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PAPER-6B – FINANCIAL SERVICES AND CAPITAL MARKETS

The Question paper comprises three case study questions. The candidates are required to answer any two case study questions out of three.

Answers in respect of Multiple Choice Questions are to be indicated in capital letters, i.e. A or B or C or D as the case may be.

QUESTION NO - I**CASE STUDY:**

A large infrastructural conglomerate (let us call it India Infrastructure Investment Corporation Ltd - shortly IIIC), whose shareholders include large institutional investors both from India (including PSUs) and abroad had invested in several infrastructural projects — all of which are having long gestation periods (minimum and maximum spans of 20 years and 30 years) respectively, through several subsidiary companies formed as SPVs numbering about 250, for specific projects. Though a significant portion of the shareholdings are by corporations like LIC and public financial institutions like SBI (around 40%), technically IIIC is not a Government company.

For making such investments, IIIC sourced funds through debt instruments like Non-Convertible Debentures and Commercial Papers with coupon rates that were best at the market at relevant points of time. Several Indian financial institutions like banks, insurance companies, mutual funds and pension funds (in effect, savings of the public at large) had invested in such NCDs and CPs to the extent of about ₹90,000 crores. IIIC's application of funds were through equity and debt investments in hundreds of subsidiary companies and associates, all of which had taken up projects like construction of roads, expressways, airports, seaports, waterways, power & energy sectors, maritime infrastructure etc. Though the operations of many of these subsidiary companies and associates were progressing but slowly, some of them had hit roadblocks in terms of local body approvals, land acquisition issues, litigations etc. In any case, as mentioned earlier, even to generate revenues and cash flows enough to service its debts, IIC knew that it would take a minimum of 10 to 15 years from even its fastest projects.

However, as there were big names in the shareholders list and the company could get support from various Governments and State Agencies that accorded projects after projects, IIIC was also able to obtain good, why, even great ratings from the various credit rating agencies (CRAs). Such good ratings were the comfort bells for the above mentioned institutional investors, the AUM (Assets under Management) of which comprised of public money as deposits or NCD investments of mutual fund investments or insurance savings.

Though much of the CPs and NCDs issued by IIIC were for the maximum permitted 10 years, in order to have better marketability of the debt instruments, IIIC also issued short term CPs - the redemptions of which became difficult in view of cash flow situations.

At first, two subsidiaries reported having trouble paying back loans and inter corporate deposits to other banks and lenders. In a few weeks, there was another report that another subsidiary failed to repay a short term loan of ₹ 1,000 crores from another leading public financial institution, resulting in turmoil and resignations of senior officials in that institution. Successive news items kept coming about defaults in loan repayments and non-servicing of loans on committed dates by one or the other subsidiary. Amidst the melee, the rating agency which had reaffirmed a rating of A1 Plus, within the next 40 days made two successive rating actions which saw the downgrading to D for specific commercial papers, citing reasons of “recent irregularities in debt servicing driven by the material weakening of the company’s liquidity profile”.

It was widely believed that the CRA acted more reactively than proactively possibly because they have always had zero accountability and even at their worst performing scenarios, the maximum rebuke they used to get were something like this : “Rating agencies need better market intelligence and surveillance rather than depending upon historical data and some structure based on past estimates.” Even in this case, the fact that IIC’s short term borrowings increased by 30% in one year, has not rung any alarm bells. In a nation that is very quick to blame the lenders who trusted the ratings and the auditors for not doing a perfect post mortem, no blame lies on those whose recommendations are held sacrosanct as in most case they are mandated by regulators even.

The founder CEO, who was later accused of having given himself a very fat remuneration all along, suddenly resigned citing ill-health as pressures started mounting. The Government, realizing that the impending fall-out was already causing tremors in the financial markets, moved to take control and replaced the entire Board. Serious Fraud Investigation Office (SFIO) started investigation as there were huge procedural lapses. Though there is no fraudulent motives imputed or alleged as of now on the company, the findings that the company has had multiple layers of holding and subsidiary companies and has had a complicated web of inter-corporate relationships, have made the new management to go on record that the erstwhile board had indulged in ‘massive mismanagement of public funds’. The issue has caught the eye of MCA, SEBI, NCLT etc. and developed as a major worry in the financial market horizon of the country.

Several institutions and mutual funds who have invested in CPs and debt securities, due to the strict NPA norms they are subjected to, began classifying their investments as Non-performing and have also taken haircuts of their investments in installments. An intense discussion also started among the financial market players on the role of rating agencies. The market value of quoted mutual funds got a severe beating, resulting in erosion of invested values for ordinary investors.

