The third is inflation whereby the replacement cost of a company goes up in relation to its market cap. In depressed stock markets, this ratio of market cap to replacement value of its assets (called *q ratio*) decreases and such, the company becomes a target for acquisition.

Diversification strategy leads to M&A since companies do not have the expertise to enter and thrive in all types of businesses. Acquisitions help to hasten the results of a diversification strategy.

Management and deal compensations also play a role in M&A. Top management thrives on salaries and incentives based on operational performance. Investment banks thrive on transaction fee. Sometimes, they become a trigger for M&A, especially in a high growth economy with a feel-good factor and booming stock market.

15.3 Overview of Corporate Re-organisation through Integration of Companies

Having discussed the various aspects of corporate re-organisation through split-up of a company in the previous chapter, it is now appropriate to look at the other dimension of the discussion on corporate re-organisation, which is through integration of companies. As is the case with restructuring, integration of companies can also be achieved through two routes: (i) the *asset route* and (ii) the *equity route*. The asset route is adopted to physically integrate the balance sheets of two or more companies. *Merger* and *amalgamation* are the common terms associated with this method of integration. Under the equity route, the integration is not at the balance sheet level but at the shareholding level. The shares of a company change hands from one shareholder to another, thereby bringing such company into the fold of the person acquiring such shares. Sometimes, it can also be achieved by a new allotment of equity shares instead of a transfer of shares. Depending on the manner and the intent of the transaction, it can either be classified as an *acquisition* or a *takeover*. The essential difference in approach between the two methods is that the asset based approach organically integrates the balance sheets of the amalgamating companies such that only one entity remains thereafter. In the equity based approach, two or more companies can be combined into a common ownership while retaining their distinct corporate persona. Due to the fundamental differences in both the approaches, they require in-depth understanding. Before deliberating upon their respective intricacies, their essence is captured in Exhibit 15.1.

Integration of Companies

ASSET ROUTE
Amalgamation
through merger or reconstruction

- Two or more companies can be integrated at a time.
- Integration achieved by combining balance sheets.
- Involves transfer of assets and liabilities as chosen from the transferor to the transferee.
- Merging company(ies) are dissolved without winding up.
- Shareholders of merging companies mostly continue as shareholders of the combined entity.
- Involves a lengthy process for addressing the interests of shareholders and creditors of the integrating companies through a scheme

EQUITY ROUTE
Acquisition/Takeover of a target
company by an acquirer

- An acquirer being a company or other person(s) acquires or takes over a target company.
- Integration achieved by combining economic interests or control.
- Involves transfer of shares or new allotment of shares by the target company to the acquirer. Does not involve transfer of assets or liabilities. No balance sheet impact on the target.
- Target company retains its corporate entity.
- Target company shareholders are taken out by settling their claim with a purchase consideration, usually in cash.

Exhibit 15.1 Methods for Integration of Existing Companies

Chapter 16 discusses the intricacies of acquisitions and takeovers, while this chapter focuses on mergers and amalgamations.

15.4 Introduction to Mergers and Amalgamations

15.4.1 Concepts and Definitions

Merger and amalgamation are words that are used in corporate finance parlance almost synonymously to denote integration of companies. The Dictionary of Banking and Finance defines a merger as *the joining together of two or more companies.* However, in the Indian context, it appears that the word merger is used in common parlance for one company blending with or getting *absorbed* by another while an amalgamation is used in the context of more than two companies combining together. Statutorily, a definition is available in the IT Act though it has only a limited connotation for tax purposes. Halsbury's Laws of England considers amalgamation as *a blending of two or more existing undertakings into one undertaking, the shareholders of each blending company becoming substantially the shareholders in the company, which is to carry on the blended undertaking.....*

The Companies Act does not define an amalgamation or a merger. Therefore, these terms are interpreted as being included in the term *arrangement* as defined in Section 230(1) read with Section 232. Section 232 talks about arrangements that are in the nature of amalgamation of two or more companies wherein the undertaking(s) of the transferor company are transferred to the transferee company. It goes onto explain that if a company is blended into another company, it becomes a *merger by absorption* and if two or more companies are blended into a new company, it becomes a *merger by formation of a new company* (also known as *reconstruction*). However, these explanations do not provide any exact definition of the words *merger* and *amalgamation*. However, over the years, courts have always held the view that an arrangement (which includes a merger or amalgamation) should be construed with a wide connotation.[5] The words *amalgamation* or *reconstruction* have to be interpreted looking into the scheme as a whole.

A more specific definition of *amalgamation* is provided in the IT Act. According to Section 2(1B), amalgamation in relation to companies means the *merger* of one or more companies with another company or the merger of two or more companies to form one company so that:

- All the property of the amalgamating company or companies immediately before the amalgamation becomes the property of the amalgamating company by virtue of the amalgamation.
- All the liabilities of the amalgamating company or companies immediately before the amalgamation become the liabilities of the amalgamating company by virtue of the amalgamation.
- Shareholders *holding not less than three-fourths in value of the shares* in the amalgamating company or companies become shareholders of the amalgamated company by virtue of the amalgamation and not otherwise.

Analysis and Conclusions

From a combined reading of several definitions as stated above, judicial interpretations and financial terminology, the inferences that can be drawn are as follows: amalgamation, merger, absorption and reconstruction.

- *Amalgamation* is a generic word used to denote an outcome of *integration* of two or more companies into a single company such that all the blending companies (known as the *transferor* companies) are dissolved without a process of winding up and only the blended company (known as the *transferee* company) remains as a legal entity.
- *Merger* is an amalgamation of two companies one on one wherein a transferor company blends into a transferee company and loses its corporate existence. Looked at from the other side, this process is also known as *absorption* of one company (transferor) by another (transferee).
- *Reconstruction* is an amalgamation under which one or more companies are blended together into a new company. All the transferor companies lose their corporate existence and are survived by the new transferee company. The shareholders of the transferor companies get shares in the new company as consideration. Reconstruction is known as *consolidation* in the US. A case in point is the US banking conglomerate Citigroup which was a new company created for consolidating the business of Citicorp and Travelers Insurance Group.

15.4.2 Structure of an Amalgamation

- Amalgamation (either by way of a merger or reconstruction) integrates the balance sheets of the transferor companies with that of the transferee company. Therefore, the claims of the transferor companies need to be settled through a *consideration*.

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[5]See Larsen & Toubro Ltd In Re (2004) 54 SCL 461/121 Comp Cas 523 (Bom)

- The *consideration* can be settled fully in cash or fully in stock by deciding on a *share-swap ratio*or by both. The consideration is paid to the transferor company's shareholders by the transferee company in cash or issuance of its stock based on the share swap ratio or partly by one and partly by the other. The swap ratio denotes how many shares in the transferor company will entitle its shareholder to how many shares in the transferee company. For example, if the share swap ratio is 3:4, it represents that for every 4 shares held in the transferor company, a shareholder is entitled to 3 shares in the transferee company. It may be noted that the shareholder gets to own only the shares in the transferee company after the amalgamation since the transferor company's shares are extinguished. This is unlike a demerger wherein shares in both companies are retained as the demerged company does not lose its corporate existence.
- Under the IT Act, only amalgamations that involve consideration to be settled in shares are recognised since *shareholder carry* is a pre-requisite to make the transaction *tax neutral*.If three-fourths of the shareholders of the transferor company are not carried into the transferee company, the transaction loses its status as an *exempted transfer* and would be subject to taxation. It would also lose consequential benefits such as carry forward of losses and unabsorbed depreciation under Section 72A of the IT Act.
- Amalgamations through a share swap are also known as *true mergers* or *mergers among equals* as the business is carried on as a going concern in the combined entity with a combined pool of shareholders by *pooling of interests*. Only amalgamations that satisfy this condition are accorded tax neutrality.
- Those amalgamations that settle the consideration in cash or its equivalent amount to *business purchase*. Business purchase amalgamations are essentially in the nature of acquisitions whereby one company purchases another by settling its shareholders in cash and merges both the companies. In such cases, tax neutrality is not accorded as there is a transfer of business from the seller to the buyer.
- An amalgamation presupposes the discontinuance of the corporate identity of the transferor company. Therefore, whether the amalgamation is done as a true merger or as a purchase, the separate legal entity of the transferor company should be dissolved.

15.4.3 Amalgamation under Law

Any type of amalgamation of companies as explained in the preceding discussion is recognised as a *scheme of arrangement* under Company law. All schemes of arrangement involving amalgamation of companies are governed by Sections 230–234 of the Companies Act.[6]

According to these provisions, a scheme of arrangement involving an amalgamation has to be presented to the NCLT by an application for a confirmation order under Section 232. The NCLT may call for meetings of members and creditors to be convened for this purpose. At the meetings, the company is required to furnish inter alia, an independent valuation report and the share swap ratio for consideration along with other terms of the scheme. In addition, a certificate from the auditor of the company that the accounting treatment proposed in the scheme is in conformity with the prescribed accounting standards shall also be filed. In the case of listed companies, a fairness opinion on the valuation from the merchant banker shall also be filed.

The scheme shall be passed by majority of persons representing three-fourths in value among those present and voting or by proxy or by postal ballot, as the case may be. The minority representing not less than 10% of the voting rights or 5% of the total outstanding debt of the company are entitled to raise objections to the scheme. Once the scheme is approved by the requisite majority and passed by the NCLT, it is binding on the minority. The order of the NCLT will automatically vest all the property of the transferor company with the transferee company without any further process of law. It shall also dissolve the transferor company without winding up. The transferee company will become the combined entity and shall carry on the business as provided in the scheme. The scheme usually specifies the *Appointed Date*, i.e. the record date from when

[6]Read with Companies (Compromises, Arrangements and Amalgamations) Rules, 2016.

the scheme is reckoned for the amalgamation, transfer of property and accounting purposes. However, the scheme becomes operational from the *Effective Date*, i.e. the date from when the order of the NCLT comes into effect to implement the scheme. During the intervening period when the scheme is under consideration by the NCLT, it is usually provided in the scheme that the transferor company shall conduct its business affairs on behalf of the transferee company.

The Companies Act also makes a provision for fast track amalgamations between small companies and holding and 100% subsidiary companies.[7] According to Section 233, such schemes need not be a part of the NCLT proceedings, if these are passed by members holding 90% of the shares and by 90% of the creditors in value terms. Similarly, in schemes involving the amalgamation of a listed company into an unlisted company, the provisions for listing of the transferee company are provided under Section 233 read with SEBI Regulations.[8] Cross border mergers are provided for under Section 234 whereby an Indian company may merge with a foreign company and vice versa through the depository receipts route. If a foreign company merges with an Indian company, its shareholders would be issued Indian Depository Receipts (IDRs) in exchange. Similarly, if the Indian company merges with the foreign company, domestic shareholders would be issued GDRs/ADRs of the foreign company. This is, however, subject to FEMA and FDI policy regulations.

It may be noted that in schemes involving the merger of a WOS with its parent company, the scheme would not provide for any issue of shares by the parent to itself (being the shareholder of the subsidiary) as that would result in a company holding treasury shares in itself. Accordingly, the scheme would state the position in the following lines:

> *"Transferor Company is a wholly owned (100%) subsidiary of Transferee Company, on amalgamation no separate consideration shall be paid by the Transferee Company to the Shareholders of the Transferor Company and no shares shall be issued by the Transferee Company to any person in consideration of or consequent upon the amalgamation and the share capital of the Transferor Company shall be extinguished upon the Scheme becoming effective.*
> *Pursuant to the Scheme coming into effect, investments made by the Transferee Company in the Transferor Company in the equity shares shall automatically stand cancelled.*
> *On the Scheme becoming effective, the Transferor Company shall be dissolved without winding up in accordance with the provisions of Sections 230 to 234 of the Act."*

15.5 Types of Mergers

15.5.1 Horizontal Mergers

A horizontal merger happens between companies engaged in the same business activity and competing with each other. These are most commonly seen in competitive industries and are similar to a bigger fish swallowing a smaller one to survive. Industry consolidations cause horizontal mergers. During the first half of the 20th century, horizontal mergers were popular in capital intensive and large industries such as oil and steel which required to scale up massively to promote growth and consolidation. In the later period, other industries such as pharmaceuticals, banking, telecommunications, automotives, engineering etc. also saw horizontal mergers. Examples are Novartis (Sandoz-Ciba Geigy), Glaxo-SKB, Exxon-Mobil, HP-Compaq, Daimler Benz-Chrysler, Arcelor-Mittal, Times Bank and HDFC Bank, ICICI Bank-Nedungadi Bank-Bank of Madura, Centurion Bank-Bank of Punjab, IDBI Bank-United Western Bank, ING Vysya

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[7] No treasury shares are allowed to be held in a merger of a holding company and its subsidiary

[8] Refer to paragraph 7 in Chapter 14.

Bank- Kotak Bank, Sun Pharma-Ranbaxy etc. Horizontal mergers are common to this day due to the fact that they help in consolidation of larger players in an industry and provide necessary exit to the smaller and fringe players.

Horizontal mergers are regulated by the government for possible monopolistic tendencies. In India, the Competition Commission of India was set up under the Competition Act, 2002 to examine horizontal mergers as an advisory body to the Government of India. The Commission is expected to have regulatory powers in future. The Commission examined Air India-Indian Airlines merger for possible anti-competition trends in Indian civil aviation industry. The Sherman Act, 1890 and the Clayton Act, 1914 are the anti-trust laws in USA governing monopolistic tendencies. The famous anti-trust proceedings with respect to Microsoft Corporation were under the Sherman Act. In the UK, the Office of Fair Trading established under the Fair Trading Act of 1973 investigates merger activity and refers cases to the Monopolies and Mergers Commission set up under the Monopolies and Mergers Act, 1965. Similarly, the European Union Merger Regulation grants the European Commission exclusive authority to review and conduct anti-trust investigations into mergers concerning the EU economy. One of the cases examined by the EU Commission was the Arcelor-Mittal merger.

Case Study

Lafarge-Holcim Merger

In 2014, the Swiss cement maker Holcim and the French cement company Lafarge announced their plans to merge to create the world's largest building materials company. Given the size of the proposed merger, it was bound to face regulatory and anti-trust hurdles. The proposal met with resistance from anti-trust regulators in several jurisdictions and the combined entity was required to divest assets which contributed almost 15% of the combined EBITDA in countries such as Chile and India. However, both the companies estimated that the combined synergy could save them about €1.4 billion annually. The global merger was completed by July 2015 to create LafargeHolcim.

In India, Lafarge faced a road block with the CCI. The merger, if allowed, would have created a dominant player in eastern India. Holcim's ACC and Gujarat Ambuja had 10.7 million tonne capacity while Lafarge had 7.8 million. The combined capacity of the two companies would have resulted in 18.5 million tonnes which was almost 40 percent of the region's 46 million tonne capacity. Accordingly, Lafarge submitted a proposal to the CCI in April 2015, which included the divestment of two of its plant with a combined capacity of 5.1 million tonnes. By August 2015, LafargeHolcim entered into an agreement to sell its eastern India assets to Birla Corporation Ltd. for ₹5000 crore. However, the deal was called off due to regulatory issues relating to the transfer of mining rights captive and critical to the two plants. As a way to overcome the problem relating to transfer of mining rights attached to its cement plants, Lafarge India's entire corporate entity was put up for sale. Ultimately, LafargeHolcim found an alternate buyer in Nirma Ltd., the Ahmedabad-based soap-to-cement conglomerate which agreed to buy Lafarge India at an enterprise value of $1.4 billion. This proposal was approved by the CCI so as to complete the Indian leg of the merger between the two companies. Accordingly, Lafarge India was to be completely divested and the combined entity was to operate only through the assets held by the erstwhile Holcim India through ACC and Ambuja Cement.

Case Study

ICICI Ltd.-ICICI Bank Ltd.

In 2002, ICICI Ltd. (ICICI), one of India's foremost financial institutions and two of its group companies, ICICI Capital Services Ltd. and ICICI Personal Financial Services Ltd. amalgamated with ICICI Bank Ltd., a banking company in which ICICI held 46% at the time of the amalgamation. ICICI, which was established in 1955 as a development financial institution at the instance of the World Bank, the Government of India and the Indian industry was designed for project financing in India. Over the years, especially after the liberalisation in 1991, ICICI entered other financial products and services and set up independent subsidiaries and affiliates in venture capital, asset management, investment banking, commercial banking, broking and marketing, personal finance, internet stock trading, home finance and insurance. It also merged the SCICI, a group company originally formed to finance the shipping industry with itself. The merger of ICICI with its own bank was the culmination of a process of transformation of ICICI from a development financial institution into a universal bank. As per the explanatory statement furnished to the members on the amalgamation, the proposal was explained and justified as a forward-looking step. Relevant extracts thereof are as follows:

"The issue of universal banking, which in the Indian context means conversion of long-term development financial institutions into commercial banks, has been discussed at length over the past few years. The Reserve Bank of India in its Mid-term Review of Monetary and Credit Policy for fiscal 2000 and its circular on Approach to Universal Banking issued on April 28, 2001, announced that it would consider proposals from development financial institutions (like ICICI) wishing to transform themselves into banks on a case-by-case basis. In its Mid-Term Review of Monetary and Credit Policy for fiscal 2002, the Reserve Bank of India encouraged financial institutions to submit proposals for their transformation into banks.

As a bank, ICICI would have the ability to accept low-cost demand deposits and offer a wider range of products and services and greater opportunities for earning non-fund based income in the form of banking fees and commissions. In view of the benefits of transformation into a bank and the Reserve Bank of India's pronouncements on universal banking, ICICI explored various corporate structuring alternatives for its transformation into a universal bank. ICICI also held discussions with the Reserve Bank of India on an appropriate transition path and compliance with regulatory requirements. ICICI Bank also considered various strategic alternatives, in the context of the emerging competitive scenario in the Indian banking industry and the move towards universal banking. ICICI Bank identified a large capital base and size and scale of operations as key success factors in the Indian banking industry. The strategic alternatives examined by ICICI and ICICI Bank included an amalgamation of the two entities, in view of ICICI's significant shareholding in ICICI Bank and the existing strong business synergies between the two entities. ICICI also considered the re-organisation of its subsidiary companies.

The amalgamation is expected to be beneficial to both ICICI and ICICI Bank shareholders. The management and the Board of Directors of ICICI believe that the amalgamation would enhance value for ICICI shareholders through the merged entity's access to low-cost deposits, greater opportunities for earning fee-based income and the ability to participate in the payments system and provide transaction-banking services. The management and the Board of Directors of ICICI Bank believe that the amalgamation would enhance value for ICICI Bank shareholders through a large capital base and scale of operations, seamless access to ICICI's strong corporate relationships built up over five decades, entry into new business segments, higher market share in various business segments, particularly fee-based services, and access to the vast talent pool of ICICI and its subsidiaries.

The merged entity would be the second largest among all banks in India, ranked on the basis of their total assets. The merged entity would leverage on its capital base, comprehensive suite of products and services, extensive corporate and retail customer relationships, technology-enabled distribution architecture, strong brand franchise and vast talent pool. The merged entity would have improved capability to offer a wide range of products and services, ranging from project finance to retail finance, with a diversified resource base, improved portfolio risk management capability and deeper client relationships."

Case Study

Tech Mahindra-Mahindra Satyam Merger

In a composite scheme of amalgamation made in 2012, Mahindra Satyam which was earlier acquired by Tech Mahindra through a competitive bidding route, was merged with the acquiring company along with other group companies Venturbay Consultants, C&S System Technologies, CanvasM Technologies and Mahindra Logisoft Business Solutions. The swap ratio for Satyam was fixed at 2:17 implying that for every 17 shares held in Mahindra Satyam, shareholders will get two shares in Tech Mahindra. The merger was approved by shareholders, CCI, stock exchanges and the High Court. According to company sources, the combined entity would be a $ 2.4 billion entity and would benefit from operational synergies, economies of scale, sourcing benefits and standardisation of processes to create a top-level information and communications technology service provider. The merger could have been accomplished earlier but was kept on hold due to the class action suits against Mahindra Satyam in the US following the accounting fraud disclosed by the original promoter of the company.

Case Study

Merger of Ispat Industries with JSW Steel

JSW Steel acquired a 41.29% stake in the Kolkata-based steel maker Ispat Industries Ltd. for ₹2,157 crore in 2010 at ₹19.85 per share, a 7% discount to the prevailing market price. At that time, Ispat Industries was a struggling steel maker with heavy leverage and production problems. The lenders to the company had been looking out for acquirers to bail them out. JSW, subsequently, made the mandatory open offer under the Takeover code and took control of the company. Though it was stated at the time that Ispat Industries will be retained as a separate company, JSW proposed to merge Ispat Industries with itself in 2012.The merger was settled after the promoters of Ispat Industries (Mittals) agreed to settle for a minority stake in the merged company.

The appointed date for the merger was July 1, 2012 and was proposed at a share swap ratio of 1:72, i.e. one share of JSW for every 72 held in Ispat Industries. Ispat Industries (by them renamed as JSW Ispat) was proposed to be dissolved without winding up. The scheme mentioned that certain units of both the companies were to be transferred to a WOS of JSW Steel and the rest of the undertakings would be merged into JSW Steel. The merger was proposed so as to form a steel behemoth and catapult JSW into the top 25 companies of India. It was also to make JSW a global scale steel manufacturer and one of the top few in India.

15.5.2 Vertical Mergers

Vertical mergers happen between companies engaged in different segments of a product value chain so as to integrate the entire value chain. It is common knowledge that all the segments of a product chain do not add proportionate value. The lower ends have lesser value addition and it goes up as the chain gets nearer to the end customer. The top end enjoys branding and visibility that make its value addition the maximum. Vertical mergers help in reaping the synergies across the value chain. The group company mergers in the Reliance group (RIL-REPL, RPPL, RPL) are a good example of horizontal mergers.

Case Study

Case of RIL-RPL Merger

The merger of the two group companies of the Reliance group, Reliance Industries Ltd. (RIL) and Reliance Petroleum Ltd. (RPL) created history of sorts. RIL is India's biggest petrochemicals manufacturer and RPL had the largest single location refinery in the world. The merged company, at that time, ranked second in India after Hindustan Unilever Ltd. in terms of market capitalisation and second to Indian Oil Ltd. in terms of revenue. The merged company became India's own fully integrated energy company with operations in oil and gas exploration and production, refining and marketing, petrochemicals and textiles. The merger was concluded at a swap ratio of 1:11 (one share of RIL for every 11 shares in RPL). It was a case of absorption of RPL by RIL whereby the merged company was retained as RIL. The Ambani family owned 34 percent of the merged RIL. The merger also took RIL into the big league of Fortune 500 companies. Another landmark was that the combined entity had possibly the largest shareholder population in the world of about 3.5 million.

The merger was justified in terms of positioning the combined entity better for achieving scale, size, integration and enhanced financial strength and flexibility to pursue future growth opportunities, in an increasingly globally competitive environment. This was true given the fact that though the combined RIL was big in the Indian context, it was still small compared to the global oil majors. The merger was also strategically positioned to meet the increased investments required in the oil retailing business and the other new business initiatives of the group, notably Reliance Infocomm Ltd. (now Reliance Communications Ltd.). RPL's huge cash kitty of about ₹5000 crore would provide support to RIL while RIL's tax shelters would shield such incomes to some extent. The combined entity would also save considerably on sales tax on inter-company sales.

Case Study

Sesa Goa-Sterlite Merger

In a complex scheme of arrangement, the Vedanta group merged several group companies, i.e. Sterlite Industries, Madras Aluminium and Sterlite Energy into Sesa Goa, a company that the group had acquired earlier. The amalgamation was proposed through share swap. The scheme, on one hand, envisaged integration of mining and manufacturing segments of their metal businesses and on the other, it was meant to rationalise group holdings of the apex holding company, Vedanta Resources listed on AIM London and to remove cross holdings. The main businesses related to alumina, power generation, copper products and power generation.

15.5.3 Conglomerate Mergers

Pure conglomerate mergers are between companies that are in diversified industries with no visible synergy. These are done basically with the intention of diversifying and de-risking the expansion and growth of a corporate empire. Conglomerate mergers were very popular during the 1960s and 1970s when companies used diversification as their main corporate growth strategy. Companies such as General Electric created a conglomerate which had businesses ranging from manufacturing equipment, to television and even financial services. However, conglomerate mergers are also seen in companies with related product lines (AOL-Time Warner) or in different geographical markets (Daimler Benz, Ford-Chrysler). Most conglomerate mergers done between very large companies which usually been found to destroy shareholder value due to becoming too big with no defined control structures, over-estimation of synergies and economies of scale, employee integration issues and even unjustified deal considerations. Some of them may also fall by the way side during deal negotiations due to complex issues that could arise from commercial, regulatory or policy angles. Since stakes would be very large in conglomerate mergers, they are difficult to accomplish at the time of deal making and to produce desired outcomes thereafter.

Case Study

Merger of ITC Bhadrachalam with ITC

ITC Bhadrachalam, a 62% subsidiary of ITC was merged with the parent in 2001 through a scheme of amalgamation with a share exchange ratio of 16:1 based on a valuation by SB Billimoria and Co. The merger added about ₹2 crore to ITC's equity capital and hardly diluted the holdings of its parent, British American Tobacco Plc(by 0.3%) and other Indian financial institutions, thereby ensuring no discord.

The merger was made based on the following business objectives and rationale:

- Support to the broad spectrum corporate campaign of ITC transforming from primarily a cigarette maker to a diversified conglomerate.
- ITC Bhadra was the market leader in the value-added paper segment which is poised to grow at 20% annually. The merger supported its funding requirements more smoothly from the parent.
- The merger supported the strategic intent of scaling up ITC-Bhadra's manufacturing capacity to global standards and the acquisition of the right technology at the right time.
- The merger helped to consolidate ITCs specialty paper and packaging divisions yielding significant operational synergies.
- ITC also stood to gain a whopping ₹130–140 crore in profits after tax in the year of amalgamation itself. The gains arose on account of unabsorbed depreciation and accumulated losses in ITC Bhadra's balance sheet. The benefits from the second year onwards were estimated between ₹25 to 30 crore.
- The merger also meant an increased topline of ₹600 crore for ITC, besides higher profitability due to income tax and VAT savings and savings in operating costs.

15.6 Failed Mergers

Ambitious mergers might sometimes fail to either take off before materialising or do not deliver the desired outcomes after completion. History is replete with several failed attempts and mergers. Sometimes, mergers may also fail on account of regulatory or anti-trust concerns when complex issues are involved or two dominant players wish to merge. One such cross border attempts by an Indian company, Bharti Airtel, was not successful. It ultimately acquired Zain Telecom in a subsequent transaction.

Case Study

Failed Merger Talks of Bharti-Airtel-MTN

Bharti-Airtel, India's largest mobile operator and MTN of South Africa engaged in talks for a possible merger of the two companies to create the largest telecom company in emerging economies with a subscriber base of 200 million, also making it the third largest in the world after China Mobile and Vodafone.

Since Indian law did not permit Bharti to merge with MTN and the South African government wanting to preserve MTN's identity as a South African company, a complete merger through a share swap route was not possible. Therefore, both the companies proposed a complex cross holding structure whereby Bharti would have acquired 49% shareholding in MTN and in turn MTN and its shareholders would have acquired about 36% economic interest in Bharti through GDRs listed in Johannesburg. MTN offered to pay $2.9 billion and shares equivalent to 25% of its share capital to Bharti Airtel in return for 36% stake in the Indian company. Similarly, Bharti proposed to buy 36% of MTN, controlled by the Lebanon-based Mikati family and a trust representing senior management and employees, by offering 0.86 rand (or $10.44) and 0.5 Bharti Airtel share for each MTN share so acquired through a global depository receipt issue. Reckoned together with its earlier cross holding, Bharti would have ended up owning 49% of MTN. The cash outflow at the Sunil Mittal-chaired company will be around $7 billion, which net of the $2.9 billion received from MTN and up to $1 billion in cash and cash equivalents, will reduce to between $3–4 billion.

The complex deal structure was necessary since a straight forward share swap by Bharti would have meant that Bharti had to be dually listed in India as well as in South Africa to enable MTN shareholders to get a South African listed share in exchange for their MTN shares. Similarly, the merger of MTN with Bharti would have meant the dissolution of MTN which was not acceptable to the South African government. Therefore, a direct merger of MTN into Bharti or vice versa was ruled out due to regulatory and policy restrictions. The complex cross holding structure at corporate level of both companies was devised without involving the shareholders. Therefore, it was structured as a cross holding acquisition instead of a true merger. This structure was stated to be a via-media to enable the integration of both companies in the intermediary phase till policy and regulatory hurdles were removed by both countries for a full-blown merger.

The deal discussions were extended for a long time to enable it to garner support from both the governments at political level. However, the South African government was not happy with the structure and demanded that dual listing of MTN was the only route that it would approve in order to protect the character of MTN as a South African entity.The deal also fell in trouble due to the appreciation of South African rand against the ₹ which increased the deal size by about ₹2000 crore. Finally, the deal was called off by Bharti in September 2009 after nearly four month-long intense discussions since an agreeable structure could not be arrived at to approach regulatory authorities for necessary clearances. There were also doubts from the Indian side, if Bharti would breach the FDI cap on telecom through the deal. The transaction valued at $23 billion would have been the single largest FDI into South Africa and one of the largest outbound FDIs from India.

Case Study

Failed Merger Talks of Mascon Global-Maars Software

In the domestic acquisition scene, in March 2001, Mascon Global had announced a merger with Maars Software. It was called off later in July citing poor market conditions. Earlier that year, the boards of the two companies had met and announced equity swap of 9:1. In yet another case, Polaris Software Labs was to acquire a New Jersey based company Data Inc. for a value of 21 million. The deal was coordinated by UBS Warburg and was subject to due diligence by KPMG. After the acquisition process reached an advanced stage, Polaris called it off citing objections made by its audit committee. The incident even led to a lawsuit by Data Inc. in the US on the ground that Polaris had gone back on the terms and conditions in the original agreement.

Case Study

Failed Merger of UTI Bank-Global Trust Bank

In 2001, UTI Bank (now Axis Bank) and Global Trust Bank (since merged with Oriental Bank of Commerce) announced a merger to create the largest private sector bank in India at the time (since ICICI Bank was not merged with ICICI until 2002). However, the subsequent developments involving the investigation by SEBI into the affairs of Ketan Parekh group revealed that GTB had a large exposure to their entities and that the GTB scrip was pumped up by them prior to the merger announcement. Due to these developments, UTI Bank announced that it was backing out and immediately thereafter GTB also made a similar announcement even while their merger application was pending before the RBI. The matter, however, did not subside with it. The SEBI investigation led to the exposure of a full-blown stock market scam by Ketan Parekh and associated entities which even got the then Chairman of UTI into controversy. GTB was, subsequently, found to be unworthy of being a going concern by its auditors and was merged perforce by the RBI with Oriental bank of Commerce, thereby bringing the curtains down on the merger saga of both the banks.

15.7 Financial Evaluation of Mergers

Since a merger is basically a cashless integration of two companies, the financial effectiveness of the transaction depends upon the respective implication for the transferor (seller) and the transferee (buyer) company. The share-swap ratio which is fixed based on a stand-alone valuation of the two companies has profound effect on the financial outcome for each company. If a merger is expected to increases the EPS of the combined entity after providing for the additional shares to be issued under the share swap, it is said to be *EPS Accretive* and is, therefore, considered beneficial in enhancing shareholders' wealth. However, if it actually results in a fall in the EPS subsequent to the merger, it is said to be *EPS Dilutive* and therefore, value destructive.

15.7.1 M&A Analysis

M&A analysis is about determining the financial outcome of a merger based on future expected cash flow from the combined operations. This would require a clear estimation of the cost savings and revenue increments that are likely to occur. The entire business plan has to be worked out taking these factors into account to determine the FCFF. The long-term growth rate and the WACC of the combined operation will also need to be estimated. Thereafter, a DCF analysis will determine the present value of the combined entity.

The excess of the combined PV over the stand-alone PVs of the merging companies as shown above is the quantification of the synergy effect. If synergy is positive, the merger is justified, if not it is value destructive. In valuing the synergy, other incidental items such as transaction costs and tax effect will also need to be factored in.

The second aspect in M&A analysis is to compare the value of the purchase consideration whether paid in stock or in cash to the PV of the incremental cash flow (synergy). Obviously, if the purchase consideration is more than the PV of the synergy, the buyer stands to lose. In a stock swap, paying more would mean issue of more shares. This becomes EPS dilutive at the combined entity level and dilution of transferee shareholders' wealth as well.

ILLUSTRATION 1

Stand-alone Equity Value of Amalgam (Transferee Co.: ₹20,000,000
Stand-alone Equity Value of Mergo (Transferor Co): ₹5,000,000
Estimate Equity Value of Combined Entity: ₹30,000,000
Current Issued Capital of Amalgam (shares): 20,000
Current PAT of Amalgam = ₹200,000
Expected PAT of Combined Entity post merger = ₹300,000

Key Computations:

Current EPS = 200,000/20,000 = ₹10
PV of Synergy = 30,000,000 – (20,000,000+5,000,000) = ₹5,000,000
From the above data, it is evident that if the share swap ratio results in Amalgam issuing anything more than 10,000 shares to the shareholders of Mergo, the merger will be EPS dilutive to Amalgam's shareholders.

If the consideration is paid in cash,

The cash equivalent of 10,000 shares is 30,000,000/30,000 × 10,000 = ₹10,000,000 which is the cut-off.

In other words, if the cash consideration paid is anything more than the stand-alone EV of Mergo and the PV of the synergy, it will result in a loss of EV for the shareholders of Amalgam.

In fixing the share swap ratio for the merger of two listed companies, a lot depends on the ruling P/E ratio of both companies. The share swap is favourable to the company that has a P/E. This is explained in Illustration 2.

ILLUSTRATION 2

Furnished below are the data pertaining to Amalgam Ltd., Mergo Ltd. and Absorb Ltd. Let us consider the effect of a merger between (a) Amalgam and Mergo and (b) Amalgam and Absorb based on a share swap ratio fixed based on their current market price (CMP). Mergo and Absorb are the transferor companies respectively and Amalgam is the transferee company.

		Amalgam	*Mergo*	*Absorb*
1	Profit After Tax (PAT) ₹	100,000	25,000	20,000
2	Paid Up Share Capital (Shares)	10,000	5,000	10,000
3	EPS	10.00	5.00	2.00
4	Ruling P/E ratio	20	15	25

(*Contd.*)

5	CMP	200	75	50
6	Equity Value	2,000,000	375,000	500,000
	Share Swap Ratio between amalgam and Mergo			
7	Based on CMP	3:8		
8	Less than CMP Ratio		1:3	
9	More than CMP Ratio			2:3
10	Shares to be issued by Amalgam	1,875	1,667	3,333
11	Post-merger Share Cap (Shares) (2 + 10)	11,875	11,667	13,333
12	**Post-merger EPS (combined PAT/11)**	**10.53**	**10.71**	**9.38**
13	**Post merger weighted PE**	**19.00**		
14	**Post-merger Market Price (12x13)**	**2.0000**	**203.57**	**178.13**
15	**Post Merger Market Cap (11x14)**	**2,375,000**	**2,375,000**	**2,375,000**
16	**Combined market cap pre-merger**	**2,375,000**	**2,375,000**	**2,375,000**
17	**Gain/(Loss) post merger (16-15)**	—	—	—
18	Equity Value for Amalgam (2x14)	2,000,000	2,035,714	1,781,250
19	**Gain/(Loss) post merger (18-6)**	—	**35,714**	**(218,750)**
20	Equity Value for Mergo (10x14)	375,000	339,286	593,750
21	**Gain/(Loss) post merger (20-6)**	—	**(35,714)**	**218,750**
	Share Swap Ratio between Amalgam and Absorb			
7	Based on CMP	1:4		
8	Less than CMP Ratio		1:5	
9	More than CMP Ratio			1:3
10	Shares to issued by Amalgam	2,500	2,000	3,333
11	Post-merger Share Cap (Shares) (2 + 10)	12,500	12,000	13,333
12	**Post-merger EPS (combined PAT/11)**	**9.60**	**10.00**	**9.00**
13	**Post merger weighted PE**	**20.83**		
14	**Post-merger Market Price (12x13)**	**200**	**208.33**	**187.50**
15	**Post Merger Market Cap (11x14)**	**2,500,000**	**2,500,000**	**2,500,000**
16	**Combined market cap pre-merger**	**2,500,000**	**2,500,000**	**2,500,000**
17	**Gain/(Loss) post merger (16-15)**	—	—	—
18	Equity Value for Amalgam (2x14)	2,000,000	2,083.333	1,875,000
19	**Gain/(Loss) post merger (18-6)**	—	**83,333**	**(125,000)**
20	Equity Value for Mergo (10x14)	500,000	416,667	625,000
21	**Gain/(Loss) post merger (20-6)**	—	**(83,333)**	**125,000**

It may be observed from the above table that while Mergo has a lesser P/E than Amalgam, Absorb has a higher P/E. Therefore, if the share swap ratio is fixed exactly in line with the CMP and the post-merger P/E adjusts itself on a weighted average basis, there is no gain or loss from the merger to both the transferor and the transferee shareholders.

In reality, two things will vary the outcome of an absolutely neutral merger.

(i) The share swap ratio is fixed based on fair value and not just the CMP. If the share swap ratio moves away from the CMP ratio, there is a positive or negative impact on shareholder wealth of either company even if the post-merger P/E is assumed to be on a weighted basis.

(ii) The P/E does not exactly adjust on a weighted average basis post-merger. The merger announcement usually triggers a price response based on how the share swap ratio is skewed in favour of either the transferor or the transferee company. Post-merger, the P/E of the combined entity determines the impact on shareholder wealth of the respective companies.

In the above analysis, the relative impact on the transferor and the transferee company can be inferred as explained below:

- In the case of merger between Amalgam and Mergo, if both the companies are being valued equally pre-merger and the post-merger P/E adjusts correspondingly, there would be no impact on shareholder wealth. Even if the merger is EPS accretive for Amalgam, if the reduction in the post-merger P/E more than off-sets the EPSaccretion, the shareholders of Amalgam will stand to lose. In the case of Mergo, any post-merger P/E that is more than the weighted P/E will benefit its shareholders.
- In the case of merger between Amalgam and Absorb, the P/E ratio of Absorb is higher than that of Amalgam. This would result in higher issue of shares to its shareholders. Consequently, the merger would be EPS dilutive for Amalgam. Unless the post-merger P/E offsets the fall in EPS of the merged entity exactly, there would be erosion of wealth for the shareholders of Amalgam. The shareholders of Absorb benefit due to the higher P/E of their company that enables them to get higher number of shares in the merged company. This more than compensates for the fall in the EPS of the merged company so as to give them a gain post-merger.

The common inference here is that if the P/E ratio of the merging company is higher than that of the absorbing company, the shareholders of the absorbing company stand to lose from the merger. On similar lines, if the P/E ratio of the merging company is lower than that of the absorbing company, the shareholders of the merging company stand to lose from the merger.

15.7.2 Determinants of Financial Outcome in a Merger

The financial outcome of a merger depends on the following factors:

- *The share swap ratio:* This determines the consideration in the deal. As explained in the previous paragraph, it has an impact on the shareholder wealth of the respective companies. The effect of negotiations by both parties to the transaction on the agreed share swap ratio also has an effect on shareholder wealth.
- *The synergy effect:* The positive impact of synergy on the cash flow of the combined entity is the reason due to which the merger is expected to be EPS accretive. This requires a clear estimation of the future savings in costs and enhancement of revenues. If there is an over-estimation on this account, the merger could prove to be EPS dilutive.
- *P/E ratio:* The pre-merger P/E of both the companies and the behaviour of the post-merger P/E of the combined entity also determine the impact on shareholders. As demonstrated in the illustration above, the company with a better pre-merger P/E ratio stands to benefit in the fixation of the share swap ratio. This is the reason why companies that are under-valued become targets for M&A deals. The acquirer usually identifies valuation asymmetry in the market as a reasonable means to ensure that a transaction becomes financially beneficial to it.

- *The post-merger integration process:* Even if synergy is appropriately quantified but the post-merger integration process is not carried out properly, the actual synergy realised may be sub-optimal or even negative. The merger could, thus, result in destruction of shareholder value for the combined shareholders. Many failed mergers fall under this category. A case in point is the disastrous merger of Daimler Benz and Chrysler.

15.7.3 Arriving at Goodwill/Capital Reserve in a Merger

A merger has to result in a gain to one company and a capital loss to the other based on the value of the business being transferred and the consideration provided in the form of shares issued by the transferee company. I-GAAP, IFRS and US-GAAP presently prescribe acquisition method of accounting to all types of mergers wherein goodwill or capital reserve has to be recognised. The following illustration provides a simple working.

ILLUSTRATION 3

Mergo Ltd. wishes to merge with Amalgam Ltd. The following are the Balance Sheets of both the companies as on appointed date of the scheme.

