Economics, Management and Entrepreneurship
Prof. Pratap K. J. Mohapatra
Department of Industrial Engineering & Management
Indian Institute of Technology – Kharagpur

Lecture - 49
Capital Financing

Good morning, welcome to the 49th lecture on economics, management and entrepreneurship. If you remember towards the end of the last lecture we in fact started the topic. We started the discussion on capital financing. So there we said that any company would require money to fund it is fixed assets and working capital assets. For that it requires funds. Thus funds can be of a long term nature, a medium term nature or a short term nature and there are different forms of fund and there are different sources of fund.

In our last slide in the last lecture, we were discussing about private and public sources of capital. This was the last slide.

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Public/Private Sources of Capital

Public capital are raised through securities that are

- ***offered*** to the public through an offer document filed through ***Securities Exchange Board of India (SEBI)***
- ***traded*** in public through secondary markets such as *National Stock Exchange (NSE)* and *Bombay Stock Exchange (BSE)*

Private capital is raised through

- loans from bank and financial institutions
- securities privately placed with a small group of investors like private equity funds, venture capital firms, financial institutions, insurance companies, mutual funds, and wealthy individuals.

And we said that when money is raised through securities through the public or from the public then it has to go through the government procedure and the SEBI is the body through which all these public offerings are made. Whereas one can also go through private capital, private means of raising capital through banks, from banks and financial institutions and also by issuing securities to be placed privately with a small group of investors.

This was what we discussed in our last class, we will continue our discussion and we will see that there is a whole gamut of sources of financing capital for any enterprise. Now there are different stages of a company.

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Patterns of Funding

A. Company Formation Stage:

(i) Issue of equity shares to the promoters
(ii) Loan from banks and financial institutions
(iii) Shares and debentures to the relatives, friends, business partners, employees, financial institutions, banks, mutual funds, and venture capital funds

B. Major Growth Stage of the Company

Capital from public
- First issue is called ***Initial Public Offering (IPO)***
- Subsequent offerings – ***Seasoned Offerings***

There are different requirements of funds. At the formation stage issue of equity shares to promoters is normally made those who promote the starting of an enterprise. They are entitled to get the equity shares, also loan from banks and financial institutions are obtained. In addition, the company can go for shares and debentures to the relatives, friends, business partners, employees, financial institutions, banks, mutual funds and venture capital funds.

Now when the company is in the growth stage normally capital is sought from public, the first issue is called the initial public offerings and subsequent offerings are normally called seasoned offerings or secondary offerings.

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Financing with Common Stock

Equity shareholders collectively own a company.

They enjoy the rewards and bear the risks of ownership.

Liability is limited, however, unlike an entrepreneur or partners.

Equity shareholders enjoy right to income, right to vote, and pre-emptive rights (priority to buy new shares), and right in liquidation (last priority).

Let us study financing with common stock or equity funding. Equity shareholders collectively own a company as we have already seen, the real owners of a company are the equity shareholders. They enjoy the rewards and also bear the risk of ownership, but as you know the liability is limited unlike an entrepreneur or a partner whose liability is unlimited as we have already discussed.

Equity shareholders enjoy right to income, right to vote and they get priority to buy new shares when they are issued by the company and of course they have the last priority when the company is liquidated, so this is a because their owners they get the last priority.

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Advantages of Common Stock Financing

1. It is a permanent capital without any liability for repayment.
2. No obligation for payment of dividends.
3. It enhances the creditworthiness of the firm.

Disadvantages of Common Stock Financing

1. The cost of capital is very high, the rate of return expected by the shareholders being very high.
2. Dividends are not tax-deductible.
3. Cost of issuing equity stocks is high (underwriting commission, brokerage costs, etc.)
4. Sale of equity stocks dilute the control of the existing shareholders.

The advantages of common stock financing are many. Firstly, it is a permanent capital without any liability for repayment, no obligation for payment of dividends only when the

board of company decides to pay the dividends, the dividends are paid else not and therefore it enhances the credi2rthiness of the firm. Whenever the company wishes to get money from banks or financial institutions then it has higher credi2rthiness.

Of course there are certain disadvantages, usually the cost of issuing of capital is very high and the rate of return expected by the shareholders is also high. Dividends are not tax deductible by the company. When they pay dividends taxes are also paid by them. Cost of issuing equity stocks is high that I have already told because of underwriting commission, brokerage costs et cetera.