In this background, the following questions have been framed:

*You are required to answer **all** of the following Multiple-Choice Questions in Part - A and also give reasoned replies (minimum **125** words) to each of the questions in Part - B.*

PART- A**10 x 2 =20 Marks**

1. Normally the role of Credit Rating Agencies (CRA) is
 - (A) Financial due diligence of an enterprise
 - (B) Limited to giving opinion on any specific instrument
 - (C) Giving investment recommendation
 - (D) Opining on the holding or subsidiary companies as well
2. In India, the Credit rating agencies are licensed to operate by
 - (A) Reserve Bank of India
 - (B) SEBI
 - (C) Ministry of Corporate Affairs
 - (D) Ministry of Finance
3. Credit Rating process is initiated
 - (A) Suo'moto by CRAs
 - (B) At the request of rated entities
 - (C) By mandatory requirement of SEBI
 - (D) None of the above
4. The regulatory authority of CRAs is
 - (A) Ministry of Corporate Affairs
 - (B) SEBI
 - (C) Credit Rating Regulatory Authority of India
 - (D) None of the above
5. Once a rating has been assigned, when can the next revision happen?
 - (A) Next financial year
 - (B) On the happening of an event such as default of interest payment
 - (C) Regular monitoring triggers |
 - (D) Again, at the request of the rated entity
6. When any upgrading or downgrading of rating happens
 - (A) The CRA shall make a disclosure through its website to the investing public
 - (B) The CRA shall communicate to the rated entity

- (C) *The CRA should inform the regulatory authority of the rated entity*
(D) *All of the above*
7. *In the given case study, the loss for institutional and individual investors is predominantly caused by*
- (A) *The Company, which mismanaged public funds*
(B) *The auditors who have given true & fair certification to the company's financials*
(C) *The rating companies which had given good rating of the securities*
(D) *The regulator which had failed in its oversight function*
8. *The Credit Rating process is not mandatory for*
- (A) *Listed Non-Convertible Debentures*
(B) *Initial Public Offerings of companies that are getting listed*
(C) *All Public Deposits by NBFCs*
(D) *Commercial Papers by Corporates*
9. *The more prominent risk that CRAs have to bear in mind is*
- (A) *Financial risk of the entities*
(B) *Business Risks encountered by the rated entity*
(C) *Operational Risks relating to people and process*
(D) *None of the above*
10. *Which one of the following is not a Credit Rating Agency?*
- (A) *Fitch*
(B) *Credit Analysis & Research Ltd.*
(C) *CIBIL*
(D) *Standard & Poor*

PART – B**(5 x 6 = 30 Marks)**

1. *In the given case study, discuss the role and failure, if any, of the Credit rating agency.*
2. *In your opinion, should the credit rating agencies be better monitored and regulated to be made more accountable?*
3. *What, in your view, is the fundamental reason for the financial mess that was created in the above case study and how could it have been better addressed?*
4. *What is the CAMEL model in rating methodology? Is it sufficient in case of large public offerings of debt securities?*

5. *If you are asked to rate as 1 to 4 (1 being most responsible) in the MCQ No. 7 above, how would you rate and why?*

Answer to Case Study - I

PART – A

- 1 (B)
- 2 (B)
- 3 (B)
- 4 (B)
- 5 (C)
- 6 (D)
- 7 (A)
- 8 (B)
- 9 (A) or (B)
- 10 (C)

PART – B

Ans. to Q. (1)

Answer:

The role of the CRA is to provide an appropriate rating for a debt instrument, monitor periodically whether the rating holds and revise it if appropriate. This process has to be done continuously until the life of the rated instrument.

For this, the CRA is required to be registered under SEBI, appoint a compliance officer to ensure compliance with the various requirements laid down by SEBI.

In the case of CPs, CRA has to additionally obey RBI's mandate and report to RBI under RBI's money market regulations, which also provides for continuous monitoring and reporting.

CRAs are required to have adequate trained and qualified professionals to ensure the validity of their registration.

Further, conflict of interest is avoided by certain prohibitions for CRAs to rate entities in which they are interested.

There are also prescribed ethical codes of conduct which provide for honest, timely, consistent, informative reporting that can be relied upon.

These have been laid down since the ratings are an indication used by lenders, notwithstanding the regulatory disclaimer by CRAs that the rating is not an investment recommendation.

When a rating is very high, it is certainly taken to be truly reflective of the entity's performance when a lender decides to lend funds to the entity.