Liabilities	*Amalgam Amt. ₹*	*Mergo*	*Assets*	*Amalgam*	*Mergo Amt. ₹*
Share Capital Equity shares of ₹10 each	10,000	2,100	Net Fixed Assets	14,000	6,500
Reserves and Surplus Share Premium General Reserve P&L Account	 2,000 8,000 1,500	 500 2,000 400	Investments	4,500	500
Long-term Borrowings	6,000	3,500	Current Assets	12,000	3,000
Current Liabilities	4,000	2,000	Miscellaneous Expenditure	1,000	500
Total	**31,500**	**10,500**	**Total**	**31,500**	**10,500**

Under the scheme of the merger, the share swap ratio has been fixed at 1:3 whereby one share in Amalgam would be issued for every three shares held in Mergo. In addition, shareholders of Mergo will be paid cash consideration of ₹1,500. The fair value of Amalgam's share is ₹25 per share.

The assets and liabilities of Mergo have to be considered as per the revaluation shown as under:

Fixed Assets	-	6,000
Investments	-	700
Current assets	-	2,700
Current Liabilities	-	2,100
Long-term liabilities	-	3,700

The balance sheet of Amalgam Ltd. after the merger would appear as follows:

Liabilities	*Amt.* ₹	*Assets*	*Amt.* ₹
Share Capital Equity shares of ₹10 each	10,700	Net Fixed Assets	20,000
Reserves and Surplus		Investments	5,200
Capital Reserve	350		
Share Premium	3,050		
General Reserve	8,000		
P&L Account	1,500		
Long-term Borrowings	9,700	Current Assets	13,200
Current Liabilities	6,100	Miscellaneous Expenditure	1,000
Total	**39,400**	**Total**	**39,400**

Working Notes

The Capital Reserve of ₹350 is the gain on the merger to Amalgam Ltd., which is computed as follows:

Total value of assets of Mergo Ltd. at their agreed values – 9,400
(Fixed Assets + Investments + Current Assets)
Less total value of outside liabilities -- 5,800
(LT Liabilities + Current Liabilities) -------
3,600
Less Purchase Consideration paid to shareholders of Mergo
Shares in the ratio of 1:3 $70 \times 25 = 1,750$
Cash consideration 1,500 3,250

Net gain to Amalgam (capital reserve) 350

15.8 Valuation in M&A

An integral and probably the most important aspect of M&A is the aspect of valuation of the companies, divisions or assets involved. In most of such cases excepting those relating to asset stripping, the transfer is envisaged on a *going-concern* basis. Therefore, if the business being transferred is fairly established with a good future potential, it is valued under the discounted cash flow or DCF method. If it is case of merger of two listed companies, their market capitalisation is also taken into account for arriving at the appropriate valuation. The tangible value of assets may be considered as important in certain businesses involving critical natural resources such as minerals, metals and oil. In technology or brand intensive businesses, intellectual property is considered critical in the valuation process. Human resource valuation becomes a key factor in valuation of knowledge intensive and service businesses. Sometimes, if the business is nascent and cash flow is yet to stabilise, other methods such as the relative valuation method are chosen. In some other cases, where there are stiff entry barriers, the replacement cost of setting up a like business may be considered in arriving at a suitable valuation. The task in M&A transactions is to arrive at a fair price range based on one or more methods that justify the context and facts of a given transaction.

15.8.1 Valuation Context in Mergers

To arrive at benchmark valuation in M&A transactions, it is necessary to understand the ground rules and contextual issues:

- In an amalgamation, in the nature of a true merger (i.e. a merger of equals), it is necessary to arrive at the *stand-alone valuation* of both the companies *on a going concern basis* in order to arrive at the share swap ratio. *The synergy visualised in the merger is not factored into determination of the share swap ratio*.
- In an *amalgamation in the nature of purchase* (i.e. a stronger or bigger company acquiring a weaker or smaller company and merging it with itself), it is customary to offer some cash consideration along with a share swap ratio. In such cases, the immediate cash made available to the shareholders of the target company is intended as a sweetener to approve the deal. Even in such cases, the context is the same as in the earlier case and the stand-alone valuation of both companies is taken into account. From the valuation arrived at for the target, the cash consideration is deducted before arriving at the share swap ratio.
- In a scheme of purchase amalgamation (ibid) wherein the purchase consideration is being paid entirely in cash or in its equivalent terms, the valuation of the acquirer is not relevant. Valuation of the target alone is necessary to arrive at the purchase consideration. This is akin to the context of an acquisition wherein it is the target company whose valuation matters. Such transactions are structured as amalgamations only on account of other benefits such as brands, licences, regulatory issues etc.
- Since a merger is a negotiated transaction, each party provides enough information to the other to make an informed investment decision. Though listed companies are bound by strict secrecy law to prevent insider information from being shared, they can help the other party by lawful means in making their case. Therefore, in the course of discussions and based on the documentary information that may be provided, it would be easier for both parties to prepare their valuation model for the other company and accordingly assess what could be a good swap ratio. In listed companies, the independent valuers who are assigned the task of valuation are provided enough information by both the companies to complete their job. Furthermore, the merchant banker is also provided with all necessary information and the valuation reports of the independent valuers so as to be able to provide a fairness opinion thereon.
- Valuation for an M&A transaction in an unlisted company becomes even more difficult due to the absence of a market capitalisation benchmark and difficulty in correlating deal comps and trading comps. Valuers usually look for listed surrogates to determine the trading comps.
- The role of negotiations in the determination of deal price needs to be understood well in the context of M&A. Since these are high stake deals, most M&A bankers are expert negotiators and advise their clients admirably during the process and most of the time take the lead in such talks. In order to have fruitful negotiations, both parties would arrive at their own assessment of the worth of their company and what could be the premium that they can top it up with during the negotiation process. How much of the synergy the buyer is willing to share with the seller depends upon the facts of a given case and the position of the respective parties. Generally speaking, the stand alone value as estimated by the seller becomes the target's reserve price and the investment value of the target as estimated by the buyer becomes the cut-off price for the buyer.

A detailed analysis of arriving at valuation benchmarks, i.e. *stand-alone fair market value* for the seller and *investment value* for the buyer is provided in Annexure 2 of Chapter 16.

15.8.2 M&A Valuation Approaches and Methodologies

Though it is not proper to prescribe a particular method as appropriate for M&A valuation, it is possible to outline the appropriateness of these methods in the context of the situation of a particular transaction. Some of these are referred to once again in Annexure 2. These general principles are as follows:

- The *DCF method* using forecasted free cash flow is the most appropriate for mergers of mature companies since these are transactions under the pooling method on a *going concern* assumption. Obviously, the usefulness of this method depends upon the reasonableness of the underlying assumptions. Since mature companies with stable business and cash flow models are better placed for financial forecasting, the assumptions would be more sustainable. Moreover, DCF methodology requires extensive business data for forecasting and is, therefore, appropriate for mergers wherein valuation is made with extensive information at the disposal of the valuer. There would even be a due diligence done prior to the actual confirmation of the merger swap ratio by both parties.
- *Relative valuation* using a transaction multiple approach and inter-firm comparison is a useful tool for companies that are comparable and sufficient data is available. It also provides a cross-check on DCF value. The deal comps and trading comps provide enough corroboration of the valuation arrived at under other methods as well as justification to the deal price.
- The *surrogate valuation* method can be applied for unlisted companies vis-à-vis comparable listed companies. This is similar to the transaction multiple methodology and applies certain multiple factors to the company's top line, EBITDA and bottom line. The pitfall in this method is that often, an apple may be compared to an orange.
- The *Net asset value* or *break-up value* method is suitable for asset-intensive business models, especially if such companies do not have a sustainable future viability. Break-up valuation is often used in valuation of sick companies while replacement value method is adopted for profitable companies in such industries. Asset based valuation methods for on-going companies with sustainable businesses often set the *floor price* for the transaction.
- *Target stock price history analysis* is used in the context of mapping the historical price information of a listed company contemplating a transaction. Though this is not a method by itself, it provides a useful tool in the overall valuation process.
- *M&A multiples method* uses the comparable valuation multiples being used currently for other transactions in the market. This is commonly adopted by investment banks in advising their clients about the reasonableness of the price in a particular transaction. Though this method is not scientific and lacks a basis, it provides a useful cross-check if a company is over paying based on current deal comps.
- In schemes of amalgamations requiring confirmation by the High Court (now NCLT), over the years the courts have developed the view that a *fair value* determined through weightages given as follows: NAV method (1), Earnings Method (2) and Market Price Method (2) is an acceptable valuation approach in the case of listed companies. This is, of course, the normal template that the courts look for. It is, however, open to the valuer to use any other approach so long as it is justifiable as held in many court decisions discussed in this chapter.

The above list is not exhaustive but it drives home the point that valuation is a both a subjective and objective exercise. A valuer has to weigh the pros and cons of each available technique and adopt a balanced approach. The following table provides an illustrative list of valuation methodologies adopted in select transactions.

Table 15.3 Valuation Methodologies in Select Mergers in India

Name of Company	*Type of Transaction*	*Valuation Methodology Adopted*
Tata Consultancy Services Ltd.	Merger of CMC Ltd. with TCS	DCF based on the Management Business Plan for CMC Ltd. (since it was unlisted) and Analyst consensus estimates for TCS.
Dalmia Bharat Ltd.	Merger with Odisha Cement Ltd.	Odisha Cement was valued using a mix of DCF, Trading Comps – (EV/EBITDA and Fair Value/ Tonne) and Current Market Price. Dalmia Bharat was valued on DCF as a holding company. The equity value of subsidiaries was added to it. Dalmia was also valued on Deal Comps - EV/ EBITDA and Fair Value/Tonne and Current Market Price.
Ranbaxy Laboratories Ltd.	Merger with Sun Pharmaceutical Industries Ltd.	DCF was the primary method as both were established companies. Since both were listed for a long time, respective CMPs were also factored into determination of fair value with appropriate weightage.
Jaiprakash Power Ventures Ltd.	Intra group scheme of arrangement - to value the power businesses as going concerns and merge them with a group company.	Since the power businesses had long term Power Purchase Agreements, future cash flow was well defined. Therefore, DCF was the method applied. It was cross checked with the market value attributable to the power businesses in the CMP of the company.
Jaypee Cement Corporation Ltd.	Sale of cement businesses to be merged as going concerns with UltraTech Cement Ltd.	DCF method and Replacement Cost method were used. Deal Comps based on benchmark multiple per tonne of cement production capacity were used to cross check the intrinsic valuation based on the two primary methods.
ING Vysya Bank	Merger with Kotak Mahindra Bank	DCF, NAV, Relative Valuation and Market Multiples method were used to value both banks and fix the swap ratio.
Cairn India Ltd.	Merger with Vedanta Ltd.	Vedanta was valued using SOTP valuation as it had several subsidiaries. Value of its own business and value of investment in subsidiaries were added. Vedanta being complex, no trading comps were used. While DCF was the primary method of valuation, market price on NSE and the NAV as per balance sheet were also used as the company was in a capital intensive business. Cairn was valued on the SOTP method for each of its wells. Each well was valued on DCF. The NAV and market price were also used as secondary methods with appropriate weightages.

15.8.3 Judicial Review of Valuation

Generally, the courts over the year have taken a view that valuation is a technical exercise which is best left to the experts and the courts shall not sit in judgement of the methodologies adopted and their appropriateness or their arithmetical accuracy, unless it can be shown that there was a blatant error on the face of the valuation or that it was deceitful or otherwise contrary to the interests of the shareholders or public policy. However, while deciding on the fairness of valuation, the courts generally seek established methods to be applied by valuers and to that extent if there is no substantiation in a given valuation methodology, it may be overruled. Valuation may also be challenged in a court of competent jurisdiction for judicial review by minority shareholders or creditors opposing a resolution based on valuation, the Central Government on grounds of public interest, the stock exchange or SEBI and the revenue authorities on proper grounds.

Some important judgements in this regard are furnished in the cases.

Case Study

Judgement in the Case of TOMCO's Merger with Hindustan Unilever Ltd.[9]

In the case of TOMCO's sale to Hindustan Lever Ltd., the share swap ratio was fixed at 2:15 in favour of HLL (now HUL). The valuation was done using the dividend yield method, the net asset value method and the market value method giving appropriate weightage to each method in arriving at the final ratio. This valuation was upheld by the Hon'ble Supreme Court in a review petition filed by the complainant against the judgement of the Bombay High Court supporting the valuation. The Supreme Court observed that considering the market price of the shares of both companies as on the review date (17-06-1993), the exchange ratio was fair. The market price of TOMCO share was ₹52.50 and that of HLL was ₹375. The EPS of TOMCO for the previous year was ₹0.30 with a book value of ₹29.75 per share and that of HLL was ₹7.03 and ₹23.80 respectively.

The issue to be examined in this case was whether a combination of three methods could be adopted and if not, which method would be appropriate. Obviously, both companies were comparable on book value but not on EPS, P/E ratio and market price.

The Supreme Court observed, "it will, therefore, appear that in a case of amalgamation, a combination of all or some of the methods of valuation may be adopted for the purpose of fixation of the exchange ratio of the shares of the two companies.". Justice R.M.Sahai observed, "it is not required to interfere only because the figure arrived at by the valuer was not as good as it would have been if another method would have been adopted. What is imperative is that such determination should not have been contrary to law and that it was not unfair for the shareholders of the company which was being merged."

Supreme Court's View in the case of Miheer H. Mafatlal[10]

In the landmark judgement of the Hon'ble Supreme Court in the case of Miheer Mafatlal, one of the aspects of the scheme of amalgamation that was challenged was the basis of valuation for fixing the share swap ratio. It was contended that the scheme was, otherwise, unfair to the equity shareholders as the exchange ratio of equity shares of the transferor and transferee companies was ex-facie unreasonable and unfair to the shareholders of the transferee-company in so far as it provided that two equity shares of the transferee company will be allotted against five equity shares of the transferor- company at their respective face value of ₹100/- per share.

[9]Hindustan Lever Employees' Union v. Hindustan Lever Ltd. and others 1995 Supp. (1) SCC 499

[10]Miheer H. Mafatlal vs Mafatlal Industries Ltd. (1996) 4 CLJ 124 (SC)

The Supreme Court observed, "but what was lost sight of was that the jurisdiction of the Court in sanctioning a claim of merger is not to ascertain with mathematical accuracy if the determination satisfied the arithmetical test. A company court does not exercise an appellate jurisdiction."

Supreme Court's View in the case of G.L. Sultania[11]

*"*Generally speaking, the courts have always maintained that valuation is a technical exercise to be done by the experts and that courts will interfere only on grounds of lack of fairness or when a blatant error has been committed in the valuation process."

Supreme Court's View in the case of Mahadev Jalan on Use of Market Price[12]

"Where shares in a company are bought and sold on the stock exchange and there are no abnormalities affecting the market price, the price at which the shares are changing hands in the ordinary course of business is usually their true value. These quotations generally reflect the value of the asset having regard to several factors taken into consideration by the persons who transact business on the stock exchange and by buyers who want to invest their money in any particular share or shares."

15.8.4 Independent Valuation and Fairness Opinion

Valuation in mergers and amalgamations is conducted by the respective companies through their registered valuers who are usually chartered accountants or other permitted professionals. In some cases, a third independent valuer is appointed to provide a third party opinion on the valuation jointly arrived at by the appointed valuers. Under the current provisions, independent valuation in a scheme of amalgamation or restructuring becomes mandatory for seeking approval of the NCLT for all petitions filed under Sections 230–234 of the Companies Act. In the case of listed companies, SEBI Regulations also stipulate the requirement of independent valuation / fairness opinion. The fairness opinion is provided by the merchant banker who is advising the companies on the transaction. In the context of an amalgamation or a capital reduction, a listed company is obligated under the provisions of the listing agreement to share with the stock exchange the scheme or petition being filed with the NCLT.

15.9 Transaction Process in Mergers and Amalgamations

Mergers and amalgamations are essentially commercial and legal processes where the process of getting approvals from the adjudicating authority overwhelms the other aspects of the transaction. They can be long drawn processes taking sometimes more than a calendar year to accomplish since multiple clearances from various agencies would be required before final approval is accorded. Merger of listed companies can get into a litigatory process of the minority shareholders or any other stakeholder lobby opposes the scheme on justifiable grounds. The important and essential transaction steps for a scheme of arrangement are briefly furnished below:

15.9.1 Transaction Process in a Scheme of Arrangement

- *Engagement of Buy Side/Sell Side Investment Banker:* The investment banker engages in discussion with the transferor (seller or target) or the transferee (buyer) company depending upon whether he

[11]*G L Sultania vs. SEBI –(2007) 78 CLA 425* (SC)
[12]CWT vs Mahadev Jalan 86 ITR 621

represents the buy side or the sell side and who initiates the transaction. At this stage, the strategic objective has to be well understood and the broad transaction structure may be determined. Initial due diligence, preparation of suitable literature for discussions with the potential buyer and valuation is done to understand the deal parameters. Independent valuations are also initiated at this stage by the seller. In parallel, the accountants will also be involved for commencement of audit, if required to prepare the financial statements that would become the basis for the deal. In this process, the proposed appointed date for the transaction is also determined.

- *Negotiations, Deal discussions:* The investment banker initiates the process of finding the other party to the transaction. When both interested parties begin deal discussions in the right earnest, both parties try to do as much business due diligence as possible to try and understand the strategic fit. Thereafter, the negotiations centre around the valuation and other commercial terms and deal structure. This is by far the most critical stage in the deal when the commercial terms are being discussed as it has a direct bearing on the deliverables of the investment bankers from both sides to the deal. At the conclusion of this phase, a term sheet would be ready to be placed before the board of directors for approval and signed off.
- *Board Approval:* In a transaction that is essentially an intra-group restructuring without there being an external party, the proposed deal is put up to the Board of Directors for being adopted by the Board. In other transactions involving an amalgamation or a divestiture in the nature of a demerger since another company in the form of an acquirer is involved, the draft term sheet has to be put up to the respective boards of the buyer and seller along with the suggested share swap ratio as confirmed by the independent valuers from both sides.
- *Due Diligence and Confirmation:* Post term sheet execution, both parties get into exclusivity and commence due diligence. Once the due diligence is concluded, final negotiations take place on the findings of the report, material adverse findings and negotiating them, revision in deal valuation or mechanics and the final term sheet is drawn up which would be approved by the respective boards and taken up for drafting of the scheme.
- *Preparation of the Draft Scheme:* After the execution of the term sheet, the draft scheme is prepared and approved by both parties to make suitable application to the NCLT for necessary directions.
- *Adjudication Process:* The NCLT process begins with the filing of the petition under Section 230–232 of the Companies Act, praying for directions from the Tribunal. Under the Tribunal's directions, the meeting of members/creditors are convened separately and held to approve the scheme by the requisite majority. If this step is successful, both the companies make a second filing with the Tribunal for hearing on the petition. If there is no dissent from the minority, the hearings can be concluded early and the NCLT will seek the recommendations of the official liquidator and the ROC before setting the date for the final hearing. Upon completion of all the statutory formalities, in the final hearing, the NCLT will confirm the scheme. The orders would be passed at a subsequent date and usually, it takes about 10 days to receive the order from the Tribunal.
- *ROC Formalities:* The order of the NCLT has to be filed with the ROC to make the scheme effective from the date of filing. The ROC records the dissolution of the merged company and issues the necessary certificate. Similarly, the associated formalities for increase in authorised capital of the merged company, change of name, amendment of MOA and AOA may also be accomplished at this stage.
- *Stock Exchange Formalities:* In the case of listed companies, the application with the Tribunal is also simultaneously filed with SEBI and the concerned stock exchanges seeking to strike off the dissolved company from the exchange as well as to permit listing of additional shares to be issued by the merged company, if any. The listing of an unlisted merged company is also accomplished after the merger is confirmed and effective.

- *Statutory and Internal Compliances:* Issue of shares to the shareholders of the merging company or the demerged company, ROC filing, payment of stamp duty, obtaining new certificate of incorporation after name change, preparation of the post-merger / restructuring balance sheet, issue of communications all external agencies and statutory/government authorities, reconstitution of board of directors and other incidental steps.

15.10 Judicial Pronouncements on Schemes of Arrangement

15.10.1 Miheer Mafatlal Case

The landmark judgement of the Hon'ble Supreme Court in this case laid to rest several contentious aspects of a court's jurisdiction in sanctioning a scheme within the ambit of Sections 391–393 of the Companies Act,1956 and to what extent the courts would interfere in the detailed aspects of a scheme. The issues before the Supreme Court in this case were as follows;

1. *Whether the respondent-company was guilty of hiding the special interest of its director from the shareholders while circulating the explanatory statement supporting the Scheme and whether thereby the voting by the equity shareholders got vitiated.*
2. *Whether the Scheme was unfair and unreasonable to the minority shareholders represented by the appellant. Whether the proposed Scheme of Amalgamation was unfair and amounted to suppression of minority shareholders represented by the appellant and hence, liable to be rejected.*
3. *Whether separate meeting of minority shareholders represented by the appellant was required to be convened on the basis that the appellant's group represented a special class of equity shareholders.*

Firstly, the Supreme Court clarified that a court is not supposed to merely act as a rubber stamp and must not almost automatically put its seal of approval on a scheme. However, the Supreme Court also went on to explain the scope of a court's responsibility under Sections 391–393 in that the Court has to consider the pros and cons of the scheme with a view to finding out whether the scheme is fair, just and reasonable and is not contrary to any provisions of law and it does not violate any public policy. *No court of law would ever confirm any scheme of compromise or arrangement arrived at between the parties and which might even be supported by the requisite majority if the Court finds that it is an unconscionable or an illegal scheme or is otherwise unfair or unjust to the class of shareholders or creditors for whom it is meant*.

Nevertheless, the Supreme Court observed that the Court in such proceedings neither has the expertise nor the jurisdiction to delve deep into the commercial wisdom exercised by the creditors and members of the company who have ratified the scheme by the requisite majority. Consequently, the Company Court's jurisdiction to that extent is peripheral and supervisory and not appellate. The Court acts like an umpire in a game of cricket who has to see that both the teams play their according to the rules and do not overstep the limits. But subject to that how best the game is to be played is left to the players and not to the umpire. The Court cannot, therefore, undertake the exercise of scrutinising the scheme placed for its sanction with a view to finding out whether a better scheme could have been adopted by the parties. The Supreme Court observed, "*the court is really not concerned with the exact details of the matter and if the shareholders approved the scheme by the requisite majority, then the court only looks into the scheme as to find out that it is not manifestly unfair and/or is not intended to defraud or do injustice to the other shareholders*."

The Supreme Court laid down the following contours of functionality for a Court in proceedings for confirmation of a scheme of amalgamation.

- The sanctioning court has to see to it that all the requisite statutory procedure for supporting such a scheme has been complied with and that the requisite meeting as contemplated by Section 391(1) (a) have been held [Section 230(1) of the Companies Act, 2013].
- That the scheme put up for sanction of the Court is backed up by the requisite majority vote as required by Section 391 sub-section (2).
- That the concerned meetings of the creditors or members or any class of them had the relevant material to enable the voters to arrive at an informed decision for approving the scheme in question and whether all such material was placed before them.
- That the proposed scheme of compromise and arrangement is not found to be violative of any provision of law and is not contrary to public policy.
- That the Company Court has also to satisfy itself that members or class of members or creditors or class of creditors as the case may be, were acting bona fide and in good faith and were not coercing the minority in order to promote any interest adverse to that of the latter comprising of the same class whom they purported to represent.
- That the scheme as a whole is also found to be just, fair and reasonable from the point of view of prudent men of business taking a commercial decision beneficial to the class represented by them for whom the scheme is meant.
- Once the aforesaid broad parameters about the requirements of a scheme for getting sanction of the Court are found to have been met, the Court will have no further jurisdiction to sit in appeal over the commercial wisdom of the majority.

15.10.2 Other Cases

Similar views as in the Miheer Mafatlal case (*supra*) were echoed in other cases as well.

Case Study

TOMCO Case

The TOMCO case was decided prior to the Miheer Mafatlal case and was also quoted in the judgement given by the Supreme Court in the latter case. The Supreme Court took a similar view therein and said,

"The Court will decline to sanction a scheme of merger, if any tax fraud or any other illegality is involved. But unless it is shown that there is some illegality or fraud involved in the scheme, the Court cannot decline to sanction a scheme of amalgamation."

Ion Exchange (India) Ltd.[13]

The Bombay High Court observed,

"The law as it has evolved in the area of mergers and amalgamations, has recognised the importance of the court not sitting as an appellate authority over the commercial wisdom of those who seek to restructure business. The need for this restatement is all the greater today where the interplay of competition and the forces of the market demand efficiency, cost effectiveness and high levels of productivity."

[13]Ion Exchange (India) Ltd. (2001) – 105 Comp. Cas 115 - Bom

Kirloskar Electric Company Ltd.[14]

In this case which involved the reconstruction of a sick company pursuant to BIFR proceedings through a hive-off, the Karnataka High Court observed,

"When the only course left for the BIFR was to recommend to the High Court for winding up of the company and in that circumstances, if the sick company itself with the assistance of its members and creditors as a whole and with the active support of the labour puts forth a scheme of reconstruction for revival of the company and as aforesaid, when all the shareholders, unsecured creditors have approved such a scheme with overwhelming majority and even the secured creditors as aforesaid have approved the scheme with three-fourths majority, the High Court cannot blindly by technical interpretation refuse to sanction the Scheme on the ground of non-compliance with Section 391(2)."

Case of Mahindra Satyam

A group of minority shareholders of Mahindra Satyam (formerly Satyam Computer Services) filed a petition in the Andhra Pradesh High Court opposing the proposed share-swap ratio for the merger of Mahindra Satyam with Tech Mahindra.

The petitioners prayed in their petition as follows, "It is submitted that the applicants are not opposed to the merger, but are opposed to the current share swap ratio, ill timing of merger based on previous year's financial statements, grossly incorrect methodology used for valuation and the transferee favouring the scheme." Accordingly, the petition prayed for the court to revise the swap-ratio of 2:17, giving shareholders two Tech Mahindra shares for every 17 owned in Mahindra Satyam. On its part, Mahindra Satyam stated that the swap ratio was decided by consultants and was done in a fair manner.

In defence of their argument on questioning the valuation, the petitioners alleged that on one hand Mahindra Satyam had continuously been growing and on the other, Tech Mahindra's financial performance on stand-alone basis was going down.

On the issue of financial year to be adopted, the petition stated that based on the timing of the merger announcement merely 10 days before the closure of the next financial year ending march 2012, it was not fair making it effective retrospectively from April 1, 2011.

"It is evident that a strategy has been devised to avoid taking the values of the companies based on the latest financial results. The strategy gains more prominence on the back of continuous recovery/ growth trend exhibited by the petitioner company (Mahindra Satyam) and deterioration of the transferee company (Tech Mahindra) which factors will not have been given their due weightage, if the latest financial audited results are not utilised as base line for the merger," the petition alleged.

15.11 Investment Banking Perspectives in Mergers and Amalgamations

Having discussed the characteristic features of mergers and amalgamations, it is appropriate to understand the role of the investment banker in such transactions and consequently the investment banking perspectives attached to M&A advisory services rendered by investment banks. As indicated earlier in this chapter, M&A practice has been one of the conventional and lucrative areas of business for investment banks.

[14] Kirloskar Electric Company Ltd. (2003) – 4 CLJ 15 (Karnataka)

15.11.1 Arriving at the Transaction Structure

- An investment bank plays the role of a transaction adviser in a merger transaction since the actual process is primarily statutory and legal. The investment banker's role is mainly in the commercial area of the transaction. This would consist of understanding the strategic requirements of the client and structuring the transaction accordingly. The role-play is two-fold: (i) advising the client on the transaction and (ii) facilitating the execution of the transaction. Therefore, the main areas would consist of formulation of the transaction and deal structure, valuation, identification of the other party to the transaction either from the buy side or the sell side and thereafter facilitating the transaction by hand holding the client during negotiations and until the MOU/term sheet is signed and the scheme is passed on to the legal counsel and compliance team to get it approved from various authorities. Investment banks, thus, play the crucial role of conceiving and executing the framework of the transaction.
- It may be mentioned that mergers are negotiated transactions and the synergy benefits are shared between both companies. Mergers also pass through several layers of scrutiny from shareholders, creditors, employees, analysts, shareholder advisory firms, media, regulatory and statutory authorities. Valuation and deal parameters become extremely important for the scheme to win the support of all stakeholders. Therefore, negotiations form the crux of the commercial area in the transaction. Investment bankers use their expertise in negotiating the best terms for their client, whether from the buy or the sell side. The transaction methodology has to be worked out carefully after assessment of the facts involved and looking at the practical and regulatory possibilities.
- A true merger results from mutual dialogue and exploration of synergies for the merger. It is executed in a positive atmosphere with full co-operation from both sides. Therefore, the negotiation aspects centre mainly around the how mutual interests would be served through the merger. The investment bankers play a major role in the negotiations to serve common interests. This is seen commonly in vertical mergers.
- Sometimes negotiated business purchases are structured as mergers. The advantage herein is that the transferor company uses its stock as acquisition currency but gets control on the target company by ensuring that the transferor company's shareholders form a minority in the combined entity. This is achieved by structuring a suitable cash component in the consideration. Such transactions involve large companies on both sides and may pose commercial and regulatory issues for structuring as acquisitions. Such large companies could be banks, public utilities or corporations. Acquisition of such entities is often viewed with suspicion. A merger may be the only way to accomplish such large combinations.
  - Arcelor-Mittal merger is a case in point. It was also reported that the Tata Steel-Corus acquisition was also proposed to be structured as a scheme of arrangement under UK law for merger of Corus with Tata Steel's UK subsidiary, though the shareholders of Corus would be paid cash consideration in exchange for their shares. The rationale was that Tata Steel would be able to get 100% control on Corus if it were sanctioned as a merger by the Court unlike in an acquisition wherein there could be outside shareholding left even after the acquisition is completed and Tata Steel gets management control.
  - In 1991, when AT&T acquired NCR, it was reported to have paid a substantial sum (US$ 50 million or even more) to ensure that the transaction passes the test of pooling of interests. By using the pooling method, the EPS of the combined entity went up by 17% than under the purchase method, though the cash flow remained the same. At that time, AT&T was six times larger than NCR, but could convince the SEC to get the transaction passed as a merger and not a business purchase.
  - The ING Vysya-Kotak Mahindra bank merger was an all stock merger which was advantageous to Kotak Bank in many ways as compared to an acquisition. While it preserved cash for the acquirer,

it also obviated the need to invoke the Takeover Code Thirdly, it was also easier for getting the approval of the RBI without stiff conditions for the combination as it was structured as a merger.

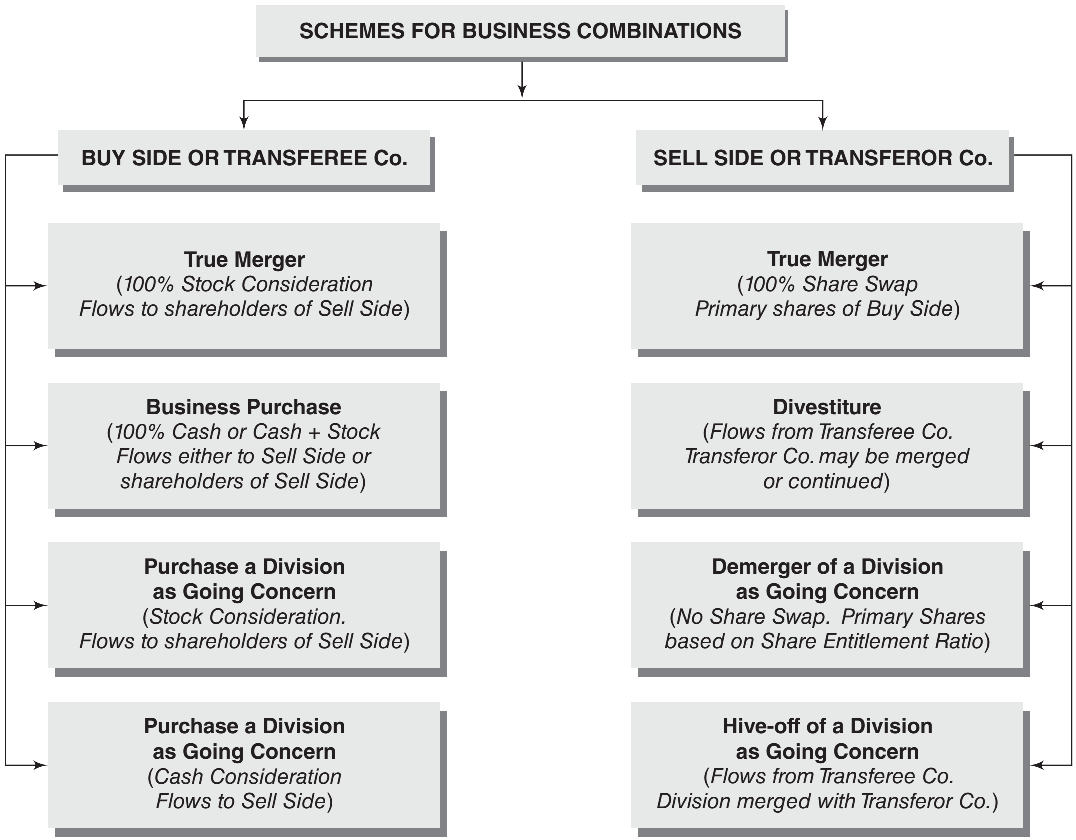

Exhibit 15.2 Alternative Transaction Structures under Schemes of Arrangement

Case Study

Arcelor-Mittal Merger

Mittal Steel Co. made won an unsolicited competitive bid against Severstal of Russia in 2006 to takeover Arcelor SA based in Luxembourg. Though this was an acquisition, it was agreed that both companies would be merged. The merger was effected by way of a tender offer by Mittal Steel. As per the final offer, shareholders of Arcelor were given 13 Mittal Steel shares and 155.60 euros in cash for 12 Arcelor shares. Mittal Steel also offered 13 Mittal Steel shares and 188.42 euros in cash for 12 Arcelor convertible bonds. Based on the above structure, Arcelor shareholders became owners of 50.5 percent of the merged company (Arcelor-Mittal) and the Mittal family became the owners of 43.6 percent of the capital and voting rights. Subject to completion of the merger, FTSE confirmed that Arcelor-Mittal would be treated as a French company for the purpose of inclusion in FTS Eurofirst Indices.

15.11.2 Deal Analysis and Recommendation

M&A transactions being of high value, it would be necessary to conduct an M&A analysis using appropriate financial model to estimate financial outcome of the transaction on the combined entity vis-a-vis the transferor and the transferee companies. Since these are large transactions, apart from the financial impact, the size of the transaction, accounting, tax and regulatory implications need to be examined in detail to identify potential hurdles and complications. This is one of the most critical areas of professional advice of an investment bank advising on the transaction. The analysis will reveal, if the merger is EPS accretive or dilutive for the combined entity. It will also enable in determining the appropriate transaction structure and the type of consideration to be paid, the valuation benchmarks, synergy effect and the amount of premium that the buyer may be willing to pay as part of the consideration to the seller.

15.11.3 Determination of Currency for the Merger

- Mergers, by definition, are predominantly stock transactions. A small amount of cash may be used to buy fractional components or dissenting members and creditors as per the scheme approved by the court. Therefore, to the extent of stock used, they are cash neutral to the merging and the merged companies. This is the reason why, if the merged company is listed, its stock becomes a currency for M&A. Deciding on a stock merger depends on two vital factors: (i) the current market valuation of the buyer or the transferee company and (ii) whether a shareholder carry is intended or not. Generally, if the buyer is valued well in the market, a stock merger is preferred as it would mean a favourable stick swap ratio. In a true merger, stock is always preferred since there is pooling of interests. Furthermore, it may be difficult to finance the transaction in cash.
- Amalgamations involving business purchase are financed predominantly by cash since these transactions usually involve buying out the dominant shareholders or purchase of divisions of the transferor company. The intent, therefore, is not to have a shareholder carry from the selling company. Here again, the listed stock of the purchasing company may be used partly to fund the transaction, if raising the complete cash becomes difficult. Issue of debt paper, preference shares and taking over of seller's liabilities are the other ways in which the financing can also be supplemented.

15.11.4 Memorandum of Understanding

Deal structuring in the context of a merger would imply the broad framework of execution encompassing various aspects relating to the transferors and the transferees after considering the strategy, valuation, regulation and financing aspects. The final deal structure subject to necessary approvals is the culmination of the efforts of the investment bank in transaction advisory and negotiation. It is usually documented in the form of a Memorandum of Understanding or Letter of Intent, as the case may be. This document would have a validity period during which time the transaction should fructify. If not, it terminates on its own without any significant binding obligations on both sides.

General Features of a Merger Deal Structure

The deal structure addresses the following aspects:
- The total deal size based on the valuation agreed to between both parties.
- Share swap ratio arrived at in the case of a merger.
- Assets to be taken over at book value or as per revaluation to be carried out. If revaluation is already completed, these values can be incorporated.
- Liabilities to be taken over if any, as per the book values or settlements to be reached with creditors.

- Exclusions from the list of assets and liabilities to be taken over.
- Mode of settlement of total consideration—cash component, stock component and debt component.
- Price per share for fresh issue by the transferee company.
- Board and management structure of the combined entity and incentive plan or stock options for the key managers.
- Other key terms relating to retention of employees and operational or business matters.
- Main conditions precedent to the transactionsuch as authorisations, board approvals and compliances.
- *Break-fee,* if any, to be paid by the buy side in case it decides to disengage from the transaction after the term sheet is signed.
- *Exclusivity period* available to both parties to conclude the deal after the signing of term sheet. At the conclusion of the exclusivity period, either the transaction should have been consummated or one of the parties should have broken it off. In neither case, the term sheet can be extended by mutual consent, in the absence of which it lapses automatically without further liability on either party.

15.12 Other Regulatory Aspects in Merger and Amalgamations

15.12.1 The Competition Act 2002

Competition laws (also known as *anti-trust laws*) began to be enacted in late 19th century with Canada being the first country to do so with the passing of the Combines Act of 1889 followed by the US and European countries. At that time, the economies in these countries were booming and it was necessary to ensure that monopolies were not perpetrated by influential and wealthy entrepreneurs and their corporations at the cost of healthy competition and growth. *Business trusts* were being created by such influential groups which were primarily holding companies encompassing huge business empires in a conglomerate structure. The Sherman Anti-Trust Act passed in 1890 in the USA was the first step to counter the rapid monopolistic growth of business trusts. The Clayton Act was a similar anti-trust law passed in later years.

India did not have anti-trust law until the passage of the Competition Act in 2002. Its predecessor, the MRTP Act enacted in 1969 aimed more at the prevailing inequality of incomes and concentration of economic power in the hands of powerful industrialists by exploiting the industrial licensing system to their advantage. But its stifling and tiring provisions hampered growth and in comparison with competition laws of many countries, it was inadequate for fostering competition in free markets and trade. The MRTP Act's main provisions relating to business combinations were denotified in 1991 following economic liberalisation and the government worked on the enactment of a new law to provide anti-trust regulatory framework in tune with the globalised domestic economy. The Competition Act, 2002 was a result of these efforts which replaced the MRTP Act.

The Competition Act, 2002 was passed by the Parliament in the year 2002, to which the President accorded assent in January, 2003. It was subsequently amended by the Competition (Amendment) Act, 2007. In accordance with the provisions of the Amendment Act, the Competition Commission of India (CCI)and the Competition Appellate Tribunal (CAT) were established. The Competition Commission of India is fully functional quasi-judicial body with a Chairperson and six members. The provisions of the Competition Act relating to anti-competitive agreements and abuse of dominant position were notified on May 20, 2009.

Section 5 of the Competition Act stipulates the applicability of the Act. According to its provisions, the Act applies to acquisitions (by voting rights or control), amalgamations and mergers. However, certain threshold limits have been specified for a transaction to come under the ambit of this section. Those transactions which are below the threshold limits are exempted from the provisions of the Act.

- Orders issued by the CCI are appealable to the Competition Appellate Tribunal within 60 days. Similarly, orders of the CAT are appealable to the Supreme Court within 60 days.
- Under the provisions of the Act, the CCI also has *suo moto* powers of inquiry into any combinations that require reference upto a period of one year from the date the business combination takes effect. Similarly, the CCI also has referred jurisdiction for inquiring into any combinations referred to it by another statutory authority.
- Combinations/acquisitions without notifications are *void abinitio* under the Act and this provision shall have precedence over the provisions of the Companies Act. CCI may impose penalties for violations under the Act. Failure to notify could result in penalty upto 1% of the assets or turnover of the company in default, whichever being higher.

Notwithstanding the provisions of Section 5 of the Act, the following business combinations are expressly exempted from the requirement of mandatory reference under the Act:

- An acquisition of shares or voting rights solely as an investment or in the ordinary course of business upto a limit of 25% of the paid-up equity capital or voting rights of a company.
- Acquisition in accordance with a shareholders' agreement or articles not leading to acquisition of control.
- Creeping acquisitions in joint ventures without transfer of control.
- Strategic unrelated diversifications without control.
- Acquisition of shares pursuant to underwriting commitments.
- Rights/Bonus/Stock Splits.
- Group company combinations/holding—subsidiary combinations.
- Acquisition/purchase of current assets.
- Foreign combinations having assets/turnover below the prescribed threshold level for establishing Indian nexus.