Sale of equity stocks dilute the control of the existing shareholders. These are the disadvantages.

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Financing with Preferred Stock

1. Dividend is not an obligatory payment (payment is entirely within the discretion of directors)
2. Dividends are a fixed percentage of the share's par value.
3. Dividends are not tax-deductible.
4. Dividends, if unpaid, at some time cumulate and are paid later.
5. Claim of the stockholders is prior to the claim of the equity stockholders.
6. Normally the stockholders do not have right to vote.
7. The firm can call the shares, wholly or partly, at a certain price.
8. Shareholders can convert to equity shares at a certain ratio.
9. Preference shares may be perpetual or redeemable.

When the company goes for financing with preferred stock then there are certain characteristics. Firstly, dividend need not be made, is not obligatory, it is entirely within the discretion of the directors. Dividends are a fixed percentage of the share's par value whenever they are paid. Again dividends are not tax deductible. Dividends if unpaid at some time cumulate and are paid later.

And when liquidated the claims of the stockholders is prior to the claim of the equity stockholders. The equity stock holders have the last priority in getting their money back when the company gets liquidated and the preferred stockholders have a higher priority, but these

stockholders do not have the right to vote. The firm can call the shares wholly or party at a certain price.

Shareholders can convert to equity shares at a certain ratio if the firm so desires and preference shares maybe perpetual or redeemable. Redeemable means the company can buyback the preference shares or perpetual means it can continue.

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Advantages of Preference Stock Financing

1. No legal action if dividends are not paid.
2. Being part of the stockholders' equity, it enhances the creditworthiness of the firm.
3. There is no dilution of control because of no voting right.
4. No mortgage.

Disadvantages of Preference Stock Financing

1. It is expensive, because dividends are not tax-deductible.
2. Skipping payment of dividends can damage the firm's image.

The advantages of preference stock financing are that no legal action if dividends are not paid and being part of this stockholder's equity it enhances the credi2rthiness of the firm and because there is no voting right the control is not diluted and unlike bonds or debentures there is no mortgage. The disadvantages could be that it is expensive, because they are not tax deductible. Skipping payment of dividends can damage the firm's image.

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Borrowed Funds

- Long-Term Bonds (or Debentures)

- Term Loans (or term finance)

Now if on the other hand the company goes for borrowing funds to meet it is capital needs then there are normally 2 ways, but of course you will see that there are many ways, one is the long term bonds or debentures and term loans or term finance. We shall discuss these ones in great detail now.

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Bonds (or Debentures)

Short-term financing through ***promissory notes*** given to banks can generate funds needed for 2 – 5 years.

A ***bond*** is a long-term note given to the lender by the borrower stipulating the terms of repayment and other conditions.

Almost all debt issues by GoI, State Govts, Govt Undertakings, and financial institutions are generally ***unsecured*** obligations and are called ***bonds***.

All debt issues that are made by ***private*** entities are usually ***secured*** obligations and are called ***debentures***.

The principal and the interest are paid at specified date.

Firstly, bonds or debentures, basically they are required for short term financing through promissory notes given to banks to generate funds needed for 2-5 years. A bond is thus; these are promissory notes. Promissory notes usually are short term financing whereas a bond is a long term note given to the lender by the borrower stipulating the terms of repayment and other conditions.

So whereas promissory notes are short term financing for short term requirement, bonds are for long term requirements and normally the government bonds are bonds issued by government undertakings and government financial institutions are generally unsecured obligations and are called bonds, whereas all debt issues that are made by private entities are usually secured obligations and area called debentures.

There is a fine difference between bonds and debentures. Normally bonds are those debts that are issued by Government of India, state governments, government undertakings and finance institutions and normally they are unsecured meaning that there is no mortgage associated with it. Whereas when they are issued by private organizations they are usually secured and are called debentures. Principal and interests are normally paid at the specified dates.

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Now there are different characteristics of debentures. There is a trustee who manages the issue of debentures, normally it is done through a trust deed or also called indenture and usually a trustee is a bank or an insurance company or a firm of attorneys. Debentures can be converted into equity shares, in those cases they are called convertible debentures, normally as I said it can be secured or it can be unsecured.

