Legal Compliance for Incorporating Startup

Prof. Indrajit Dube
Department of Humanities and Social Sciences
Indian Institute of Technology, Kharagpur

Lecture - 19
Types of Instruments for raising the fund

I welcome you in Lecture 19 regarding Legal Compliance for Incorporating Startup, and I am in the Model of Financing and Legal Compliance. And to be more specific I am going to talk with you Types of Instruments for raising the fund. And when I am using this particular what type of instrument for the raising of fund you possibly you can understand that I am already talking about the companies, because if you remember my first lecture in this particular module I have said that which organization can access what kind of fund, and when you are using the word the raising the fund or instrument using raising the fund we are basically indicating either a private placement or primary market.

And this particular type of fund or this two particular type of market only can access by the companies not by any other organization; so what about the discussion which we are going to do relating to the raising of fund or which of the instrument it is basically for the companies.

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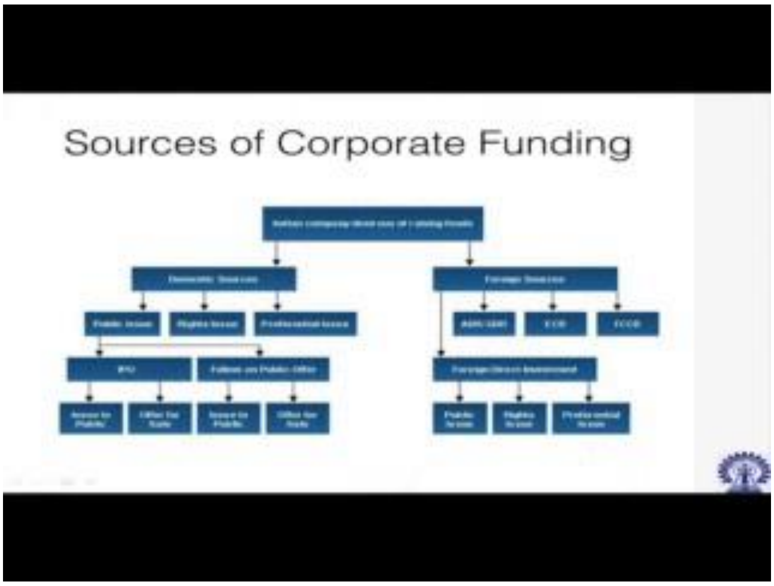

Now, I have a provided a diagram here this is not made by me but I have taken from somewhere else, wherein it indicates that what sources Indian company may raise the fund or rather it basically indicate the places from where we can go for raising the fund. And if you look into this particular diagram it is distinctly divided into two categories. One is the domestic source and other is the foreign source. So, let me explain to you first the domestic source and then I will come to the foreign source. Now in case of a domestic source you can for a public issue and which I was discussing with you in detail in the previous I mean next lecture I am going to talk with you in detail. In the public issues you will find there is a two kind of issue is possible; one is initial public offer and other is a follow on public offer.

Now, under the initial public offer again you will find this is a issue to the public, that means you basically make an allotment to any people who are shown their interest to subscribe your shares or you know it can be offered for sale; an offer for sale is generally happen through the issuing houses. Whereas, again in case of a follow up public offer that means you have already gone to the public issue and then you wanted to again go to market to raise the further capital. When I am talking here a market please do remember this is a primary market so in that case also again you can go to issue the public or you might go for offering the sale through the issuing house. Now issuing house at those particular houses that basically help in case of the small issue, that means you basically allot all the issues to one or two houses and they in terms going to sale this particular share based on certain terms and condition to the public.

Now, apart from that you can do the right issue. Right issue means whoever is holding the shares in your company you generally again issue some number of shares to them in proportion. That means if he is holding a one share you can issue two shares to that particular person. So, it is one is to two kind of a ratio you might get or you know there can be a preferential issues. Preferential issues are generally happen for a particular group of people mainly those people who are in the management, so you wanted to give kind of a preference to this particular people by issuing a number of shares. But even it might happen to the financial institutions also who has made the investment in your company and you need the further fund and you want to visit through these particular preferential issues.