15.12.2 Stamp Duty

Stamp duty is attracted to all *instruments* conveyancing immovable or movable assets. The Indian Stamp Act, 1862 is the central law in the subject and each state government enacted its law since stamp duty on immovable property and movables (other than shares) is a state subject under the Constitution. So, when the issue of levying stamp duty on schemes of arrangement was proposed, the key issue was whether a court order under Sections 391–394 of the Companies Act, 1956 amounted to an instrument conveyancing property and as such could duty be levied on it. After rulings by the Bombay and Calcutta High Courts, the Supreme Court in the case of *Hindustan Lever Ltd. vs State of Maharashtra*[15] upheld the constitutional validity of stamping a court order sanctioning a scheme of arrangement under Sections 391–394 of the Companies Act, 1956. Prior to it, since it is a judicial process, most states did not levy any stamp duty on mergers and amalgamations which were settled through exchange of shares. With the amendments to the Bombay Stamp Act, 1958 and the Supreme Court upholding the validity of stamp duty on schemes of arrangements, several states enacted amendments to their State Stamp Acts for levying such duty on mergers and amalgamations. Even in states that have so far not amended their stamp law, the operation of the judgement in HLL's case makes them entitle to levy stamp duty on all schemes of restructuring involving transfer of property.

Based on a Ministry of Finance notification dated December 25, 1937, transfer of assets between a holding company and its 90% subsidiary or between companies held by the same shareholders to the extent of atleast 90% is exempt from payment of stamp duty. On similar lines, until stamp duty on schemes of arrangement is provided for in the Indian Stamp Act so as to make it a central subject, uniform rates of stamp duty would not prevail across the country.

[15]AIR (2004) SC 326

15.12.3 Other Laws

Apart from complying with the provisions of the Companies Act and other corporate law as may be applicable, it may be necessary to seek further approvals under other Central or State enactments depending upon the industry segment and whether a closure of a unit with retrenchment of workers is envisaged or not. For instance, if a merger of banks is envisaged it requires the approval of the RBI under the Banking Regulation Act. Similarly, closure of unit or retrenchment has to be cleared by the labour court under the concerned Central or State labour law. The closure of a unit would require approvals under the Industries (Development & Regulation) Act in the case of licensed industries. The merger of sick companies is governed under the provisions of the Insolvency and Bankruptcy Code, 2016.

15.12.4 Squeeze Out

A squeeze out is required in a scheme of amalgamation when there are dissenting shareholders. This could happen in a scheme wherein the transferor company decides to pay a cash consideration to shareholders of the transferee company instead of a share swap or in cases of a merger through share swap with a dissenting minority that needs to be settled in cash. In such cases, Section 235 of the Companies Act comes into play providing a time bound compulsory squeeze out according to the provisions mentioned therein.

IMPORTANT TERMINOLOGY

Absorption
Amalgamation
Amalgamation in the nature of Merger
Amalgamation in the nature of Purchase
Appointed Date
Arrangement
Bail-out Merger
Capital Reserve
Conglomerate Merger
Effective Date
Goodwill
Horizontal Merger
Merger
Pooling of Interest
Purchase Consideration
Reconstruction
Reverse Merger
Section 72A Merger
Share Swap Ratio
Shareholder Carry
Synergy
True Merger
Vertical Merger

TEST YOUR UNDERSTANDING

PART – A

I. Pick the right answer(s) or the alternative that best fits the description from the alternatives provided under each question.

1. In a three-way unification of companies, a holding company and its subsidiary propose to get absorbed by another loss-making associate company. This transaction is termed as:
   (a) Reverse demerger (b) Merger in the nature of absorption
   (c) Fantastic merger (d) Triangular merger
   (e) Three-way merger (f) Amalgamation
2. If a profit-making company gets absorbed by a loss-making company, the transaction is termed as:
   (a) Amalgamation (b) Merger
   (c) Reverse merger (d) Hive-off in the nature of merger

(e) Reverse demerger
(f) Unhappy merger
(f) Sloping merger

3. In an amalgamation in the nature of a purchase:
   (a) The entire assets and property of the merging company are transferred to the merged company and based on the valuation of both the companies, the purchase consideration is fixed.
   (b) The assets and liabilities of the merging company to be transferred are finalised and valued to arrive at the purchase consideration which is paid in the form of shares of the transferee company based on the share swap ratio.
   (c) The purchase consideration is paid by the transferee company in the form of shares or cash or both and the transferor company is dissolved.
   (d) The assets and liabilities may or may not be transferred in full by the transferee company based on the valuation of the transferor company.
   (e) Based on the mutual valuation of the two companies, the share swap ratio is fixed to pay the purchase consideration.
4. In a true merger with 'pooling of interests':
   (a) The entire assets and property of the merging company are transferred to the merged company and based on the valuation of both the companies, the share swap ratio is fixed.
   (b) The assets and liabilities of the merging company to be transferred are finalised and valued to arrive at the purchase consideration which is paid in the form of shares of the transferee company based on the share swap ratio.
   (c) The purchase consideration is paid by the transferee company in the form of shares or cash or both and the transferor company is dissolved.
   (d) The assets and liabilities may or may not be transferred in full by the transferee company based on the valuation of the transferor company.
   (e) Based on the mutual valuation of the assets of both the companies, the share swap ratio is fixed.
5. If a holding company spins off its subsidiary and then merges it with itself, the share swap is made between:
   (a) The holding and the subsidiary companies.
   (b) The shareholders of the holding company and the subsidiary company.
   (c) The holding company and the shareholders of the subsidiary company.
   (d) The shares held in the subsidiary with additional shares in the holding company.
   (e) The shares in the holding company are exchanged for shares in the subsidiary company.
6. In an amalgamation, the share swap ratio is fixed on the basis of:
   (a) Book value of assets and liabilities on the date of merger.
   (b) DCF valuation of both the companies.
   (c) Earnings capitalisation method.
   (d) Market Value of the shares of both the companies.
   (e) A fair value based on different approaches of valuation.
7. A listed company has two subsidiaries, one that is also listed and the other unlisted. It wishes to do a spin-off of the unlisted subsidiary and a merger between the two subsidiaries. This would result in:
   (a) An open offer in the listed subsidiary.
   (b) An IPO for the unlisted subsidiary.
   (c) A de-listing offer for the listed subsidiary.
   (d) One unlisted subsidiary.
   (e) One listed subsidiary.
8. A listed company has two subsidiaries, both listed. It wishes to do a spin-off of one subsidiary and a merger between the two subsidiaries. This would result in:
   (a) An open offer in the listed parent.
   (b) An IPO for the spun-off subsidiary.

(c) A backdoor listing for the other subsidiary. (d) Two listed group companies.
(e) One listed subsidiary.

9. A promoter group has two companies, both listed. In the bigger company, they have 38% stake and in the smaller company they have a 62% stake. They now propose a merger between the two companies and the share swap ratio is fixed in such a way that their stake in the combined company goes up to 51%. This has the following implication(s):
   (a) The Takeover Code will be triggered off in the bigger company.
   (b) The Takeover Code will be triggered off in the smaller company.
   (c) The promoters will be compelled to make a de-listing offer for the merged entity.
   (d) The scheme will be held valid with an open offer requirement
   (e) The company will be prosecuted for violation of corporate governance norms.
   (f) The scheme will be held valid without any further requirements.
10. In accounting for a merger under the purchase consideration method, a company is faced with a situation wherein it does not know how to transfer a capital reserve in the transferor's books to the transferee's books. This can be achieved in the following way:
    (a) The transferee can reduce the capital reserve from the purchase consideration.
    (b) The transferee can allot shares to the extent of the capital reserve.
    (c) The transferee can settle the capital reserve in cash.
    (d) The transferee can allot shares to the shareholders of the transferor company to the extent of the capital reserve.
    (e) The transferee can net off the capital reserve from other reserves appearing in its books.
    (f) The transferee can reduce the book value of the assets taken over to the extent of the capital reserve.
11. In financing the merger of two companies through purchase consideration method, the transferee comes up with a scheme of issuing deep discount bonds to the shareholders of the transferor company. This has the following implication:
    (a) The scheme is not compliant with an amalgamation in the nature of purchase.
    (b) The transferee is not permitted to do so since the shareholders of the transferor have to be settled in cash.
    (c) Since this is a buyback of shares, it has to be financed only in cash.
    (d) The deep discount bonds have to be valued at not less than the original issue price of the shares.
    (e) The swap ratio of bonds to shares shall not be less than the issued capital of the transferor company.
    (f) The issue price of the bonds shall be equal to the purchase consideration.
12. In a merger of two companies, the first company requests the second company to revalue its assets before fixing the share swap ratio. This is not possible since it is a merger of two companies.
    (a) Yes (b) No
13. In a merger of two companies A and B, the share swap ratio has been fixed taking into account an impending acquisition by A of another company C. The shareholders of B wish to have two ratios: one assuming that the acquisition will go through and the other assuming it will not. The investment banker of A holds that there cannot be multiple share swap ratios for one merger transaction. Who is right?
    (a) Shareholders of B (b) Investment banker of A
14. In an amalgamation in the nature of a merger of two companies, the absorbing company demands that the merging company should be valued on the basis of its assets before fixing the share swap ratio. This is not possible since the merger has to be at book values.
    (a) Yes (b) No

15. Company A is an unlisted holding company and is in need of capital. Company B which is its listed subsidiary, has a problem of excess free cash flow. The CFO of Company A proposes a preferential offer to Company B. The CFO of Company B proposes a high dividend distribution. The financial adviser of the group suggests that there should be a share repurchase by Company B. The tax advisor to the group says that Company B should be merged with Company A. The Chairman of Company A fears that this would lead to a back-door listing of Company A. Since they could not agree on the offer formulation, they engage an investment banker who advises that a separate SPV should be floated in which both the companies are equal shareholders. Which of the following alternatives is the most tax efficient and also meets the strategic requirement?
    (a) Advice of CFO of company A
    (b) Advice of CFO of company B
    (c) Advice of Group Financial Adviser
    (d) Advice of Group Tax Adviser
    (e) Advice of Investment Banker
16. An investment bank announces the merger of its banking associate with itself. This amounts to:
    (a) Insider trading
    (b) Core investment banking
    (c) Universal banking
    (d) Non-banking financing
    (e) Conglomerate banking
17. In a scheme of merger, Doctor Ltd. decides to keep its intellectual property out of the merger scheme by transferring it to a third company prior to the merger. This is proposed so as to retain the IP advantage for the future. The other company in the scheme, Gambler Ltd. opposes the move and objects to the scheme for being fraudulent. Can the Court overrule either party and decide the case?
    (a) Yes
    (b) No
18. Madaari Securities Ltd., a broking and underwriting firm wishes to merge with Kabaali Capital Ltd., an investment bank to become Kamaali Capital Securities Ltd. Will this merger be allowed?
    (a) Yes
    (b) No
19. In financing the merger of two companies through purchase consideration method, the transferee comes up with a scheme of issuing deep discount bonds to the shareholders of the transferor company. This has the following implication -
    (a) The scheme is not compliant with an amalgamation in the nature of purchase.
    (b) The transferee is not permitted to do so since the shareholders of the transferor have to be settled in cash.
    (c) Since this is a buyback of shares, it has to be financed only in cash.
    (d) The deep discount bonds have to be valued at not less than the original issue price of the shares.
    (e) The swap ratio of bonds to shares shall not be less than the issued capital of the transferor company.
    (f) The issue price of the bonds shall be equal to the purchase consideration.

PART – B

20. How do you distinguish a merger from an amalgamation? What are the legal connotations of both the words?
21. What is the process flow of a merger and the role of an investment banker therein?
22. How does one ensure fairness in a scheme of amalgamation so as to pass judicial scrutiny?

For answers to Part A, refer to Appendix B at the end of the book.

16 Acquisitions and Takeovers

LEARNING OUTCOMES

- Introduction to Substantial Acquisitions, Negotiated and Hostile Takeovers, Buyouts and their distinguishing features with Case studies.
- Global regulation of Substantial Acquisitions and Takeovers.
- Discussion on Takeover Code 2011 with Case Studies.
- Role of Investment Banks in Substantial Acquisitions and Takeovers—various aspects of acquisition strategy, target identification, transaction structuring, valuation, negotiation, financing and deal structure.
- Cross Border Outbound Acquisitions and Structured Acquisitions.
- Leveraged Buy-Outs, anatomy of LBO, financing pattern, LBO Analysis with Case studies.
- Well known domestic and international Case Studies in Acquisitions and Takeovers.

16.1 Introduction to Acquisitions and Takeovers

After having discussed the aspect of integration of companies through mergers and amalgamations in Chapter 15, it is necessary to discuss the alternative method of business combinations using the equity route. Acquisitions and Takeovers are common in their modus operandi, they happen at the shareholder level without affecting the balance sheets of the respective companies. Acquisitions and takeovers are two mechanisms by which companies change hands through transfer of ownership of shares or transfer of control. While both these words are loosely used almost interchangeably, there is a lot of distinction between the two.

16.1.1 Acquisition

Acquisition means the purchase of or getting access to significant stakes in a company, often making such acquirer a significant shareholder in the company. The word *acquisition* has not been defined under any Act. By a reading of its description from various non-statutory sources, it may be concluded that *acquisition is the act of acquiring ownership or property*. Therefore, an acquisition of shares in a company only means that a person becomes the owner in such shares. It does not convey the intent behind the acquisition. Many a time, strategic and financial investors make significant acquisitions in companies either for a business or financial reason. Such investments are much more than mere portfolio stakes and are often off-market direct investments into the company or through bulk secondary purchases from existing shareholders. Such acquisitions are known as *substantial acquisitions*.

16.1.2 Takeover

The word *takeover* has more of a negative connotation that conveys the intent to displace the existing management and seek control of affairs of the company. Such control may be acquired through ownership of shareholding or by other means. Again, *takeover* has not been defined under any Act. The dictionary of Banking and Finance defines it as *an act of buying a controlling interest in a business by buying more than 50% of its shares*. It has to be appreciated that a takeover does not always entail the necessity to acquire more than 50% shareholding. M.A. Weinberg defines a takeover as, *a transaction or series of transactions whereby a person (individual, group of individuals or company) acquires control over the assets of a company either directly by becoming the owner of those assets or indirectly by obtaining control of the management of the company.* From this descriptive definition, it is evident that the essential feature of a takeover is the intent to take control of a company directly or indirectly. Takeover can be through friendly means, in which case it is with the consent of the existing management. However, it can also be through the hostile route whereby the existing management is forced into submission to hand over charge to the acquirer. Takeover is a term that is usually associated with a hostile bid for control while the word *acquisition* is many a time used to connote a friendly takeover as well. In some companies, where ownership is divorced from management, an acquirer

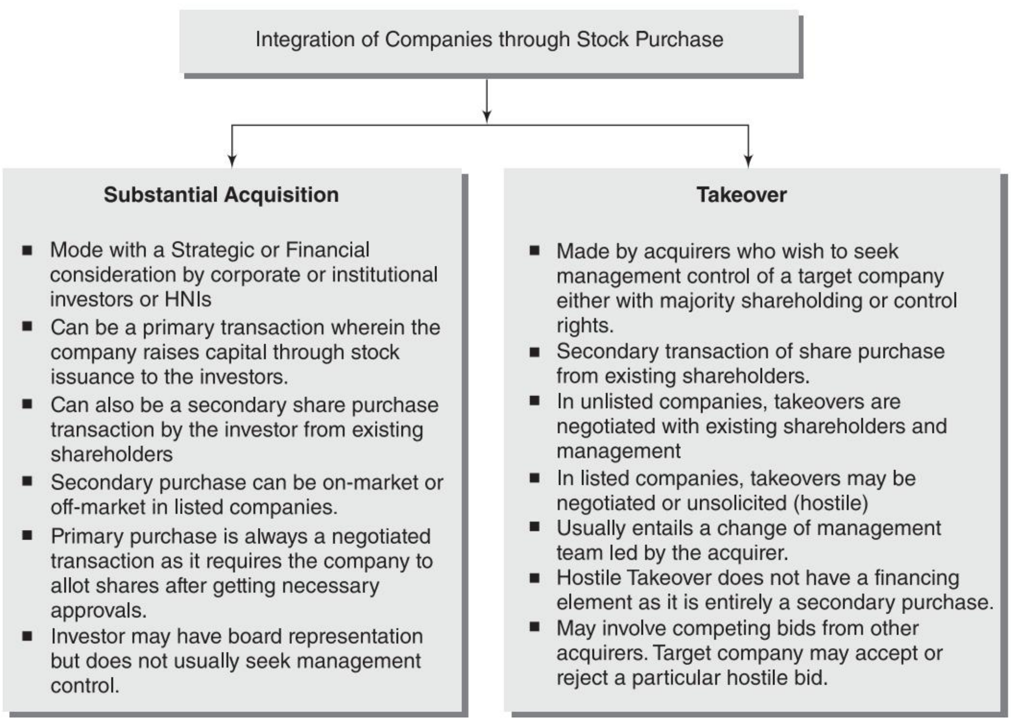

Exhibit 16.1 Acquisition and Takeover

could take ownership control of the company but might decide to continue with the existing management by nominating some representatives on the board of the company for the purpose of monitoring. Such takeovers are known as *management buy-in*.

16.1.3 Buy-out

A specific type of substantial acquisition (51% and above, sometimes 100%) that does not exactly fit into the description of a takeover is the *buy-out*. In this case, a company is acquired by its own management or by a large PE fund or a syndicate of investors. If the company is listed, a buy-out may be planned by taking a company private or by keeping it listed. If the buy-out is carried out by the incumbent management of a company with the help of financial or PE investors, it is known as a *management buy-out or MBO*. The buy-out of Dell Inc. by Michael Dell is an example of an MBO which took the company private. In the MBO of Centurion Bank, the management along with a team of investors bought out the bank but decided to keep it listed. When buy-outs are carried out with a major part of the finance raised through debt capital, it is known as a *leveraged buy-out or LBO*. The LBO of RJR Nabisco is one of the most well known cases discussed later in this chapter. Some large PE funds that specialise in buy-outs and LBOs are known as *buy-out funds*. KKR (Kohlberg, Kravis, Roberts), Blackstone, TPG Capital are some of the well-known global buy-out funds.

16.2 Strategic Acquisitions

Strategic acquisitions are made by corporate investors in a company with business objective rather than an investment objective. From the issuer's perspective, a company invites strategic equity with a view to further its business interests rather than to raise capital. Therefore, the key differentiator of strategic investors vis-à-vis other investors is the intent behind the investment. Strategic equity is not invited by an issuer through a placement process. On the contrary, the investment becomes an integral part of a larger business understanding reached between the issuer and the investor.

Broadly, strategic acquisitions can be classified as acquisition of strategic minority stakes, joint ventures and techno-financial collaborations. Joint ventures and techno-financial collaborations involve either a minority or a majority stake but are heavily entwined in a business relationship. Joint ventures are unique due to the presence of joint control on the venture.

16.2.1 Strategic Minority Stakes

Acquisition of strategic minority stake refers to an investment made by a strategic investor in a company with the intention of having a presence in its business and not for the purpose of acquiring management control of such company. Acquisition of strategic stakes is a common phenomenon among companies in different or complementary businesses. Sometimes, a strategic investment forms a part of a large project consortium. Similarly, in projects executed under the public private participation model, the government may acquire a strategic stake in a project for ensuring orderly execution of the project. Strategic stakeholders do not normally look for majority stakes or to dislodge the existing management of the company in which the stake is acquired but sometimes retain certain important management rights to protect their minority interest. Usually, strategic minority stakes are retained at the threshold of 26% voting rights in the company. Sometimes, they may even be lower if the company is widely held or the business association is very strong.

In the era of globalisation, cross border strategic stake acquisitions are quite common. Several foreign companies look towards acquiring such stakes as an entry strategy into the domestic market of a country. This would, however, depend on the Foreign Direct Investment (FDI) policy of respective countries.

In circumstances, wherein the foreign company acquires a minority stake in a domestic company, such stake is meant to provide an indirect presence for the foreign company in the domestic market. The strategic position could either be a long-term strategy or merely meant as a launch pad for more involved initiatives at a later date.

16.2.2 Joint Ventures

A Joint Venture (JV) can be incorporated as a company or operated as a special purpose association with separate books and bank accounts. In the former case, it is called an Equity JV since the separate company would be capitalised with the capital contribution from both the parties. In the latter case, it is a contractual arrangement between two parties and therefore, it is known as a Contractual JV. Whatever the constitution of a JV, the essential feature that distinguishes a JV from a strategic minority stake is the exercise of joint control by both the partners. Herein we discuss Equity JVs.

JVs are entered into with specific objectives such as entry into a foreign market with local support, access to ready markets and other strategic considerations such as technological support, branding and harnessing intellectual property. JVs are generally favoured over the creation of a new subsidiary or the acquisition of an existing company, owing to strong commitment from the partners, flexibility in operation and structuring investments and saving in capital and operational costs.

Most of the JVs in India in the 1990s and thereafter were fall outs of the liberalisation and FDI policies followed by the government since 1991. These have been in the nature of foreign companies entering India through the JV route pursuant to the liberalised FDI policy. In the first phase of FDI investments into India post-1991, JV was a preferred route as compared to setting up of 100% subsidiaries by foreign companies since in most sectors, the maximum FDI was restricted to 51%. However, in later years, some sectors were opened up for 100% FDI whereby foreign investors set up their own 100% subsidiaries or converted existing JVs into 100% subsidiaries.

In the Indian context, access to new markets has been the general priority of the foreign partner while access to technology and domain knowledge has been the main driver for the Indian partner. An example in this context is the joint venture between the Maharashtra Electricity Supply Board (MSEB), Enron, General Electric and Bechtel which went on to create the Dabhol Power Company in Maharashtra. MSEB looked at the technology, global experience, resourcefulness and global size of Enron, GE and Bechtel. GE and Bechtel in parts had the know how in the equipment and construction of power plants respectively while Enron as a global energy generator and trader wanted access into the vast market for electric power and gas consumption in India. However, the JV folded up due to the subsequent bankruptcy of Enron.

Joint ventures were found in all leading industry sectors in India. In the automotive sector (example, TVS-Suzuki, Maruti Udyog, Hero-Honda, Toyota-Kirloskar, Tata Motors-Fiat), chemicals, financial services (example, Prudential-ICICI, DSP-Merrill Lynch, Kotak-Goldman Sachs, JM-Morgan Stanley), engineering (L&T-Komatsu) are just a few examples. Maruti Udyog Limited (MUL) was established in February 1981 through an Act of Parliament to meet the growing demand of a personal mode of transport caused by the lack of an efficient public transport system. Suzuki Motor Company was chosen from seven prospective partners worldwide. A Joint Venture agreement was signed with Suzuki Motor Company (now Suzuki Motor Corporation of Japan) in October 1982, by which Suzuki acquired 26% share of the equity in MUL. A manufacturing licence was also issued for the manufacture of passenger cars. Suzuki subsequently increased its equity to 40% in 1989 and further to 50% in 1992, converting Maruti into a non-government company.

After a decade and a half of liberalisation during which a spate of JVs with MNCs were launched, the Indian JV sector started to taper off slowly. Primarily, all JVs were started to bring in new technology and expertise into Indian businesses or to provide an entry strategy to the foreign partner. These reasons, however, lost much of their relevance after 15 years of reforms. Several Indian JVs broke off in subsequent years either by the foreign partner buying out the Indian partner or the foreign partner exiting through a sell-off to the Indian partner. Among the JV exits in India are TVS-Suzuki and Hero-Honda in the two-wheeler segment, Government of India (GOI)-Suzuki and Mahindra-Renault in passenger cars, JP Morgan-ICICI, Merrill Lynch-DSP, JM-Morgan Stanley in investment banking and several others in different sectors. The only driver that may still exist for JVs between foreign companies and their Indian counterparts can be the continuing sectoral caps on FDI in certain sectors such as media, newsprint, insurance and banking.

16.2.3 Techno-Financial Collaborations

Financial foreign collaborations in the Indian context are associations between resident Indian companies and their foreign counterparts for exchange of technical and / or financial inputs for mutual benefit. Several Indian companies and other ventures sought foreign collaboration in the past to bring in contemporary technology or necessary investment into their industrial projects in India. Foreign collaborations can be envisaged by new and existing companies as well. In the case of new companies, such collaboration could be in connection with setting up of a new project or business that could require technology, equipment sourcing, fabrication and erection of the main plant, product standardisation and in some cases, marketing support or buyback support. In the case of existing companies too, such collaborations could be envisaged either in the existing business or for a new business initiative. There could also be pure licensing and/or marketing alliances between Indian and foreign companies without any technology transfer.

Techno-financial collaborations involve a wide gamut of transfer of inputs from the foreign collaborator to the Indian counterpart in the following areas: (i) Transfer of scientific technology, designs and drawings, technical specifications, skills in equipment or process handling, know-how and other forms of technical and scientific intellectual property, (ii) contract for training of the technicians and other experts of the Indian party by the foreign technicians or supply of trained manpower or consultants from abroad, (iii) supply or fabrication or help in sourcing of critical equipment, plant and machinery, components, raw materials and other critical production inputs and (iv) investment in the equity of the Indian company through cash or through supply of capital goods or through technology transfer or through a combination of all the three elements.

16.3 Negotiated and Hostile Takeovers

Since a takeover is about change in management control, it cannot be accomplished without management control or the power to control board composition or influence decision-making. When a potential acquirer identifies a target company for a takeover, there can be two ways to go about doing it: (i) *Negotiated or friendly takeover* and (ii) *Hostile Takeover*. A negotiated takeover happens when the acquirer initiates a dialogue with the incumbent management of the target and the board accepts the proposal and recommends it to the shareholders. This would require an extensive negotiation process. The bid may, sometimes, need to be improved in order to win the acceptance of the target's board.

On the other hand, if an acquirer decides to go ahead and make an offer to the shareholders of the target company without any dialogue or support of the board of the target company, it becomes a *hostile bid* and if successful, results in a hostile takeover. Sometimes, hostile bids are launched after the board of the target company rejects a takeover proposal. Hostile bids are probably the most expensive way of acquiring control of a company as the process is open ended after the announcement of the bid. The way the market price of the target's share reacts to the announcement determines the outcome and cost of the transaction to the acquirer. Sometimes, competitive bids are launched by other potential suitors in response to the first bid. When the situation becomes highly competitive, it becomes an expensive deal for the successful acquirer. The reason why successful hostile bids are few in comparison with negotiated bids and other forms of substantial acquisitions is the difficulty, higher cost and requirement of huge cash resources in accomplishing them.

AOL's hostile takeover of the bigger Time Warner in 2000 at a deal size of $164 billion is hailed as the largest successful such transaction of all time, though its post-deal performance left a lot to be desired. The takeover of Genzyme Corp by Sanofi-Aventis was also a successful hostile takeover. In 2015, Mylan Labs, one of the world's largest generic drug companies, made an unsuccessful hostile bid of $26 billion with a tender offer directly to the shareholders of generic drug maker Perrigo but it received too few takers to gain majority control of its target. Several large shareholders and proxy advisors were against the deal. Mylan's unsuccessful bid was preceded by Teva's unsuccessful bid on Mylan itself. Since the AOL-Time Warner transaction, there were very few successful hostile bids because it is very difficult to take over a large corporation that is determined not to be sold, and rarely do deals happen under hostile conditions. Some of the other famous global unsuccessful bids were BHP Billiton's bid on Rio Tinto to create the world's largest mining conglomerate ($148 billion), Pfizer's bid on Allergan ($150 billion), Kraft-Heinz's bid on Unilever Plc ($143 billion), MCI Worldcom-Sprint ($129 billion) and Monsanto's hostile bid on Syngenta ($47 billion).

India never had a successful history of hostile bids due to strong promoter-led management structure in most listed companies. In addition, the cultural, regulatory and political structure in India was not conducive for hostile takeovers. In the early 1980s, Lord Swaraj Paul led a fight to takeover Escorts and DCM Shriram in a hostile bid but had to eventually backtrack in the face of political and government owned institutional resistance. The Reliance-L&T battle for control, BAT's unsuccessful attempt to take control of ITC, the GESCO bid by Abhishek Dalmia and ITC's attempt on Indian Hotels are other examples of hostile bids in India that never went the full distance.

Case Study

Pfizer's Bid on AstraZeneca

AstraZeneca is a global pharmaceutical company formed out of the merger of Astra BV of Sweden and Zeneca Group Plc of Britain in 1999. Pfizer Inc. is a US based multinational pharmaceutical company. Both the companies figure in the top pharmaceutical companies of the world though Pfizer is much larger in revenues than AstraZeneca . In 2014, Pfizer made a takeover bid on AstraZeneca with a transaction size of $118b making it the largest ever in the pharmaceutical space. However, the board of AstraZeneca rejected the total cash offer at a pricing of £55 per share. The pricing was based on a revised offer by Pfizer improving upon its original offer of £53.50 per share which the board of AstraZeneca felt was an undervaluation for their company.

Thereafter, Pfizer decided not to revise the bid within the timeline set under the UK Takeover Code and walked away from the deal. Pfizer made an announcement that it did not intend to go for a hostile takeover. The directors of AstraZeneca were of the view that the offer should have been atleast £58 and upwards for it to recommend it to its shareholders.

The proposed transaction ran into fierce opposition from politicians in UK and Sweden and the United States over the likelihood that the merger would lead to thousands of job cuts. In addition, there were concerns that Pfizer's main motive in the transaction was to look for tax saving through an 'inversion' of its corporate structure shifting it out of the US. Pfizer would also have been in a position to use the huge cash pile it had accumulated outside the US tens over the years avoiding high US taxation. In addition, AstraZeneca's portfolio of molecules under development in lucrative areas such as oncology attracted Pfizer's attention for a possible synergy in their business plan and to become the world's largest pharmaceutical company.

Subsequent to this failed attempt by Pfizer, the US government came down heavily on tax inversions by US companies with suitable amendments to its domestic taxation law which made such structures less attractive for domestic tax saving. Though Pfizer made another subsequent bid of $150 billion on Ireland based Allergan in 2015, that transaction too did not materialise due to pricing issues and regulations that meant no tax saving from the deal. Pfizer walked away from the Allergan deal paying a break fee under their agreement. In the meantime, AstraZeneca's own forecast for its business looked very bright as it began to commercialise its pipeline R&D.

The above developments meant that Pfizer's takeover bids did not yield any results and its proposed tax and corporate strategy remained unsuccessful for the medium term till it came up with its next bid on another target in mind.

Case Study

Raasi Cement

It was a takeover that started on a helpful note with India Cements (IC) acquiring shares of Raasi from the open market route at the instance of the promoters of Raasi in the wake of an imminent takeover threat. In the process, IC acquired more than 18% of Raasi and made an open offer for 20% under the Takeover Code as per the extant provisions at the time. IC had gained experience in takeover battles before by successfully snatching Visakha Cement from the jaws of Gujarat Ambuja Cements Ltd. The battle for Raasi stretched over several months and witnessed an intense fight between IC and the promoters of Raasi (the B.V.Raju family). The Raasi promoters fought an unsuccessful battle to fend off the takeover with several interesting weapons including the poison pill. The drama ended with IC paying a consideration of ₹445 crore for Raasi and another ₹115 crore for the promoters' stake in Vishnu Cements, a group company of Raasi. IC was keen on the acquisition so to get access to the large cement market in Andhra Pradesh and to consolidate its position as the leading cement manufacturer in South India. In addition, IC got access to limestone reserves, a major raw material for cement. The acquisition also meant improvement in logistics and saving on operational costs for IC. This transaction ranks as one of the rare cases of a successful hostile takeover in India.

16.4 Global Regulation of Substantial Acquisitions and Takeovers

World over, substantial acquisitions and takeovers are a subject of regulation to protect existing managements of companies from undesirable attempts to displace them and to ensure that shareholders in general and minority in particular are protected. In the USA, takeovers are regulated by statute codified both under Federal and State law. The Securities Exchange Act, 1934 provides for strict disclosures and the regulation of *tender offer* (called o*pen offer* in India).The US adopted takeover regulation around the same time as the UK in 1968 by passing the Williams Act which later got incorporated into the Securities Exchange Act. While USA and UK had widely held public companies at that time, Continental Europe was characterised by closely held companies. These features differ crucially from the concentrated ownership structures and the insider-oriented governance model with widespread cross holdings, which in India is known as a *promoter group*. The US law aimed to protect and to guarantee an equal treatment of all shareholders with respect to information and procedure so as to prevent a premature and under-priced selling of shares.

In Europe, regulation is contained in the European Commission's directives on mergers resulting in concentration of economic power. Thus in Europe, the regulation on mergers and acquisitions is based on the size of the entities rather than on whether they are listed or not. In UK, the law on takeovers is not a statutory regulation. It is in the form of a *City Code on Takeovers and Mergers*, framed for the city of London in 1959. The accent of this Code is not on financial matters but on the aspect of fairness to shareholders and business standards including protection of human rights. The City Code UK went through an overhaul in 2006 with the introduction of the Takeover Directive Regulations and certain amendments to the Code itself in 2010. Singapore and Australia also have well established takeover law that governs substantial acquisitions in their jurisdiction more or less on similar lines involving the tender offer framework. The European Union wanted to bring in a uniform takeover law across EU countries in 2001 which was defeated in the European Parliament. The European Directive issued in 2004 was made voluntary on member states which could also have their national laws in the matter. Thereafter, Germany introduced its own law called Acquisition of Securities and Takeover Act in the wake of Vodafone's hostile acquisition of Mannesmann AG which sent shock waves across corporate Germany. France adopted the European Directive but introduced substantial domestic regulation in 2011 (AMF Regulations) ostensibly in a bid to protect French companies from being taken over by companies from other countries, notably the US. Japan introduced detailed guidelines for takeover regulation in 2005 to supplement the provisions of its Securities and Exchange Act.

The takeover law in most countries follows a similar pattern to regulate substantial acquisitions and hostile takeovers. The law in some countries such as Germany also provides a framework for takeover defences in a legal way by enabling the board of the target company to introduce *golden parachutes* and *poison pills*. The UK law stipulates that these measures can be introduced only with the express approval of the shareholders and the Indian law follows similar lines in the 2011 version of the Takeover Code. In most countries other than the USA, the takeover law prescribes threshold limits upto which an acquirer is free to acquire shares of a listed company. Thereafter, the requirement for a mandatory tender offer kicks in. The threshold limits are between 25 and 40% in most countries. The mandatory bid requirement is one of the hallmarks of the UK Code. In USA, there is no concept of a mandatory code and it is purely voluntary on the part of the acquirer. Similarly, the US law does not provide for any minimum size for the tender offer while in the UK, the mandatory bid shall be for a minimum of 50% of the target company. The laws of many other countries prescribe that the mandatory offer shall be for the whole of the target company. This was one of the key recommendations of the committee that went into revamping of the takeover law in India. However, SEBI felt that such a stipulation would make acquisitions and takeovers prohibitively expensive in a fledgling market and therefore, adopted a rational approach to prescribing minimum size for the mandatory bid.

The Takeover Codes in certain countries also provide for a competitive situation emerging due to bids by more than one prospective acquirer. A competitive situation is possible either due to two or more concurrent hostile bids on a target company or a competing bid emerging after an acquirer has negotiated with a company for takeover and it has been recommended by the board to its shareholders. In both cases, since competition is involved, shareholders stand to benefit as the rival bids would try to outbid each other. The City Code UK prescribes a detailed auction methodology to resolve a takeover tussle. It prescribes the auction methodology conducted over five business days to determine the winning bidder if the competitive situation remains at the close of business hours on Day 46 (the next day after the mandatory 45 day period during which competing offers can be put in). Under Delaware law (the predominant corporate law in the US), when a potential acquirer makes a serious bid for a target company, the target's board of directors is required to act as would "auctioneers charged with getting the best price for the stock-holders at a sale of the company." [1](*Revlon v. MacAndrews & Forbes*, 173) Similarly, the Williams Act requires takeover bids to remain open for at least 20 business days on the grounds that the delay facilitates auctions. The law encourages competing bids to emerge so that it maximizses the exit price to shareholders. In addition, auctions promote efficiency by

[1]Peter Crampton on auctions and takeovers in USA.

shifting corporate assets into the hands of those that value them the most. Auctions also tend to mitigate litigation risk from disgruntled shareholders against the company and its board by requiring the target board to seek the highest bid. In Singapore, similar auction system was proposed under the 2015 Consultative Paper of the Securities Industry Council to amend The Singapore Code on Takeovers and Mergers.

As far as *squeeze out* of minority shareholders pursuant to a hostile or negotiated acquisition is concerned, the takeover laws in several countries have express provisions for a compulsory squeeze out of the minority, if the prescribed threshold is reached by the acquirer. For example, according to the City Code of London, if the acquirer is successful in reaching 90%, he can squeeze out the minority compulsorily on the same terms as in the mandatory bid. The minority may also compel the acquirer to squeeze them out in case the acquirer declines for any reason. These provisions are subject to the right to approach a competent court for directions to the contrary which would be difficult to get considering that the majority has already consented. The law in India is also harmonised in this direction after the revamping of the takeover law in 2011 and subsequent period. Similar provisions exist in USA when the acquirer is successful in reaching the threshold of 90% (85% in some states).

16.5 Indian Regulation of Substantial Acquisitions and Takeovers

In India, regulation of substantial acquisitions and takeovers is based on a threshold stake to be obtained in a company and the listing status of the company. In a listed company, acquisition of stakes below the prescribed threshold can be either through a primary issuance or through a secondary purchase. A primary issuance ranks as a PIPE which is explained in Chapter 11. A secondary purchase can either be through an on-market purchase or an off-market spot deal. Both such acquisitions in listed companies require disclosures under the SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, popularly known as the Takeover Code. Thereafter, if an acquisition goes beyond the prescribed threshold, it gets governed by the provisions of the Takeover Code.

16.6 The Takeover Code 2011

The regulation of substantial acquisitions and takeovers is a codified law under the SEBI Act, 1992 in the form of the Takeover Code introduced in 1994. The Regulations were overhauled in 1997 and again in 1999. It provides a regulated procedure for substantial acquisitions and takeovers with respect to listed companies. The Takeover Code was put to further review in 2009 and based on the Achutan Committee Report in 2010, the Takeover Code was given a complete makeover to suit the changing economic trends in India. Accordingly, the Takeover Code 2011 was introduced which governs all substantial acquisitions in listed companies. However, the Takeover Code does not apply to unlisted companies that continue to be regulated by the provisions of the Companies Act. Therefore, the Indian law on this subject regulates acquisitions and takeovers based on the criterion of listing status and not on the basis of economic power. Unlisted companies have to look for protection under the Companies Act with regard to takeovers.

The SEBI Takeover Code brought in several new features into the acquisition law that were not present in the earlier listing guidelines for companies. The basic theme of the Code is to provide for fair play and transparency in acquisitions and takeovers but at the same time to ensure that they are not stifled into extinction. The fair play is provided in terms of stipulation of a public offer to be made whenever there is a substantial acquisition or takeover so that the other shareholders get an equal exit route as well. The transparency is sought to be brought in through mandatory disclosures and guidelines on the conduct of the public offers.

As mentioned above, the Takeover Code went through refinement over the years based on the findings of the Justice Bhagwati Committee initially and later on the Achutan Committee (Takeover Regulations Advisory Committee). The Takeover Code 2011 is presently an exhaustive codified law on substantial acquisition of shares/control in listed companies.

In the lines of the US law, the Takeover Code in India covers both direct and indirect acquisitions and after the amendments in 1999, also covers cases involving acquisition of control as it covers acquisition of shares.

16.6.1 Main Architecture under the Code

1. The Code applies to both substantial acquisitions beyond the prescribed threshold and takeovers. There is no separate recognition for hostile takeovers and such offers are treated on par with negotiated takeovers.
2. For the purposes of the Code, An *acquirer* means any person who directly or indirectly acquires or agrees to acquire shares or voting rights or control over the target company either alone or together with persons acting in concert. Therefore, acquisition can be through equity shares or equity convertibles or shares with disproportionate voting rights.
3. Any acquirer with or without *Persons acting in concert* or PAC who acquires shares or voting rights in a company (hereinafter called holdings), which when aggregated with the existing stock of such holdings of the acquirer in the company is upto 5% of the total, shall disclose within two days at every stage (2% or more) the aggregate of the holdings to the company with additional disclosure of the beneficiary. For this purpose, *Persons acting in concert* or PAC mean persons with a common purpose of substantial acquisition of shares or voting rights or gaining control over a target company. The Code lists out certain categories of persons who would be deemed to be persons acting in concert such as companies under the same management as the acquirer and their directors, their merchant bankers, their stock brokers and other specified categories.
4. No acquirer shall acquire holdings, which when aggregated with the existing stock of such holdings of the acquirer in the company equal or exceed 25% of the total, unless such acquirer makes a public announcement to acquire shares through a public open offer to the extent of a minimum of 26% of the voting capital of the company as prescribed under the provisions of the SEBI (Substantial Acquisition of shares and Takeovers) Regulations 2011.
5. No acquirer together with persons acting in concert can acquire any more holdings in the target company without complying with the open offer requirements, if the existing holdings have already reached 75%. In other words, such acquirer who already has more than 25%, can do a *creeping acquisition* of up to 5% per year without triggering off the open offer requirements till the maximum limit of 75% is reached. However, any such purchase or sale transaction amounting to 2% or more of the share capital of the target company shall be reported in the same manner as described in (1) above.
6. The above requirements apply both to direct acquisitions of holdings or control in listed companies or through indirect acquisitions through holding companies whether listed or unlisted and whether in India or abroad. For this purpose, *Control* includes the right to appoint majority of the directors or to control the management or policy decisions either individually or through persons acting in concert. Such control can be by virtue of shareholding or voting rights or management rights through shareholder agreements or other arrangements.
7. In the case of bail out of financially weak and sick companies, the Code prescribes a special procedure. The acquirers of such companies would be exempted from the open offer requirements on a case-by-case basis.
8. As a part of the open offer, an acquirer may opt to delist the target company of such intention is made clear in the offer letter to the shareholders. However, for such offer to be successful, the open offer

should ensure purchase of a minimum of 90% from the shareholders so as to satisfy delisting requirements. Therefore, if an acquirer has 25% in a company, the mandatory open offer shall be for a minimum of 65%, if delisting is intended. If delisting is not intended, the offer shall be for a minimum of 26% and maximum of 50%.