When secured it is secured by a mortgage, normally immovable properties and to pay back the date in time company creates a sinking fund paying every month certain amount or every year certain amount to that fund to be able to payback the date with interest in time. The call feature of debenture is that the company can redeem the debentures at a specified price and the redemption period is usually specified and the amount is also specified.

And the interest that the company pays is called the bond rate, it is a statutory obligation and it is tax deductible expense. So interests are tax deductible unlike the dividends.

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Advantages of Debt Financing

1. Interest being tax-deductible, debt capital is less costly.
2. Control is not diluted, since the bond-holders do not have voting rights.
3. Call provisions provides flexibility in the capital structure.
4. Issue costs are significantly lower compared to that of equity and preference capital.
5. It provides protection against high unanticipated inflation.

Disadvantages of Debt Financing

1. Obligatory payments
2. There is therefore a financial risk.
3. Reduces firm's financial flexibility
4. Real cost of debt can be high if the inflation becomes unexpectedly low.

The advantages of debt financing interest being tax deductible, debt capital is less costly and since the debt holders or bond holders are not owners, control is not diluted. There is a call provision sometimes associated. Therefore, the flexibility in capital structure can be more. Issue costs are significantly lower compared to that of equity and preference capital shares and it provides protection against high unanticipated inflation.

If inflation is high then real cost of interest paid is much less in case of dept financing, but there are certain disadvantages as well. First is that it is obligatory on the part of the company as a firm to payback it is payments in time therefore it incurs a financial risk. It reduces the firm's financial flexibility and the real cost of dept can be high if the inflation is unexpectedly low just as it provides protection against high unanticipated inflation, the reverse may also be true if the inflation is not so high then the real cost can be very high.

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Bonds are usually issued in units, each having a ***par value*** or ***face value***.

Two ways of paying interests

1. ***Registered Bonds***
   - Interests are paid to bondholders when they become due.

2. ***Coupon Bonds***
   - Bondholders convert coupons attached to the bonds into cash at a bank.

Bonds are usually issued in units each having a par value or a face value and when it matures this amount is paid back by the company. 2 ways of paying interests they can be registered bonds or coupon bonds. In case of registered bonds interests are paid to the bondholders when they become due.

In terms of coupon bonds, the bond holders convert coupons that are attached to the bonds into cash at a bank that means they actually submit the coupon to a bank and get cash in turn. They are called coupon bonds. There are different types of innovative bonds that have come into existence. We will discuss some of them.

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Innovative Bonds

Deep Discount (Zero-Interest Coupon) Bond

- No interest paid
- Redeemable after specified number of years with specified amount (issued at steep discount over its face value)

Convertible Debenture

- Partially or wholly convertible into equity shares following SEBI guidelines

Floating Rate Bonds

- Interest rate linked to a benchmark rate (Treasury Bill Interest rate)

One is called deep discount bond or a zero-interest coupon that means in this case no interest is paid. The principal and all interests accumulated is paid back at the end of the maturity

period. Redeemable after specified number of years with specified amount and normally therefore the discount rate is extremely high that means you pay a small amount and you get a very large amount at the end of specified number of years.

Thus the discount rate is extremely high that is called a deep discount or a zero-interest coupon bond. Another type of bond is convertible debentures, here the debenture can be partially or wholly convertible into equity shares following the SEBI guidelines, the Security Exchange Board of India guidelines, they are called convertible debentures. Normally bonds are associated with fixed interest rates but it is possible to have floating interest rates.

In such cases the interest rates are linked to a benchmark rate. Normally they are the treasury bill interest rate, the government interest rate. When the government interest rate varies, the interest rate paid to the bondholder also varies and there is a fixed relationship between the bond interest rate and the treasury bill interest rate, they are called floating rate bonds.

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Indexed Bonds

- Payoff has two parts:
    - A fixed amount (*e.g.*, a discount bond)
    - A variable component that depends on some index

Strips Debentures

- Many components (one for the principal and many for the interest coupons), each separately listed and traded in stock exchange

Next, indexed bonds, in this case there are 2 types of payments or payoffs to the bondholders. First is the fixed amount which is a very big amount, normally the discount bond and a variable component that depends on some index like treasury bill interest rate. So it can have the combination of the deep discount bond and the floating rate bonds accepting that it is the discount rate is not very high.

Then there can be strips debentures in which the particular debenture may have different component, one for the principal and many for the interests and each of them can be separately listed and traded in the stock exchange. So these are strips debentures.