Now, when we are talking about this IPO and follow up public offer please remember this can be for any kind of instrument now which we have discussed in subsequent part of my lecture; that means it can be either a equity shares or it can be a preference shares, it can be debentures, it can be bonds, it can be even the deposits, whatever the instrument you use for this raising this capital. Now when we are talking about the foreign source there is a lot restriction for accessing the following foreign source.

Now in the case of the foreign source the first thing is that you can go for a foreign direct investment. Now foreign direct investment again it can be through the public issue, right issue, preferential issues and this is guided by again your effective regulation, that means foreign institutional promotion board or it might be through the RBI regulations or it might be even the capital market regulatory also prescribes some kind of regulation.

So, wherein the foreign investor basically bring the fund and make an investment in your company and there you can go for all this kind of issue either it can be a public issue, right issues or preferential issues. Like, if they wanted to increase their stake, if they wanted to go for refinancing this particular company or they wanted to bring debt investment for further particular project or may be addressing the need for the immediate fund requirement, so in those particular cases they can go for any one of them.

Apart from that there is a concept called ADR or GDR which is basically known as depository receipt. By issuing this particular depository receipt you can again access the foreign market, and I am going to discuss about this ADR and GDR little later part of my lecture today. This is the full form of ADR is American Depository Receipt and the full form of GDR is Global Depository Receipt. Now there can be ECB; that means External Commercial Borrowing these are basically in form of debt or there can be FCCB; that means this is again a form of debt and wherein you basically want to raise not the equity part you raise the capital through the debt instrument.

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Now, let me take you to the next point of the discussion is what are the capital instrument. Now capital instrument can be divided in two broad categories; one is the equity shares and another is preference shares. Now equity shares are those shares who actually have a right over the management, that means if you are holding the equity shares then in that case you have right to vote, the moment you have right to vote that means you can elect that who will be in the board of directors of this particular company. That means, equity share holders are generally having a management director over that particular company.

Now again equity shares can be a generally equity or it can be differentially equity. Now general equity means it is the same class of people, that means you will get a one vote at the sometime there will be fixed rate of dividend. Now when you are talking about differentially equity in that particular case it might valid the putting right might vary as well as you know the equity payment of the dividend also varies, but there is some kind of a restriction. That means you can only issue the differential equity after you are continuing in some number of years in a market before that you cannot issue the differential equity.

But, you will find that in India still differential equity did not really accepted very nicely by the investors. So, you will find a very few companies generally go for issuing these particular differential equity. Now in the preference share you will find these particular shares generally get a preference in the payment of the dividend, at the sometime at the time of winding up they get the preference relating to payment of the capital back. So, they are little different form the equity shares, but the one thing is that they do not have a voting right in general working of the company or general management of the company unless they there is some specific issues which is affecting right of the preference shares holder.

So, again preference shares can be divided into a four category. It can be redeemable preference shares, it can be cumulative preference shares, it can be non cumulative preference shares, and it is a participatory preference shares. Now when I am talking about redeemable preference shares; that means all the preference shares after some point of time you need to be redeem, that means you need to pay back the money which you have raised through this particular preference shares and then you have to take that particular preference share back. So, that is what called redeemable preference shares.

Now cumulative preference shares means where there is a fixed rate of a dividend has been promised and that particular dividend keep on accumulating if there is a declaration of the dividend or even if there is a no declaration of the dividend in a particular year and then if you are going for a next year then you have to pay back those particular year dividend. That means, if you are not paid a dividend in previous year you need to pay that particular dividend the next year when you are paying the dividend through the share holder.

Now, non cumulative means it do not cumulate, that means dividend do not cumulate. And when we are talking about the participate preferential share it means that you are going to get the normal rate of dividend as it is promised at the time of issuing of this preference shares, but in addition to that if anything is being left out after making the payment to the equity share holders then that might be distributed or you might be allowed to participate in similar manner as the equity share holder got this particular dividend

So, these are the capital instrument which you might use for raising this particular fund. Now while you are going to issue this particular instrument please do consider about the management control, please do consider about what you are cost of the fund that means what you are getting by making an investment in this fund or you sharing a more dividend or more profit to the investors or you know is it going to be a beneficiary for you in terms of a development. Sometimes you should remember that if you are not chose a right instrument for your organization it might create a financial (Refer Time: 12:52) for you because you might be paying more than whatever you should pay as a startup.