9. Voluntary offers are permitted under the Code by acquirers satisfying the following criteria:
   (a) Persons holding between 25% and 75% such that the post offer shareholding does not cross 75%.
   (b) Persons making voluntary offer should not have acquired shares in the target company in the preceding 12 months and no shares can be acquired during the offer period except through the offer. In addition, the acquirer cannot make another voluntary offer in next 6 months after the first offer. Voluntary offers can be made for a minimum of 10% or more subject to the overall regulation of 75%. There is no option to delist the target company in a voluntary offer as is available in a mandatory offer.
10. Once the open offer is announced, no further acquisitions are allowed other than through the offer and for six months after the completion of the offer.
11. The purchase consideration may be paid by or listed debt paper, listed shares of the acquirer or convertibles thereof or a combination of all.
12. Once an open offer is announced, the board of directors of the target company have obligations not to obstruct the offer through the following measures unless a special resolution by shareholders is passed:
   (a) Issue of new shares
   (b) Buyback of shares
   (c) Alienate any material assets
   (d) Effect any material borrowings
   (e) Issue any warrants or other convertibles
   (f) Rights issue
   (g) Terminate material contracts
13. The independent directors of the target company shall provide guidance to shareholders atleast two working days before the commencement of the tendering period.
14. Counter-Offers:
   (a) To be made within 15 days from the date of publication of the detailed public statement by the acquirer. No counter offer is possible thereafter.
   (b) The size of the counter offer shall be for a minimum of X shares. X is defined as X = (A + B – C) wherein A is the shares held by the acquirer, B is the proposed open offer and C is the shares held by the party making the counter offer.
   (c) The original offer can be revised upward in response to a counter offer upto three days from the tendering period.
   (d) The last date for tendering shares in acceptance of every competing offer shall stand revised to the last date for tendering shares in acceptance of the competing offer last made.

   It may be noted that there is no procedure for an auction to be conducted in case the competitive situation does not get resolved during the offering period. The successful bidder is determined based on the results of the tendering process.
15. The target company cannot be delisted for 12 months after the open offer.

16.6.2 General Obligations of Target Company

- No board appointments can be made during offer period (other than that of acquirer subject to conditions).
- Business to be conducted in the ordinary course.

- Other than through special resolution, no material changes, alienation of assets, borrowings, issue of securities, buybacks, capital restructuring, material contracts or vesting of ESOP rights etc. are permitted during offer period.
- The company cannot set any record date for corporate action such as bonus shares, dividends etc. beginning with the third day prior to the open offer until the completion of the offer period.
- List of shareholders to be furnished to acquirer, if required.
- The board of directors shall constitute committee of independent directors to provide recommendations to shareholders on the merits of the open offer which the company shall publish for the guidance of shareholders two days before open offer period begins.
- Information provided to one competing acquirer shall be provided to all competing acquirers.

16.7 Important General Exemptions from Open Offer Requirements

The open offer requirements specified above do not apply to the following acquisitions:

- Inter-se transfers between promoter group members and persons acting in concert with them at market related prices.
- Acquisitions in the ordinary course of business by underwriters, merchant bankers and other intermediaries, loan conversions by banks, invocation of pledge by banks.
- Buyback by promoters from financial institutions, registered VCFs and FVCIs.
- Acquisitions in sick companies pursuant to a scheme of rehabilitation, court approved mergers, SARFAESI Act enforcement and CDR (without transfer of control), conversion of loans into equity by banks pursuant to SDR and other schemes of RBI.
- Acquisition pursuant to de-listing.
- Increase in shareholding of any shareholder beyond 24.99% pursuant to buyback provided shares are resold to market within 90 days.
- Transmission of shares.
- Rights upto the extent of entitlement (without any conditions) and beyond entitlement (with price and other conditions).
- In unlisted companies.
- GDRs/ADRs without conversion into underlying shares.
- In addition to the general exemptions as above, SEBI can accord case-by-case exemptions based on the facts of each case.
- Where Central Government has appointed directors under Companies Act, such directors have formulated a plan seeking acquirers that is fair and reasonable. The case of Mahindra Satyam case falls under this category.

Case Study

Some Interesting Takeover Code Cases

Acquisition of Mahindra Satyam by Tech Mahindra

Pursuant to CLB order in 2009, the Board of the Directors of the Target Company started the process of competitive bidding in which the acquirer was selected as the highest bidder. The acquirer entered into share subscription agreement with the Target Company for the allotment of 30,27,64,327 equity shares representing 31% of the expanded capital of the Target company at a price of ₹58 per share which has resulted into triggering SEBI Takeover Code. The Open Offer was made at the same price for a further acquisition of 20%. The open offer was made pursuant to the relaxation granted by SEBI in terms of regulation 29A of the SEBI Takeover Code.

HUL Voluntary Open Offer-2013

Capitalising on weak market sentiments, Unilever PLC along with Unilever NV (its Netherlands subsidiary) acting as PAC, made a Voluntary Open Offer under the Takeover Codefor the acquisition of 22.52% of the Voting Share Capital of Hindustan Unilever Ltd. (HUL).The target was to increase the stake of Unilever from the existing 52.48% to 75%, the maximum allowed for promoter holding in a listed company. The offer was not subject to any minimum level of acceptance.

It was the largest voluntary open offer in India at the time. The offer consisted of 48,70,04,772 shares representing 22.52% percent of the total outstanding shares of HUL. Unilever offered ₹600 per share, payable in cash. It translated into a premium of about 29.5% over the SEBI price, 26% over HUL's last one month's average trading price on the BSE and 25% over the last one week's average trading price on the NSE. The potential total value of the transaction at the offer price (assuming full acceptances) was around ₹29,220 crore. The offer received a mixed response of 65.7% with shareholders tendering 32 crore shares. Unilever could garner 14.8% stake spending ₹19,202 crore. Unilever had chosen not to revise the price upwards calling the final open offer price fair and reasonable.

The entire success of the Unilever open offer lay in the hands of FIIs who held 22.1% stake. To this extent, the institutional holding in the free float was substantially higher than normal. Institutional holding comprised almost 63% in the free float and 30% in the open offer (of which FIIs held 22.1% and DIIs held 8%).There were six institutional investors including Aberdeen, LIC and Oppenheimer or Virtus Emerging Markets Fund. Aberdeen held close to 5%, LIC about 3.5%. Both the funds did not participate in the open offer calling the price not attractive enough and not at a significant premium to the stock's trading price of ₹587.40. The price had crept up in response to the offer.

GSK Voluntary Open Offer-2013

As part of its strategy to consolidate its position in high growth emerging markets, GSK Plc (GlaxoSmithKline Beecham Plc) decided to spend as much as ₹6400 Crore to increase its stake in its Indian pharmaceuticals subsidiary GSK Pharmaceuticals Ltd. to 75% through a voluntary open offer.

This was the biggest voluntary open offer after the HUL open offer. The offer was made by GSK's wholly owned subsidiary in Singapore GlaxoSmithKline Pte Ltd. The transaction was to be funded through GSK's existing cash resources. The deal was expected to be earnings neutral for the first year and accretive thereafter.

This offer was preceded by its voluntary open offer for GlaxoSmithKline Consumer Healthcare Limited wherein it consolidated promoter stakes from 43.16% to 72.46% by paying out ₹5221 crore.

GSK on 16th December, 2013 made an open offer to buyback as many as 20.61 million shares, or 24.3% of the GSK Pharma, at a price of ₹3100 per share,representing a 26% premium to its closing share price.

GSK's offer was fully successful and the shareholders responded by tendering all the shares proposed to be bought in the offer. GSK was able to acquire 24.33 percent stake through the open offer, taking the promoter holding in the company from 50.67 percent to 75 percent, the maximum a promoter can hold in a listed firm. This was the second biggest voluntary open offer after Unilever Plc, in June 2013 to buy shares worth ₹29,220 crore. GSK's was the only open offer in 2013 to be fully subscribed that helped GSK reached the maximum allowedthreshold of 75%.

Kalindee Rail—Unsuccessful Hostile Bid under the Takeover Code

Kalindee Rail was a Delhi based promoter driven listed company. Promoters owned minority stake of 15.6% at the time. It was engaged in EPC contracts for railway signalling, telecommunication and track laying and related civil work, including railway electrification.

Kalindee's financial performance was affected in 2013 due to general slowdown in the economy and postponement of investment in infrastructure projects. It incurred significant loss. As a way to stem the financial difficulties and seek stronger shareholder support, Kalindee offered to raise funds through a preferential allotment (PIPE) to Texmaco Rail & Engineering Limited, a Kolkata based group company of Adventz, led by Saroj Poddar.

While the PIPE was yet to take place, sensing Kalindee's vulnerability, Jupiter Metal Pvt. Ltd., an unlisted company based in Jaipur announced a voluntary hostile open offer to acquire 30% of Kalindee at ₹65 per share on conditional basis. Immediately, therefter, as a defence mechanism, Kalindee's board approved the sale of a 24.9% stake via preferential allotment to Texmaco to avert the hostile takeover. Jupiter alleged that Kalindee had violated the Takeover Code by allotting equity via preferential allotment just under 25% of the company when an open offer was in progress. It wrote to SEBI on the matter. However, Texmaco maintained that negotiations with Kalindee had been in progress much before the voluntary open offer by Jupiter was announced. However, SEBI did not pursue the matter to stall Texmaco's PIPE in Kalindee. Kalindee, subsequently, informed the BSE that it had sold shares to Texmaco Rail on preferential basis at ₹65.13 a share.

Immediately thereafter, Temaxco bought the entire promoters' stake of 11.74% on expanded equity at ₹65 a share. Simultaneously, ICICI Securities Ltd., on behalf of Texmaco Rail, filed an open offer document to buy a 30% stake in Kalindee Rail at ₹68 per share. Texmaco inducted three directors on Kalindee's board.Jupiter revised its voluntary offer price to ₹70 a share. In response, Texmaco revised its open offer to ₹71 a share. Jupiter did not revise its price further.In the open offer battle, Texmaco was a clear winner winning bids for 12.4% while Jupiter could garner only 0.5%. Texmaco, thus, consolidated its stake to 49% and Jupiter exited the takeover bid. Texmaco, thus, became the new promoter in December 2013, about 7 months after the takeover tussle began. Two years later, Kalindee was merged into Texmaco.

Fame Cinemas—Unsuccessful Hostile Bid under the Takeover Code

Fame India (originally Shringar Cinemas) had multiplex presence in 12 cities with 95 screens. Fame also had two wholly owned subsidiaries namely Shringar Films (film distribution) and Big Pictures Hospitality Services (food courts). INOX Leisure is a diversification subsidiary of Gujarat Fluoro-chemicals Limited (GFL). At the time it was a pan-India operator in 21 cities with 115 screens.Reliance Mediaworks (ADAG company) was formerly a listed company called Adlabs which was acquired by (Anil Dhirubai Ambani Group or ADAG) in 2005. It operates BIG Cinemas and is the market leader with over 500 screens.

INOX began attempts towards a negotiated acquisition of Fame in 2009 and in Feb 2010, it was announced that it had acquired 43.28% of Fame Equity from the promoters for ₹66.48 crore through a block deal valuing the company at ₹153.6 crore. It was known by then that Reliance was also in negotiations and had offered ₹80 per share when the ruling market price was around ₹50. ADAG was negotiating for a takeover since 2007.The reason why the promoters preferred to sell to INOX at a far lesser price is unknown. There was no control premium but a nominal non-compete fee of ₹1 crore was paid to Fame promoters.Within a few days, the INOX Group acquired a further 7.20% through block deal on the BSE, thereby increasing their stake from the earlier 43.28% to 50.48%. This was done to counter ADAG's hostile bid. Concurrently, ADAG too acquired a small portion to take their stake in Fame to 6%. ADAG had already held 9% in INOX through open market purchases.

As per the old Takeover Code, INOX announced an open offer to acquire up to 8,231,759 equity shares aggregating to 20% of Fame at ₹51 per share. After this announcement, ADAG acquired a further 6.12% increasing their stake to 12.14%. ADAG also wrote to SEBI alleging that INOX had already negotiated an year ago for controlling stake and that the open offer was delayed. At this juncture, ADAG announced a voluntary open offer as a competitive bid to the INOX offer to acquire up to 52.48% of the fully diluted equity of Fame at ₹83.40 per share. The Reliance offer was at 63.5% premium over the INOX offer. They subsequently made market purchases to creep up close to 14%.Before both offers could close, Religare Securities bought 5.12% from the market and crept up close to 6% in Fame.Since INOX already had 50.48%, ADAG could have acquired 52.48% only if INOX sold its stake in the ADAG offer since the free float at that time was 39.46%. Therefore, ADAG's strategy appeared to be force INOX to increase its open offer size and thereby make the deal more expensive for itself.

Since ADAG offer was better, they managed to mop up 19% in the voluntary open offer. They added further market purchases to creep up to 35%.Post open offer, INOX crept up to 59%, thereby ensuring that the free public float was almost 0. This position continued for almost 2 years during which the battle for Fame was wide open. In 2012, INOX sealed the takeover battle by subscribing fully to a rights issue by Fame. ADAG did not participate in the offer and saw its position dilute to 22%. INOX moved up to 71%. Together they still controlled 93% of the company.

The road thereafter had three possibilities:

- Inox had to greenmail ADAG to sell off its 22% and subsequently dilute its stake to 75% through IPP to keep the company listed.
- ADAG exiting through the market which would have put selling pressure on the Fame stock.
- A merger of Fame with INOX which meant that ADAG would have had minority stake due to its Fame stake and direct INOX stake.

The matter reached a definitive stage when INOX announced a merger of Fame along with its subsidiaries with itself in 2012. The merger created the country's largest multiplex chain with 257 screens. As of March 2012, INOX held 73.14% in Fame India while ADAG owned 22.38%. Since ADAG had diluted much of its minority stake in INOX in 2010 to fund its stake purchases in Fame, its overall position in the merged entity remained marginal at around 10%.The gainer in the whole takeover saga was INOX Leisure which saw its scrip going up after the merger announcement as also becoming the largest player in the multiplex market.

16.8 Squeeze Outs in Acquisitions and Takeovers

Under the Takeover Code, squeeze out happens when an acquirer opts to delist the target and obtains the minimum threshold of 90% required under the de-listing regulations. Thereafter, squeeze out follows the requirements of those regulations which are described in Section 13.13 of Chapter 13. In the case of substantial acquisitions and takeovers of unlisted companies, the procedure mentioned in Section 236 of the Companies Act has to be followed as described in Chapter 13 (*ibid*).

16.9 Regulation in Unlisted Companies

Substantial acquisitions (strategic or financial) and takeovers in unlisted companies are not regulated by the Takeover Code of SEBI. Instead they are regulated under the Companies Act which does not provide any restrictions as such on unlisted public companies. Private companies have restrictions in their articles that need to be complied with. Unlisted public companies may also have provisions in their articles governing substantial acquisitions. Usually, these are a result of shareholder agreements signed with external investors. These aspects have been discussed in Chapter 12.

As far pricing regulations for substantial acquisitions in unlisted companies are concerned, the Act leaves it to be determined through fair valuation by a registered valuer. However, if the acquirer is a non-resident, the provisions of FEMA and FDI Policy are attracted. This would depend on the level of foreign or overseas investment envisaged, type of industry, pricing of shares etc. Several of these transactions have been put under the *automatic route* without prior approvals subject to fulfilment of necessary conditions. Pricing under FEMA is based on any international method of arm's length pricing as is well accepted and found appropriate by the valuer who can either be a chartered accountant or merchant banker.

16.10 Role of Investment Banks in Substantial Acquisitions and Takeovers

The role of an investment bank in substantial acquisitions and takeovers is both advisory and regulatory. The advisory part plays the predominant role, if the target is an unlisted company. In the listed space, the regulatory role is overarching as there is a statutory requirement for the appointment of a manager for the open offer under the Takeover Code. In this respect, an investment banker plays the most prominent professional role in an acquisition as compared to a merger. On the transaction advisory side, understanding the requirements of the client and structuring the transaction is extremely important as it would determine the cost and the success of the deal. The role-play is two-fold: (i) advising the client on the transaction and (ii) facilitating the execution of the transaction.

The main areas of professional service would consist of formulation of the transaction and deal structure, valuation, identification of the target or the acquirer either from the buy side or the sell side, facilitating the negotiations (in a negotiated acquisition) or formulating the takeover strategy in a hostile acquisition, hand-holding the client during the transaction and achieving deal closure. In transactions that involve an open offer under the Takeover Code, the investment banker plays the role of an independent professional just as with IPOs. The offer management includes due diligence, periodical reporting to SEBI, preparing the offer document and meeting disclosure requirements and ensuring statutory compliance. Investment banks, thus, play a comprehensive role in substantial acquisitions and takeovers both as advisors and offer managers.

Keeping in mind the extensive role played by investment banks in acquisitions and takeovers, some of the important aspects of their role play are discussed in the following paragraphs in some length.

16.10.1 Transaction Strategy and Evaluation

At the first instance, it is very important to identify the strategic objectives of the management of a company (either seller or acquirer) behind a proposed transaction. These mostly stem for business reasons and corporate strategy of the company as discussed in the previous chapter. It is necessary to appreciate that strategic reasons for M&A are common. Acquisition is just a method of execution. Consequently, the benefits of a proposed transaction need to be evaluated strategically, financially and from a regulatory and tax perspective to determine the most desired outcome. Though the regulatory and tax implications are different between mergers and acquisitions, the financial analysis is very much the same to determine the NPV from a buyer's perspective and the FIRR from a seller's perspective.

Notwithstanding the above, since acquisitions are essentially share purchase transactions, the determination of the final purchase consideration is dependent upon a host of factors. Firstly, the ruling market price and P/E of both the companies, the keenness of the parties to do the deal, the emergence of competing buyers and how the negotiations go determine the outcome, consideration and how the synergy advantage is shared between the parties. In a hostile acquisition, the pricing goes higher due to the resistance offered by the target. Therefore, the investment banker's role is not limited to financial evaluation but to ensure its execution as well so as to achieve the best possible outcome.

In a takeover bid, the acquirer has to prepare an acquisition strategy for a designated target in consultation with its investment banker. The strategy should keep in mind the present shareholding pattern of the company, the expected financial resourcefulness of the promoters of the target and their expected course of action when the open offer is triggered by the acquirer, the availability of free float in the market, the likely response of institutional shareholders or investors holding significant chunks of shares outside the promoter group, the likely stand that could be taken by the independent directors on the board of the target company, the statutory pricing under the Takeover Code that could be applicable for an open offer, the expected movement in the share price of the target in the two weeks preceding the announcement, the expected offer size, i.e. the minimum of 26% or more, the expected deal size, financing arrangements and source of funds for conducting market purchases prior to the announcement and for completing the open offer. The blue print for the acquisition strategy should also do a contingency analysis and a backup plan in case things do not pan out as expected and the walk away point in the deal. This will ensure that the acquirer does not end up going through the transaction destroying value in the process. The timing for triggering the open offer should also be planned carefully so as to suit the requirements of the acquirer. In case the acquirer requires persons acting in concert, the tying up of the acquisition syndicate is extremely vital in the pre-deal process. The investment banker plays a significant role in the pre-deal process in not only arriving at the roadmap for the transaction but also to put in place a powerful syndicate of investors and persons acting in concert with the acquirer.

16.10.2 Identification of Target

Generally speaking, undervalued companies are always targeted by buyers. According to Thomas Liaw, this has three aspects. First is what he calls *kick-in-the-pants* explanation, in which the acquirer is stimulated to adopt a higher valued operating strategy. The second is the *sitting-on-a-goldmine* hypothesis that basically argues that the market will revalue the target in the light of information about an impending deal. The third is *inflation* whereby the replacement cost of a company goes up in relation to its market cap. In depressed stock markets, this ratio of market cap to replacement value of its assets (called *q* ratio) decreases and such, the company becomes a target for acquisition.

However, undervaluation alone does not suffice to make a good target. The company's growth plan and future potential are significant in determining the strategic benefits to the buyer which may not entirely be captured in its current valuation. Other factors like necessity of growth capital, over-leveraged balance sheets, technological barriers etc. may drive companies to seek buyers who may be able to bring in the required inputs. Last but not least, the extent of promoter holdings in the target has a significant bearing. Companies with diluted promoter holdings are usually soft targets as compared to those with financially strong promoters. Investment bankers are the experts in target or buyer identification based on the strategic requirements, facts of a given case, options available and the general investment climate.

16.10.3 Arriving at the Method of Acquisition or Takeover

An acquisition or takeover of a company can happen in three different methods:

- *Takeover Bid with or without Open Market Purchase:* Under this route, the acquirer decides to trigger the open offer under the Takeover Code for the target company. However, since the law provides a window of acquiring upto 24.99% without an open offer, it is customary for the acquirer to purchase shares of the target listed company from the secondary market and consolidate these holdings with an open offer. The timing of crossing 24.99% can be worked out based on when it would be convenient to go for the open offer. If the open offer is successful, the acquirer ends up in majority or else still remain a substantial shareholder. Thereafter, it is up to the acquirer to takeover the company or not depending upon the strategic objectives behind the acquisition. Hostile acquisitions are most often started through this route whereby the identity of the acquirer can be kept confidential through proxy buying until the Takeover Code is triggered on.

In the open market purchase route, the acquirer does not come in contact with the promoters or management of the target company until after the disclosure requirements are met. If the acquirer wishes to go for the open offer, the public announcement has to be made upon reaching the trigger point of 25%. Thereafter, the public offer is made and if the existing promoters wish to contest they could make a counter-offer. Since the Takeover Code provides enough leeway for a corporate battle of control through a system of competitive bids, the success of the takeover bid depends upon how events pan out thereafter.

Case Study

Bombay Dyeing Ltd. Greenmailing

Mr. Arun Bajoria, the jute baron from Kolkata, made a takeover bid for Bombay Dyeing Co. Ltd. in late 2000. The offer was to buy-out Mr. Nusli Wadia's stake in the company so as to gain management control. Simultaneously, he also went on record with an offer to sell out his entire holding to Reliance Industries at a price even lower than the price of ₹200 asked of Bombay Dyeing. Mr. Bajoria had by then used the open market purchase route to acquire about 14% of the company. At that time, the ruling market price of the company's share was around ₹105.

On a representation from Bombay Dyeing, the Company Law Board restrained Mr. Bajoria from exercising his voting rights. During that period SEBI investigated whether Mr. Bajoria had informed Bombay Dyeing once his holding crossed 5% as per the provisions of the Takeover Code. Attempts were also on at Bombay Dyeing to prevent a hostile takeover of the company. However, it was apparent that Mr. Bajoria did not wish to go for an open offer under the Takeover Code to attain majority stake. He was, however, interested in taking up the 15% held by LIC at that time. His acquisition through the market purchase route had included shares held by UTI.

A controversy arose on the violation of the disclosure requirements under the Takeover Code due to the manner in which the market purchases were made. The shares were acquired using the route of financing a loan against pledge of the shares of the company, which were subsequently appropriated towards default by the borrower in repaying such loan. Using this mechanism, a potential acquirer can use a third party as a conduit for the acquisition by providing finance as a loan. The borrower would purchase the shares of the target company and pledge them as security. The loan would be intentionally defaulted so that the shares become those of the acquirer by default. Since this does not amount to a direct acquisition, Mr. Bajoria claimed that the disclosure requirement did not arise.

Case Study

BSL Ltd.

In this case, the promoters of BSL decided not to react using a counter offer put up by Mr. Sarda, the acquirer, for a 30% stake in BSL. The Financial Institutions (FI) held 8.6% of the stake and the promoters had not even contacted them or chalked out any other strategy to thwart the takeover bid. The holding of the promoters was 36.78% and they were banking on the idea that the open offer would not elicit a favourable response from the minority holders. This belief was backed by the fact that the Sarda open offer at ₹80 was a conditional offer, which meant that the acquirer would return all subscriptions to the open offer if it were below the 30% level. In the meantime, the promoters reportedly made market purchases to consolidate their stake.

- Negotiated Acquisition/Takeover: The acquirer strikes a deal to acquire a stake in the target company from one or more existing shareholders so as to make a substantial acquisition. The sellers could be the promoters themselves or other non-promoter shareholders. In cases involving strategic disinvestments by the promoters, this route is generally adopted. In a negotiated acquisition, the sellers are paid the sale consideration by the acquirers and therefore, the company does not get any benefit of the consideration. In a strategic divestiture, the acquirer provides an exit route for the existing promoters, such that if the acquirer triggers off a strategic disinvestment by buying out the existing promoters with an attractive exit price, it becomes a *friendly takeover*. The expression friendly takeover has two dimensions: (i) it is friendly because the promoters ultimately sell their stakes willingly and (ii) it is a takeover since the existing promoters have to make an uncontemplated exit.The negotiated acquisition route calls for deal making between the seller and the acquirer that would require the services of expert investment bankers. The investment banker may find the target company, structure the deal, help in negotiations and finalise the terms. If the investment banker were on the sell side, it would be an advisory role until close of the deal. If an open offer is triggered off, the buy side investment banker would manage such offer.

Case Study

INDAL

This was the largest ever all-cash buy-out takeover in corporate India at the time. Hindalco, part of the Aditya Birla Group, acquired down-stream aluminium major, Indian Aluminium (Indal). The acquisition deal, which was announced in March 2000, involved a staggering price of ₹1008 crore for a 74.62 percent stake in Indal. The deal was structured in two parts consisting of a buy-out and an open offer. The first part of the deal, which involved the buy-out of Alcan (the Canadian parent company) in Indal through the transfer of 54.62 percent stake of Alcan to Hindalco, was completed immediately. The second part, for the rest of the 20 percent stake, for which an open offer was announced, had to be completed by the end of June 2000.

The entire acquisition was funded from the company's own internal accruals, investments and liquid funds. The company had liquid funds and investments aggregating ₹1200 crore as against the aggregate cost of ₹1008 crore required for financing the acquisition. Even after such a huge drain on cash, the residual debt-equity ratio of Hindalco was 0.2, which was well below the industry average.

The company had made it clear that it did not propose to raise any debt or issue fresh equity for this purpose.

The takeover by Hindalco came close on the heels of an earlier unsuccessful bid by Sterlite Industries to acquire Indal during which time, Alcan defended its 34% stake in Indal successfully. This was subsequently consolidated to 54%. However, a subsequent refocus in strategy globally by Alcan in favour of up-stream products led to the sell-out of Indal to Hindalco. For Hindalco, it made perfect business sense because while it was India's largest integrated alumini*um company, Indal was a market leader in alumina and down-stream products.*

The deal was advised by DSP Merrill Lynch representing the AV Birla group and JM Morgan Stanley representing Alcan.

Case Study

A Failed Acquisition

During the heights of the technology boom of 2000, Indian software companies announced a slew of acquisitions both at home and abroad. Many of them eventually did not materialise. While some of them failed on account of high valuations in the wake of the subsequent meltdown, others failed on due diligence. An example is Film Roman, a prime time television animation company, in which Pentamedia Graphics was to pick-up a 51% stake for $15 million in cash as per the agreement. After Film roman was de-listed, Pentamedia renegotiated to acquire a 60% stake instead of a 51% for the same amount. However, Pentamedia did not make the payment by the due date and proposed an alternative to acquire a 49.9% stake for $10 million. Film Roman rejected this proposal and the transaction was called off. Many other deals failed on account of high valuations, lack of proper due diligence and unfulfilled parameters such as easy client transferability and geographical spread. On similar lines, the acquisition of San Vision technology initiated by DSQ software in July 2000 remained hanging over the purchase consideration. At the time of the initial agreement, DSQ had agreed to pay $30 million in an all-stock deal. But due to the crash in stock market valuations, San Vision called off the deal.

Case Study

Vedanta—Cairn

VEDANTA Resources listed in AIM London agreed to buy as much as 60% of oil & gas explorer Cairn India for $9.6 billion,The Vedanta acquisition of Cairn fell into controversy. Initially, it was about ONGC's right of first refusal as per the shareholders' agreement. Previously, ONGC had turned down an offer from Cairn to sell its stake for $5 billion in 2005. Later the government insisted that since the production sharing contracts for some of Cairn India's assets need prior government approval , the transfer of control should also be cleared by it. ONGC also complained to the government that despite owning 30% of the oil blocks, it was paying all the royalty for the crude that the block produces and a 30% share of the cess at ₹2,500 per tonne to the government. There were also various contracts signed with the government by Cairn for the exploration which required to be transferred to the new owner. The deal was cleared after a prolonged delay both by ONGC and the government after Vedanta agreed to a change in the royalty terms.

Case Study

British Petroleum—Reliance Industries

UK's British Petroleum Plc agreed to buy 30% in RIL's KG oil and gas assets for $7.2 billion. RIL made a formal application to the Oil Ministry. Though the sector fell under automatic FDI without FIPB approval, the Oil Ministry decided to refer the deal to the CCEA of the Government of India since the deal size was large. The Ministry had wanted to know if the New Exploration Licensing Policy (NELP), under which Reliance won blocks like KG-D6, provided for the sale of interest and if BP could take oil and gas produced from the area outside the country, as per the extant rules. The Home Ministry had also asked if Reliance could not have offered the stake to state-owned gas utility GAIL (India) or any other PSU. After nearly five months wait, the government cleared UK's BP Plc buying 30 percent stake in most of RIL oil and gas blocks, including the showpiece KG-D6 gas fields, for USD 7.2 billion. The CCEA, headed by the Prime Minister, approved the deal making it the single largest inbound FDI in India.

Case Study

Vodafone

Hutchison sold its entire stake in the telecom JV with Essar to Vodafone in 2007 through an offshore deal involving two companies in Cayman Islands. The Cayman Islands company had, in turn, routed the investment through Mauritius. The deal got into a controversy after the IT department raised a demand for ₹11000 crore on Vodafone for failure to deduct tax under Section 195 of the IT Act on capital gains made by Hutch. After four years of judicial review of the transaction, the SC ruled in favour of Vodafone dismissing the plea of the department that the situs of the shares was in India and therefore, the economic benefit of an Indian asset had been transferred for a gain. The SC examined the issue of tax planning vs. tax avoidance based on the previous judicial principles laid down in established cases such as McDowell's case, Ramsay and Westminster cases. They also examined the validity of treaty shopping under the Indo-Mauritian DTAA. The judgement paved the way for several other such cross border inbound acquisitions to get cleared from potential capital gain tax in India. However, the IT Act was amended with retrospective effect in 2012 to provide for the taxing of such indirect acquisitions done outside India though the Revenue Department did not issue notices of demand immediately on Vodafone or other such acquirers.

- *Acquisition through Share Purchase and/or Preferential Allotment:* When an acquisition is intended for the benefit of a company, it is customary to build the stake of the acquirer through a secondary share purchase. If desired, it may be combined with a new issue of equity so that the company receives the proceeds. The new issue would rank as a PIPE in listed companies. Induction of strategic partners and private equity investors into a company is generally through this route.

If the transaction is accomplished entirely through issue of primary shares, there would be no seller and a buyer in the acquisition. The acquirer enters into a subscription agreement with the company for subscribing to the preferential offer. The Takeover Code does not get triggered until the acquirer maintains a stake of less than 25%.

The transaction methodology has to be worked out carefully after assessment of the facts involved and looking at the possibilities discussed above. The transaction structure has a tremendous impact on the timing, cost and realisation of acquisition gains.

16.10.4 Valuation and Deal Size

Valuation Context in Acquisitions and Takeovers

In negotiated acquisitions, complete information is provided to the potential buyer by the seller as a part of the due diligence review so as to make informed decision. This helps in fine tuning the valuation model. In hostile acquisitions, such information is not forthcoming and the bidder has to depend entirely upon information available in public domain, understanding of the industry trends and how the target's business plan would pan out, the synergy in the deal and how that could be quantified, the feel about the expectation of purchase consideration by the target, regulatory pricing requirements, transaction comps prevailing at the time and the expected range of negotiation.. This, sometimes, brings in some constraints in determining the intrinsic value of the target and the optimum price. However, a valuation model taking into account the above factors is necessary as a benchmark both for the buy side and the sell side. Valuation of an unlisted company is difficult for the buyer in a different way due to the absence of a market capitalisation benchmark and difficulty in correlating deal comps and trading comps.

Acquisition Premium

The premium paid in an acquisition over the market capitalisation or stand-alone value of the target is known as the *acquisition premium*. If the buyer is a strategic investor and not an acquirer of the company, it is also known as *strategic premium*. Since deal dynamics are different in acquisitions as compared to mergers, the final price could be higher than the original price offered by the buyer. Generally speaking, the transfer of controlling stakes (as in a buy-out) commands higher acquisition premium. This higher component is known as *control premium*. On similar lines, indirect acquisitions using holding companies may also factor in a holding company discount due to the lack of direct control.

Case Study

Corus Steel and Arcelor

In the case of the Tata Steel's acquisition of Corus, the bid was commenced in October 2006 at a deal value of US$ 8 billion but by the time it ended, the deal value went up to US$ 12.1 billion, which was a 50% increase. This upset many calculations for the Tata Group as it steeply increased the fund requirements. Similarly, in the Arcelor-Mittal merger, Mittal Steel has to increase the bid size from Euro 18.6 billion to Euro 26.5 billion by the time it was clinched. In terms of price per share, that translated into €40.37 that was nearly double of what was offered initially. The agreed offer price was 27 percent higher than Arcelor's last trading stock price at that time. In both these cases, there were competitive bids due to which the deal size increased considerably.

If the current valuation of a target in the market is high, it denotes that the regulatory pricing can be a hurdle in negotiation. The acquirer needs to factor in a strategic premium or a control premium over and above the current goodwill enjoyed by the company. If there is a competitive situation, it could drive up the acquisition premium even higher. This could vitiate the deal for the buyer. This is the reason why acquisitions are few when market valuations are high. *Target stock price history analysis* is, sometimes, used to determine the higher acquisition premium to be paid in such situations. Though this is not a method by itself, it provides a useful tool in determining the legitimacy of the price. Unless the deal has strong strategic off-shoots that are not factored into current valuations, such expensive deals are often destruction of shareholder value.

Regulatory pricing under the Takeover Code is determined as the *minimum price* arrived at by considering the highest of the following:

- Highest Negotiated Price by the acquirers and persons acting in concert for acquisitions made within the first 24.99%. This price shall factor in non-compete fee, if any paid by the acquirers to the target. Any consideration paid to the sellers in the form of non-compete or any other fee shall be treated as purchase consideration for the purpose of this clause.
- Preceding 52 weeks weighted average acquisition price.
- Preceding 26 weeks highest acquisition price.
- Weighted average market price of the company's scrip for the preceding 60 days before the open offer announcement.
- For infrequently traded shares, the price arrived at by the investment banker managing who shall arrive at the value on established parameters.

In determining the price to be offered, the implications of an open offer on the total cost of the transaction and the success of the acquisition need to be factored in. An *open offer price analysis* could be done on the basis of what the target company can deliver to shareholders as maximum value today. It takes into account the present market price and a portion of its future value that can be offered as premium to market price to the selling shareholders.

Examples of Acquisition Premium

Acquisition premium could be based on several factors such as the quality of manufacturing facility and manpower, distribution network, brands etc. For example,Nicholas Laboratories bought over Roche mainly because Roche had a well-trained sales force that could complement Nicholas's business. Hindustan Unilever Ltd. acquired Brooke Bond since it had 17 well-known brands in tea business. Other examples for strategic pricing are:

- Coca Cola offered a price to Parle Soft drinks equal to its current turnover, i.e. a multiple of one on sales.
- The Khaitans of the Williamson Magor paid a price of ₹290 crore to Union Carbide for Eveready Ltd. The ₹290 crore included ₹150 crore for future earnings, ₹100 crore for brand value and ₹40 crore as control premium.
- Whirlpool Corporation paid ₹300 crore for its 51 percent stake in Kelvinator India. The share price was fixed at ₹197.16 per share, which was the average price of the share over the previous six months.
- SRF paid a sum of ₹325 crore for acquiring the Ceat's Nylon tyre cord plant. A new plant of same capacity would have cost ₹450 crore and a gestation period of 18 months.

The general approach to arriving at acquisition valuation benchmarks, i.e. *stand-alone fair market value* for the seller and *investment value* for the buyer is provided in Annexure 2.

16.10.5 Financing the Transaction

Currency for Acquisitions

Acquisitions and takeovers are mostly cash based transactions. This is because they involve either purchase of secondary shares (also known as *vendor shares* in acquisition terminology) or subscription to fresh issue of shares by the acquired company. As per the Takeover Code, in an open offer, the consideration shall be payable as follows:

- In cash; or
- By issue, exchange and or transfer of shares (other than preference shares) of acquirer company, if the person seeking to acquire is a listed body corporate; or
- By issue, exchange and or transfer of secured instruments of the acquirer company with a minimum "A" grade rating from a registered credit rating agency.
- A combination of the above.
- The payment through debt securities as above is subject to two conditions: (i) the acquirer company being able to obtain approval of its shareholders, (ii) if any part of the shares forming part of the acquisition were acquired in cash prior to the open offer, the consideration payable in the open offer shall only be in cash.

From the above discussion, it is evident that acquisitions and takeovers are financed by a combination of the following sources:

- Cash or cash equivalents.
- If the acquirer is a corporate, primary equity shares of the acquirer company provided that if the target company is a listed company, the acquiring company's shares shall be listed.
- Debt securities of the acquiring company provided they have minimum stipulated credit rating.
- Assuming the liabilities of the target company.
- In the case of buy-out or acquisition of an unlisted company, issue of preference shares or debt convertibles of the acquiring company, subject to necessary approval.

Sources of Finance

From the above discussion, it is apparent that an acquisition basically a cash rich transaction since the consideration needs to be structured predominantly in cash or equivalent. Acquisitions under the Takeover Code are designed for acquirers rich in cash since there is not enough time available from the time the open offer is triggered off to the date of making the public announcement. In addition, there are requirements to open a cash escrow account that make it stringent upon the acquirer to have adequate resources at hand. In short, the sources of cash have to be tied up before execution of the transaction. Due to these stringent requirements, syndicating acquisition finance is also one of the most important functions of an investment bank and probably, the most challenging. Several structures may have to be worked out before arriving at the optimum structure that satisfies the requirements of the financiers, the acquirer and the regulatory framework.

The sources that are considered for acquisition financing in the Indian context are the following:

- Internal accruals of the acquiring company that constitute distributable surplus and are further available in the form of liquid cash or cash equivalents.
- Disposal of some surplus assets of the acquiring company to raise cash.
- If the acquirer is a company, it can raise cash from its promoters or promoting entities either by way of debt capital or as equity subject to satisfaction of regulatory requirements. If the company raises debt or equity capital on its balance sheet, this provides enough cash to finance the acquisition. In some cases, the acquiring company does not raise the capital on its balance sheet. Instead, it invites the promoters to jointly bid for the acquisitions as co-investors in the transaction. Such co-investors are called PAC under the Takeover Code.
- Inviting investment banks, private equity funds or specialist buy-out funds to join the acquirer as PAC. This is a well-developed structure that led to several big-ticket acquisitions in the US and European markets. This trend caught on in India as well with several large private equity and buy-out funds partnering M&A activity in recent times. Blackstone, Carlyle, KKR, TPG Capital, Newbridge, Temasek among others are examples.

- Raising of long-term debt from banks or from capital market by the acquiring company on its own balance sheet. This is subject to approval of the lenders, satisfaction of lending norms including acceptable credit rating and adequate asset coverage for such lending, While acquisition debt capital is quite prevalent in developed markets, the climate is not as favourable in the Indian banking system and capital market. Fund raising in the Indian system is predominantly for actual users and not acquirers.
- Raising of debt capital on a different balance sheet other than that of the acquiring company. This could be another existing company or a SPV. This type of structure is used most commonly in LBOs and cross border acquisitions that require tax optimisation. A structured LBO is not quite prevalent in India as yet but it has been used by Indian companies in overseas acquisitions. One of the first transactions similar to a LBO was the buy-out of Tetley by Tata Tea. Thereafter, the Tata group's acquisition of Corus and the AV Birla group's acquisition of Novelis are examples of highly leveraged buy-out structures though they fall short of a pure LBO.

16.10.6 Deal Structuring in Negotiated Acquisitions

Deal structuring in the context of an acquisition would imply the broad framework of execution encompassing various aspects relating to the transferors and the transferees after considering various aspects relating to the proposed transaction structure, regulation, purchase consideration, capital structure and body of sellers, valuation, payment terms and other compliance aspects. The deal structure is the culmination of the efforts of the investment bank in transaction advisory and negotiation. It is usually documented in the form of a Term Sheet or MOU between the parties which would be converted into a binding *share purchase agreement* going forward. The term sheet provides an exclusivity period to complete the due diligence and confirm the terms between the parties. The deal structure as presented in the MOU or term sheet is the basis for the transaction documentation that is drafted by legal advisers at a later stage.