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Methods of Offering in the Primary Market

A. Public Offering
- Initial Public Offering (IPO) of equity shares
- Seasoned (or Secondary) Equity Offering for additional capital
- Bond Offering – much less complicated than the issue of equity

B. Rights Issue
- It involves selling securities in the primary market by issuing rights to the existing shareholders.
- When the company issues additional equity capital, it has to be offered to the existing shareholders first on a pro rata basis.

C. Private Placement
- Issue of securities (shares and convertible debentures) to a select group of persons less than 50.

Now normally in the primary market there are different methods of offering these securities. If equity shares are offered they are called public offering and the first time when they are offered they are called initial public offering as I told you already and subsequently if the company needs more capital through capital market, then it can also issue seasoned equity or secondary equity offerings for additional capital.

Also as I have told you bonds can be issued to the public and it is much less complicated than the issue of equity shares. So this method of offering is known as public offering. Next we have rights issue. It involves selling securities in the primary market by issuing the rights to the existing shareholders. That means that when the company issues additional equity capital it has to be offered to the existing shareholders first on a pro rata basis.

So in this case the holders of the equity shares have right to be the first to be offered the shares when additional shares are issued by the company and the third type of offering is private placement. So here issue of securities that means shares and convertible debentures are made to a select group of persons which is to be < 50, then it is called private placement. So these are basically public offerings and primary market rights issue.

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Term Loans (Term Finance)

Used to finance fixed assets and working capital.

Given by banks and financial institutions

- ***All India financial institutions***: IFCI, ICICI, IDBI;
- ***Specialized institutions***: Exim bank, IL&FS, Power Finance Corporation, IDFC, and SIDBI, and Insurance companies like LIC and GIC
- ***State-level financial institutions***: State Industrial Development Corporations, State Financial Corporation
- ***Commercial Banks***

Rupee term loans or Foreign currency term loan (for import of assets)

Now we come to term loans, which is also known as term finance. Usually term loans are used to finance fixed assets and working capital needs and they are offered by banks and financial institutions and we have listed some of them in India, all India financial institutions like IFCI, ICICI, IDBI. There are specialized institutions such as Exim bank, IL&FS, Power Finance Corporation, IDFC and SIDBI and Insurance companies like LIC and GIC.

There are state level financial institutions such as state industrial development corporations, state financial corporations and of course the commercial banks. Now for import of certain assets foreign currency term loan maybe obtained or otherwise rupee term loans can be obtained as term loans.

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Repayable in 1 – 10 years.

There is a security (with the asset bought – ***prime security***, else some other asset – ***collateral security***) .

Mortgage of immovable properties (for fixed assets) or **hypothecation** of movable properties (for working capital advance)

Financial institutions levy restrictive conditions (***covenants***) on the borrowing firm with regard to the nature of the project, etc.

Term loans are partly **convertible** into equity, at the option of the financial institution.

Several banks may also participate in a single loan **(syndicated loan)**

Normally these loans are repayable between 1-10 years and usually there is a security associated with this term loan and usually it is the asset that is bought which is called the prime security or it can also be another asset which is then called collateral security and mortgage of immovable property for fixed assets if the term loan then it is a mortgage basically or it can be a moveable property such as vehicle or inventory.

It is hypothecated to the term loan to the bank if it is for working capital advance such as inventory. Now financial institutions usually levy many conditions while they lend the money and these conditions are known as covenants and normally they are with regard to the nature of the project. These conditions are levied so that they do not run the risk that the project will not be a successful project.

Also term loans can be partly convertible into equity if the financial institutions so wishes. Lastly several banks may join together and then to give a single loan in that case it is called a syndicated loan.

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Working Capital Advances

- Given by commercial banks against ***hypothecation*** (against movable property or inventory) or ***pledge*** (goods deposited with the banks)
- Four ways of operation

  a. Cash credits/overdrafts
  The borrowing company borrows as often as it needs, provided it does not exceed a limit.
  b. Loans
  A fixed amount
  c. Purchase/discount of bills
  The purchase bill is sent to the bank for payment.
  d. Letter of Credit
  The bank opens a letter of credit in favour of the firm to enable it to buy an asset/service and undertakes the responsibility of meeting its obligation.