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Then the next aspect of capital instrument which we have a discussed before is a convertible debenture. Convertible debenture is basically a mixed of debt instrument as well as equity instrument. That means you initially issue this particular instrument as a debt instrument, but you give the option that after completion of the specific time period the person who is holding the instrument he has option to exercise to convert the particular instrument as the equity in instrument or continue at a debt instrument. So that is the reason it called a convertible. So, you can convert this particular debt instrument into the equity.

Now this is quite good for private equity fund or maybe the debenture capital is or may be the institutional investors, because if they are not sure initially that how you are going to grow in the market or you have enter into a market which is not yet define or you are you know by created a very (Refer Time: 14:11) in a particular market and they are not sure about how market is react over your venture. Then in that case they generally prefer to make an investment through this particular convertible debenture, because an initially it is secure because it is a credit instrument that means it is a debt instrument so there is a kind of charge which they can create by subscribing this particular instrument on your asset.

And at the same time when you are growing or if you are going for IPO they can capitalize over this particular instrument by issuing the by selling it in the open market once this particular IPO is settled or you have gone to the secondary market. Now, again as I have talked with you a little before relating to the global deposit receipt; global deposit receipt are basically used for accessing the market future beyond America, that means any other international market expect the America we generally use the global deposit receipt and this is mainly for the European countries we use this particular global depository receipt.

Now depository receipt means you are basically issuing your equity to a custodian and the custodian in terms issuing the depository receipt against the equity which you have issued and that particular depository receipt in terms is been listed into that particular market where it is been issued. So, it is issued actually in the primary market. So, anybody can subscribe this particular instrument in that particular primary market and they can again sell this particular instrument into that the secondary market which is been listed in that market.

So, global depository receipt actually helped in transporting the fund from one jurisdiction to another jurisdiction in a most surface manner. Please do remember this is also important because many of the country are not capital convertible, that means you can really did not able to bring the raw money from one country to another country. That means, if you wanted to bring Euro in India you are not allowed to do that, because India is not a capital convertible country.

So, in that circumstance you possible need to have a global depository receipt to be issued. Now the mechanism of American depository receipt is also the same, but it is only issued in case of America and it is issued only in American Dollar. So, again there custodian issue the depository receipt and that particular depository receipt is subscribed by the investor in the primary market and this particular depository receipt are listed in a stock change and then they a can be traded to that particular stock exchange.

So, in both the cases of either global depository receipt or American deposit receipt the market liquidity is very high. And now it is you will find in an Indian regulator are giving a more right to this particular depository holder like they have allowed to (Refer Time: 17:46) by this particular depository holder in selection of the board member or like in a share holder in the domestic jurisdiction. So, popularity of this particular instrument are increasing over the years and Indian companies will find more and more going to the overseas market to accessing the cheap fund which is already available or which is already stacked in somewhere and they wanted to access those particular thing.

Now, India also started with this own depository receipt called Indian Depository Receipt that means some of the foreign company are accessing the Indian market to raise their fund. This is the basically (Refer Time: 18:28) and India has also defined this how and what condition this Indian depository receipt can be issued to the foreign company in Indian market.

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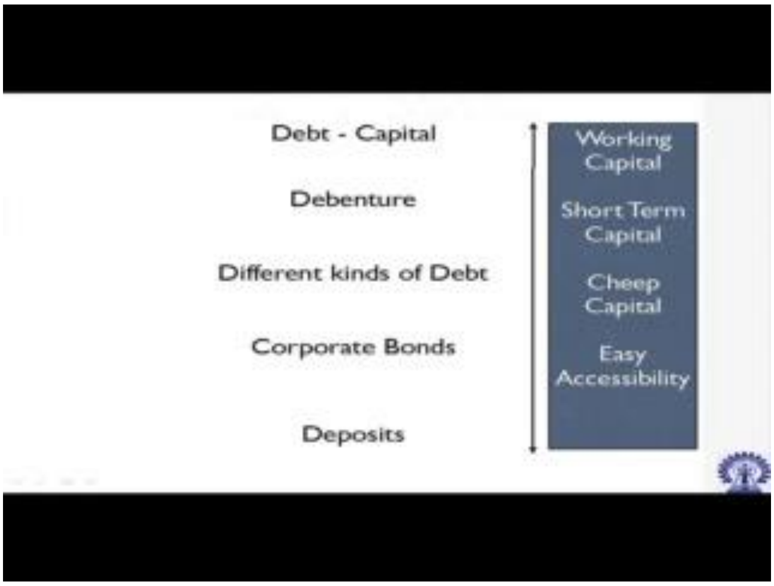