General Features of a Deal Structure

The deal structure addresses the following aspects:

- The total deal size based on the enterprise value or price per share agreed to between both parties.
- The number of shares and the percentage of acquisition, the categories of sellers forming part of the transaction.
- Break-up of acquisition between primary shares and vendor shares as applicable.
- Total Purchase consideration for shares and any other component such as royalty or technical know how fee, management fee, non-compete fee etc. The Takeover Code prescribes non-compete fee paid to the sellers to be treated as purchase consideration for the shares.
- Time frame for the acquisition, staggered acquisition if any, settlement of purchase consideration, milestone payments if any, payment mechanisms etc.
- Mode of settlement of purchase consideration—cash component, stock component and debt component and liabilities proposed to be taken over.
- Type of instrument and its features in case of a debt instrument.
- Details of liabilities of the target to be assumed either at book value or negotiated value by the acquirers.
- Identification of acquirers and extent of acquisition by each in case of a consortium.
- Earn out contingent payment model if any, which is structured so that a part of the purchase price is contingent upon the target company's achievement of business volumes, gross revenues or EBITDA milestones post-acquisition.
- Broad management structure and incentive plan or stock options for the key managers as applicable.
- Main conditions precedent to acquisition or buy-out, apart from statutory approvals.

- *Break-fee* to be paid by the acquirer in case it decides to disengage from the transaction after the term sheet is signed.
- *Exclusivity period* available to both parties to conclude the deal after the signing of term sheet. At the conclusion of the exclusivity period, either the transaction should have been consummated or one of the parties should have broken it off. In neither case, the term sheet can be extended by mutual consent, in the absence of which it lapses automatically without further liability on either party.
- Escrow amount to be deposited by the acquirer at the time of signing of term sheet to demonstrate commitment to the deal. The escrow agreement usually stipulates stringent conditions and the break fee, if payable by the acquirer is set off from it.
- *Non-compete agreement* between both parties in the aftermath of the transaction and terms thereof including payment of non-compete fee, if any by the acquirer to the seller.

16.11 Transaction Process in a Substantial Acquisition/Takeover

The transaction process for a substantial acquisition or a negotiated takeover of an unlisted company through transfer of shares or a preferential allotment of primary shares follows similar deal process as a private equity transaction.Readers may refer to the process flow exhibit in Chapter 12. In a listed company acquisition, if the Takeover Code is not triggered, it is akin to an off-market secondary market transaction. If the deal involves primary shares, it becomes a PIPE transaction.

In acquisitions through the open offer route under the Takeover Code, regulations prescribe a detailed process of compliance with various requirements concerning the public announcement, preparation and circulation of the letter of offer, advertisements, conducting the offer, arriving at the shares to be acquired, opening and maintaining of escrow account until completion of offer formalities, revisions if any, closure of the offer and remittances to eligible sellers and necessary filings with SEBI at every stage of the offer process. The steps required for compliance with the offer requirements are very stringent and time bound and the investment banker plays a very important role in ensuring that the offer meets all process requirements and compliances.

In acquisitions and hostile bids involving non-resident acquirers and their PACs, the process requirements under FEMA and the FDI Policy should also be factored into the overall offer process and compliance requirements.

16.12 Outbound Cross Border M&A from India

Outbound cross border M&A from India essentially means the acquisition of foreign companies by Indian companies. Section 234 of the Companies Act permits the amalgamation of an Indian company with a foreign company through a depository receipt swap ratio instead of a share swap ratio. However, the trend of outbound M&A from India is itself of recent origin arguably beginning with the well known case of Tata Tea (now known as Tata Global Beverages) acquiring UK based Tetley Tea in 2000, the second largest tea company in the world at the time. Later on, another publicised acquisition was that of Essel Packaging which took over Propack of Switzerland to form Essel Propack. The merger created the biggest producer of laminated tubes in the world. The trend accelerated since then and by 2003, it became a steady flow. More than 40 foreign companies were taken over by Indian companies in 2003. Many middle-sized companies also joined the fray such as Sundaram Fasteners that acquired Dana Spicer Europe, Amtek Auto that acquired the GWK group in the UKand Subex Systems which completed the largest software industry acquisition in UK head-quartered Azure Solutions. In 2006, Allcargo Movers India, a Chennai based logistics company acquired Belgium-based ECU Line Group a leading global player in air, sea and road transportation. Suzlon, a leading company in the wind power business won a takeover battle in 2007 with the mighty French state-owned nuclear company Areva and acquired a controlling 87% stake in Repower, a German wind power company albeit at a very high cost financed through debt. The biggest of the outbound acquisitions was the $12.1 billion Tata-Corus deal, though the Bharti-MTN deal would have been the biggest had it gone through. In subsequent years, ONGC Videsh's oil acquisitions, Mahindra & Mahindra's acquisition of Ssangyong, Indian Hotels buying Orient Express, Bharti's acquisition of Zain Telecom and Adani group's buy of Abbot Point Coal Terminal are some more landmark overseas transactions.

Indian companies wanting to acquire companies abroad have to comply with various aspects of The Companies Act, FEMA, SEBI Act and the various requirements imposed by the RBI under its Overseas Direct Investment (ODI) regulations. Also, takeover and anti-trust regulations, if any, applicable in the overseas jurisdiction of the target company needs to be adhered to. Furthermore, complex international tax law needs to be examined to arrive at an optimal structure for the acquisition. Last but not least, the pattern of financing also determines the complexity of the transaction structure.

Presently, FEMA allows Indian companies to acquire or set up their wholly owned subsidiaries or to enter into joint ventures abroad to the extent of 400% of their net worth as per the last audited balance sheet through the automatic route. Investments above that level need the prior permission of the RBI. Also no prior approval of RBI is required for opening offices abroad. Similar provisions exist for automatic remittance of funds from India by the parent for initial expenses, recurring expenses and acquisition of immovable property outside India for its business and for residential purpose of its staff.

Overseas acquisitions can be funded through a variety of sources such as drawal foreign exchange in India, capitalisation of exports, balances held in Exchange Earner's Foreign Currency accounts (EEFC), share swaps through ADR/GDR, External Commercial Borrowings/Foreign Currency Convertible Bonds, ADRs/GDRs, etc.

A substantial portion of investments takes place through Special Purpose Vehicles (SPVs) set up for the purpose abroad. Existing Wholly Owned Subsidiaries (WOS)/Joint Venture (JV) or the SPVs are being used to fund acquisitions through LBOroute.

Unlike most large international M&A transactions that typically feature stock swaps, Indian acquisitions have predominantly been cash deals financed by a combination of internal resources and borrowings due to FDI and FEMA restrictions in India. Share swaps have not yet emerged as a favoured payment option in India, except in a couple of large transactions in the software industry in which 100% FDI is permitted. As far as leveraging is concerned, most of the leveraging came from banks and investors outside India. Indian banks are also permitted to finance overseas subsidiaries and joint ventures of Indian companies either through the debt or equity route, including working capital requirements.

16.13 Regulatory Overview on Overseas Acquisitions and Stock Swaps

All companies that have made an ADR/GDR issue earlier and are listed on an overseas stock exchange would be entitled to the facility of overseas business acquisitions using the ADR/GDR stock swap route. The issue of fresh ADRs/GDRs consequent to such acquisition is covered under the automatic route. The overseas companies that are acquired under this route shall be in the same core activity as the Indian company as stipulated by the RBI in the relevant FEMA Regulations that prescribe the ODI regulations. Companies that have not made an ADR/GDR issue earlier need to approach the special committee of the RBI for approval under this acquisition route.Similarly, transactions beyond the prescribed ceiling would require the prior approval of the RBI. The ADRs/GDRs issued under this route have to be new securities and not re-issued securities. The automatic route is subject to the overall FDI limits applicable to a particular sector.

The acquisition has to conform to valuation norms as per the recommendations of the investment banker, which in the case of a listed company shall be based on its market capitalisation. The market capitalisation shall be computed on the basis of the monthly average trading on the overseas exchange, for three months preceding the month in which the acquisition is committed to. The premium would be based on the recommendation of the investment banker taking into account the due diligence report. In the case of an unlisted company, such valuation has to be on the recommendations of the investment banker. For this purpose, an investment banker managing such issue shall be registered with the SEC, USA, or under the Financial Services Act in UK or with the appropriate regulatory authority in Europe, Singapore or Japan. The complete details of the transaction have to be reported to the RBI and the Ministry of Finance within a period of 30 days of the completion of such transaction.

16.14 Leveraged Buy-Out

These are specialised deal structures that have been developed by investment banks over the years through increased innovation and sophistication in deal structuring for M&A. The essential characteristic of a LBO is to enable a takeover through massive debt capital financing. Bloomberg defines a LBO as *'a transaction used to take a public corporation private that is financed through debt such as bank loans and bonds. Because of the large amount of debt relative to equity in the new corporation, the bonds are typically rated below investment grade, properly referred to as high-yield or junk bonds. Investors can participate in an LBO through either the purchase of the debt (i.e., purchase of the bonds or participation in the bank loan) or the purchase of equity through a LBO fund that specialises in such investments'.* LBOs can be initiated or led by the company's incumbent management as well with the support of outside buy-out investors. Such LBOs are called Management Buy-Outs or MBOs.

LBO activity initiated in the US and peaked during 1986-89. KKR is one of the most well-known investment banks credited with leading some of the largest LBOs of those times. The largest at that time was the LBO of RJR Nabisco in 1988 by KKR with a purchase price of US$ 24.6B. The other large LBOs were Beatrice Corporation in 1985 at US$ 6.2B, the Safeway Stores at US$ 4.2 billion, and the Borg Warner Corporation at US$ 3.8 billion. The total purchase price of 20 largest LBOs formed between 1983 and 1995 was US$ 76.5 billion *(Mergerstat Review, 1996)*. The LBO market saw a downturn in 1989 when US$ 4 billion worth of defaults on junk bond servicing was seen in the first eight months. Most of the large deals done between 1985and 1989 defaulted on junk bond payments and 18 went into bankruptcy by 1991. The reasons attributed for the failure of these LBOs are faulty buy-out pricing, excessive leveraging, riskier investments, lesser debt service coverage and regulatory changes. The 1990s were much more subdued for LBOs with transactions worth about US$ 24 billion reported in 1996. This was also partly due to the fact that there were less potential LBO targets available in the 1990s as compared to the 1980s.

It can be said that while the first phase of LBOs represented an era of debt driven acquisitions, the new millennium represents an era of equity driven acquisitions led by large private equity and buy-out firms. RJR Nabisco remained the largest LBO until 2006 when KKR led buy-out group took over hospital chain HCA. This was succeeded in 2007 by private equity group, Blackstone's takeover of Equity Office Properties Trust, the biggest owner of US office buildings for US$ 39 billion. This was immediately followed by KKR and Texas Pacific group led buy-out of TXU, the largest power producing company in Texas for US$ 45B. This consisted of a debt component of US$ 31.8B. Goldman Sachs, Lehmann Brothers Holdings, Citigroup and Morgan Stanley were co-investors in the equity portion of the transaction.

16.14.1 Stages in a Leveraged Buy Out

Typically, a LBO has four facets to it: (i) Arrangement of finance, (ii) Taking Private, (iii) Restructuring and (iv) Secondary IPO (SIPO). These are explained below:

Arrangement of Finance

- The primary modes of financing LBOs are sponsor equity, sub-ordinated debt and senior bank loans. Typically, about 10% of the cash is contributed by the investor group headed by buy-out specialists (such as KKR, Blackstone, TPG Capital, Thomas H.Lee etc.) and / or by the target company's management group (in a MBO). This becomes the equity capital of the new company that is incorporated for the LBO (the SPV). Investment banks and private equity investors and Family Offices are brought in to fund an additional 15–20% of the equity of the SPV. The existing management of the target company are provided a performance incentive package including handsome stock options.
- About 40–50% of the cash requirement is raised through senior bank takeover financing loan that would be secured with the assets of the target company. The bank loan is usually syndicated with several commercial banks. Usually, the bank loans have a ten year tenor with bullet repayments or structured obligations and the loan life generally extends beyond the LBP life, i.e. the loans may be carried in the books of the target even after the LBO investors have exited.
- The balance of the debt component is raised through subordinated debt which consists of loans and/ or high-yield junk bonds and mezzanine debt or quasi-equity. In case of bankruptcy of the company, these are next in line for repayment to senior bank loans. LBO market got triggered due to the junk bond explosion in the late 1980s. According to Morgan Stanley, the junk bond market grew from an average of US$ 7 billion in 1970 to an average of US$ 146 billion in 1988. Data developed at Drexel Burnham Lambert (another buy-out investment bank) showed that in 1982, only 3% of junk bond issues were issued for LBOs while by 1985, it grew to 50%. Although traditional LBOs relied primarily on senior bank loans, the role of investment bankers greatly facilitated the growth of LBO junk bonds in the capital market. These investment banks provided multiple services such as transaction advisory, comfort letters and bridge financing.
- Junk bonds were issued as sub-ordinate debt since they carried payment-in-kind (PIK) provisions and were also known as PIK notes. The junk bonds were privately placed with pension funds, insurance companies, venture capital investors, HNIs and family office funds.

The debt is raised in an investor backed existing company or a SPV, floated either as a private company or in any other constitution. Alternatively, the lead buy-out firm assumes the debt.

Taking Private

- At this stage, the investor group buys out all the shares from the existing shareholders and takes the company private. This is accomplished through a tender offer route by the SPV. Alternatively, it goes for an asset purchase and buys out all the assets of the target company through the SPV. Some redundant assets may be sold off at this stage to reduce the debt burden on the SPV.

Restructuring

- At this stage, the management strives to cut costs, increase operational cash flow and change marketing strategies to boost the top line. The internal restructuring process could be all encompassing including rationalisation of work force and shutting down uneconomical operations.

Taking Public through SIPO (Reverse LBO)

- Once the restructuring goals are achieved, the target company is taken public again, basically to unwind the leverage and provide exit for investors in the LBO. Therefore, the *reverse LBO* is achieved through an offer for sale of secondary shares *(Secondary IPO or SIPO*) by the LBO investors and the company gets relisted. With the proceeds of the offer for sale, the debts of the firm / SPV are redeemed and the balance of the profit accrues to the LBO investors. Usually, the whole transaction is aimed at in a cycle time of five years. According to a study done on reverse LBOs between 1976 and 1987, the LBO investors made an average annualised return of 268% on their investments.

16.14.2 LBO Structure

From the above process description of a LBO, it is evident that the whole process involves a concerted scheme among lead buy-out specialists, investors and bankers. LBO climate has not yet developed in India due to regulatory constraints for banks, aversion of bankers in participation in direct acquisition financing,lack of depth in the capital market for high risk corporate debt securities and the inability for Special Purpose Acquisition Companies (SPACs) to list in India. It would be some more years before the climate for such transactions becomes more conducive in India.

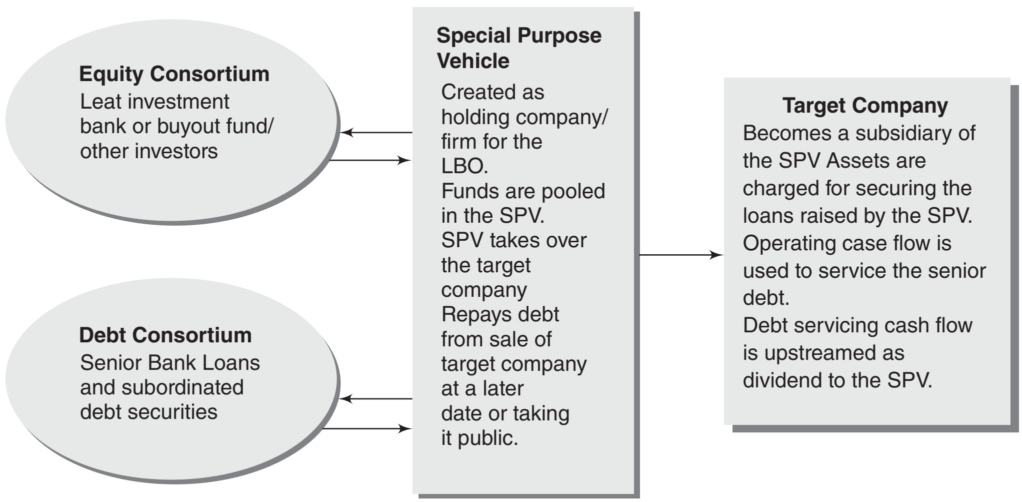

Exhibit 16.2 LBO with SPV Structure

16.14.3 General Framework of Structured Acquisitions

Structured acquisition refers to a customised transactions wherein special purpose acquisition vehicles or *Acquisition SPVs* are created for an intended transaction along with other SPVs to raise the required financing (*Financing SPVs*). These structures are typically used in LBOs since a huge amount of external debt finance is raised which will be non-recourse to the sponsors and co-investors in the LBO. In order to keep the debt off-balance sheet, Financing SPVs are used to park the funds and service the debt obligations. Acquisition SPVs are used to converge the equity and debt financing, to optimised for cross border taxation and hold the shares of the target company. The number of SPVs to be used depends upon the complexity of the holding, financing and tax structure. Generally speaking, cross border acquisition structures are more complex than pure domestic LBO structures since they need to incorporate the additional feature of tax optimisation based on international tax treaty framework of the acquirer and the target jurisdictions, zero tax intermediary jurisdictions (known as *tax havens*) and avoidance of double taxation.

General Steps in Formulating a Structured Acquisition

- Generally, the domestic acquirer forms a holding company in an international financial destination having favourable tax treaty with the acquirer country so as to serve as the promoter holding company. Specific to Indian companies, a two-tier structure may be used by listed companies to overcome the application of Section 186 of the Companies Act.
- Downstream Financing SPVs are formed for raising debt finance and Acquisition SPVs for the actual acquisition of the target in its own jurisdiction. As mentioned above, the number of SPVs and their jurisdictions are determined on a case-to-case basis.
- Usually in large cash based acquisition deals, significant amount of non-recourse leveraging is used. In the Tata-Corus transaction, equity was used for 53% and debt for 47% of funded acquisition value.
- International banks provide bridge finance as well as underwrite long-term senior debt to be raised for acquisition. Senior debt generally constitutes about 50% of the total LBO capital structure and represents the cheapest source of financing.
- Senior debt is generally secured against assets of the target company and comes with a very stiff term sheet. There would be several strict covenants by lenders such as ring fencing their debt, escrow accounts, debt service reserves and cash sweeps especially for highly leveraged acquisitions.
- Debt is structured non-recourse to the parent. Debt is raised in a jurisdiction that is comfortable to banks and *pushed down* to the target destination as equity.
- Bridge loans are usually provided by the financing consortium of banks against long-term debt commitment as it would take time to tie up such credit facilities. Debt can be bridged to long term bank financing, mezzanine loans arranged through investment banks and high yield bonds floated in the international institutional capital market.
- Sub-ordinate or mezzanine debt usually constitutes between 20–30% of the total LBO capital structure. This high-yield debt has higher financial costs than senior debt but the term sheet is less onerous with facilities such as bullet repayments, interest-only payments etc. Junk bonds and sub-ordinate debt have little security for the investors aside from the cash flow generated by the company. In many situations, high-yield debt is callable by the company after a few years, at a premium, which gives the company the option to retire or refinance the high-cost debt on better terms in the event that the company does well during and after the LBO life.

Case Study

Beatrice LBO

KKR acquired Beatrice at a price of US$ 6.2 billion by paying $40 in cash and $10 in stock for every share in Beatrice. KKR also assumed $2 billion in debt of Beatrice. The transaction was financed as follows:

- US$ 400 million in equity from fund investors of KKR and US$ 7.1M from Kelly (ex-senior manager at Beatrice) and other top management executives.
- US$ 800 million in preferred shares.
- US 3.3 billion in senior bank loans.
- US$ 2.5 billion in junk bonds.
- US$ 1 billion of non-refinancing debt (would be paid by the target company in due course).

At the second stage, KKR formed a new company to which the entire undertaking of Beatrice was demerged as 15 different divisions. KKR acquired all the shares of the SPV. The banks had required that Beatrice should operate only with 5% cash equity and sell US$ 1.5 billion of assets in the first 18 months. Accordingly, KKR got into the act and this started a string of asset sales that lasted for four years until Beatrice was completely liquidated in 1990. Beatrice divisions were sold off as 11 mid-sized companies, 5 of which were structured as MBOs. By the end of 1986 itself, KKR managed to sell assets of value totalling US$ 5.75 billion which allowed KKR to repay almost the whole of the bank loans. Most of the divisions were sold at higher than expected profits.

Case Study

Tata Tea—Tetley LBO

The Tata Tea buy-out of Tetley UK, had many firsts to its credit. It was a structured acquisition through the creation of an off-shore Special Purpose Vehicle (SPV) by Tata Tea to provide bankruptcy remoteness and not leverage its own balance sheet. It was also India's first leveraged buy-out transaction. It was also India's largest overseas corporate acquisition until then. The deal size of GBP 305 million was structured by Rabo Bank. The deal positioned Tata Tea among the global leaders in second position.

The SPV created for this purpose called Tata Tea Great Britain, was capitalised with an initial sum of GBP 70 million out of which Tata Tea contributed 60 million. Tata Tea's US subsidiary, Tata Tea Inc., contributed the balance of 10 million. The SPV then leveraged its capital at a debt-equity ratio of 3.36 to raise a debt of GBP 235 million to complete the total financing for the deal. The entire debt amount of 235 million was broken up into four tranches with varying tenors from 7 to 9.5 years, with a floating coupon rate of around LIBOR + 400 basis points. Rabobank was the lead financing agency with an exposure of 215 million while venture capital funds contributed the balance of 20 million. The entire debt was structured as non-recourse to Tata Tea by securing it against Tetley's brands and physical assets.

The entire deal size of GBP 305 million consisted of the purchase consideration of 271 million, legal, banking and advisory costs and future financing requirements. The SPV acquired all the assets of Tetley in an all-cash buy-out.

Case Study

Tata Steel—Corus LBO

Tata Steel made a bid to acquire the Anglo-Dutch steel maker Corus in late 2006 for US$ 8B which was contested by Companhia Siderurgica Nacional(CSN) of Brazil. Finally, Tata Steel won an eight round bidding to acquire Corus for US$ 12.1 billion. Investors representing 97% of Corus approved the offer. While Tata Steel's final bid was at 608 pence per share of Corus, CSN's competitive bid ended at 603 pence per share. The acquisition was the second biggest in the steel industry after the Arcelor acquisition by Mittal Steel at US$ 38.3 billion. Corus was to be taken private as a result of the acquisition in March 2007.

Tata Steel adopted a LBO route to finance the acquisition and planned to raise over US$ 10 billion for the financing of the deal. The entire financing structure was broken up into two parts: a US$ 3.5 billion fund infusion from Tata Steel and the balance of about US$ 8 billion coming from a LBO structure. For this purpose, Tata Steel proposed to infuse US$ 2 billion as equity into a Singapore based SPV, Tata Steel Asia Holdings and the balance contribution was proposed as a bridge loan to the SPV. The bridge loan of US$ 1.5 billion was refinanced by Tata Steel from a syndicate of banks led by ABN Amro Bank and Standard Chartered Bank. The refinancing consisted of subordinated debt and a short-term loan for one year. The equity contribution by Tata Steel was financed by own cash and liquid investments, about US$ 700 million of equity pumped in by its promoter holding company, Tata Sons through a preferential issue of shares and exercise of conversion of warrants and the balance through syndicated loans on its own balance sheet.

The debt consortium was led by ABN Amro Bank, Deutsche Bank and Credit Suisse. The loans structured as non-recourse loans to Tata Steel were to be serviced out of cash accruals of Corus. Tata Steel did not propose any guarantees or credit enhancements to the lenders to the SPV. The entire debt facility was broken up almost 50-50 into senior bank loans and subordinated mezzanine loans to the SPV with a tenor of 7–10 years. The senior loans were raised at around 200–225 basis points over LIBOR (which was 5.41% at that time) and the mezzanine finance was raised at around 400–450 basis points over LIBOR. The debt package also consisted of providing working capital financing to the tune of around US$ 670 million to Corus after the acquisition and refinancing of its existing term loans of US$ 2.7 billion.

The entire financing for the transaction would be pooled into the SPV and then loaned to Tata Steel's UK SPV, Tata Steel UK. As per the transactions alternatives under UK law, it could either be an acquisition or a merger with the agreement of the shareholders of Corus. Under the scheme of arrangement, Tata Steel UK would pay off the shareholders of Corus and then file for a scheme of merger of Corus with itself. In the scenario of an acquisition, Corus would be delisted and it would continue to exist as a subsidiary. The Tata group was contemplating the merger route in preference to the acquisition route in order to get 100% control without any outside shareholding.

Case Study

Hindalco—Novelis LBO

Hindalco, an Aditya Birla Group (AVB Group) company, announced its plans to buy out Novelis Inc., an Atlanta-based aluminium downstream major for an enterprise value of nearly US$ 6 billion. The transaction was structured as a LBO and for this purpose, the AVB Group floated a SPV called AV Metals in Canada. The terms of agreement signed between Novelis and Hindalco envisaged that the latter would pay $44.93 a share to Novelis's shareholders, amounting to a cash consideration of US$ 3.5 billion. Hindalco aimed to acquire 100 percent of Novelis. As per Canadian law, if it acquired 66.6 percent of the equity capital of Novelis, it could automatically buy the remaining shares at the same price. Novelis also agreed to pay a break-up fee of US$ 100 million in case Novelis backed out of the acquisition.

In order to finance the acquisition, a LBO structure was proposed. As per the financing structure, AV Metals would take loans worth US$ 2.8 billion from three financial institutions, namely UBS, ABN Amro and Bank of America. This included a bridge loan of $1.4 billion at a coupon rate of 7.2 percent. Essel Mining & Industries, a closely held company of the AVB group, would bring in US$ 300M while Hindalco would mobilise US$ 450 million (₹2,025 crore) from its treasury operations. In all, the SPV would pool in US$ 3.5 billion to finance the LBO.

In addition to the debt raised for the LBO, the existing debt in the balance sheet of Novelis amounting to US$ 2.4 billion was being assumed by AV Metals. Therefore, the aggregate purchase consideration amounted to almost US$ 6 billion. UBS, ABN Amro and Bank of America underwrote the total debt amount with UBS taking care of the major portion. UBS was also the financial advisor to Hindalco.

At the time of this transaction, Novelis, which was spin-off from the Swedish aluminium major Alcan two years prior to this deal, was the global leader in aluminium rolled products and aluminium can recycling. The company operated in 11 countries and made US$ 10 billion of revenues. It had 12,500 employees in 11 countries. Novelis produced 19 percent of the world's flat rolled aluminium products.

Case Study

Energy Future Holdings Corp LBO

In October 2007, KKR, Goldman Sachs Private Equity and TPG Capital completed the $47 billion LBO of Energy Future Holdings Corp (earlier known as TXU) at a price per share of $69.25 valuing the company at 4.7x of its revenues and 184x of its PAT. The equity component of the offer was $8.3 billion and the debt component of the LBO was almost $40 billion including the debt of $13 billion already on the books of the company making it the largest ever LBO in history at the time. The debt financiers included Warren Buffet who participated in $2 billion financing. The target was the largest coal power plant operator in Texas and served 3 million retail utility customers in a stable business. The underlying bet during the LBO was that plunging natural gas prices that had hurt wholesale electricity profits would reverse course and that profits would increase at coal power plants owned by TXU.

In the aftermath of the LBO, oil prices actually rose over the ensuing seven years except for a short decline during the 2008 recession and natural gas prices fell even further. The result was that electricity from natural gas power plants became even cheaper, making it difficult for Energy Future Holdings' coal plants to compete. TXU's coal plants began to lose money and the $40 billion LBO debt used to take the company private became a weight dragging the business down. By 2014, the company couldn't make its scheduled debt payments and was forced into bankruptcy. The buy-out funds had charged $560 million in advisory and monitoring fees out of the company during the LBO life and created an operating structure that was meant to squeeze the company of its cash left after debt servicing. This left very little cushion for the company to stand on when business cash flows began to decline. The biggest LBO, thus, became the biggest non-financial bankruptcy in US history. At the time of bankruptcy filing, the company's debt on books had swelled and itlisted assets of $36.4 billion and debt of $49.7 billion. The lenders lost heavily in the bankruptcy and so did the limited partners. Warren Buffet recorded a loss of 900 million.

For KKR, this was the second instance of an LBO backfiring on it after the bankruptcy of RJR Nabisco, the $30 billion LBO led by the firm in the 1980s which was the biggest at the time. The fiasco of Energy Future Holdings was quite in contrast to the result of another LBO made around the same time. In 2006, Bain Capital, KKR & Merrill Lynch completed the $32.7 billion LBO of hospital chain HCA (Hospital Corporation of America. It was one of the most successful LBOs of all time and when the company was relisted on NYSE five years later by the LBO investors, it returned them handsome profits.

16.14.4 LBO Financial Analysis

LBO analysis is done on very similar lines to any DCF financial model but it incorporates leveraging and an estimate of the future value of the company at the time of exit of the LBO investors. This is because leverage is the most significant cost in the transaction and also, the LBO investors require working out an IRR model for their investment risk. Therefore, unlike a conventional DCF model which measures the value of an unleveraged firm, LBO analysis considers the availability of debt, cost of debt, draw down of loans, estimated financial costs, LBO transaction costs, available tax shields,operating cash flows during the loan life period, debt servicing cash flow, free cash flow to equity and the probable exit value for investors at the end of the expected LBO life.

The key inputs and estimations in LBO modelling would be the following:

- The estimated Purchase Consideration or Offer Price per share for the target. This depends on the stand-alone value and the estimates acquisition premium.

  In the LBO of Tetley by Tata Tea, Tetley's valuation for the purpose of arriving at the purchase consideration was done on the basis of discounted future cash flow method taking into account Tetley's own cash accruals and Tata Tea's own strengths incorporating therein the effect of leverage.

- Financial forecast during the LBO life – detailed cost and revenue estimates with assumptions thereof.
- Proposed debt-equity financing structure for the LBO. The WACC is determined based on the DER.
- The hurdle rate for the equity investors. Since the company is so heavily leveraged at acquisition, equity holders require a large projected IRR, typically in the range of 30% to 40% annualised.

The key computations in the LBO model are the following:

STEP 1

- Operational forecast or projected P&L statement of the target with forecasted EBIT.
- The revised capital structure based on the LBO debt financing.
- The periodic financial costs to be serviced through the P&L.
- Debt servicing and reserve requirements as per senior / sub debt lenders' term sheet.
- Incremental normal capital expenditure and working capital reinvestments.
- Post debt servicing free cash flow discounted at the WACC to arrive at the DCF valuation of the company at the time of proposed exit at the end of the LBO life.
- The above computations will provide an idea of the exit price for the LBO sponsors and investors.

STEP 2

- The investor return model based on (i) the equity invested at zero date, (ii) estimated consideration to be realised on exit, (iii) amount of outstanding debt at the exit date to be repaid out of sale proceeds of the equity and (iv) the post-sale net consideration available to investors discounted at their hurdle rate. If the NPV of this model is positive, it meets their return expectations. Alternatively, the FIRR of this model may be calculated and if it meets the hurdle rate of the investors, the transaction is doable.

  The investor return model is an additional feature in LBO modelling as compared to a normal acquisition model. In a normal acquisition, the acquirer estimates the net appreciation in the value of the target company (*investment value*) and accordingly decides the acquisition price which will return a positive NPV. This analysis is provided in Annexure 2. In a LBO, Step 2 as stated above is required since the acquisition is financed with debt and what accrues to the LBO sponsors and investors is only the residual cash flow.

Simple LBO illustration

Purchase Price (EV) of Target				
5x of Current EBITDA of ₹500 crore				2500
Transaction Costs of LBO (1.5%)				37.5
Expected Exit Value based on EBITDA at the end of Year 5				
7x of Year 5 EBITDA of ₹750 crore				5250
LBO financed by 80% debt and 20% equity				
Debt	2030	Interest rate 10%		
Equity	507.5			
Assuming bullet payment of Debt with interest at the end of LBO life				
Total Debt outstanding			3045	
Net Cash flow to equity			2205	
Equity IRR on a 5 year LBO			34%	

IMPORTANT TERMINOLOGY

Acquisition
Acquisition Premium
Buy-out
City Code on Takeovers & Mergers
Creeping Acquisition
Hostile Takeover
Inbound
Joint Venture
LBO
Management Buy-in
MBO
Negotiated Acquisition
Open Market Purchase
Open Offer
Outbound
Persons acting in Concert
Reverse LBO
Secondary Purchase
SIPO
SPV
Squeeze Out
Strategic Acquisition
Structured Acquisition
Takeover
Takeover Defences
Techno-financial Collaboration
Tender Offer

TEST YOUR UNDERSTANDING

PART – A

I. Pick the right answer(s) or the alternative that best fits the description from the alternatives provided under each question.

1. A PE fund takes a 26% stake in a company through a PIPE transaction and argues with the investment banker that they are not in a controlling position because they are an institutional fund. Therefore, they do not require to make an open offer under the Takeover Code. The i-banker disagrees. Who is right?
   (a) PE fund (b) Investment banker
2. The promoter group of a company decides to take the assistance of a large private equity fund in making a counter-offer in response to an open offer made by an acquirer. The private equity fund is then called:
   (a) Black Dog (b) Blue Label (c) Hungarian Opening (d) White Knight
   (e) Red Herring (f) Dark Horse (g) Poisson Curve (h) Check and Mate
   (i) Windsor Castle (j) White Stallion (k) Her Royal Highness

3. A hostile bidder offers to buy 100% of a company with a simultaneous FPO through an OFS for 25% so as to retain the minimum public shareholding. This is valid since the company will continue to be listed and the acquirer's stake is capped at 75%.
   (a) Yes (b) No
4. Robert DeCosta Ltd. (RDL) announces a hostile bid for 53% of Michael Gonsalves Ltd. (MGL). RDL does not own any shares in MGL but RDL's subsidiary holds 26% in MGL from a previous amalgamation scheme. This is therefore not a voluntary offer but a mandatory offer.
   (a) Yes (b) No
5. A squeeze out is a mechanism by which the controlling shareholders of a company vote to transfer the shares of the minority to themselves at a price that is agreed to by the majority through a special resolution of 75% favourable votes.
   (a) Yes (b) No
6. If promoters increase their stake in a listed company through rights renunciation beyond 5% of the total issued capital, it amount to:
   (a) Good strategic planning
   (b) Substantial acquisition under the takeover code
   (c) Substantial acquisition that will not trigger off takeover code
   (d) Invalid acquisition
   (e) Hostile takeover
   (f) Shall be valid only if pricing guideline is followed.
7. In a Bought-out Deal (also known as a Bought Deal), the investment bank that makes the BOD:
   (a) Takes the company public through a public offer
   (b) De-lists the company
   (c) Holds its stake till maturity
   (d) Buys off the promoters through an open offer
   (e) Makes an Open Offer to the public
   (f) Exits through an Offer for Sale of secondary shares
   (g) Makes a preferential allotment
   (h) Makes the company buyback the equity.
8. The promoters of a company provide for affirmative rights and shares with differential voting rights to themselves to ward off potential takeover attempts. These arrangements are called:
   (a) Beegees (b) Scorpions
   (c) Hungarian Openings (d) Red Herrings
   (e) Dark Horses (f) Poisson Curves
   (g) Check and Mate (h) Poison Pills
   (i) Windsor Castles (j) White Stallions
   (k) His Royal Highnesses
9. A PE fund wishes to buy a significant stake of 24% in a listed company and has been discussing with the company about the transaction as a combination of funding the company and acquiring secondary shares from a big institutional investor. In the meantime, a buy-out fund makes a hostile bid by announcing an open offer to acquire 51% of the company. In a bid to save the company, the promoter group with a shareholding of 32% requests the assistance of the PE fund as a white knight to make a counter offer. The financial advisor of the PE fund advises the fund that such a step would amount to acting in concert with the promoters, and its own position will become that of an acquirer leading to

an obligatory open offer. The i-banker advising the company states that the advisor is clearly wrong and the PE fund's support to the promoters will form part of the same on-going PE transaction. Who is right?

(a) The financial advisor (b) The investment banker

10. In a LBO, the acquirers aim at the following:
    (a) Acquire the target company's assets so as to make asset sale
    (b) Acquire the target company's shares so as to do a share buyback and get 100% control
    (c) Acquire the target company's brands and intellectual property so as to make a brand sale
    (d) Acquire the rights to manage the company by a contract with the existing shareholders
    (e) Replace existing management with shareholders
    (f) Take the company private so as to make a SIPO through a preferential allotment
    (g) Take the company private so as to make a SIPO at a later date.
11. In a LBO, the acquirer has created a SPV to finance the transaction. The SPV is capitalised with assets transferred by the acquirer company through a hive-off against which the SPV has allotted shares to the acquirer. The debt has been raised through bank loans which are secured against those assets. The SPV now proposes to sell the assets to pay the shareholders of the target company to which the lenders object. This has the following consequence:
    (a) The lenders have a right to object since the assets are a security given to them.
    (b) The lenders have a right to enforce the security against the SPV.
    (c) The lenders may agree to the sale provided the assets of the target are substituted as security.
    (d) The lenders may foreclose the debt and demand repayment prior to the sale of assets.
    (e) The lenders can bring an attachment order on the assets to prevent their sale by the SPV.
    (f) The lenders can insist that the SPV pay the proceeds of the assets to them to set off their debt.
12. In a LBO structure, the acquirer has created a 100% subsidiary SPV to finance the transaction. The SPV issues bonds to the shareholders of the target company to acquire 100% stake of the target. The bonds are secured against the assets of the target company. The bonds are proposed to be listed so that they provide liquidity to the bondholders. If at a later date, the SPV is merged with the target company:
    (a) The bondholders become shareholders in the merged entity
    (b) The bonds will rank as sub-ordinate debt in the merged entity
    (c) The bondholders will receive shares from the acquirer in lieu of the bonds.
    (d) The acquirer can redeem the bonds by issue of its own shares
    (e) The merged entity will become the subsidiary of the acquirer.
    (f) The bonds will be delisted from the market
    (g) The merged entity will cancel the bonds against shares held by the acquirer
13. In an open offer following a hostile bid, the acquirer increases the offer price suo moto before there is a counter-offer by the existing promoters. Such an increase is invalid under the Code.
    (a) True (b) False
14. In an open offer, if the acquirer makes a conditional voluntary offer to acquire a 30%. If the response to the offer is to the extent of 14%, the offer is deemed to have failed and all the money collected is to be refunded.
    (a) Yes (b) No
15. A management buy-out is proposed in a company in which the management already has ESOPs amounting to 12%. They now propose to acquire the promoters' stake of 24%. The investment banker states that this would trigger the Takeover Code. The management maintains that the buy-out is only for 24% and the rest are ESOPs. Who is right?
    (a) The management (b) The investment banker

16. In a negotiated acquisition, the Takeover Code of SEBI does not apply as it is applicable only to hostile takeovers.
    (a) Yes (b) No
17. A listed company decides to spin-off its wholly owned subsidiary and thereby get it listed. Immediately thereafter, the subsidiary proposes to go in for a substantial acquisition by a strategic investor. The investor proposes to make an open offer and retain the maximum permissible under law. The shareholders object to this scheme stating that the strategic investor could have acquired a stake in the subsidiary directly from the parent without listing it. By listing it and making an open offer, the public shareholders are being deprived of future growth potential of the subsidiary. The investment banker claims that the scheme is perfectly valid under law and the investor was not obligated to buy shares in an unlisted subsidiary. Who holds the correct position under law?
    (a) The shareholders (b) The investment banker
18. In an Open Offer under the Takeover Code, an acquirer makes an Open Offer for the entire non-promoter shareholding of the company. Which of the following scenarios is valid under the Takeover Code?
    (a) The public response is for the entire offer whereby the acquirer becomes 100% shareholder of the company
    (b) The Open Offer is rejected by the public in full and the acquirer gets to keep only the shares already acquired before the open offer.
    (c) The public accepts 25% of the offer whereby the acquirer's post-offer stake settles at 56%.
    (d) The public accepts 75% of the offer whereby the acquirer's post-offer stake settles at 76%.
19. In a buy-out deal, the existing promoters with 34% stake wish to exit the company selling their entire stake to the acquirer. The rest of the shareholding is with the public. The acquirer is open to the option of the company being listed or not. CMP = ₹110 per share, Average market price under SEBI formula = ₹93 per share, negotiated price with promoters = ₹125 per share.
    (i) Does the open offer get triggered?
        (a) Yes (b) No
    (ii) What would be the applicable price for the open offer?
    (iii) What is the minimum and maximum size of the open offer?
20. Angela Kernel Gmbh, a German Company intends to acquire 22% of Namo Smrithi Ltd., a listed Indian company which already has 16% stake by another German Company Boris Graf Gmbh. Therefor,e the acquisition by Angela will trigger the Takeover Code.
    (a) Yes (b) No
21. A company wishes to do cash less acquisition. However, it does not wish to do a stock swap for the acquisition. Therefore, it decides to do an amalgamation through purchase method wherein the consideration (in stock) will be issued to the acquired company. This is possible.
    (a) Yes (b) No
22. A company is interested in the assets and business of a target company rather than in its legal entity. The best way to accomplish its acquisition objective would be to settle the purchase consideration to the target company.
    (a) Yes (b) No
23. A company is interested in an acquisition wherein the continuance of the legal entity of the target is necessary. The best way to accomplish its objective would be to pay the purchase consideration to the shareholders of the target company without effecting an amalgamation.
    (a) Yes (b) No

24. A buy-out fund wishes to acquire 100% of a target company through a tender offer and merge it with another portfolio company which was acquired in the previous year. In the proposed merger, the stock swap will be made between the shareholders of the target company and the PE investor.
    (a) Yes (b) No
25. A buy-out fund decides to do a LBO through a SPV floated for this purpose. The leverage in this case, is reflected on the balance sheet of the SPV, the equity in the target is owned by the SPV, the equity in the SPV is owned by the buy-out fund, the debt servicing is done by the SPV, while the mortgage is reflected in the balance sheet of the target.
    (a) True (b) False
26. The founders of a company holding 26% presently wish to make a counter offer for only 30% of the public holding while the acquirer has made an open offer for the entire 62% of the public shareholding. The i-banker maintains that the open offer is invalid since it is for more than 20% and the counter offer is also invalid since it is less than the minimum quantity required. The i-banker is right.
    (a) Yes (b) No
27. In an Open Offer, if the acquirer makes an offer to acquire a minimum of 30% and the response to the offer is to the extent of 14%, the offer is deemed to have failed and all the money collected is refunded.
    (a) Yes (b) No
28. Mid-way in an open offer, if the acquirer decides to increase the quantity of the offer, he has to make another public announcement before there can be a counter-offer.
    (a) Yes (b) No
29. In an Open Offer, the escrow account is opened in order to protect the acquirer company from bankruptcy such that the persons tendering their shares in the open offer need not have any recourse to the company in which they own shares.
    (a) Yes (b) No
30. A company makes a PIPE placement to a PE fund amounting to a 26% acquisition. This triggers the Takeover Code and under the regulations of SEBI, an open offer to the extent of an additional 25% is required so as to make it a 51% acquisition.
    (a) Yes (b) No

PART – B

31. What are the triggers for the Takeover Code? What are its main requirements?
32. Are hostile takeovers possible under the Takeover Code? How does one ensure success in a hostile takeover within the framework of law?
33. What are the strategic issues in M&A that investment bankers have to take into account in determining transaction structure?
34. What are the valuation approaches and techniques adopted in M&A?
35. What are the financing options in M&A? How does one choose from them?
36. What is a buy-out? How is different from a substantial acquisition or a takeover? Explain in your own words with an illustrated example, the rationale of taking a company private for the purpose of a SIPO.
37. What is a divestiture? What are the different methods available for a divestiture? Explain the methodology of a divestiture through a BTA (Slump Sale) and how it is different from a divestiture through share sale.
38. Is a hostile acquisition a preferred method of acquiring control of a target company? How does it compare with other available alternatives?
39. Under what circumstances does a hostile acquisition become the best possible strategy?
40. What is the transaction structure of a classical LBO? Is it possible in the Indian scenario?