The next firm of financing working capital is called working capital advances. Normally they are given by commercial banks against hypothecation that is against moveable property or inventory or pledge, pledge means in this case goods are actually deposited with the banks, the difference is that here the goods are deposited with the banks and hypothecation means the goods remain with the firm and there are 4 ways in which it operates.

One is cash credit or overdraft, the borrowing company borrows as often as it needs, provided it does not exceed a limit, this is called cash credit or overdraft or it can take a loan which is a fixed amount. Or the purchase bill is stent to the bank for payment. This is called purchase or discount of bills; the bills are discounted or it can be letter of credit in which case the bank opens a letter of credit in favor of the firm to enable it to buy an asset or service.

And undertakes the responsibility of meeting it is obligation that is called a letter of credit. So these are different forms of getting working capital advance.

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Private Placements

- Compared to public issues, private placement of debentures with a small number of financial institutions is cheap.
- Write a promissory note rather than appoint a trustee, follow standard processes and procedures, and enumerate and satisfy all conditions (***covenants***).
- Good for small and medium-sized firms.

Next private placement, now compared to public issues private placement of debentures with a small number of financial institutions is normally cheap. Here one has to just write a promissory note rather than appoint a trustee. Follow certain standard process and procedures and enumerate and satisfy all the covenants or conditions. Now these private placements are good for normally small and medium sized firms.

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Project Finance

- A loan granted by a financial institution – especially a large international bank - for a particular project
- Case of private placement to a large firm.
- Usually offered to power, telecom, and transportation projects.
- All stakeholders – investors, contractors, plant managers, suppliers, customers, and government – have to sign contracts and share the risks.
- The debt is supported by the project cash flows.

Now for big firms or large firms the alternative is project finance. It is a loan granted by a financial institution especially a large international bank maybe World Bank for a particular project. This is like a private placement to a large firm. Projects like power projects, telecom projects, transportation projects are usually funded as project finance by large international banks. Here the stockholders have to sign contracts and share the risks.

Who are the stockholders? The investors, the contractors, plant managers, suppliers, customers and government, all of them have to sign the contract before the bank gives the money and the debt is then supported by the project cash flows. So it is hoped that the project will generate revenues and cash from which the debt will be paid back this is called project finance usually for large projects and for large firms.

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Miscellaneous Sources

A. Deferred Credit

- Suppliers of machinery allow repayment over a period of time.

B. Lease Finance and Hire Purchase

Lease Finance
The lessor grants the lessee the right to use an asset (building, land, or equipment) in return for periodic lease rental payments. The lessor is the owner.

Hire-Purchase
- Payment for hiring is made in several installments
- It consists of part of principal and interest on initial investment.
The user becomes the owner after the last installment.

Now apart from these there are a large number of other sources of capital which we would like to discuss. One, deferred credit, this means let us say machinery is purchased. The supplier of the machineries allow repayment over a period of time that means it is not purchased on cash, but over a period of time the payment can be made, this is the case of credit purchase.

This is also one form of source of capital. The company does not have to pay back the money at the same time when it buys the asset. Next is lease finance and higher purchase. Here the firm is the lessee, the lessor grants the lessee the right to use an asset such as a building, land or equipment in return for periodic lease rental payments. Thus the lessor is the owner. So a land owner or a building owner allows the firm to use these assets by paying rental payments.

This is lease finance and naturally these payments are tax deductible whereas the lessor is the actual owner. Also it is possible to have a hire-purchase scheme where the payment for hiring is made in several instalments, it consists of the principal and interest, but after the last instalment the user becomes the owner, so the difference between the 2 is that here the user becomes the owner and here unless the lease is renewed the lessor is the owner and not the user.

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Installment Purchase

-Similar to hire-purchase system.
- Here the user becomes the owner in the beginning ,not after the payment of the last payment.

C. Unsecured Loans and Deposits

Unsecured loans
- Provided by promoters.
- The amount equals the promoters' contribution required by the financial institutions less the subscribed capital.

Public Deposits
- Unsecured borrowing from public for 1 – 3 years.

Installment purchase similar to hire-purchase here the user becomes the owner in the beginning not after the payment of the last payment that is the difference. Now we have another firm of the miscellaneous firm and one among the miscellaneous firms, unsecured loans and deposits. Unsecured loans are provided normally by promoters and the amount

equals the promoter's contribution required by the financial institutions less the subscribed capital.

They can also be public deposits that are also unsecured they are borrowed from public for 1-3 years.