Now let me take you to next slide which is talking about the debt instrument or the debt capital. Now it comprises of debentures different kind of debt corporate bonds and the deposits. Now debt capital are generally raise by the people for the working capital or the short term capital or if they wanted to have a cheap capital or easy accessibility of this particular capital then they generally go for a debt capital. Now debt can be raise directly from the financial institution which I have talked with you or you might go to the primary market or even through the private replacement you can raise this particular debt.

Interesting part in case of the debt instrument is that you have a lot of flexibility to design around. So, if somebody asks you that how many types of debt instruments are available in Indian market possibilities is very difficult to count it, even people keep on innovating in the date market like let me give you some example. Like, there is DIB discount bond. Now in DIB discount bond what you do? You generally issue this particular instrument in a highly discounted rate may the cost of the instrument is 10 Rupees and you are issuing that particular instrument in 2 Rupees.

But at the time of the majority you are going to pay the full amount of this particular value of the instrument or face value of the instrument. You are going to pay the 8 Rupees against the 2 Rupees which you have taken as an investment. And this is a unsecured debt, that means it is not creating any charge over the access of this company. So, you will find best on the requirement which you have in that particular segment or type of the risk which you have in the business you can keep on designing this particular instrument. And that is where the debt instrument is quite popular and in generally people raise this particular instrument for the short term or for the working capital.

So, what also people also try to find out that it should be cheaper in compare to the equity, because in case of the equity if you were issuing you cannot redeem the equity or you cannot take it back the equity after certain part of time. So, what you need to do you need to keep on paying the dividend until that particular person is going to sell that particular equity if you are going for the buy back and buy back also not a easy job, it is a very difficult job and you need to follow certain rules for the buy back.

Now, buy back means where the company is purchased his own equity from the secondary market. Now that is in case of the debt this flexibility is there, if you think that well now we do not require that particular debt you can pay back that particular debt after completion of that particular certain time and it is actually address your name whatever you require at that particular point of time. So, in some cases corporate also allow to issue the deposits and this are known term deposit, that means for a specific period of time the deposit is issued by the corporate to the people and on the majority you can get the principle as well as the interest on that particular deposit.

Now, as I have talked with you there convertible instruments are getting more and more popular today and there are a number of convertible instruments which you are finding in the market today.

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And this convertible instrument may be the convert of preference shares to the equity shares, because as I told you that in case of preference shares you do not have a voting right wherein the case of equity shares you have a voting right or even you might earn on more against your investment. Because if the dividend are generally paid higher in case of the equity share holding compare to preference share holder, because preference share holder generally get the equity in a specific amount which is not so in case of equity share holders.

Now there is a convertible equity you can find. Convertible equity is a generally you know if they are giving some kind of a specific right like management right in terms of differential equity or there can be a other specific kind of right which is attached with this specific equity or there can be some class of the equity which can be issued with the permission of the regulator to a specific group of people. Similarly, there can be a convertible bond and preference shares and there can be bond with the management rights. Now this bond with the management rights is very uncommon and it is basically privated by the Companies Act at present.

But you will find when this public financial institutions are making a huge investment through this particular bond they basically try to ensure kind of right over the management like if there is a major decision has been taken by the management relating to the change of the business or restricting of the business then in that case they need to go back to this financial institutions or the bond holder and they need to take the permission from this bond holder. So, even though this is not allowed in voting right is not allowed, debenture is not allowed to issue the voting right but you will find some kind of negative right has been infused today through the process of the agreement while they are issuing this particular debentures.

So, These are the basically the different form of the debenture which instrument which you will found and which will generally people use for raising the fund from the primary market or through the private replacement or through the negotiated investment which I have discussed in the last lecture.

Thank you.