For answers to Part A, refer to Appendix B at the end of the book.

Annexure 1 Financing Profile of some Indian Acquisitions and Takeovers

I. Acquisition through Amalgamation of Raasi Cements with India Cements

India Cements Ltd. (ICL) acquired a stake of 9.61% of Raasi Cements Ltd. (RCL), a Hyderabad based cement manufacturer. In February 1998, ICL acquired a further 8.16% from one of the promoters of RCL after negotiations following the hostile bid through its subsidiaries and associate companies acting in concert. The Takeover Code was, thus, triggered off and an open offer was made for another 20%. Just before the open offer, a further stake of 32% was acquired from the promoters of RCL, thereby buying them out completely. By the end of 1998, ICL group held 85% of the share capital of RCL, thus, making it a subsidiary. However, ICL wished to have complete control of RCL with no outside shareholding. Therefore, a scheme of amalgamation of Raasi Cement with ICL was proposed and approved by the High Court in October 1999 by which it became a part of ICL.

In order to finance the purchase of RCL, ICL issued non-convertible debentures worth ₹184.25 crore and a further amount of ₹160.8 crore was raised through a rights issue. The debentures were secured against the assets of ICL. ICL passed on the entire fund requirement of the purchase to its two subsidiaries ICL Financial Services Ltd. and ICL Securities Ltd. which acquired the equity of RCL to the extent of ₹62.2 crore and ₹80.6 crore respectively. Therefore, it was an entirely debt based acquisition and the rights issue helped ICL in balancing its debt-equity ratio.

II. Acquisition of Vishnu Cements by India Cements

ICL Securities Ltd. (ICLS), India Cement's wholly owned subsidiary acquired in October 1999, an equity stake of 49.05% in Sri Vishnu Cements Ltd. (SVCL).Prior to its merger with ICL, Raasi Cement Ltd. (RCL) acquired 39.5% of the equity of SVCL. Subsequently, in December 1999, India Cements Ltd. (ICL) and its subsidiaries made an open offer to acquire the residual shareholding of SVCL. Consequent to the open offer, ICL group held 94.16% of SVCL.

ICLS raised an amount of ₹72.5 crore to acquire shares of SVCL by pledging the acquired shares with financial institutions HDFC and IL&FS and Bank of America. In addition, as part of the scheme of amalgamation of RCL, ICL acquired the 50% stake held by ICLS in RCL for a payment of ₹50 crore. RCL had itself raised loans to finance its purchase of SVCL stake. Therefore, the total acquisition was for around ₹250 crore and was financed by loans taken by RCL and ICL.

III. Sterlite Industries' acquisition of Hindustan Zinc Ltd.

Sterlite Industries Ltd. (SIL) had previously acquired BALCO, a state owned aluminium company from the Government of India, an acquisition that was entirely funded through its internal generations, loans from banks and an equity issue. Buoyed by this success, SIL bid for 26% stake in Hindustan Zinc Ltd. (HZL), another state owned company. This acquisition was made through Sterlite Opportunities and Ventures Ltd. (SOVL), a SPV set up by SIL and another group company. After the initial bid, SIL acquired a further stake of 20% through an open offer to the shareholders of HZL. This was followed up by a share buyback that was successful.

The SPV required a total amount of ₹777.6 crore for the acquisition. This was financed partly by equity from SIL and its other group company amounting to ₹123 crore. The SPV raised debt finance of

₹661.5 crore, out of which ₹411.5 crore was raised through issue of fully convertible debentures and the balance of ₹250 crore by way of inter corporate deposits. The debentures were issued to its own holding company SIL. SIL, in turn, raised US$ 76 million in the form of overseas borrowings and ₹186 crore of domestic borrowings, which were secured against the assets of SIL. These borrowings were used to finance the SPV both for the debentures and the inter-corporate deposit. In addition, some amount of borrowing was also raised by way of pledge of HZL shares by the SPV from ICICI Bank. This finance was used by the SPV to fund SIL's other group company. To sum up, the HZL acquisition was entirely financed through debt capital raised through the holding company SIL and other group entities.

IV. Cadila Healthcare's acquisition of German Remedies Ltd.

Cadila Healthcare Ltd. (CHL) acquired German Remedies Ltd. (GRL), for a cash consideration of ₹202 crore. This was financed through bank loans of ₹80 crore that were secured against CHL's formulation unit. An amount of ₹35 crore was raised through issue of commercial paper. All other borrowings in that year took the aggregate borrowing to ₹260 crore. This amount was used to finance the acquisition of GRL since it was entirely a cash acquisition.

V. Nicholas Piramal's Brand Acquisitions

The company acquired pharmaceutical brands from Ambalal Sarabhai Enterprises at a cost of ₹85 crore in 1999–2000. In that year, the company made an equity issue of ₹30 crore. This fund along with operational accruals and accumulated profits were used in the acquisition of the said brands. This is understandable since brands are intangible property and cannot be used as security for bank loans.

Annexure 2 Arriving at Valuation Benchmarks in M&A Transactions

The main issue that comes up in M&A of an unlisted company or a company without enough comparables is about what the company is worth to its present owners. This is known as *Stand Alone Fair Market Value* (FMV). Most of the time, the potential synergies in the deal are created by the buyer rather than the seller. Therefore, the buyer should not end up paying for synergies and value that he creates post deal. However, if the FMV is not determined, there is a chance that it might happen. Similarly, the sellers too should know the value of what that they have to sell. FMV should represent the *minimum price* that a financially motivated seller would accept. Further, a controlling shareholder in a private company gets a better price than a minority shareholder. Lack-of-control interest in a company is usually substantially less that interest's proportionate ownership in the value of the business on a control basis. Therefore, the FMV determination is the first step in valuation for M&A.

Investment Value (IV) is the value to a particular buyer based on that buyer's circumstances and investment requirements. This value includes synergies or other advantages the strategic buyer anticipates will be created through the deal. It follows that IV will be different for each buyer. The excess of IV over FMV is called the *Acquisition Premium*, which is generally paid to achieve the synergies that the combination will create. In control acquisitions, it includes an element of *ControlPremium*. These two terms are used interchangeably in buy-out transactions. Historically, acquisition premium in the US had a mean of 30% and a median of 40% through the 1990s. Premium can vary widely from deal to deal based on competitive factors, consolidation trends, economies of scale and buyer/seller motivations. To negotiate the best possible price, the buying company should determine the *maximum IV* of the deal for it. This represents the *maximum price* that the buyer can pay. Negotiations, therefore, have to range between the FMV and the IV. Buyers should always start negotiation from the FMV. The farther the deal moves from it and gets closer to the IV, the less attractive it gets for the buyer. The closer the acquisition price to the IV, it erodes value for buyer's shareholders and reduces the margin of error for the buyer.The key decision in every transaction is for the acquirer to decide how much of the acquisition premium will be shared with the seller. This is where valuation and bidding strategy are interwined and the proportion of the premium to be shared will depend upon the competitive situation of the transaction. If many potential bidders are interested in the target, then the acquirer may have to part with a significant portion of the acquisition premium and include the same in the bid price. On the other hand, in a sole bidder situation, the acquirer can successfully argue that the strategic premium belongs to him and the seller is entitled to the value derived from independent cash flows only. *Therefore, the bottom line is that even if the target is a good company, it does not make a good investment if the price is not right*.

As in valuation for other purposes, in M&A valuation, *cash is king*. The difficulty with earnings is that it does not represent the amount that is available to capital providers. If a company is earning well, but using it up for payment of taxes and reinvestment, there can be negative cash flow to investors. Therefore, Free Cash Flow to Firm (FCFF) also known as Net Cash Flow to Invested Capital[2] (NCF_{IC}) is considered the correct measure of wealth creation by a business. The invested capital (also known as capital employed) is the total of the company's equity and interest bearing debt. This is also known as the Enterprise Value.

The basic fundamentals of valuation are common even under M&A, i.e. measuring return (free cash flow or earnings as the case may be), measuring risk (WACC) and using the two, measure value. For further discussion on the DCF method, readers may refer to Chapter 4.

[2] The term 'invested capital' was introduced by McKinsey & Co. to finance literature.

Determination of FMV

It follows a similar process as the DCF valuation method with a little change in approach by moving to a capitalisation method rather than a discounting method. However, in order to arrive at a capitalisation rate, it is necessary to arrive at the discount rate first. The capitalisation rate is the discount rate less expected growth rate. Therefore,

$$\text{Cap Rate } R_C = \text{Discount rate } R_D - \text{Expected growth rate G.}$$

The reciprocal of the Capitalisation Rate = 1/(Rd – G) is known as the *Multiplier* or multiple.

In order to compute FMV, we require the FCFF (NCF_{IC}) and discounting rate which is the WACC. The NCF_{IC} follows the usual pattern of determining the free cash flow which is maintainable based on current level of operations.

In arriving at the FMV, the NCF_{IC} on a stand-alone basis is used.

There are two approaches to using the NCF_{IC}:

Single-Period Capitalisation Method (SPCM)

Under this method, the NCF_{IC} for one year (which is considered representative of future maintainable cash flow) is alone considered. Therefore, the latest year's cash flow may not be the best possible estimate of the future. The other parameters required is the expected infinite rate of growth 'g'. With these two, the SPCM method calculates present value PV as follows:

Single Period Capitalisation Model

$$PV = CF(1 + g)/ (d - g)$$

where PV is the FMV, CF is the cash flow estimate considered as maintainable, d is the WACC and g is the infinite growth rate. (d-g) is called the Capitalisation Rate. The inverse of the capitalisation rate gives the multiplier as a finite number.

Multiple Period Discounting Method

This is the same as the usual DCF methodology using a financial forecast and finding FCFF for the discrete period and the terminal value of FCFF. The only difference that can be suggested is to value the terminal cash flow on the basis of the SPCM mentioned above, i.e. use (FCFF of terminal year) × (1 + g)/(d – g) where (d – g) is the capitalisation rate.

Determination of Cost of Equity

Cost of equity follows the established CAPM Model for listed companies. However, since the computation of beta and the market equity risk premium are complex for unlisted companies, the Modified CAPM and the Build up Method are two variations that can be used:

$$\text{MCAPM } Re = Rf + B(ERP) + SCP + SCRP$$

wherein

Re = Cost of Equity
Rf = Risk free rate
B = beta (also known as systematic risk in investing in equities in general).
ERP = market equity risk premium
SMECP = SME Company Premium – increase in the required rate of return to compensate for the risk associated with the smaller size of a company (unlisted company).
SCRP – Specific Company Risk Premium – increase or decrease in the required rate of return caused by specific strengths or weaknesses within the subject company, which is known as unsystematic risk.

The SCRP is also known as *alpha*.

Under the Build up Method, it is more or less the same as for the CAPM and the model reads as follows: -

$$Re = Rf + ERP + SCP + SCRP$$

The build up method eliminates the beta factor by assuming the beta to be 1, i.e. the average of the market's overall volatility. Implicitly, this model assumes that a company's specific risk factors that would cause its beta to be greater or lesser than one will be captured in the SCRP.Rf in India can be the G-sec rate of around 6–7%, ERP could be considered at 7%, SMECP at between 4–5% and SCRP at 7% for most cases.

The WACC

The key issue about WACC is that it should be based on the weights obtained as per the *market value* of debt and equity of the company rather than the *book value*. Normally, the WACC for large cap listed companies would be 12% (India) and 5% (US), mid cap companies will be about 16% (India) and 10% (US), large and later stage private companies will be about 20% (India) and 15%(US) and small private companies, VC companies will be ranging between 25–40% (India) and 20–30% (US) depending on the stage of the company and the leverage involved.

Since many unlisted companies may actually have lower leverage due to financing from internal resources or have high leverage due to inadequate promoters' capital, the WACC gets distorted. *It is therefore useful to determine the value on invested capital (i.e. enterprise value using WACC) rather than equity value using discounting rate of cost of equity.* Also, it is true that the acquiring company usually restructures the capital of the target by bringing in its own efficiencies of raising capital. Therefore, *the value of the target should be based on enterprise value without considering its pre-deal capital structure.*

One of the keys to valuing a target company in a cross border acquisition is the WACC as applicable to the acquirer in the target jurisdiction. In the past, several Indian acquirers were out-bid by rival bidders from developed countries whose WACC in their home jurisdictions was lower. However, the WACC relevant in a cross border acquisition is that of the target company alone. Therefore, while evaluating alternative options in different jurisdictions, one of the key variables would be the WACC applicable to the acquirer in the target jurisdictions. WACC will also depend upon the financing mechanism employed to finance the deal. If the acquirer uses leverage for funding the acquisition by raising debt against the cash flows of the target company, then it should incorporate the same in the computation of the WACC of the target company. In addition, the higher cost of equity due to additional leverage to be services out of the target's cash flow would make the WACC higher for the acquirer.

When the Asset Approach is Relevant

Sometimes, acquisitions are made primarily to achieve control of the assets owned by the target. This is especially true of asset intensive businesses such as the core sector industries comprising steel, cement and heavy engineering. In such industries, acquisitions provide faster inorganic growth than setting up green field projects which would not only require complicated statutory clearances but lengthy implementation time as well. Similarly, some targets may possess valuable surplus assets such as a strategic location that may not be gettable otherwise or piece of vacant land that may command a significant market price. This is also true of distressed companies wherein the existing assets are generating little or negative cash flow.

Thus, the circumstances when asset approach (also known as *cost approach*) is used in M&A is when the acquirer's primary objective is to acquire specific tangible or intangible assets or when the target only tangible assets and no perceivable cash flow (or other such instances of distress selling by the sellers). In such situations, sellers have to resort to sale at the asset value which is usually the rock bottom price for the seller and *bottom fishing* for the acquirer.

However, asset approach is inappropriate in valuing minority interests. It is appropriate only when majority stakes are being acquired. This is because the methodology presupposes the authority to liquidate assets or sell surplus assets, if necessary, which comes with majority stake alone. An exception to this rule is in the acquisition of holding companies which own controlling stakes in large asset driven businesses.

Asset valuation methods can be used either under a *going concern* premise or a *liquidation* premise. It is customary to derive the values accordingly for each item on the balance sheet. Intangibles are valued at the cost of acquisition. Self generated intangibles are valued at their market value using the super profit method or other appropriate alternatives. Non-operating assets are added to the enterprise value, only if majority stakes are being acquired, not otherwise. Similarly, other specific categories such as off-balance sheet assets and liabilities will need to be treated based on the transaction and the negotiation between the parties.

Valuing Start-Ups and High Tech Businesses

In the valuation of early stage or technology driven companies, adjustments may be required to the metrics used for valuation. Instead of a single stage cash flow, the multiple period discounting method may have to be used to factor in variations in the company's growth for each period. Similarly, the forecasting itself may require three scenarios—pessimistic, realistic and optimistic with suitable probabilities or weightages attaches to each of them.

Market multiples are, sometimes, used in start-ups using surrogates. However, suitable adjustments may be required for lack of marketability. Traditional multiples such as P/E, EBITDA and EBIT multiples are rarely applicable in a start-up scenario. However, in cases where revenue forecasts are acceptable, either a topline multiple or EBITRAD (Earnings before Interest, Taxes, Research and Development, Depreciation and amortisation) multiple can be used. Sometimes industry specific multiples are used in start-ups just as in the case of established companies. Examples of such industries are telecom, airlines, internet services, BPOs etc.

Determination of Investment Value

The FMV of equity or the Asset Value of equity derived as described above has to be subject to three adjustments for arriving at the FMV: (i) adjustments relating to synergy, (ii) adjustments pertaining to premiums and (iii) adjustments pertaining to discounts for each case. Synergy adjustments relate to recomputation of NCF_{IC} on a combined basis due to revenue enhancements, cost reductions, practice improvements and financial economies. The other two adjustments pertain to lack of control in the case of minority stake acquisitions and lack of marketability discount for private company acquisitions. Since marketability or the lack of it is itself dependent on the stake being acquired, the adjustment for premium should be done first and then for the lack of marketability discount. The acquisition premium (or control premium) over a period of 10 years in the 1990s in the US has resulted in an average of 35–45% with a median value of 27 to 35%. Therefore, control premium is generally 30–40% higher than the stand-alone value. Similarly, minority discount is derived from control premium:

$MID = 1 - (1/(1 + CP))$ where MID is the minority discount and CP is the control premium.

ILLUSTRATION

Net Income = 5, adjustment for excess compensation – 1, Cap Rate 20%
Capitalised Value = 5/20% = 25.
Adjusted Cap Value = 4/20% = 20
Resulting Implied Lack of Control Premium = (25 – 20)/25 = 20%

- Other grounds for adjustment of FMV to arrive at Investment Value are:
- Discount for non-voting shares.
- Key Person Discount: Recognises the diminution in value that occurs from excessive reliance on a person who is critical to the success of the business.
- Portfolio Discount: Occurs when a company owns a portfolio of unattractive operating divisions or assets that may be worth more when considered separately than as a part of a combined business.
- Blockage Discount: This discount may be imposed to reflect the negative effect on share price when a large block of shares is offered for sale at one time.
- Discount for trapped in gains – Applies if the target company will suffer high taxation due to the transaction for built in gains in the appreciation of its assets.

Premiums and discounts constitute the largest adjustment to the FMV to arrive at the IV.

Fundamental Financial Concepts[1]

Appendix

A

A.1 Concept of Future Value

The theory of finance rests on the fundamental principle that money should never be idle and should keep earning interest with passage of time. Taking this concept ahead, the value of a sum of money should appreciate with time due to the accumulation of interest. This would give rise to the concept of *'future value'* of money. Suppose you have ₹1,000 today and you deposit it with a financial institution which pays 10% interest compounded annually, for a period of 3 years. The deposit would grow as follows:

		₹
First year:	*Principal at the beginning*	*1,000*
	Interest for the year (₹1,000 × 0.10)	*100*
	Principal at the end	*1,100*
Second year:	*Principal at the beginning*	*1,100*
	Interest for the year (₹1,100 × 0.10)	*110*
	Principal at the end	*1,210*
Third year:	*Principal at the beginning*	*1,210*
	Interest for the year (₹1,210 × 0.10)	*121*
	Principal at the end	*1,331*

Formula

The general formula for the future value of a single amount is:

$$\text{Future Value} = \text{Present Value } (1 + r)^n$$

[1]The contents of this Appendix are extracted from 'Financial Management—Theory and Practice' by Dr. Prasanna Chandra, McGraw Hill Education India Ltd. with necessary permission from the author. Readers may refer to the latest edition of this book for further discussions on financial concepts.

where r is the interest rate per year and n is the number of years over which compounding is done. The factor $(1 + r)^n$ is called the future value factor, $FV_{r,n}$. It is very tedious to calculate this factor unless you have a calculator. To reduce the tedium, tables are available. A set of sample computations are furnished in Table A.1 for various combinations of r and n. A comprehensive table is furnished at the end of this book.

Table A.1 Value of $FV_{r,n}$ for Various Combinations of r and n

n/r	*6 %*	*8 %*	*10 %*	*12 %*	*14 %*
2	1.124	1.166	1.210	1.254	1.300
4	1.162	1.366	1.464	1.574	1.689
6	1.419	1.587	1.772	1.974	2.195
8	1.594	1.851	2.144	3.106	3.707
10	2.012	2.518	3.138	3.896	4.817

ILLUSTRATION 1

If you deposit ₹1,000 today in a bank which pays 10% interest, compounded annually, how much will the deposit grow to after 8 years and 12 years?

The future value, 8 years hence will be

$$₹1{,}000 \times (1.10)^8 = ₹1{,}000 \times (2.144) = ₹2{,}144$$

The future value, 12 years hence will be

$$₹1{,}000 \times (1.10)^{12} = ₹1{,}000 \times (3.138) = ₹3{,}138$$

A.1.1 Doubling Period

Investors commonly ask the question: How long would it take to double the amount at a given rate of interest? To answer this question, we may look at the future value interest factor table. Looking at Exhibit 10.1, we find that when the interest rate is 12%, it takes about 6 years to double the amount; when the interest rate is 6% it takes about 12 years to double the amount, so on and so forth. Is there a thumb rule which dispenses with the use of the future value interest factor table? Yes, there is one and it is called the Rule of 72. According to this thumb rule, the doubling period is obtained by dividing 72 by the interest rate. For example, if the interest rate is 8%, the doubling period is about 9 years (72/8). Likewise, if the interest rate is 4%, the doubling period is about 18 years (72/4). Though somewhat crude, it is a handy and useful thumb rule.

A.1.2 Shorter Compounding Periods

So far we have assumed that compounding is done annually. Now, consider the case where compounding is done more frequently. Suppose you deposit ₹1,000 with a finance company, which advertises that it pays 12% interest semi-annually, which means that the interest is paid every 6months. Your deposit (if interest is not withdrawn) grows as follows:

First Six Months: Principal at the beginning = ₹1,000.00
Interest for 6 months = ₹60.00 (₹1,000 × 0.12/2)
Principal at the end ₹1,060.00

Second Six Months: Principal at the beginning = ₹1,060.00
Interest for 6 months ₹63.6 (₹1,060 × .12/2)
Principal at the end ₹1,123.60

Note that if the compounding is done annually, the principal at the end of one year would be ₹1,000 (1.12) = ₹1,120.0. The difference of ₹3.6 (between ₹1,123.6 under semi-annual compounding and ₹1,120.0 under annual compounding) represents interest on interest for the second 6 months.

The general formula for the future value of a single cash amount when compounding is done more frequently than annually is:

$$\textit{Future Value} = \textit{Present Value}\ (1 + r / m)^{m \times n}$$

where r is the nominal annual interest rate, m is the number of times compounding is done in a year, and n is the number of years over which compounding is done.

ILLUSTRATION 2

How much does a deposit of ₹5,000 grow to at the end of 6 years, if the nominal rate of interest is 12 % and the frequency of compounding is 4 times a year? The amount after 6 years will be

$$₹5{,}000\ (1 + 0.12 / 4)^{4 \times 6} = ₹5{,}000\ (1.03)^{24}$$
$$= ₹5{,}000 \times 2.0328 = ₹10{,}164$$

A.1.3 Effective versus Nominal Rate

We have seen above that ₹1,000 grows to ₹1,123.6 at the end of the year if the nominal rate of interest is 12% and compounding is done semi-annually. This means that ₹1,000 grows at the rate 12.36% per annum. The figure of 12.36% is called the *effective rate of interest*, i.e. the rate of interest under annual compounding, which produces the same results as that produced by an interest rate of 12% under semi-annual compounding.

The general relationship between the effective rate of interest and the nominal rate of interest is as follows:

$$r = (1 + k/m)^m - 1$$

where r is the effective rate of interest, k is the nominal rate of interest, and m is the frequency of compounding per year.

ILLUSTRATION 3

A bank offers 8 % nominal rate of interest with quarterly compounding. What is the effective rate of interest?

The effective rate of interest is: $(1 + 0.08/4)^4 - 1 = 0.0824 = 8.24\%$

Table A.2 gives the relationship between the nominal and effective rates of interest for different compounding periods. In general, the effect of increasing the frequency of compounding is not as dramatic as some would believe it to be, the additional gains dwindle as the frequency of compounding increases.

Table A.2 Nominal and Effective Rates of Interest

Nominal Rate %	*Effective Rate Percentage*			
	Annual Compounding	*Semi-annual Compounding*	*Quarterly Compounding*	*Monthly Compounding*
8	8.00	8.16	8.24	8.30
12	12.00	12.36	12.55	12.68

A.1.4 Future Value of an Annuity

An annuity is a series of periodic cash flows (payments and receipts) of equal amounts. The premium payments of a life insurance policy, for example, are an annuity. When the cash flows occur at the end of each period, the annuity is called a regular annuity or a deferred annuity. When the cash flows occur at the beginning of each period, the annuity is called an annuity due. Our discussion here will focus on a regular annuity—the formulae of course can be applied, with some modifications, to an annuity due.

Suppose you deposit ₹1,000 annually in a bank for 5 years and your deposits earn a compound interest rate of 10%. What will be the value of this series of deposits (an annuity) at the end of 5 years? Assuming that each deposit occurs at the end of the year, the future value of this annuity will be:

$$₹1{,}000\,(1.10)^4 + ₹1{,}000\,(1.10)^3 + ₹1{,}000\,(1.10)^2 + ₹1{,}000\,(1.10) + ₹1{,}000$$
$$= ₹1{,}000(1.464) + ₹1{,}000\,(1.331) + ₹1{,}000\,(1.21) + ₹1{,}000\,(1.10) + ₹1{,}000$$
$$= ₹6{,}105.$$

The time line of this annuity is shown in Exhibit A.1.

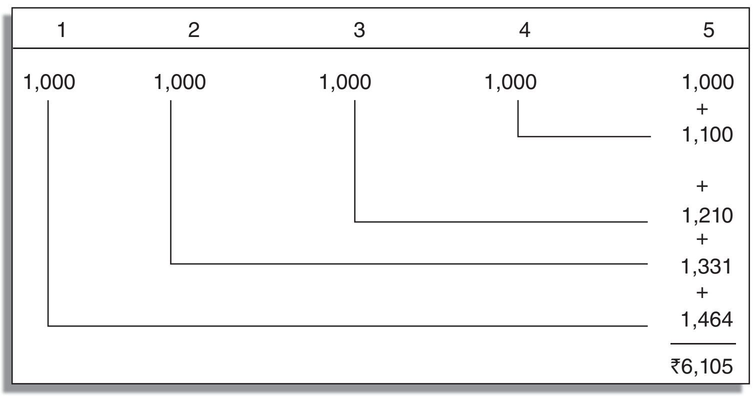

Exhibit A.1 Time Line for an Annuity

Formula

In general terms, the future value of an annuity is given by the formula:

$$\text{Future value of an annuity} = \text{Constant Periodic flow} = \left(\frac{(1+r)^n - 1}{r}\right)$$

where r is the interest rate per period and n, the duration of the annuity. The expression in the bracket is the future value annuity factor, $\text{FVA}_{r,\,n}$. A set of sample computations are furnished in Table A.3 for various combinations of r and n. A comprehensive table is furnished at the end of this book.

Table A.3 Value of $\text{FVA}_{r,n}$ for Various combinations of r and n

n/r	*6%*	*8%*	*10%*	*12%*	*14%*
2	2.060	2.080	2.100	2.120	2.140
4	4.375	4.507	4.641	4.779	4.921
6	6.975	7.336	7.716	8.115	8.536

(*Contd.*)

8	9.897	10.636	11.436	12.299	13.232
10	13.181	18.977	15.937	17.548	19.337
12	16.869	18.977	21.384	24.133	27.270

ILLUSTRATION 4

Four equal annual payments of ₹2,000 are made into a deposit account that pays 8 % interest per year. What is the future value of this annuity at the end of 4 years?

₹2,000 ($FVIFA_{8\%,\ 4\ yrs}$) = ₹2,000 (4.507) = ₹9,014

A.2 Concept of Present Value

The concept of present value of money is actually the inverse of the future value concept and forms the core of most financial computations. Suppose someone promises to give you ₹1,000 three year hence. What is the present value of this amount if the interest rate is 10 %? The present value can be calculated by discounting ₹1,000 to the present point of time, as follows:

Value three years hence = ₹1,000
Value two years hence = ₹1,000 (1/1.10)
Value one year hence = ₹1,000 (1/1.10) × (1/1.10)
Value now (present value) = ₹1,000 (1/1.10) × (1/1.10) × (1/1.10)

Formula

The process of discounting, used for calculating the present value, is simply the inverse of compounding. The present value formula can be readily obtained by manipulating the compounding formula.

$$\text{Future Value} = \text{Present Value } (1 + r)^n$$

Dividing both the sides of the above equation by $(1 + r)^n$, we get,

$$\text{Present value} = \text{Future value} \times \frac{1}{(1+r)^n}$$

The factor $1/(1+r)^n$ in the above equation is called the present value factor, $PV_{r,n}$. A set of sample computations are furnished in Table A.4 for various combinations of r and n. A comprehensive table is furnished at the end of this book.

Table A.4 Value of $PV_{r,n}$ for Various Combinations of r and n

n/r	*6 %*	*8 %*	*10 %*	*12 %*	*14 %*
2	0.890	0.857	0.826	0.797	0.770
4	0.792	0.735	0.683	0.636	0.592
6	0.705	0.630	0.565	0.507	0.456
8	0.626	0.540	0.467	0.404	0.351
10	0.558	0.463	0.386	0.322	0.270
12	0.497	0.397	0.319	0.257	0.208

ILLUSTRATION 5

Find the present value of ₹1,000 receivable 6 years hence, if the rate of discount is 10 %. The present value is:

$$₹1{,}000\ (PV_{10\%,\,6}) = ₹1{,}000\ (0.564) = ₹565$$

A.2.1 Present Value of an Annuity

Suppose you expect to receive ₹1,000 annually for 3 years, each receipt occurring at the end of the year. What is the present value of this stream of benefits if the discount rate is 10%? The present value of this annuity is simply the sum of the present values of all the inflows of this annuity:

$$= ₹1{,}000\ [1/1.10] + ₹1{,}000\ [1/1.10]^2 + ₹1{,}000\ [1\ /\ 1.10]^3$$
$$= ₹1{,}000 \times 0.909 + ₹1{,}000 \times 0.826 + ₹1{,}000 \times 0.751$$
$$= ₹2{,}478.8$$

The time line for this illustration is shows in Exhibit A.2.

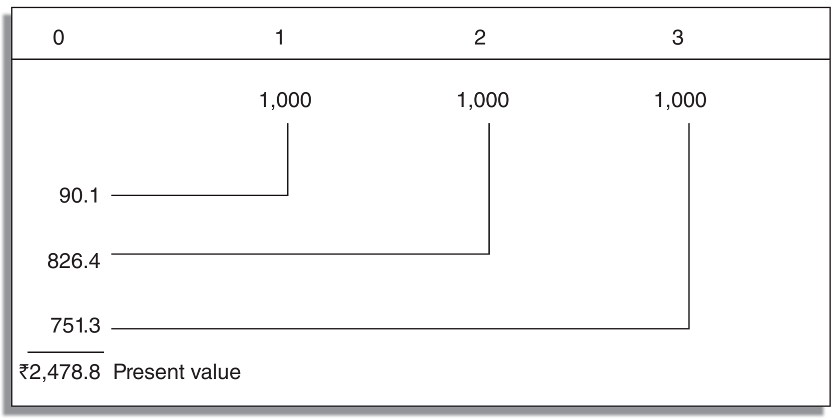

Exhibit A.2 Time Line of an Annuity

Formula

In general term, the present value of an annuity is given by the formula:

$$\text{Present value of an annuity} = \text{Constant Periodic flow} \times \left(\frac{1 - \dfrac{1}{(1+r)^n}}{r} \right)$$

where r is the interest rate per period and n, the duration of the annuity. The expression in the bracket is the present value annuity factor, PVA r,n. A set of sample computations are furnished in Table A.5 for various combinations of r and n.A comprehensive table is furnished at the end of this book.

Table A.5 Value of $PVA_{r,n}$ for Various Combinations of *r* and *n*

n/r	*6%*	*8%*	*10%*	*12%*	*14%*
2	1.833	1.783	1.737	1.690	1.647
4	3.465	2.312	3.170	3.037	2.914
6	4.917	4.623	4.355	4.111	3.889
8	6.210	5.747	5.335	4.968	4.639
10	7.360	6.710	6.145	5.650	5.216
12	8.384	7.536	6.814	6.194	5.660

ILLUSTRATION 6

What is the present value of a 4-year annuity of ₹10,000 discounted at 10%?

The $PVA_{10\%,4}$ is ₹3,170.

Hence, the present value of the annuity is

$$₹10,000 \times (3.170) = ₹31,700$$

A.2.2 Loan Amortisation Schedule

Most loans are repaid in equal periodic instalments (monthly, quarterly, or annually), which cover interest as well as principal repayment. Such loans are referred to as *amortisedloans*. For an amortised loan we would like to know (a) the periodic instalment payment and (b) the loan amortisation schedule showing the break-up of the periodic instalment payments between the interest component and the principal repayment component. To illustrate how these are calculated, let us look at an example.

Suppose a firm borrows ₹1,000,000 at an interest rate of 15% and the loan is to be repaid in 5 equal instalments payable at the end of each of the next 5 years. The annual instalment payment A is obtained by solving the following equation.

$$\text{Loan amount} = A \times PVA_{n=5,\ r=15\%}$$
$$1{,}000{,}000 = A \times 3.3522$$
$$\text{Hence, } A = 298{,}312$$

The amortisation schedule is shown in Table A.6. The interest component is the largest for year 1 and progressively declines as the outstanding loan amount decreases.

Table A.6 Loan Amortisation Schedule

Year	*Beginning Amount (1)*	*Annual Instalment (2)*	*Interest Repayment (3)*	*Principal Balance (2)-(3) = (4)*	*Remaining (1)-(4) = (5)*
1	1,000,000	298,312	150,000	148,312	851,688
2	851,688	298,312	127,753	170,559	681,129
3	681,129	298,312	102,169	196,143	484,986
4	484,986	298,312	727,482	225,564	259,422
5	259,422	298,312	38,913	259,399	23*

a. Interest is calculated by multiplying the beginning loan balance by the interest rate.
b. Principal repayment is equal to annual instalment minus interest.
* Due to rounding off error a small balance is shown.

A.2.3 Equated Monthly Instalment

In the previous illustration, we considered equated annual instalments. In many cases, such a housing loans or car loans, however, the borrower has to repay the loan with interest in Equated Monthly Instalments (EMIs). The calculation of the EMI is analogous to the calculation of the equated annual instalment, except that the unit period is one month not one year.

The calculation of EMI may be illustrated with an example. Shyam takes a housing loan of ₹1,000,000 carrying an interest of 1% per month. The loan is to be repaid over 180 months. What is the EMI? EMI is obtained by solving the following equation:

$$1{,}000{,}000 = A \times \text{PVA}_{n = 180,\, r = 1.00\%}$$

$$1{,}000{,}000 = A \times \frac{1 - \dfrac{1}{(1+r)^n}}{r}$$

$$1{,}000{,}000 = A \times \frac{1 - \dfrac{1}{(1.01)^{180i}}}{.01}$$

$$1{,}000{,}000 = A \times 83.3217$$

$$A = \frac{1{,}000{,}000}{83.3217} = ₹12{,}002$$

A.2.4 Present Value of a Perpetuity

A perpetuity is an annuity of infinite duration. In general terms:

$$\text{Present value of a perpetuity} = \text{Constant periodic flow}\left(\frac{1}{r}\right)$$

where r is the discount rate. The expression in the bracket is the present value perpetuity factor. Put in other words, it means that the present value perpetuity factor is simply 1 divided by the interest rate expressed in decimal form. Hence, the present value of a perpetuity is simply equal to the constant annual payment divided by the interest rate. For example, the present value of a perpetuity of ₹10,000 if the interest rate is 10% is equal to: ₹10,000/0.10 = ₹100,000. Intuitively, this is quite convincing because an initial sum of ₹100,000 would, if invested at the interest rate of 10%, provide a constant annual income of ₹10,000 forever, without any impairment of the capital value.

[i]Computation of exponentials of a high value such as r^{180} has to be done using logarithm tables if required to be done manually. Alternatively, one could use a scientific calculator or a spreadsheet on Excel or other similar programs.

Appendix B

Answers to Test Your Understanding Questions

Chapter 1

1. (d)	2. (a)	3. (b)	4. (d)	5. (a)	6. (e)	7. (f)	8. (c)
9. (d)	10. (d)	11. (c)	12. (d)	13. (c)	14. (d)	15. (d)	

Chapter 2

1. (b)	2. (d)	3. (a)	4. (d)	5. (b)	6. (c)	7. (d)	8. (b)
9. (d)	10. (c)	11. (b)	12 (b)	13. (e)	14. (a)	15. (b)	

Chapter 3

1. (b)	2. (b)	3. (b)	4. (b)	5. (c)	6. (e) and (f)	7. (e)
8. (b)	9. (c), (d) and (e)		10. (d)	11. (d)	12. (e)	13. (c)
14. (c)	15. (b)	16. (d)	17. (b)	18. (f)	19. (b)	20. (a)
21. (b)	22. (b)	23. (b)	24. (b)	25. (b)	26. (a) or (c)	27. (b)
28. (a)	29. (a)					

Chapter 4

1. (b)	2. (a)	3. (b)	4. (d)	5. (c)	6. (b)	7. (b)	8. (b)
9. (b)	10. (c)	11. (a)	12. (c)	13. (a)	14. (g)	15. (d)	16. (b)
17. (a)	18. (b)	19. (b)	20. (b)	21. (b)	22. (b)		

Chapter 5

1. (a)	2. (b)	3. (a)	4. (a)	5. (b)	6. (a)	7. (b)	8. (b)
9. (a)	10. (a)						

Chapter 6

1. (c) 2. (f) 3. (c) and (e) 4. (f) 5. (a) 6. (a) and (f)
7. (g) 8. (d) 9. (b) 10. (b) 11. (b) 12. (a) 13. (a) 14. (b)
15. (b)

Chapter 7

1. (b) 2. (d) 3. (b) 4. (b) 5. (a) 6. (b) 7. (b) 8. (a)
9. (b) 10. (b) 11. (a) 12. (a) 13. (a) 14. (b) 15. (b)

Chapter 8

1. (b) 2. (a) 3. (b) 4. (b) 5. (a) 6. (a) 7. (e) 8. (c)
9. (d) 10. (d) 11. (a) 12. (f) 13. (c) 14. (h)
15. None of the given alternatives
16. ₹74 (i.e. CMP ₹190 – Average Cost of Holding Post Rights ₹116)
17. (b) 18. (b) 19. (b) 20. (b) 21. (b) 22. (a) 23. (b) 24. (a)
25. (b) 26. (a) 27. (b) 28. (e) 29. (d) 30. (a) 31. (b) 32. CFO
33. (b) 34. (b)

Chapter 9

1. (b) 2. (b) 3. (a) 4. (a) 5. (b) 6 (a) 7. (a) 8. (b)
9. (b) 10. (a) and (e) 11. (a) 12. (b) 13. (a) 14. (b) 15. (a)
16. (a) 17. (a)

Chapter 10

1. (b) 2. (a) 3. (b) 4. None of the given alternatives 5. (e) 6. None
7. (b) 8. None of the given alternatives 9. (a) 10. (a) 11. (b) 12. (b)
13. (a) 14. (a) 15. (a) 16. (b) 17. (d)

Chapter 11

1. (b) 2. (b), (c), (d) and (e) 3. (b) and (e) 4. (e)
5. (a), (b), (d), (f) and (g), (e) 6. All 7. (e) 8. (f) 9. (a) 10. (c)
11. (b) 12. (b) 13. (b) 14. (a) and (d) 15. (a) 16. (b) 17. (c)
18. (b)

Chapter 12

1. (d) 2. (e) 3. (c) 4. (e) 5. (a) 6. (e) 7. (g) 8. (f)
9. None of the given alternatives 10. (g) 11. (a) 12. (b) 13. (b) 14. (a)
15. (b) 16. (b) 17. (b) 18. (b) 19. (a)

Chapter 13

1. (b) 2. (b) 3. (a) 4. (a) 5. (e) 6. (d) 7. (e) 8. (e)
9. (b) 10. (a) 11. (b) 12. (a) 13. (b) 14. (a) 15. (a) 16. (b)
17. (c) 18. None 19. (b) 20. (b) 21. (b) 22. (b) 23. (b) 24. (a)
25. (a) 26. (a)

Chapter 14

1. (b) 2. None 3. (a), (c), (d) and (e) 4. (f) 5. (a) 6. (a)
7. (a), (b), (c) and (d) 8. (a) 9. (a), (b) and (f) 10. (b) 11. (f) 12. (b)
13. (a) 14. (b) 15. (b) 16. (b) 17. (a) 18. (c) 19. (a) 20. (b)
21. (b) 22. (b) 23. (a)

Chapter 15

1. (f) 2. (c) 3. (a) 4. (a) 5. (b) 6. (e) 7. (e) 8. (d)
9. (g) 10. (b) 11. (f) 12. (b) 13. (b) 14. (b) 15. (d) 16. (c)
17. (b) 18. (a) 19. (f).