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D. Special Schemes of Institutions

IDBI's Bill Rediscovering Scheme
- Purchase of indigenous machinery on deferred payment basis
- The seller discounts the bill accepted by the firm (buyer) with a commercial bank, which, in turn, rediscounts it with IDBI.

ICICI's Supplier's Line of Credit
- Similar to the Bill Rediscovering Scheme.
- Here the seller discounts the bill directly with ICICI.

E. Subsidies, Sales Tax Deferments, and Exemptions

- Given by state governments
- Subsidies on fixed capital investment or for backward area location

Tax deferment by 5 – 12 years (it is like an interest-free loan)
Exemption of sales tax on finished goods

Now there are special schemes of institutions. In India we have IDBI having a scheme, bill rediscovering scheme and ICICI supplier's line of credit. This scheme is purchase of indigenous machinery on deferred payment basis that means the firm can buy indigenous machinery by deferring it is payment, but how it is done? the seller from whom an asset is purchased with the firm discounts the bill that is accepted by the firm with commercial bank.

And this commercial bank in turn rediscounts it with IDBI so finally IDBI pays the money and the company, the firm, makes the payment to IDBI later. Similar thing is done by ICICI's supplier's line of credit. It is similar to the bill rediscovering scheme of IDBI so here the seller directly discounts the bill with ICICI, so the difference is in this case the seller can discount the bill with any commercial bank, who in turn rediscounts it with IDBI.

And here the seller discounts the bill directly with ICICI. Then there are different other forms of sources of capital. This is particularly for government. In particular, various state governments offer different types of incentives, financial incentives to firms to setup their companies in their states. For example, subsidies maybe offered on fixed capital investment if they are in the backward areas of the state.

Or taxes may be deferred by 5-12 years, so it is like an interest free loan or state level sales tax maybe exempted on finished goods. So these are also different sources of capital.

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F. Short-Term Loan from Financial Institutions

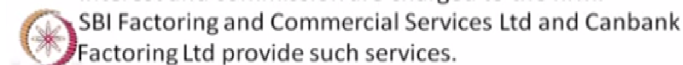
- For 1 – 3 years
- Unsecured loans

G. Commercial Paper

- A short-term (90 – 180 days) unsecured promissory note issued by the firm.

H. Factoring

- A factor is a financial institution offering services related to management and financing of credit sales.
- The factor has the responsibility of collecting the accounts from the buyer.
- 70 – 80 % of credit sales is given as loan.
- Interest and commission are charged to the firm.



Then short term loan from financial institutions for 1-3 years and they are usually unsecure. Commercial paper, a short term unsecured promissory note issued by the firm, usually for 90-180 days, 3 months to 6 months. Still another firm is called factoring. A factor is a financial institution offering services related to management and financing up credit sales, so basically it is about credit sales.

It has the responsibility of collecting the accounts from the buyer. In this case what happens, 70%-80% of the credit sales is given as loan. Interest and commission are charged to the firm and in our country SBI Factoring and Commercial Services Limited and Canbank Factoring Limited provide such services.

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I. Securitization

- It involves packaging a designated pool of assets and issuing securities that are collateralized by the underlying assets and their cash flows.

- The pool of assets are transferred to a ***Special Purpose Vehicle*** (***SPV***) or trustee. The assets are taken off the balance sheet of the firm.

- The SPV issues securities backed by the pool of assets held by it.

- These securities are called ***Pass Through Certificates*** (***PTCs***) because the cash flows received from the pool are passed on to the holders of these securities on a pro-rata basis after deduction of service fee.

Next securitization, it involves packaging a designated pool of assets and issuing securities that are collateralized by the underlying assets and their cash flows. Collateralize means it is used as, these underlying assets are used as mortgages as security. The pool of assets is then transferred to a special purpose vehicle or a trustee. Usually called SPV. Then these assets are taken off the balance sheet of the firm.

That means as if they now belong to this particular body called special purpose vehicle. Special purpose vehicle now issues securities backed by the pool of assets held by it. These securities are called PTCs or pass through certificates. Because cash flows received from the pool are passed down to the holders of the securities on a pro-rata basis after deduction of the service fee.

So we see here that this is a very novel way that certain assets are pooled together and are transferred to a company or a trustee called a special purpose vehicle who in turn issue securities and all the cash flows from these assets are passed down to the holders of the securities this is called securitization. Next form of sourcing capital is venture capital.

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Venture Capital (VC)

- Equity investment in young private companies.
- For young companies with risky propositions but promising prospects (with high rates of return).
- Capital is provided by ***venture capital firms (VCF)***
- VCFs raise capital from a number of ***fund investors*** (such as financial institutions, corporations, and individuals)
- Such investors do not need dividend or interest, but they want ***long-term capitalization and increased net worth*** of the company.
- Managers of VCFs charge investors a fixed annual fee (2 % of the capital) and retain 20 % of the capital gain realized from the investment.
- A VCF is a trust or a company and has to register with SEBI (Securities and Exchange Board of India) and cannot access public investors.

- ICICI Ventures (1988) is the first in India.

Venture capital is very much required for young private companies who have great promise in their product or service so this is a very good form of capital for these companies and in the last 10 years it has gained momentum not only in other countries in India also. For young companies with risky propositions but promising prospects and with expectedly high rates of return such companies are usually funded from the venture capital.

Now how it is formed? Capital is provided by venture capital firms or VCF. VCFs raise capital from a number of fund investors such as financial institutions, corporations and individuals. Such investors do not need dividend or interest, but they want long term capitalization and increased net worth of the company, because they would like to hold certain shares of the company.

Managers of venture capital firms charge investors a fixed annual fee something like 2% of the capital and retain 20% of the capital gain realized from the investment. So that is the charge the VCF receives for the services they offer. So VCF is a trust or a company and has to register with SEBI and cannot access public investors, so it has to get private funds to raise it is capital to be able to give it to the needing firms.

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- A venture is a partial owner.
- Unlike a lender who is interested in only security and payback, venture capitalists want high ***return on investment*** (30 – 60 %).
- They are interested in good management as well as in the product.

ICICI ventures was the first to offer such venture capital in 1988. A venture is a partial owner, is just not a lender who is interested in only security and payback. He wants high return on investment and they are interested therefore in good management as well as in a good product.

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Informal Risk Capital - Angel Financing

- Wealthy individuals invest.
- They may consist of
  - Senior corporate managers
  - Successful businessmen
  - Enthusiasts for whom investing is a hobby
  - Professionals
  - Serious investors
- Used as seed money for starting a new business.

Then there are informal risk capital and/or angel financing source. Here basically it is informal as the name indicates. Here wealthy individuals invest their money in young fledgling firms. They may consist of senior corporate managers, successful businessmen, enthusiasts for whom investing is a hobby, they maybe even professionals or they may be serious investors and such money can be used as seed for starting a new business.

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Raising Capital in International Market

A. **Euro Market (Offshore Market)**
- It is a collection (syndicate) of international banks.
- An Indian bank can access the euro markets to raise euro-currency loan, raise global depository receipts and euro-currency convertible bonds.

Eurocurrency Loan
- Eurocurrency is a deposit of currency in a bank outside the country of the currency. For example, eurodollar is a dollar deposit in a bank outside US; similarly euroyen ...
- Borrower pays a floating interest rate linked to LIBOR (London Inter-Bank Offer Rate) or SIBOR (Singapore Inter-Bank Offer Rate)
- Suppose a US firm buys jute from an Indian company. It pays a dollar cheque to the Indian company. The Indian company can deposit this cheque with a Swiss bank (Eurodollar deposit). Against this deposit, it can take loan.

Capital can also be raised in international market. There are different forms, one is Euro market or offshore market. Here it is basically a collection or a syndicate of international bank. An Indian Bank can access the Euro market to raise Euro-currency loan or raise global depository receipts and Euro-currency convertible bonds. Now let us see what these 3 things are, Euro-currency loan, GDR or global depository receipts and Euro-currency convertible bonds.

First Euro-currency loan, it is a deposit of currency in a bank outside the country of the currency for example Eurodollar is the dollar deposit in a bank outside US. Similarly, Euroyen etcetera. So what happens to get a loan? borrower pays a floating interest rate linked to LIBOR which is called London Inter-Bank Offer Rate or SIBOR, Singapore Inter-Bank Offer Rate, so that is the interest rate the borrower pays.