Chapter 16

1. (b) 2. (d) 3. (b) 4. (b) 5. (b) 6 (c) 7. (a) and (f)
8. (h) 9. (a) 10. (g) 11. All 12. (e) 13. (a) 14. (b) 15. (b)
16. (b) 17. (b) 18. (b)
19. (i) (a), (ii) ₹125 per share, (iii) Minimum 26%, Maximum 41% (without de-listing) and 66% (with de-listing)
20. (b) 21. (a) 22. (a) 23. (a) 24. (a) 25. (a) 26. (a) 27. (b)
28. (a) 29. (b) 30. (a)

Problems and Cases

Appendix C

C.1 Case on Financing Plan

Evergreen Ltd. is an unlisted public company incorporated in India. It has an ongoing business in the area of electronic component manufacture. Its customers are manufacturers of consumer electronics such as televisions, home theatres, audio equipment and the like. In order to augment its operations to meet the growing demand of the market, Evergreen is planning an expansion project to increase its manufacturing capacity. The project is estimated to cost ₹1 billion. The financing plan should be such that it does not increase the debt-equity ratio to more than 1.2:1 since the management is of the view the company being an intermediate manufacturer, its financial leverage should not be very high.

After consultation with investment bankers, the options available to the company to raise finance have been frozen as follows: (a) Rights Issue to the existing private shareholders at ₹20 per share. This alternative cannot raise more than ₹50 million. (b) Initial Public Offer at a price not exceeding ₹50 per share. (c) Rights-cum-public issue on the above lines. (d) Debt financing from bank.

Further details of the company's existing financials are furnished below:

Liabilities	*Amt. ₹ (Million)*	*Assets*	*Amt ₹ (Million)*
Share Capital *Equity shares of ₹10 each*	100	Net Fixed Assets	1,650
Reserves and Surplus		Investments	5
Share Premium	0		
General Reserve	700		
P&L Account	500		
Long-Term Borrowings	1,000	Current Assets	1,340
Current Liabilities	700	Miscellaneous Expenditure	5
Total	***3,000***	***Total***	***3,000***

Work out the optimum financing plan for the expansion project that meets the specified objectives.

Author's View

The structure that would more or less preserve the existing debt-equity ratio thereby increasing the financial leverage of the company only marginally but at the same time, provide the necessary size for an IPO is furnished below.

Financing Plan	*Amt ₹ (Million)*
Rights Issue of 2,500,000 shares of ₹10 each at an issue price of ₹20 per share	50
Initial Public Offer of 9,000,000 shares of ₹10 each at an issue price of ₹50 per share	450
Additional Long-Term Borrowings	500
Total	***1,000***

C.2 Problem on Financial Instrument Structuring

Ozone Ltd. wishes to come up with a unique debt instrument for issue on private placement basis to certain QIB investors. The features of the instrument are as follows:

- The face value of the instrument would be ₹1,000/-.
- There would be three parts to the instrument: Part X, Part Y and Part Z.
- Part X with a face value of ₹300 would have a coupon rate of 10% which shall be paid half-yearly and shall have a life of six years. The principal shall be repaid in equal instalments at the end of year 4, year 5 and year 6.
- Part Y with a face value of ₹300 shall be issued at an issue price of ₹225 and shall have a life of three years. It shall be repaid in equal instalments at the end of year 1, year 2 and year 3.
- Part Z with a face value of ₹400 shall be repaid at the end of year 7, year 8, year 9 and year 10 in equal instalments of ₹150 each.
    1. Assuming all the three parts to be detachable, find the respective YTM of each part. If an investor holds all the three parts until redemption, find out the YTM of the whole instrument.
    2. Based on respective yield analysis, provide your views on the positive and negative aspects of the structuring of the instrument.

Suggested Brief Solution

	Part X	*Part Y*	*Part Z*	*Combined*
Half-Yearly YTM	5.7%	7.7%	2.4%	3.83%
Annualised YTM	11.8%	15.9%	4.9%	7.81%

C.3 Problem on Debt Convertible Instrument

Argon Ltd. proposes to come out with a public offer of 1,000,000 fully convertible debentures with certain unique features. The company presently has a share capital of 1,000,000 shares of ₹10 each and a PAT of ₹2,000,000. The details of the proposed debenture are as follows:

- The debenture shall have three distinct parts—Part A, Part B and Part C.
    - Part A is convertible into one share at the end of 10 months at the option of the investor.

- Part B is convertible into two shares at the option of the investor at the end of 12 months. It also carries a detachable equity warrant. If the investor converts Part B as proposed, the equity warrant becomes active and entitles the investor to seek an additional share of the company in the 15th month.
- Part C is convertible into one share at the end of the 18th month at the option of the investor. However, Part C becomes convertible into two shares if the investor has exercised conversion option under Part A as well. Similarly, it becomes convertible into two shares if the investor has exercised conversion option under Part B as well. On the same lines, it becomes convertible into three shares if the investor has exercised conversion option under both Parts A and B.

The company wishes to know the fully diluted EPS in the following scenarios:

- All investors opt for conversion of Part A alone.
- All investors opt for conversion of Part B alone.
- All investors opt for conversion of Part C alone.
- All investors opt for conversion of Part A and Part B.
- All investors opt for conversion of Part A and Part C.
- All investors opt for conversion of Part B and Part C.
- All investors opt for conversion of all parts.
- All investors do not opt for conversion of any part.

Suggested Brief Solution

Option	***Fully diluted EPS ₹***
ABC	0.25
A	1.00
B	0.50
C	1.00
AB	0.40
AC	0.50
BC	0.33
None	2.00

C.4 Case on Foreign Investment

Tomahawk Fund Management Pvt. Ltd. is the Indian arm of Black Hole Capital, a large buy-out fund based in Singapore. The buy-out fund looks to acquire listed and unlisted Indian companies by buying a minimum of 51% in each company. In order to advise them on the investment strategy and regulatory mechanisms in India, the company has retained the services of Games Capel Ltd., an investment bank in India specialising in advising foreign investors.

As part of Games Capel, list out broadly and briefly, the investment routes available for Black Holes in India either directly or using Tomahawk as an investment vehicle and restrictions if any, on such investments. Your recommendations shall be based on the related regulatory provisions, foreign investment policy and tax issues.

Solution

Since case requires a descriptive answer, no solution is being suggested.

C.5 Case on IPO Strategy

From the following table, evolve a strategic financial plan for a company that is presently unlisted. The strategy could either include an IPO or otherwise. Discuss with reasons.

Present Shareholding Pattern	The company is presently closely held among the promoters, promoter group and their business associates.
Fund Requirement	There is a requirement of substantial funds to implement capital investment plans in future on an on-going basis.
Growth Strategy	The company is in a growth spiral and industry prospects are very good. However, the company has to grow fast.
Future Profitability	The company expects to generate good profitability on its present and future investments. Profits margins are expected to grow in future.
Present Gearing	The company has substantial long-term borrowings since the business is capital intensive.
Industry Scenario	The industry is in a consolidation phase and smaller companies need to ramp up quickly either to be positioned appropriately or be acquired by the bigger players.
Promoters' Support	Promoters have invested heavily into the company thus far and further support in the future to this extent is not likely.
Strategic Interest	The company would be of interest to strategic investors who would like to consolidate their presence in the industry.
Banking Relationships	The company enjoys excellent banking relationships.

Solution

Since this is an argumentative case, no solution is being suggested. It is intended that the readers should debate alternative strategies based on their understanding of the subject and its application in the given case.

C.6 Problem on Rights Issue vs FPO

Healthy Ltd. furnishes the following details with regard to its present financial position and performance:

- Share Capital—2,000,000 equity shares of ₹10 each fully paid
- Preference Capital—100,000 12% preference shares of ₹100 each fully paid.
- Accumulated Reserves—General Reserve—₹14,526,867 Capital Reserve—₹5,864,329 Profit and Loss Account (excluding current year's profits) ₹8,624,372
- Deferred tax assets—₹287,339
- Profit after tax—₹16,785,992
- Proposed Equity Dividend—10%
- Dividend Distribution Tax—20%

The company proposes to come out with a rights issue of 500,000 equity shares at an issue price of ₹26 per share. Alternatively, the company proposes to come out with a FPO of 1,000,000 equity shares at an issue price of ₹45 per share.

Compute the EPS and Book Value of share under either of the above scenarios immediately on completion of the respective issue.

Suggested Brief Solution

Per Share	*EPS ₹*	*BV ₹*
After Rights	6.16	29.89
After FPO	5.14	35.58

C.7 Problem on Book-built Offer

Fantastic Ltd., an existing profit-making unlisted company, proposes to come out with a book-built IPO of equity shares as per the following proposed plan:

- Total size of the issue—10,000,000 shares
- Promoters' quota—500,000 shares
- Reservations to be made to permanent employees/shareholders of group companies/depositors of the company/business associates/customers/directors and promoters as may be permissible under SEBI ICDR Regulations.
    - Pre-issue capital of the company comprises of 1,000,000 shares.

Work out a permissible issue structure.

Suggested Brief Solution

Issue Structure (Number of Shares)	*100% Book-built issue*
Offer through the prospectus	10,000,000
NPO	7,000,000

C.8 Problem on Green Shoe Option

Blue Shoe Company Ltd. made a public issue of 2,000,000 equity shares of ₹10 each at a premium of ₹80 per share. The issue contained a green shoe option to the extent permissible and as per the guidelines, the company appointed Shoemaker Capital Ltd. as the stabilising agent. Shoemaker opened a separate demat account called 'Special Account for the GSO shares of Blue Shoe Co.' and a separate bank account called 'Special Account for the GSO proceeds of Blue Shoe Co'. During the stabilisation period, the following transactions took place:

1. Shoemaker purchased shares from the market as follows:

Day from commencement of trading	*Number of Shares*	*Average Market Price ₹*
1	5,844	89
2	3,756	87
6	8,690	84
9	2,287	82
11	10,643	81
14	20,848	80
16	19,888	80

(*Contd.*)

21	22,762	80
24	11,446	82
27	4,860	85
28	245	86
29	7,336	85
30	4,587	86

Determine the following:
- The extent of green shoe allotment to be done by the company.
- The funds left in the GSO account after the stabilisation period is completed.
- The amount of allotment money on the green shoe allotment.
- Show the entries in the GSO shares account and the GSO proceeds account.

Suggested Brief Solution

- The extent of green shoe allotment to be done by the company is 176,808 shares.
- The funds left in the GSO account after the stabilisation period is completed is ₹990,191.
- The amount of allotment money on the green shoe allotment is ₹15,912,720.

C.9 Cases on Eligibility to go Public

Determine the eligibility of the following companies to come out with a Public Issue:

1. XYZ Ltd. is an existing profit-making dividend paying unlisted company for the past five years. The company's present net worth is ₹32 crore. Its average PAT in the past five years was ₹16.5 crore. The company is proposing to come out with a premium public issue aggregating to ₹250 crore.
2. XYZ Ltd. is an existing profit-making dividend paying listed company for the past five years. The company's present net worth is ₹32 crore. Its average PAT in the past five years was ₹16.5 crore. The company is proposing to come out with a premium public issue aggregating to ₹250 crore.
3. XYZ Ltd. is an existing profit-making dividend paying company for the past five years. Its asset base has been around ₹50 crore during this period out of which around ₹22.5 crore comprises investment in group company. The company's net worth has been growing during this period from ₹17 crore and is presently ₹40 crore. The company is proposing to come out with a premium IPO aggregating to ₹200 crore.
4. XYZ Ltd. is an existing company for the past five years. The company made profits in years 1, 3 and 5 and losses in years 2 and 4. The company's present net worth is ₹12 crore. The company is proposing to come out with a premium IPO aggregating to ₹75 crore.
5. XYZ Ltd. is an existing company for the past five years. The company made profits in years 1, 4 and 5 and losses in years 2 and 3. The company's present net worth is ₹18 crore. The company is proposing to come out with a premium IPO aggregating to ₹75 crore.

Suggested Solution

1. The company is eligible to come out with an IPO. However, since the post issue net worth is greater than 5 times the pre-issue net worth, it has to be a book-built issue only.
2. The company is eligible to come out with a FPO through the book-building route since the post issue net worth is greater than 5 times the pre-issue net worth.

3. The company can make a premium IPO either through the book-built route or as a fixed price 100% retail offer as it satisfies all primary eligibility conditions.
4. The company does not satisfy the primary eligibility conditions. Secondly, its issue size is bigger than 5 times its pre-issue net worth. Therefore, the company may make an IPO through the alternative eligibility condition which requires 75% compulsory allotments to QIBs.
5. The company satisfies the requirements with regard to profit track record and maximum issue. If it also satisfies the minimum asset base criterion, it can make either a 100% retail or a book-built issue as per its size.

C.10 Problem on Issue Pricing

Everest Ltd. is a profit-making and dividend paying company. In order to finance its future projects, the company proposes to raise equity finance through an IPO. From the following details and requirements, recommend the floor price for a 100% book-built offer.

- The ruling industry P/E multiple is 32 but the peer multiple is 35.
- The company wishes to be listed at least 30% premium to offer price at the relevant P/E multiple as mentioned above.
- The company proposes a bonus issue just before the IPO that would increase the equity base by 20% and exhaust all reserves.
- The company currently has an equity base of 2,000,000 shares of ₹10 each. The company posted a RONW of 42% for the preceding year.
- The company does not wish to have an Offer Price-Book Value ratio of more than 8 to the floor price.
- The company wishes to have a price band in the IPO.

Suggested Brief Solution

The floor price that meets the above requirements is ₹80 per share and the price band is ₹80-96 per share.

C.11 Problem on Capital Structure

Grasshopper Technologies Ltd. is an unlisted profit-making company engaged in the business of engineering and technical manufacture and services that is eligible for a 100% book-built offer. From the particulars mentioned below, recommend a suitable capital structure with regard to the proposed IPO.

Pre-IPO Capital Structure

Date	*Allottee*	*Number of Shares*	*Nature of allotment*
03/01/12	Promoters	500,000	Subscription at par
07/07/12	Promoters	600,000	Subscription at par
30/06/14	Promoters	1,100,000	Rights issue at 1:1 at par
25/08/14	Promoters	200,000	Subscription at premium of ₹5
30/03/15	VC1	600,000	Subscription at premium of ₹15
30/09/16	Promoters	400,000	Bonus Issue at 1:6

(*Contd.*)

	VC1	100,000	Bonus Issue at 1:6
31/10/16	VC2	100,000	Subscription at premium of ₹20
31/10/16	Promoters	400,000	Subscription at premium of ₹20
31/01/17	Promoters	200,000	Subscription at premium of ₹20
31/01/17	VC2	600,000	Subscription at premium of ₹20
31/01/17	HNIs	200,000	Subscription at premium of ₹20
31/03/17	***Total***	***5,000,000***	

- Issue requirements are as follows:
  - Promoters wish to subscribe to 1,000,000 shares in the issue.
  - VC1 wishes to make an offer for sale of its entire shareholding in the issue.
  - VC2 and HNIs wish to remain as shareholders after the issue.
  - The issue is made with reference to April 2017.

The recommended capital structure should comply with the above requirements as much as possible and be compliant with the provisions of the ICDR Regulations.

Suggested Brief Solution

Post-Issue Capital Structure		
	Shares%	
Promoters	4,400,000	62.26
VC1	100,000	1.42
VC2	700,000	8.49
HNIs	200,000	2.83
Public	1,800,000	25.00
Total	7,200,000	100.00

C.12 Problem on Issue Structure

From the following details pertaining to the proposed public issue of Arising Technologies Ltd., a telecom software company, prepare a suitable issue structure that would meet regulatory requirements.

The pre-issue capital consists of 1,000,000 shares are all held by the promoters.

- The total size of the issue would be 2,000,000 shares.
- Promoters seek to bring in a subscription of 200,000 shares in the issue.
- Sunshine Investments Plc., a registered FPI with SEBI, seeks a firm allotment upto 1,000,000 shares.
- Arising Dataware Ltd., a group company in which promoters hold 72%, seeks a firm allotment upto 300,000 shares.
- Two private equity firms, Megastar Group and Multistar Group seek firm allotments as may be permissible.
- Three domestic mutual funds seek firm allotments as may be permissible.
- The employees of the company and the group company seek firm allotments as may be permissible.
- The shareholders of the company and the group company seek firm allotments as may be permissible.

- Stone Technologies and Riverside Technologies, two vendors of software to Arising Technologies seek firm allotments to the extent permissible.
- Lark Issue Managers, the merchant bankers to the issue seek firm allotments to the extent permissible.
- Yellow Securities, a syndicate member and broker to the issue, seeks firm allotments to the extent permissible.
- The issue is proposed under the 100% book-built route and the company is eligible for the same.

If all the above categories of proposed investors need to be given reservations in the public offer instead of firm allotments, will the issue structure be different?

Suggested Solution

Issue Structure with Firm Allotments	*Number of shares*
Total Issue	2,000,000
Promoters contribution in the issue	200,000
Offered to the Public in terms of the Prospectus	1,800,000
No firm allotments to any category are permissible under the ICDR Regulations.	
Net Public Offer	1,800,000
Issue Structure with Permissible Reservations	*Number of shares*
Total Issue	2,000,000
Promoters contribution in the issue	200,000
Offered to the Public in terms of the Prospectus	1,800,000
Permissible Reservations	
Permanent Employees (5%)	150,000
Shareholders of unlisted Group Companies (if any) (10%)	200,000
Depositors, Bond holders or subscribers to services offered by the issuer if any (5%)	100,000
Net Public Offer	1,350,000

C.13 Problem on Issue Structure

From the following details pertaining to the proposed public issue of Arising Infrastructure Ltd., a road development company, prepare a suitable issue structure that would meet all regulatory requirements.

- The pre-issue capital consists of 1,000,000 shares held by the promoters (75%) and the JV partner Amazing Road Network Inc. USA (25%).
- The total size of the issue would be 2,000,000 shares.
- Promoters seek to bring in a subscription of 200,000 shares in the issue and the JV partners would like to bring in subscription to preserve their inter-se stake with that of the promoters.
- Sunshine Investments Plc., a registered FPI with SEBI, seeks a firm allotment upto 1,000,000 shares.
- Arising Bridge Corp Ltd., a group company in which promoters hold 72%, seeks a firm allotment upto 300,000 shares.
- Two private equity firms, Megarise Group and Multirise Group seek firm allotments as may be permissible.

- Three domestic mutual funds seek firm allotments as may be permissible.
- The employees of the company and the group company seek firm allotments as may be permissible.
- The shareholders of the company and the group company seek firm allotments as may be permissible.
- Stone Crushers and Riverside Sands, two vendors of software to Arising Infrastructure seek firms' allotments to the extent permissible.
- Bark Issue Managers, the merchant bankers to the issue seek firm allotments to the extent permissible.
- Brown Securities, a syndicate member and broker to the issue, seeks firm allotments to the extent permissible.
- The company proposes to make the issue through book-built route as it does not otherwise satisfy the eligibility criteria.

Suggested Solution

Issue Structure	*Number of shares*
Total Issue	2,000,000
Promoters and JV Partner's contribution in the issue	250,000
Offered to the Public	1,750,000
No firm allotments to any category are permissible under the ICDR Regulations. Reservations may be provided to permissible categories as per details furnished in previous solution Number14	450,000
Net Public Offer	1,350,000

C.14 Problem on Financial Ratios

From the following details, work out all the ratios required to be disclosed as the basis of the offer price in an offer document. The proposed issue is for 3,000,000 shares of ₹10 each at a premium of ₹110 per share.

Particulars	*Year 3*	*Year 2*	*Year 1*
Profit after tax	28,745,670	19,345,870	17,254,000
Dividends (incl tax)	25%	25%	30%
Share Capital in ₹(shares of ₹10 each)	70,000,000	60,000,000	50,000,000
Industry P/E	26	22	20
General Reserve	5,000,000	5,000,000	5,000,000
Securities Premium Account	2,500,000	1,400,000	500,000
Capital Redemption Reserve	2,500,000	2,500,000	2,500,000
Profit and Loss Account	28,045,540	16,799,870	12,454,000
Revaluation Reserve	2,000,000	2,000,000	2,000,000

Suggested Brief Solution

1. Adjusted EPS (for past three years)
   - (a) $Year_1$ ₹4.11
   - (b) $Year_2$ ₹3.22
   - (c) $Year_3$ ₹3.45
   - (d) Weighted Average ₹3.63

2. P/E Ratio in relation to Issue Price
   (a) Based on $Year_3$ EPS 29.33
   (b) Industry P/E
       Highest 26.0
       Lowest 22.0
       Average 23.0
3. Return on Net worth
   (a) $Year_1$ 24.49%
   (b) $Year_2$ 22.57%
   (c) $Year_3$ 26.61%
   (d) Weighted Average 24.73%
4. Minimum Return on Total Net worth after the Issue needed to maintain EPS at ₹4.11 8.77%
5. Net Asset Value (NAV)
   (a) As at end of Year ₹15.44
   (b) After Issue ₹46.80
   (c) Issue Price ₹120.00

C.15 Problem on Issue Price

1. From the following data, compute the floor price and cap for the IPO of Pavanjali Home Products Ltd.
2.

Pre-Issue Capital	750,000 shares
Earnings to Equity	₹9,675,000
Offer Price/EPS Required	25
Pre-Issue RONW	18%
Offer Price/BV	7
The floor price should be higher of the Offer Price/EPS or the Offer Price/BV	

Suggested Brief Solution

The required offer price per share is ₹501.67 and the cap is ₹602.

C.16 Problem on Cut-off Price

From the following details in relation to a 100% book-built IPO, work out the *least* and the *maximum* possible cut-off price for a 100% book-built offer. The floor price of the offer was set at ₹150 per share. There was no price band. The size of the issue was 10,000,000 shares.

Bid Price (₹ per share)	*Number of Shares*
250	200,047
225	934,878
220	4,876,992
215	6,324,475

(*Contd.*)

210	363,000
200	8,876,903
190	2,286,400
180	1,285,632
175	8,456,689
160	380,426
150	251,573

Suggested Brief Solution

The least possible cut-off price is the floor price of ₹150. The maximum cut-off price is ₹215.

C.17 Case on Issue Allocation

Fair Deal Supermart Ltd. is a retailing company with a chain of stores. It wishes to come out with an IPO of ₹150 crore comprising of shares of ₹10/- each. The company was set up six years ago at an initial investment of ₹1 crore subscribed entirely by the promoters at par. In the past two years, the company has grown tremendously making huge profits. The net worth of the company presently stands at ₹38 crore. Buoyed by its success, it is planning a major IPO that will take it to the next level of business. The management has heard from the market that it is an ideal time to go public and that their company can command a substantial premium. After talking to their merchant bankers, the company proposes to make an issue at an offer price of ₹200 per share either through the fixed price route or the book-built route.

Based on the above information, work out the issue allocation structure for the company' proposed IPO.

Suggested Brief Solution

Since the company wishes to make a fixed price or a book-built issue, it has to comply with all the primary eligibility conditions.

Issue Allocation	*Book-built*	*Fixed Price*
Total issue size (Number of shares)	7,500,000	7,500,000
Promoters	700,000	700,000
NPO	6,800,000	6,800,000
Allocation to QIBs (50%)	3,400,000	0
Allocation to HNIs (15%)	1,020,000	(50%) 3,400,000
Allocation to Retail Public (35%)	2,380,000	(50%) 3,400,000

C.18 Case on IPO Structure

King Kong Godzilla Ltd., is an Indian company engaged in the manufacture of high precision defence equipment including submarine and missile components for the defence requirements of various countries. The JV company is owned 51% by King Kong Technologies Ltd., a Hong Kong based listed company and 49% by Sitaram Godzilla Equipments Ltd., an Indian unlisted company. The JV was floated only for development of technologies for the defence sector business. The FDI is as per the current stipulations of the Government of India.

The company's fund structure is as follows:

Particulars	₹ *(crore)*
Share Capital Equity shares of ₹10 each	85
Reserves and Surplus	
Share Premium	152
General Reserve	23
Debenture Redemption Reserve	33
Revaluation Reserve	25
Capital Reserve (on merger of a group company)	52
P&L Account (Current Year)	64
Deferred Tax Liabilities	14
Long-Term Debentures	104
Current Liabilities	36
Total	588

(a) The company proposes to go for an IPO by offering 25% stake to the public as per SCRA regulations.
(b) The offer price is proposed to be finalised at an Offer-P/E of 22 or an Offer-BV of 3.5 whichever is higher.

You are required to compute the following:

1. The IPO issue structure table showing the issue price, number of shares on offer, permissible categories of reservation and NPO as per SEBI regulations.
2. The standard disclosures on basis of issue price to the extent of available information.

Suggested Solution on Issue Structure

Issue Structure with Permissible Reservations	*Number of shares*
Total Issue	28,333,333
Offered to the Public in terms of the Prospectus	28,333,333
Permissible Reservations	
Permanent Employees (5%)	5,665,000
Shareholders of unlisted Group Companies (if any) (10%)	2,833,333
Depositors, Bond holders or subscribers to services offered by the issuer if any (5%)	1,416,667
Net Public Offer	18,418,333

C.19 Case on IPO Structure

Given below are the particulars of Saawariya Infosystems, an unlisted cutting edge technology company with a path breaking product portfolio. It plans to go for an IPO to raise capital for its business plan and hires Sivaji Chiranjeev Capital, joint venture investment bank between Sivaji & Sons Ltd. and Chiranjeevi & Daughters Ltd. You are the Vice-President at Sivaji Chiranjeev Capital in charge of the assignment.

1. The Pre-issue capital was subscribed to in the following chronological order:

Particulars	
At formation of company through the MOA by the Promoter Group (Number of shares)	10,000
On 02-02-2011 (New allotment) at par to Promoter Group (Number of shares)	100,000
On 03-03-2012 (New allotment) at par to Promoter Group (Number of shares)	50,000
On 30-30-2012 (New allotment) at ₹20 per share to Jyotika Padukore Ventures (VC)	For a total consideration of ₹2,000,000
On 04-04-2013 there was a Rights Issue at 1:1 for ₹20 per share.	
On 05-05-2014 (Preferential Allotment) at ₹25 per share to Promoter Group	For a total consideration of ₹1,000,000
On 25-05-2014 New Allotment to Jyotika Ventures at ₹50 per share	For a total consideration of ₹1,000,000
On 06-06-2015 (For transfer of technology to company) at ₹30 per share to Promoter Group	For a lumpsum valuation of ₹7,500,000
On 27-07-2016 New Allotment to Ambarish Puri & Associates (VC) at ₹125 per share	
On 30-09-2016 there was a Bonus Issue in the ratio of 1:4 (one for every four held)	For a total consideration of ₹5,000,000

2. The issue is to be made as per the following objectives of the client:
   - The promoter group does not wish to participate in the IPO.
   - The company proposes to raise as much maximum capital as close as possible to a amount of ₹500,000,000.
   - The floor price of the issue would be ₹500 per share.
   - Jyotika Padukore Ventures wishes to exit to the extent of 50% of its holding pre-issue.
   - Ambarish Puri & Associates wishes to exit completely.
   - The company wishes to make the issue in the 100% book-building route.

   You are required to provide the following with respect to the issue with reference to the Floor Price:
   - *The capital structure table showing the pre-issue and post-issue capital structure.*
   - *The issue structure table showing the issue allocation.*

   Your answer should be in conformity with the regulations. Reference Date for the solution—April 2017.

Suggested Brief Solution[1]

Total Pre-issue Shares	1,012,500
Post-issue Shares (Maximum)	2,012,500
Maximum New Issue Size possible	237,500
Offer for Sale by Jyotika	137,500
Offer for Sale by Ambarish Puri	50,000
Total IPO	425,000

[1]This solution requires familiarity with additional provisions of the ICDR Regulations regarding promoters' contribution, lock-in requirements and rules regarding offer for sale by VCs. Those readers who wish to familiarise themselves with these requirements may refer to the relevant sections of the ICDR Regulations.

C.20 Case on Public Issue Structuring

You are Jimmy Issuewala, head of the merchant banking division of Indo American Capital Ltd., a leading provider of merchant banking services in India and in USA. One of your leading clients in India is Malaji Telefilms Ltd. headed by its Managing Director, Ms. Dekta Kapoor.

Malaji has tied up with Warner Sisters Ltd., a leading company in the entertainment industry in the USA to form a joint venture company called Warner Malaji Ltd. in India. The JV company proposes to offer quality entertainment in India through the television medium and has tied up with Moon TV, a satellite channel broadcaster to telecast its programs. The agreement with Moon TV envisages an engagement of five years during which, Moon TV would source its content exclusively from Malaji Warner.

To finance its business, Malaji Warner has proposed to come out with an IPO apart from other sources of financing. The summary financial plan is as follows:

Source	*₹ Million*
Promoters' Contribution	
Malaji Telefilms	500
Warner Sisters	300
Long-Term Loans	200
Public Issue	500
Total	**1500**

Ms. Kapoor has come out with the following specifications with respect to the financial structure of the company.

- The JV company should look at promoter equity of 75% post-public issue comprising of Malaji Telefilms and Warner Sisters.
- There should be a firm allotment in the issue to the extent of 20% of the total paid up capital of the company post-issue, in favour of Moon TV which has decided to invest in the JV company.
- Both the promoting companies are subscribing to the equity capital at a premium of ₹10 per share, i.e. at an issue price of ₹20 per share. Therefore Ms. Kapoor wants the issue to be priced at ₹20 per share.
- Ms. Kapoor has talked to Mr. Robert Burdoch of Star Capital, an FPI which wants to invest 20% in the issue at a price of ₹20 per share. Ms. Kapoor is excited about it and wants you to provide for the same in the issue.

You are required to make out an appropriate issue structure keeping in view the requirements of Ms. Kapoor and the ICDR Regulations.

Suggested Brief Solution

*Issue Structure**	*Number of Shares*
Total Issue 25,000,000 shares of ₹10 each at a premium of ₹10 per share	25,000,000
Promoters and JV Partner's contribution in the issue in the ratio of their holdings (as part of promoters' contribution)	8,750,000
Offered to the Public	16,250,000
There can be no firm allotments. Star Capital is eligible to apply in the compulsory QIB quota.	
NPO under 100% book-building**	16,250,000

** Under compulsory book-building route at the maximum assuming a cut-off price of ₹20 per share.*

** Minimum of 25% of the Post-Issue Capital of the Company of 65 million shares.

C.21 Case on Underwriting and Devolvement

Inspirational Enterprises Ltd. made an IPO through the 100% book-building route. The lead BRLM of the issue was Devotional Capital Markets Ltd., a leading investment bank. The co-lead BRLM was Emotional Capital Ltd. The issue also consisted of four other syndicate members, namely Conventional Securities, Inventional Securities, Dimensional Securities and Providential Securities. The issue was to raise a total amount of ₹2 billion in a price band of ₹200–220 per share. The issue was underwritten as follows:

	% of issue underwritten
Devotional Capital Markets Ltd.	25%
Emotional Capital Ltd.	10%
Conventional Securities	20%
Inventional Securities	15%
Dimensional Securities	10%
Providential Securities	20%

All the underwriters being eligible QIBs also put in their own subscriptions in the QIB component of the issue as follows:

	Number of Shares applied for
Devotional Capital Markets Ltd.	12500 shares at ₹220
Emotional Capital Ltd.	2500 shares at ₹200
Conventional Securities	5000 shares at ₹215
Inventional Securities	10000 shares at ₹212
Dimensional Securities	15000 shares at ₹216
Providential Securities	20000 shares at ₹220

The issue received a mixed response from the market. While the QIB portion was subscribed 1.70 times, the HNI portion was subscribed by 0.40 times. The retail portion was a disaster receiving a subscription of only 0.20 times. There were zero direct applications in all categories. Therefore, the cut-off price was fixed at ₹200 per share.

Based on the above information, compute the total number of shares, the subscription amount and refund amount if any, for each of the underwriters respectively.

Suggested Brief Solution

Underwriter	*Devolvement ₹*
Devotional Capital Markets Ltd.	10,000,000
Emotional Capital Ltd.	4,000,000
Conventional Securities	8,000,000
Inventional Securities	6,000,000
Dimensional Securities	4,000,000
Providential Securities	8,000,000

C.22 Due Diligence Review

Briefly furnish the check-list of information you would seek as the Lead Manager from your client for conducting Due Diligence Review for a proposed IPO.

C.23 Comprehensive Case on Public Issue

Golden Harbour Films Ltd. (GHFL) is in the entertainment industry producing telefilms, feature films, post-production facilities and marketing and distribution of films. The main promoter, *Mr. Raymond Crow* is a very successful producer having made several block-buster movies in the past such as *'Enter the Canyon'* and *'For Your Ice Only'*. With a view to expand their business to other segments and broad base their infrastructural facilities, GHFL plans to come out with a public issue as an IPO to finance the expansion plan. Mr. Crow is of the view that his company could command a significant premium in the market because of its track record and therefore wants a 100% book-built offer. You are the Vice President (Merchant Banking) of Truce Lee Managers Ltd. who has been appointed as Merchant Bankers to the proposed Issue. The following particulars have been given to you in this regard.

1. The company has been making profits in the last five years continuously in the past three years and net worth of more than ₹100 lakh during that time.
2. The present shareholding pattern of GHFL is as shown below:
   (a) *Mr. Crow and Associates – 78%*
   (b) *Mr. Jackie Fan –16%*
   (c) *Mr. Random Lee – 6%*
   (d) The total share capital is ₹100 lakh divided into shares of ₹10 each.
3. The proposed issue is for a size of ₹1000 Lacs at the minimum and ₹3000 lakh at the maximum. Mr. Crow has adequate plans to justify the expenditure for an issue size between the above limits.
4. The company had the following financials at the end of the previous financial year (2017).
   (a) Sales from production and distribution – ₹1200 lakh
   (b) Income from distribution services – ₹700 lakh
   (c) Income from post production services – ₹2000 lakh
   (d) Gross profits before Depreciation and Financial Charges – ₹1638 lakh.
   (e) Interest and Financial Charges – ₹540 lakh
   (f) Depreciation – ₹320 lakh
   (g) Tax provision – ₹233 lakh
   (h) Net Fixed assets at the beginning of the previous year – ₹2342 lakh.
   (i) Stock of films under development – ₹365 lakh
   (j) Distribution receivables pending realisation – ₹500 lakh
   (k) Cash and Bank Balances – ₹220 lakh
   (l) Post Production equipment purchases during the year – ₹269 lakh.
   (m) Advances given for films to be produced to artists – ₹219 lakh
   (n) Payments pending to producers – ₹285 lakh
   (o) Stock of films pending production – ₹200 lakh
   (p) Unpaid Stock of films and equipment – ₹245 lakh
   (q) Long-Term Loans – ₹1200 lakh
   (r) General reserve – ₹345 lakh.
   (s) Accumulated P&L Account – ₹842 lakh.

4. Mr. Crow wants minimum dilution of his stake in the company post IPO. To this end, he has arrived at an arrangement with the other two partners to buy off their stake at a pre-determined priced based on the book value of the share as at the end of the previous financial year. The agreed price is at a premium of 10% over the book value of the share. Mr. Crow wants to complete this transaction before going for the IPO.
5. You are required to compute the following with respect to the issue:
   (a) The valuation of share for the acquisition to be made by Mr. Crow of the shares held by the other two partners.
   (b) The Floor Price of share for the proposed IPO based on the **lower of** twice the Book Value or 12 times the Current EPS as at the end of the previous financial year as per the above data.
   (c) The standard financial ratios to be furnished as per SEBI requirements and the calculations thereof.
6. Provide the Issue Structure Table incorporating the following:
   (i) The Issue size and number of shares on offer.
   (ii) 10% of the Issue to be firmly placed with Hong Kong and Shanghai Bank.
   (iii) 10% reserved for allotment to Foreign Portfolio Investors on competitive basis.
   (iv) 10% reserved for the employees of GHFL.
   (v) Mr. Crow wants to bring in an additional 5% in the Issue at the proposed offer price.
   (vi) The balance will be offered to the public.

Suggested Brief Solution

The valuation of share for the acquisition to be made by Mr. Crow of the shares held by the other two partners is ₹*201.50*.

The Floor Price of share for the proposed IPO based on the **lower of** twice the Book Value or 12 times the Current EPS as at the end of the previous financial year as per the above data is ₹*366* per share.

Financial Ratios
- EPS = ₹54.50
- RONW = 29.74%
- NAV per share pre-issue = ₹183.20
- NAV per share post-issue = ₹265.50
- Minimum RONW on increased net worth required to maintain pre-issue EPS = 20.53%

Brief Issue Structure Table

Share Capital	*Nominal Value ₹*	*Aggregate Value ₹*
Present Issue 819000 shares of ₹10 each	8,190,000	299,754,000
Out of the Present Issue 5% amounting to 40950 shares at a premium of ₹356 are reserved for firm allotment to the promoter Mr. Raymond Crow and his associates	409,500	14,987,700
NOW OFFERED TO THE PUBLIC IN TERMS OF THIS PROSPECTUS 696,150 shares of ₹10 each at a premium of ₹356 per share	6,961,500	254,790,900

C.24 Problem on Buyback of Shares

From the following data, compute the residual DER of Zinda Pharma Ltd. after its proposed buyback of shares. Decide whether the buyback meets the requirement or not.

Pre-Issue Capital	1,000,000 shares
Pre-Issue Net worth	₹225,000,000
Proposed Buyback	25%
Proposed Buyback Price per share	₹400
Present DER	0.87

Suggested Brief Solution

The post buyback DER works out to 2.07 which is not permissible under company law requirements. The value of proposed buyback is also in excess of allowable limits.

C.25 Case on De-Listing of Shares

From the following data, decide whether the de-listing offer of Muhammad Alibaba Ltd. can be successful or not and at what price it would be successful.

Total Issued Capital	1,250,000 shares
Controlling Shareholders	42%
Floor Price fixed for De-listing Offer	₹520 per share
Bids received at ₹540 per share	8%
Bids received at ₹560 per share	5%
Bids received at ₹590 per share	7%
Bids received at ₹600 per share	14%
Bids received at ₹650 per share	6%
Bids received at ₹700 per share	3%

Suggested Brief Solution

The de-listing offer is not successful as the cumulative shareholding of the controlling shareholders even at the price of ₹700 per share is 85% which falls short of the mandatory minimum.

C.26 Case on Venture Capital Investing

Fairfield Digital Systems Ltd. is a technology creation company in the space of animation, graphics and other media software. The company was set up by its dynamic founder Mr. Prabhat Chandra three years ago. In these three years, the company has grown from start-up stage with an initial investment of ₹1,000,000 to its present position where the book value of its share is ₹28. All this growth has been achieved through internal generation without any further equity investment by the founder.

With a view to accelerate its growth, the company is looking out for first round financing from venture capitalists. The latest financial details of the company are presented below:

1. The current EPS = ₹6.70
2. Fund requirement at this round of financing = ₹50 million
3. Mr. Chandra does not wish to dilute more than 26% of his equity in the company at this round.

Digital Capital, a VC firm has shown interest in investing in the company subject to the specified dilution requirement of Mr. Chandra. However, the VC has stipulated that the proposed offer price per share shall not exceed 5 times the post-issue book value of the share.

Based on the above information work out the pre-money and post-money valuation along with the offer structure that meets the above requirements.