So that is linked to or indexed to these internationally accepted rates. Suppose a US firm buys jute from an Indian company, then the US firm pays a dollar cheque to the Indian company. The Indian company can deposit this cheque with the Swiss bank then in that case it is a Eurodollar deposit because it is dollar paid to another bank not the bank of the place of it is origin, it is a Swiss bank. So against this deposit now the Indian company can take a loan this is Eurocurrency loan.

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Eurocurrency Bonds (Notes)
- Issued outside the country in whose currency it is denominated.
- For example, eurodollar bonds for outside US
- Lending rates usually lower than bonds in domestic markets.

Global Depository Receipts (GDR)
- GDR issues are deemed to be foreign direct investments.
- A firm issuing GDR must have the approval of (i) Ministry of Finance and (ii) FIPB (Foreign Investment Promotion Board).
- Firm's shares are first held by a ***depository*** – usually a large international bank.
- The bank receives dividends, reports, etc., and issues claims against the shares.
- These claims are called ***depository receipts*** – each receipt being a claim on a specified number of shares.
- GDRs are denominated in a convertible currency – usually US $.
- GDRs are listed and traded on major stock exchanges.

Eurocurrency bonds or notes, these are issued outside the country in which in whose currency it is denominated. For example, Eurodollar bonds for outside US. Lending rates are usually lower than the bonds in the domestic markets. Now lastly the global depository receipts, the GDR. GDR issues are deemed to be foreign direct investment, the so called FDIs. A firm issuing GDR must have the approval of the ministry of finance and the foreign investment promotion board.

These are the 2 Indian organs through which the GDR can be issued by a firm. The firm's shares are first held by a depository usually a large international bank. This bank receives the dividends, the reports et cetera and issues the claims against the shares held by this bank. These claims are called depository receipts. Each receipt being a claim on a specified number of shares.

GDRs are denominated in a convertible currently usually US dollar they are listed and traded on major stock exchanges. So these are foreign direct investment, this is the instrument through which foreign direct investment can be obtained.

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B. Foreign Domestic Markets

- Indian companies can issue securities directly in the domestic capital markets of foreign countries.

C. Export Credit Schemes

- Many major industrial countries have established export credit agencies to finance exports of capital goods and related technical services.
- Examples: US EXIM, JEXIM, HERMES, AND COFACE
- These agencies follow guidelines under the Berne Union Convention.

Foreign domestic markets, Indian companies can issue such securities directly in the domestic capital market of foreign countries, unlike going through the process of GDR. Then there are many export credit schemes, many major industrial countries have established export credit agencies to finance exports of capital goods and related technical services. Examples like US EXIM, JEXIM, HERMES and COFACE.

These agencies they are international agencies; they follow guidelines under the Berne Union Convention. Now friends what we have covered so long very hurriedly we went through of course, we have seen that any company would require capital to start, to continue to grow throughout it is life, it requires fixed capital, it requires working capital and there are different ways through which capital can be raised.

One is public offering, public offering of securities, security basically means common stock or preferred stock and bonds or debentures, normally common stock financing those who hold common stock or equity stock holders they are the real owners of the company, they have right to vote, but they also run the risk if the company gets liquidated without giving much of the returns that they expected.

Dividends may not be paid to them whereas the preference stock holders they are also owners, but they do not have the right to vote, but they are sure of getting the dividends in time or belatedly. Now when government issues bond they are usually not secured and they are called bonds. Whereas when private firms offer or get the money from the public they are called debentures and usually they are secured, so this is the basic difference.

Now apart from these debt financing and the equity financing there are different other forms of raising capital and we have discussed quite a lot of them and in particular we have discussed various forms of innovative bonds. Bonds that are indexed, bonds indexed with treasury bill interest rates or indexed bonds, there can be discount bonds or the zero interested bonds and there are different other forms.

We have also seen venture capital as an extremely good and popular way of getting funds to start a new business. Those companies which are starting newly for them venture capital is a very, very good source of raising money to start their business. Usually when a new company starts the public is not very sure the lenders are not very sure about the success of the company.

It is at that place that the venture capitalists or venture capital firms take the risk and provide the required fund, but in return they are partial owners they like to see that the company does very well gets a good return on investment. There is also angel financing in which some professionals or wealthy citizens may also give money to start a business. Thus there is a large number of sources for getting capital and for any new company they have to find out which is best for them.

So we have discussed different firms of different sources of capital and in our next lecture we shall cover the certain aspects of entrepreneurship. Thank you very much.