Suggested Brief Solution

Pre-money Valuation ₹	142,307,692
Post-money Valuation ₹	192,307,692
Stake Offered to Digital Capital	26%
Proposed Offer Price ₹Per Share	1,423
Amount to be raised ₹	50,000,000
Offer Price / Post Issue Book Value (times)	3.64

C.27 Problem on Buyback

From the following particulars based on the latest available financials, determine the eligible quantum of buyback of shares of Reverse Engineering Ltd., a company engaged in automotive component manufacturing.

Particulars	*Amt ₹*
Paid-up equity capital	8,000,000
800,000 shares of ₹10 each	
Preference Capital 500,000 shares of ₹10 each.	5,000,000
Reserves and Surplus	
General Reserve	5,000,000
Share Premium Account	2,000,000
Capital Redemption Reserve Account	2,500,000
Profit and Loss Account (retained earnings)	1,000,000
Debenture Redemption Reserve	500,000
Long-term borrowings exceeding one year (incl. debentures)	25,000,000

The company's current EPS is ₹4.50 and the market price is ₹55. The company paid a dividend of 10% on its equity for the year under consideration. It proposes to make the buyback at ₹75 per share.

Based on the current year's financials work out the impact on the EPS, RONW and Book Value of the equity share of the company assuming that the buyback offer is successfully completed.

Suggested Brief Solution

Number of Shares bought back	46,933
Residual EPS ₹	4.78
Residual RONW	28.85%
Residual Book Value per Share ₹	16.57

C.28 Case on QIP and Preferential Allotment

The following data is available with respect to God's Own Country Travels Ltd., a company engaged in providing pilgrimage services.

Balance Sheet Data		*Amount in ₹Million*
Paid Up Equity Capital (Share of ₹10 each)		750
5% Redeemable Preference Capital		250
10% Secured Non-Convertible Debenture Capital		2000
Accumulated Profits and Revenue Reserves (brought forward)		3000
Capital Reserve (cash)		200
Capital Reserve (Non-cash)		150
Current Liabilities (8% interest bearing)		200
P&L Data		
EBITA (for current year)		1500
Depreciation for current year		300
Applicable tax rate	30%	
Equity dividend Proposed	10%	
Other Relevant Information		
DCF Value per share based on future financial forecast (₹)	300	
Current P/E trading multiple	17	
Average 26 week multiple	19	
Average 2 week trading multiple	15	

The company proposes to go in for a convertible debt structure of ₹500 million and convertible preference structure of another ₹500 million to raise capital to the extent of ₹1 billion.

The debt structure would be a 10% non-convertible debt with equity warrant. Each warrant entitles the applicant to apply for an equity share within 3 months at a conversion price based on the SEBI formula or the DCF value whichever is greater.

The convertible preference structure would consist of 5% preference share convertible into equity after 12 months at the rate of one equity share for every preference share held at a conversion price based on the SEBI formula or the DCF value whichever is greater.

Using the above information, you are required to compute the following:

(a) The number of new equity shares and the expansion in the equity capital of the company post conversion of warrants and preference shares.

(b) The EPS and Book Value of the Company post-issue on a fully diluted basis.

(c) The SEBI price applicable to the conversion price in two scenarios: (i) Preferential allotment and (ii) QIP.

(d) The debt-equity ratio of the company immediately after the issue of the convertibles.

Suggested Brief Solution

Assumed Face Value of Preference Shares ₹10 each and convertible debentures of ₹100 each.

Total Equity Shares post issue (fully converted)	130,000,000
EPS fully diluted ₹	6.24
Book Value fully diluted ₹	157.78
SEBI price per share for Preferential allotment ₹	224.53
SEBI price per share for QIP ₹	177.26
DER pre- issue	0.50
DER post-issue	0.12

C.29 Case on Transaction Pricing

The following data is available with respect to Trombone Energy Ltd., a company engaged in the generation of power and manufacture of transmission and electrical equipment.

Balance Sheet Data		*Amount in ₹ Million*
Paid Up Equity Capital (Share of ₹10 each)		750
10% Redeemable Preference Capital		250
12% Secured Non-Convertible Debenture Capital		2000
Accumulated Profits and Revenue Reserves (brought forward)		3000
Capital Reserve (cash)		200
Capital Reserve (Non-cash)		150
Current Liabilities (8% interest bearing)		200
P&L Data		
EBITA (for current year)		1500
Depreciation for current year		300
Applicable tax rate	30%	
Equity dividend Proposed	20%	
Other Relevant Information		
DCF Value per share based on future financial forecast (₹)	300	
Current P/E trading multiple	17	

(*Contd.*)

Average 26 week multiple	19
Average 2 week trading multiple	15
IPO issue price per share (2 years ago) ₹	150
Listing Price ₹	178

Using the above information, recommend the appropriate pricing for the following transactions:

(a) A FPO by the company within the limits fixed by SEBI under the general eligibility criteria for a FPO.
(b) A Rights offer
(c) A QIP offer
(d) A GDR issue with a conversion ratio of 1:1
(e) A PIPE offer to a large private equity fund for a 26% stake and for the consequent Open Offer following such acquisition.

Suggested Brief Solution

	₹ *per share*
FPO	170–185
Rights	160
QIP	200
GDR	170–185
PIPE	250–260

C.30 Problem on GDRs

Carrot Capital Management, Singapore has invested in 1 million GDRs of Billion India Developers Ltd. a leading software company. The GDRs representing shares in the ratio 3:1 were bought at a price of S$ 26.5 per GDR in 2010. The company subsequently made a rights issue of its domestic shares (excluding the GDRs) at 2:1 in early 2011. Thereafter a sponsored issue of GDRs was made in the second half of 2011 in which Carrot invested in two more million GDRs at a price of S$ 32.5. Subsequently Carrot applied for a FII registration with SEBI and invested in one million shares in the Indian market at ₹1905 per share in 2012. In 2013, the company's domestic share was trading at ₹3905. Sensing an arbitrage opportunity, Carrot applied for the conversion of its entire GDRs into shares. Thereafter, it sold 50% of its holdings in the domestic market at ₹4205 per share. Compute the average carrying cost of the holding with Carrot and its market value in ₹. Consider (1 S$ = ₹65).

Suggested Brief Solution

Carrot's holding in shares after conversion and sale in domestic market-1,000,000 shares at an average cost of ₹3,648 per share.

C.31 Case on Growth Financing Through QIP and FCCBs

Silverstone Media Solutions Ltd. is a listed Indian company engaged in the business of providing high-end animation, special effects and graphic designing for the entertainment industry. It has over the years produced technical solutions for several mega blockbuster movies such as *'Mckenna has Cold'*, *'Truncator'* and *'Day after Yesterday'*. In order to get into front-end movie production, the company decides that it has to raise significant amount of equity capital through private equity and other means. It appoints Morgan Stealthy Securities, a reputed investment bank to advise and structure the transaction.

The transaction has to be through a combination of a domestic QIP and privately placed FCCBs in the foreign capital market since the company has several business connections in the west that can be tapped for the placement. The FCCB component is envisaged at 25% of the total issue. The other details that are relevant for the transaction are provided hereunder:

1. Present Capital Structure of the Company

Shareholder	*Percentage held*
Promoter Group	*46%*
QIBs	*18%*
Chime Warner (strategic partner)	*12%*
General Public	*24%*

2. The company was listed in 2007 at ₹110 per share through a book-built IPO with a cut-off price of ₹90 per share. Thereafter it has performed steadily and has been quoting at an average P/E of 28 in the preceding 6 months which can be reckoned for the purpose of statutory computations. The company declared a PAT of ₹150 million on an equity base of ₹20 crore for the previous financial year.
3. The fund raising required by the company is in the order of ₹100 crore through the present transaction. The company can look at a variation of around 15% to this requirement either way.
4. Chime Warner wishes to increase its stake through the FCCB route by subscribing to 10% of the total issue. The earlier stake was acquired prior to the company's IPO.
5. The company wants only a combined offer of a domestic QIP of pure equity with an overseas component of FCCBs. It is not in favour of FPO, Rights or a Preferential Issue. The company is of the view that the QIP route offers more flexibility to structure the convertible as compared to FPO, rights or preferential issue.

   Based on the above information, as part of Morgan Stealthy you are required to provide the optimum transaction structure that would be in line with what is stated above. Needless to say your solution should also recommend the ideal pricing for the issue of both the equity and the FCCB. Your answer should be in conformity with the relevant regulations.

Suggested Brief Solution

QIP and FCCB pricing considered identically at 200 per share since both are happening simultaneously.

Total issue size for QIP and FCCB considered at ₹100 crore with an upward variation of just over 15%. Therefore, total issue size is 50 lakh shares.

Shareholding Pattern Post QIP and FCCB		
	Shares	*Stake*
Promoter Group	9,2000,000	37%
QIBs	7,337,500	29%
Chime Warner	2,526,250	10%
General Public	4,800,000	19%
FCCB Holders	1,136,250	5%
	25,000,000	**100%**

C.32 Case on Financing Strategy

Systech Infosoft Ltd. is a listed company in India. It made its IPO in 2007 and has since been quite an active scrip with reasonable volume of trades. Its IPO price was ₹35 (10+25) and thereafter it has seen a high of ₹150 in the boom period and a low of ₹16 in the 2008 meltdown. The average 26-week price is ₹40. The promoters of the company are businessmen with varied interests in trading of HDPE sacks, bulk export of hospital beds, surgical instruments and cotton. The company is professionally managed by software experts.

The issue facing the company is as follows:

- The company requires to get into value added segments which require fund infusion of about ₹250 million, out of which ₹50-60 million would go into development of a proprietary product for hospital inventory management. Due to the related background of the promoters, the company expects to sell this product to several hospitals globally. The balance fund requirement is to ramp up the office infrastructure and seed marketing expenses for the new segments.
- The promoters can muster about ₹50 million in all. Their present holding in the company is 45%. The rest is held by Mutual Funds (20%), FIIs (5%) and the general public (30%).
- Looking at the present position, what financing strategy would you recommend as the company's investment banker?

Solution

Since this is an analytical case, no solution is being suggested. It is intended that readers should debate the case and come up with their own recommendation based on their understanding of the subject and its application in the given case.

C.33 Case on Financing Strategy

Georgio Kirmani Ltd. is a listed company in India. It made its IPO in 2007 and has since been quite an active scrip with reasonable volume of trades. Its IPO price was ₹35 (10+25) and thereafter it has seen a high of ₹180 in the boom period and a low of ₹16 in the 2008 meltdown. The average 26-week price is ₹110. The promoters of the company are businessmen with varied interests in trading of HDPE sacks, bulk export of hospital beds, surgical instruments and cotton. The company is professionally managed by a CEO reporting to the board.

The issue facing the company is as follows:

- The company requires getting into value added segments which require fund infusion of about ₹500 million, out of which ₹100 million would go into development of a proprietary product for hospital inventory management. Due to the related background of the promoters, the company expects to sell this product to several hospitals globally. The balance fund requirement is to ramp up the office infrastructure and seed marketing expenses for the new segments.
- The promoters can muster about 10% of the fund requirement in all. Their present holding in the company is 45%. The rest is held by Mutual Funds (20%), FPIs (5%) and the general public (30%).

Looking at the present position, what financing strategy would you recommend as the company's investment banker?

Solution

Since this is an analytical case, no solution is being suggested. It is intended that readers should analyse the case and come up with their own recommendation based on their understanding of the subject and its application in the given case.

C.34 Case on Subsidiary Listing

New Millennium Technologies Inc. (NMT Inc.) is based in San Jose, California engaged in providing cutting edge solutions on real time basis for utilities such as water supply, electricity and transportation companies. The company has its main back office operations and development centre in India in Noida and Bangalore. The Indian operations have been structured as a 100% subsidiary called New Millennium Technologies (India) Ltd. (NMT Ltd.).

Due to its high growth business model, there is a need to ramp up the Indian operations. Plans are also on the anvil to make NMTL the hub for providing similar solutions to the Indian and SAARC market. All this would require fund raising to the extent of around ₹1 billion. About ₹750 million is required for capital expenditure on infrastructure facilities and the balance for one time technology development costs. NMT Inc does not want to pump in any further investments into the Indian operations. It feels that NMT Ltd. could become self-sufficient in raising funds by going public in India.

The investment made by NMT Inc in NMT Ltd. is so far to the tune of ₹250 million. The topline of NMT Ltd. is around ₹1.5 billion and the profits are in the range of ₹300 million. The company has been in operation for the past four years. The first two years were loss making but the next two years have produced profits of ₹100 million and ₹300 million respectively.

NMT Inc is listed on NASDAQ. It went public in 2006 at a price of $11.25 per share and thereafter touched a high of $28.00 towards middle of 2007. It had an all-time low of $6.78 on September 15, 2008 and generally remained below offer price for the better part of 2012. In the past four years, the trading has been of average volumes. The average 52-week price hovers around $25.00.

You are Mr. Goldman Sachs, investment banker to the group in USA and in India. What would your recommendations for the IPO strategy of NMT Ltd. be in the context of the given information?

Solution

Since this is an analytical case, no solution is being suggested. It is intended that readers should analyse the case and come up with their own recommendation based on their understanding of the subject and its application in the given case.

C.35 Case on Split-up Strategy

Titanic Industries Ltd. is a diversified company with interests in dredging, operating deep sea fishing trawlers, exports of sea-food and operating trans-oceanic passenger cruise liners. The company wishes to split-up its various businesses and look for independent growth strategies or exit options as may be found feasible.

You are part of Rose Advisors, an investment bank retained by Titanic. Your mandate is to prepare a concept paper on the methods available to break-up the company, the implications of each such method and the process involved as relevant to the given case. Your paper should be based on current Indian law.

Solution

Since the solution is a concept paper, no solution is being suggested. It is intended that readers should analyse the case and come up with their own recommendation based on their understanding of the subject and its application in the given case.

C.36 Case on Restructuring

Bermuda Triangle Shipping Ltd. (BTSL) is a company headquartered in Mauritius engaged in the business of merchant shipping using trans-ocean freight and passenger liners. It has four vessels namely, MV Armageddon, TS Titania for container freight transportation and two luxury liners called BV Cafetaria and UV Mesopotamia for passenger services. In addition, BTSL also runs an entire tourism business centre known as *Mauritania Tours and Travels* as a separate division which caters to travel and tourism services for tourists visiting Mauritius.

It also has a 100% subsidiary in India by name *Golden Quadrilateral Shipping Pvt. Ltd.* (GQSL) which is engaged in inland water transportation services for cargo in India. GQSL owns a 100% subsidiary by name *Pentagon Services Pvt.* Ltd. for handling clearing, freight forwarding and inland road transportation including logistic services for cargo. It owns another 100% subsidiary as well by name *Rhombus Tours and Travels Pvt. Ltd.* for conducted tours, travel agency, car rentals and other tourism related services for tourists and passengers.

With a view to aligning the business verticals more appropriately, BTSL has initiated a process of restructuring the group operations. The task is to achieve a vertical split between cargo and passenger related businesses such that all cargo oriented businesses in Mauritius and India are held together and on similar lines, all passenger related businesses are consolidated.

In order to achieve the above objective, BTSL has mandated *Circular Advisers*, a boutique i-bank specialising in restructuring mandates. As part of Circular Advisers, advise on the strategy for the group restructuring so as to achieve the stated objective by examining various split up and consolidation options that are available. Your strategy should optimise tax efficiencies and reduce execution complexities.

Brief Solution

Since the solution is to prepare a strategy outline, no solution is being suggested. It is intended that readers should analyse the case and come up with their own recommendation based on their understanding of the subject and its application in the given case.

C.37 Case on Demerger

Andaman & Nicobar Ltd. has two divisions: Andaman division is into tourism related business with its own passenger vessels, transport vehicles and other infrastructure. Nicobar divisions is into hospitality sector operating several hotel and resort properties. With a view to have better focus and growth, the company proposes to demerge the Nicobar division into a separate company. After consultations with investment bankers, it was proposed that a demerger would be the ideal transaction. However, there is also a proposal from another hospitality group to buy a 50% stake in Nicobar at a premium of 200% to its book value. Based on the company's combined balance sheet furnished below, you are required to arrive at the separate balance sheets of the demerged and the resultant companies and to compute the purchase consideration receivable from the buyer for the 50% stake in Nicobar.

Amount in ₹ (crore)

Liabilities	*Andaman*	*Nicobar*	*Total*	*Assets*	*Andaman*	*Nicobar*	*Total*
Share Capital Equity shares of ₹10 each			120	Net Fixed Assets	382	1146	1,528
Reserves and Surplus Share Premium General Reserve P&L Account			 752 122 117	Intangible Assets			44
Long-Term Borrowings	168	670	838	Current Assets	120	317	437
Current Liabilities	88	204	292	Deferred Revenue Expenditure			232
Total			**2,241**	**Total**			**2,241**

Brief Solution

Nicobar would have a demerger reserve of ₹533 crore and a book net worth of ₹633 crore. The acquisition price to be paid by the proposed acquirer works out to about ₹950 crore (₹949.50 crore).

C.38 Case on De-subsidiarisation

Fission Impossible Inc (FI Inc) is a cutting-edge technology company located in Maryland, USA which specializes in medical research concerning human genome science. It has a 100% subsidiary in India for data analysis and clinical studies by name Fission Impossible II India Pvt. Ltd. (FI II). The Indian subsidiary was set up in 2008 and has been capitalised entirely by the parent thus far. The paid-up capital of FI II is ₹150,000,000 consisting of 15,000,000 shares of ₹10 each. FI II bills the parent for its services and all its additional funding requirements are met through loans from the parent.

In early 2012, the US FDA directed FI Inc to initiate a process of de-linking itself from its subsidiary to address certain conflict of interest and ethical issues in the research and commercialisation process. As per the requirements, FI Inc. has to reduce its stake in FI II to 15% and take back all of its loan funding by the end of 2013. Pursuant to it, FI Inc has initiated a process to carve out its stake in FI II. It has also decided to take back all the loans funded to the subsidiary and outstanding as of date amounting to $ 25,000,000. This is proposed to be done through an IPO initially and thereafter go for either a PIPE or a QIP as may be found appropriate. They have retained the services of Lethal Solutions, a global full service i-bank. The scheme of de-subsidiarisation and separation of the two companies prepared by the i-banker for the approval of the respective Boards of FI Inc and FI II, outlines the following roadmap:

- FI II will go for a book-built IPO in February 2013 with a 35% carve out from the parent through an offer for sale of 25% and a 10% new issue. The pricing range proposed for this purpose is about ₹250 per share translating into an offer price multiple of 24 based on 2012 earnings.
- The funds raised by FI II will be used towards reducing the debt of the parent.
- After six months from listing, the company proposes to make a PIPE placement / QIP at the statutory price applicable to such placement. Keeping in view the current market trends, it is expected that the company will quote at a P/E of 30 in the first six months. The PIPE / QIP should be made to the extent necessary to repay the balance debt of the parent company subsisting in the books of the subsidiary post-IPO.

- At the end of three months from the QIP, the parent company will sell off a major portion of its balance stake held in the subsidiary through a negotiated sale to an Indian strategic partner so that its stake in the subsidiary comes down to 15%. The proceeds thereof will be repatriated by the parent so as to place the subsidiary at arm's length distance from itself in compliance with US FDA requirements.

You are Bell Gibson, the lead transaction expert, New York practice at Lethal Solutions. Prepare the strategy paper as per the above outline to be presented to the boards of the two companies, disclosing at each stage the transforming capital structure of FI II, funds to be raised/proceeds realised from sale of shares and the computations of how the separation is to be achieved. Needless to say, your solution should examine the applicability of the extant SEBI Guidelines to the above transaction and the implications thereof so as to be compliant with Indian law.

All transactions are to be completed in FY 2013. The company's accounting year ends in December. FY 2012 earnings can be referenced for all computations. Assume exchange rate at $ = ₹50 for all computations.

Suggested Brief Solution

	Shares
Post Public Offer shareholding in FI II	
FI I Inc (65%)	11,250,000
Public	6,057,000
Post PIPE Structure	
FI I Inc (58%)	11,250,000
Public (31%)	6,057,000
PIPE shareholders (11%)	2,154,400
Post Negotiated Sale	
FI I Inc (15%)	2,919,210
Public (25%)*	4,865,350
Strategic acquirer (60%)*	11,676,840

** The Takeover Code is triggered by the negotiated purchase due to which a 26% mandatory offer is required. Post offer, the acquirer will have 69% and the public holding will fall 16%. To keep the company listed, the acquirer will need to sell back 9% in the secondary market.*

C.39 Case on Restructuring and Fund Raising

Die Hard Ltd. (DHL) is a company engaged in cutting edge technology relating to stem cell research in India. Sixth Sense Ltd. (SSL) is also an Indian company engaged in the emerging sphere of nanotechnology and has come out with a new technology platform code named as *'What Lies Beneath'*. Both the companies are presently unlisted. In order to commercialise its technology, SSL's Chief Executive, Mr. Hari Puttar has been on the lookout for a strategic investor. On the other hand, DHL's Chief Executive Mr. Hare Rama has been on the lookout for a company with specialised technology platform for complementing its research. Hari and Hare have been in talks and have agreed in-principle to a transaction leading to the unification of their operations under the name OSO Technologies Ltd. (OTL).

In order to achieve the above objective, both the CEOs have requisitioned the services of Singh & King, a leading investment bank. S&K has been advised to keep the following transaction objectives in mind before suggesting the deal structure:

- SSL has to raise funds to the tune of atleast ₹1 billion (₹100 crore) before the formation of OTL so as to have enough cash for its technology operations.
- There has to be a gap of 12 months between the fund raising by SSL and the formation of OTL so as to allow SSL to show results on the proposed investment.
- The formation of OTL has to be cash neutral for DHL.
- OTL will be taken public after its formation in such a way that the investment made in SSL has to be recovered from the public issue.

Based on the above objectives, S&K have suggested the following deal structure, which was approved both by Hari and Hare:

- At the first stage, there would be a preferential allotment by SSL to DHL to raise the least amount required by SSL.
- Thereafter, there would be a spin-off of the shareholding held by DHL in SSL.
- After 12 months, SSL would be merged with DHL under the pooling method. The merged entity will be renamed OTL.
- Upon its formation, OTL will come out with an IPO which would include an offer for sale by the shareholders of the erstwhile DHL of the relevant part of their total shareholding (pertaining to the investment in SSL) so as to encash the earlier investment made by DHL in SSL.

You are Hari Bhajan Singh, President–Transaction Advisory at S&K. You have been furnished the following details to work out the deal structure as approved by your client. You are required to formulate the following:

- The Deal Structure Table with step-by-step details including the post-IPO capital structure of OTL with all the necessary computations.
- Provide the Issue Structure Table for the IPO of OTL that would conform to the relevant statutory guidelines.
- The type of offer that you would recommend for OTL and reasons therefor.
    1. Capital Structure of SSL: The present capital structure of SSL is a total issued capital of 10,000,000 shares of ₹10 each held by Promoters (60%), Obak Barama Capital, a US based VC (22%) and Kaif Sareena Ventures, an Indian VC (18%).
    2. Capital Structure of DHL: The present capital structure of DHL is a total issued capital of 50,000,000 shares of ₹10 each held by Promoters (72%) and Farah Stalin, a strategic investor (28%).
    3. Valuation of SSL: The valuation agreed to for the preferential allotment to DHL in SSL is ₹80 per share.
    4. Valuation of SSL and DHL: The share swap ratio for the merger of SSL with DHL was agreed at 1:5.
    5. IPO Pricing: The proposed pricing for the IPO of OTL has been estimated at not less than ₹325 per share.

Suggested Brief Solution

Post-Spin-off shareholding of SSL	
Promoters of SSL	6,000,000
Obak Barama	2,200,000
Kaif Sareena Ventures	1,800,000
Promoters of DHL	9,000,000
Farah Stalin	3,500,000
	22,500,000

Post-merger shareholding of DHL (OTL)	
Promoters of SSL	1,200,000
Obak Barama	440,000
Kaif Sareena Ventures	360,000
Promoters of DHL	37,800,000
Farah Stalin	14,700,000
	54,500,000

Post-IPO shareholding of OTL	
Promoters of SSL	1,200,000
Obak Barama	440,000
Kaif Sareena Ventures	360,000
Promoters of DHL	35,584,615
Farah Stalin	13,838,462
Public	16,694,423
	68,117,500

C.40 Comprehensive Case on Corporate Restructuring

East India Manufacturers Ltd. (EIML), is a diversified company with four manufacturing divisions. These are the irrigation and farm equipment division (farm division), diesel pump sets division (pump sets division), tractor manufacturing division (tractor division) and automotive components division (component division). The company has a long history of existence and grew over the decades from just a component manufacturer to a multi-dimensional manufacturer catering to all requirements in agricultural mechanisation.

The company is presently at the cross-roads. Having grown just depending on market opportunity over the years, the management finds that there is a need to have an eye on the future and go in for a comprehensive restructuring due to the following reasons:

- All the divisions of the company are not performing identically because of which the overall corporate financial performance is below the desired levels. The farm division and component division have been growing and performing well in the past six years with average growth rates of 12%–15% per year. This is because, the in the farm sector there has been a push by the government for mechanisation and banks have been aggressive in coming forward to finance farm equipment purchases by farmers. There is a need to expand this division in the near future.
- In the component division, the company has found new customers with the automobile industry booming and several product launches in the recent past. A long-term contract with one leading auto manufacturer for the supply of cylinder blocks and cylinder heads established the company firmly in the OEM business. It is exploring other such contracts, some of which are close to finalisation.
- The tractors division has remained more or less flat over the years with declining margins in the past few years. Though the volumes have remained steady, with the introduction of new manufacturers and

improved models, the competition has become intense. The company finds that it will not be able to sustain this business profitably unless it looks for new technologies, restructure operations and modernize the existing assembly lines. The induction of a strategic partner at this stage looks imperative. The company has been negotiating with Koyoka Corporation, a Japanese tractor company for a JV tie-up and the talks have been fruitful. However, valuation of this division has become a vexed issue. Though the divisional financial statements and future financial model are available, both the managements have not been able to attain common ground on the valuation approach.

- The pumpset division has been the most worrisome area for the company with mounting losses year on year. The technology has become out-dated and customer complaints on the sub-standard performance of the pumpsets have been increasing. The company does not have an effective after-sales service network which is adding to its problems. The company also does not have any product launches on the anvil while competitors have brought in latest generation electric pumpsets. The management is of the view that this business is not a core business and that the company should get rid of it without further delay to cut losses.
- The company is listed and the core promoters hold about 38% equity. The rest is distributed among QIB investors (27%) and the public (35%). The market price has been showing a declining trend due to serious concern about the company's loss-making pump set division and the under-performing tractors division. The weak sentiment in the market in the past six months has not helped matters either. The company's share price performance is furnished below.

Period		*High*	*Low*
Month 6 (latest)			
	Week 4	87	77
	Week 3	89	78
	Week 2	92	80
	Week 1	95	82
Month 5			
	Week 4	97	86
	Week 3	97	89
	Week 2	98	90
	Week 1	100	92
Month 4			
	Week 4	103	96
	Week 3	109	101
	Week 2	107	98
	Week 1	113	102
Month 3			
	Week 4	109	106
	Week 3	115	110
	Week 2	119	107
	Week 1	118	112

(*Contd.*)

Month 2			
	Week 4	126	119
	Week 3	140	131
	Week 2	139	126
	Week 1	133	130
Month 1			
	Week 4	148	147
	Week 3	152	145
	Week 2	155	148
	Week 1	156	147

- On the financing front, the company requires to infuse capital to finance its requirements in the farm division and component division. The company has raised significant debt in the past few years to fund its component division's long-term contract. The present debt-equity ratio is high at 1.70:1. For meeting the additional financing requirements of the farm and component divisions at this stage, the company requires to infuse equity financing to the extent of around ₹100 crore. QIB investors are interested to look at a QIP especially since the company is attractively priced at the moment. The core promoters do not propose to bring in any further equity due to financial constraints. However, they are not sure of the pricing strategy to be adopted for the QIP.

The company has called on you as the investment banker advising the company for a comprehensive restructuring and financing strategy plan. Discuss the plan in three distinct components as follows:

- The financing plan through a QIP placement with a detailed pricing strategy and justification thereof.
- The alternative choices available for conversion of the tractors division into a JV with Koyoka Corporation, Japan. The valuation approach that would be appropriate for the said conversion should form part of the strategy plan.
- The methods available for disposal of the loss-making pump set division and the implications thereof on the company.

Your recommendations should take into account the regulatory provisions as may be applicable and address tax issues and efficiencies as well.

Solution

Since this is an analytical case, no solution is being suggested. It is intended that readers should debate the given alternatives and come up with their own recommendations based on their understanding of the subject and its application in the given case.

C.41 Case on Strategic Acquisition

Galat Modi Ltd., is a leading manufacturer of cricket bats and other sports equipment in India and is a supplier for the prestigious ITL T-2 tournament in India. Badmashi Company, is a Japanese sports equipment manufacturer and a leading supplier to the Common Stealth Games. With a view to sharing common wealth, Galat Modi plans to offer a strategic stake of 26% to Badmashi.

Badmashi Company proposes to acquire the stake from the promoters of Galat Modi. However, they are told that this could trigger the Takeover Code since Galat Modi is listed. Therefore, the promoters of Galat

Modi suggest that Badmashi Company should go in for a preferential allotment. However, Badmashi is not agreeable to pay the same price since the shares would be subject to a lock-in. Galat Modi now proposes to go for a rights issue with renunciation by the promoters in favour of Badmashi. However, they are not able to resolve the issue of shares to non-promoters and the overall pricing policy.

Since the deal has entered a dead lock, the services of Mr. Kaju Rao, a M&A banker with Satyam Bailout Capital, a leading investment bank. As Kaju, recommend a transaction structure justifying the interests of both parties and the company.

Brief Solution

Since this is an analytical case, no solution is being suggested. It is intended that readers should debate the given alternatives and come up with their own recommendations based on their understanding of the subject and its application in the given case.

C.42 Case on Divestiture

Avaricious Capital Ltd. (ACL) is a global buy-out fund. Malicious Business Partners (MBP) is a specialist corporate acquisition company. Delicious Hospitalities Ltd. (DPL) is a long-standing, listed and profit-making hospitality services company. The promoters of DPL hold about 63% of the company. The rest is held by the public.

DPL receives an offer from ACL to buy out the entire promoters' stake and make a de-listing offer to the public to acquire the balance and de-list the company. At the same time MBP makes an offer to buy 51% of the promoters' stake and make an open offer under the Takeover Code. MBP also wants to take the company private at a later date through a de-listing offer to be made jointly by MBP and the existing promoters in such a way that eventually they hold the company mutually in the ratio of 76:24 respectively.

The promoters of DPL are now confused about the implications of these two offers. They have therefore retained Ferocious Securities Ltd., an aggressive investment banker. You are Confucius, the chief strategist at the investment bank. Making suitable assumptions with regard to pricing, etc. make a comparative analysis of the implications of the two offers from the following three separate perspectives:

(a) The promoters of DPL (b) The company (c) The public shareholders of DPL

Brief Solution

Since this is an analytical case, no solution is being suggested. It is intended that readers should debate the given alternatives and come up with their own recommendations based on their understanding of the subject and its application in the given case.

C.43 Comprehensive Case on Private Equity, IPO, Acquisition, Buyback and De-listing

Unlucky Ali is the MD and CEO of beetle.com, a web based portal company that specialises in online services and related businesses. The company was incorporated in October 2008 and raised its first round of financing in February 2009 through a Venture Capital firm called Charishma Capital for an amount of ₹15 crore by diluting 30% of the promoter holdings. Subsequently, a second round financing was done in October 2009 by Charishma and another VC by name Carona Capital to the extent of ₹40 crore for a 40% stake in the company. The company subsequently went public in August 2010 for an issue of ₹45 crore offering 30% to the public.

The financing details and shareholding pattern from the setting up of the company till the conclusion of the IPO are shown below:

Financing	*Shareholding Pattern*
Seed Stage Entirely subscribed by Unlucky Ali ₹10 shares at par amounting to ₹5 crore	Unlucky Ali 100%
First Round Charishma Capital finances ₹15 crore ₹10 shares at premium	Unlucky Ali 70% Charisma Capital 30%
Second Round Charisma Capital finances ₹10 crore Carona Capital finances ₹30 crore ₹10 shares at premium	Unlucky Ali 60% Charisma Capital and Carona Capital together hold 40%
IPO stage ₹45 crore raised through the public with a 30% dilution ₹10 shares at premium.	Unlucky Ali, Charisma Capital and Carona Capital together hold 70% Public holds 30%

The company has not had a good performance record since its inception. The online services did not take off in a big way and the company's product offerings on the portal have been taking time to catch up with the potential customers. The company's revenue projections from products, services, endorsements and advertisements did not materialize to a significant extent and therefore, the company closed its first three financial years ending March 2009, 2010 and 2011 making losses. When the company went for its IPO in 2010, it had to go through the book building route as it did not have a profit track record and minimum net worth. In May 2012, the market price of the company's share is quoting below par.

In October 2012, a strategic investor by name A.R. Suleiman approached Unlucky Ali and expressed his interest in the company. Unlucky Ali held a series of discussions and understood that the entry of Suleiman can turn the company around. Subsequently, the modalities for the acquisition were discussed and it was proposed that Suleiman would buy out the entire stake held by Charisma Capital giving them a 20% premium over their cost of acquisition.

Since the company was making losses, Charisma Capital was glad to make an exit at a premium of 20%. Coming to know of this development, Carona Capital also expressed the desire to exit the company. It was therefore decided that after Suleiman's acquisition was completed, immediately the company would announce a buyback of shares to the extent of those held by Carona Capital and the public. As a result, the company would get de-listed and be held mutually between Unlucky Ali and A.R. Suleiman.

To put the whole plan into action, Unlucky Ali summoned the services of Mr. Shankar Hariharan, the CEO of Colonial Advisors Ltd., a reputed investment bank. In order to advise Ali, Shankar has deputed you to do the following:

1. Prepare the Capital structure statement of the company from the seed financing stage till the IPO stage showing at the end of each stage of financing:
   (a) the cumulative paid up capital in ₹Lakh
   (b) the cumulative number of shares issued of ₹10 each
   (c) the cumulative share premium collected by the company
   (d) shareholding pattern showing individual % of shares held by each investor in the company

2. Calculate the total % stake to be acquired by A.R. Suleiman from Charisma Capital and the consideration to be paid for it in ₹Lakh based on the agreed formula.
3. To examine whether A.R. Suleiman's acquisition would trigger off the Takeover Code and in which case, consider the open offer before the company makes the proposed buyback.
4. To examine whether the buyback proposal is feasible and if so, the total % of capital that can be bought back by the company in its proposed buyback. If the buyback is not found feasible, to suggest alternative means necessary to achieve the stated objectives.
5. The final shareholding pattern between Unlucky Ali and A.R. Suleiman after all the proposed transactions are completed.
6. The proposed transaction date with reference to the above plan is January 2013.

Suggested Brief Solution

Shareholding Pattern at the time of IPO	
Unlucky Ali	42%
Charisma Capital	20.50%
Carona Capital	7.50%
Public	30%
A.R. Suleiman acquires 20.50% of Charisma Capital's stake for ₹	30 crore
The routes available for the completion of the balance acquisition by A.R. Suleiman are not being discussed herein since that would defeat the purpose. Readers may explore them on their own.	
Shareholding pattern after the process is eventually completed	
Unlucky Ali	42%
A.R. Suleiman	58%

C.44 Comprehensive Case on Acquisition

Planet Hotels and Resorts Ltd. (PHRL), is a well-established hotel and luxury resorts chain enjoying an excellent brand reputation in the five-star and luxury hotel category. Over the years, the company set up seven leisure resorts under the resorts division to cater to the needs of the luxury tourism segment and has met with considerable success. The company has a share capital of 200,000,000 shares of ₹10 each and is held 46% by the existing promoters, 28% by QIBs and the rest by the general public.

While the top management is driving the luxury hotels and resorts businesses adequately to capitalize on the existing economic boom, it is also seriously eyeing the budget hotel category so as to become a full-service hotel company and broadbase its business model. The management also believes that the budget category business is a volume play and more stable in the long term. Since the company is performing strongly at present, the management is of the view that the time is opportune for it to diversify into the related segment while growing the existing strongholds. Moreover, the company even has a strong cash position to look at a suitable acquisition without setting up the budget hotel business on its own.

With the above background, the company started looking out for opportunities that may be available to enter the budget hotel segment through the inorganic route. The management identified a company called Fringe Hotels Ltd. (FHL), a listed company in the budget hotel category with a repertoire of ten well-performing hotel properties in prime cities. After a preliminary due diligence, PHRL concluded that FHL would be a good strategic fit in all respects. FHL, which has an issued and paid up capital of 50,000,000 shares of ₹10 each, is controlled 38% by the promoters, 32% by QIBs and 30% by the general public. The share price of FHL is currently ruling high at ₹187 due to the generally strong sentiment in the market and more so in the case of the hotel industry.

The management of PHRL has identified the following alternatives for the acquisition of FHL keeping in mind that the cost of the acquisition would be quite high at this point of time:

- Acquire 25% from the secondary market and make an open offer for 26% of FHL under the Takeover Code. Assuming the plan goes through successfully, this would give PHRL a 51% stake in FHL. The existing promoters would continue to hold 24% and the public would hold the balance of 25%. PHRL also believes that subsequent to the open offer, it can adopt the creeping acquisition route to buy a further stake either from the market or from the existing promoters to the extent permissible under law, thereby consolidating its position as the single largest shareholder in the company.

The management feels that as far as the process till the open offer is concerned, it is reasonable to expect that the overall cost of the acquisition would be at a price that would be 30% more than the current market price of ₹187 per share of FHL because of the price reaction that would happen after the secondary market purchases are begun and the subsequent public announcement is made.

- The second available route is to negotiate with the existing management of FHL for a strategic stake of 24% through the preferential allotment route. Based on market enquiries made by PHRL, they have come to understand that FHL is looking to raise equity capital and would not be averse to a strategic investment by a stronger hotel chain. The management of PHRL believes that they can as a part of the investment, seek a board seat on FHL and affirmative rights in key decisions. This way, the disadvantage of having a minority stake can be addressed for the present. Gradually, PHRL can consolidate using the creeping acquisition route or the substantial acquisition route as the case may be. Under this alternative, PHRL believes that the cost of the acquisition would not be more than 10% of the current market price of FHL.
- The third route is to negotiate with the promoters of FHL for a friendly takeover. PHRL believes that though FHL is doing well, the promoters may eventually sell out if the right price is offered considering the wave of consolidation happening the industry. PHRL believes that a deal could be struck for the promoters to sell-off 28% of their stake and retain a minority stake of 10%. This way they would also benefit as investors in FHL in future. PHRL will also buy another 6% immediately from the secondary market. Since this would trigger the Takeover Code, assuming the open offer goes through, PHRL will end up with a dominant stake of 60% in FHL.

Under this route, the management of PHRL believes that they will have to pay control premium to the promoters of FHL which they estimate would take the acquisition price per share upto 50% more than the current market price.

- The fourth option for PHRL is to explore the possibility of a merger of FHL with itself. The management of PHRL feels this can be put through with the existing promoters of FHL and other shareholders by convincing them that vertical growth could become tougher for stand-alone budget hotel companies without linkages to other segments of the industry. The benefits of being strategic shareholders in the consolidated company could also be a better position in the future for the promoters of FHL. As far as the shareholders of PHRL and the market are concerned, they are also expected to take the merger positively and approve the same resulting in a higher market valuation for PHRL. Based on initial homework, the swap ratio could be 1:2.5 (one share of PHRL for every 2.5 shares held in FHL).

You are the investment banker engaged by PHRL to advise them on the preferred strategy among the alternatives provided above. You are required to deliberate on each of the above strategies and come up with your recommendations. The strategic interests of PHRL and the cost efficiency of the transaction should form an integral part of your analysis.

Solution

Since this is an argumentative case, no solution is being suggested. It is intended that readers should debate the given alternatives and come up with their own recommendations based on their understanding of the subject and its application in the given case.

C.45 Case on Acquisition Defence Strategy

Skyfell Technologies Ltd. is into the business of building design solutions for bridges, flyovers and airports. The company was started by the design engineering team of Daniel Frog and Sean Mockery. The company clocked revenues of ₹126 million for FY 15 and is on the road to reaching 150 million in FY 2016. It registered an EPS of ₹4.20 for FY 2015 on an issued capital of 12.6 million shares. The company was ill-advised by investment bank Worthless Capital which got the company listed in 2014 when the markets were depressed. The company is suffering from a bloated equity base and depressed valuation even after the markets have corrected. Its current shareholding pattern is as follows:

- Promoters and PAC: 22%
- FIIs: 14%
- DIIs: 21%
- Distributed public shareholding: 43%

The promoters are worried that due to their low holding, the company is an attractive target for a hostile bid by rivals who may be larger with better financial resourcefulness. The promoters and PAC have no further finances to protect their position. Therefore, they have now approached Ruthless Advisors, a specialist M&A advisory firm for help.

Outline the defence approach to be taken in the given circumstances as may be possible under Indian law and regulation with suitable justification and workings. Make assumptions as may be found necessary.

Solution

Since this is a discussion case, no solution is being suggested. It is intended that readers should debate the given situation and come up with their own recommendations based on their understanding of the subject and its application in the given case.

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