The CRA has failed in its responsibility since, it must have been aware that much of IIC's liquidity depended on receivables from its subsidiaries and associates and defaults from these would have been visible from the first time of default.

CPs should not be raised under RBI Regulations if there has been default in debt servicing. In order to raise CPs, there appears to have been a concerted hiding of non-servicing of debts.

All the crumbling could not have happened in the last few days. It must have happened slowly and steadily, given that different instruments required servicing of interest or principal at different points of time. Any subsidiary's default should have been reported by its debenture trustee or CRA, whereupon IIC's CRA should have woken up to accordingly revise the ratings.

Thus it is the complete break-down of the regulatory mechanism by sheer non-compliance to an existing system by CRA.

There has been a 30 % increase in the short term borrowing in the past one year. This important signal which should have triggered an effort to be alert, was ignored by the CRA.

That infrastructure projects have undue time and cost over-runs is a fact known at the outset, even at the time of initial ratings. Consequently, delays in debt servicing may have been anticipated. Hence an A1 at the initial rating itself may not have been appropriate. Even if IIC had a good track record which prompted the award of many projects from the government and funding by LIC and public financial institutions, there was evidently, need to sustain an active monitoring process for revising the rating promptly. This was a failure.

IIC had more than one agency's rating and all of them were great ratings. This may imply that a good initial rating may have been fair. But the monitoring process has surely failed.

CRAs have to do the due diligence assessment before they award a rating and put in on watch with respect to certain impending variability's and assumptions. These have not been done properly. Otherwise a downward revision of the grading would have happened.

Ans. to Q. (2)

The CRAs can be monitored better to make them responsible for maintaining a rating. They can be made to function with common parameters so that what is stated by one CRA means the same across all CRAs. As of today, each CRA has a different system of rating, though, broadly, a 'high' rating by one also would mostly be high by another. However, standardization across agencies by adopting compulsory parameters and industry specific parameters should be made.

CRAs may be made to publish cumulative default rates.

CRAs may be made to publish the extent of risk in asset-liability mismatch by designing standard parameters for evaluation and reporting.

Data of default must flow immediately from the point of default to the CRAs so that they take the danger signal seriously and trigger better monitoring processes. Such triggers should also be standardized.

CRAs must be made to report a revised rating as on the date of default, within a reasonably short stipulated period. They may retain the earlier rating and not downgrade it due to a single lapse, but instead of the current passive concurrence to the earlier rating, they should actively publish the revised rating, be it same or different.

The CRAs should have a procedure to work out a probable default rate in the short, medium and long term. The high ratings especially should be intensely monitored since users assume almost no risk of default and are often surprised by bankruptcy. Ripples of such shocks affect even common man in the form of mutual fund investments.

The rating system and reporting should be revamped to capture individual instruments, the parent organization, subsidiary, prominent borrowers, associates, etc. in a fashion that enables a user find out readily the sensitivity of a particular organization to defaults of organization connected to it. Then, based on this sensitivity analysis, the most sensitive factors may be watched out more intensely.

CRAs must also be made to take cognizance of certain accounting ratios affecting liquidity and revalidate or revise their ratings if necessary. Thus instances of short term borrowings leaping up and not being noticed and reported will not happen (in this case, short term borrowings stepped up by 30 % and went unnoticed while yet being within law or regulation). Accountability will have to be fixed so that CRAs take note of these matters.

CRAs are being paid by the companies issuing debt for the rating done by them. Instead, there, there can be a central organization which charge companies for the rating and compensate the credit rating agencies for rating done by them.

Many financial institutions are capable of making their own research about the credit worthiness of the bond issuer. SEBI is also encouraging the asset managers to build their internal research capabilities. These parameters should be compared with those of the CRAs by a central organization so that points of variations can invite attention and if need be, revision in the ratings.

Ans. to Q. (3)

The fundamental mess was created by the management (or rather mismanagement). CRAs and auditors come in as reporters and highlighters of the mess.

While infrastructure sector has an inherently long gestation period, a liquidity crisis in spite of institutional support (LIC/SBI) for the parent is clearly financial mismanagement.

The system under SEBI, RBI, CRAs, Companies Act, audits (both statutory and internal audits), are broadly in place to send out enough warning signals. Persons at the helm have decided to hide events and adopted unfair, unethical strategies to continue to raise money without accountability and have chosen to abandon the organisation in the wake of the impending crisis after unfairly enriching themselves.

Though the SFIO has not yet nailed fraudulent motives, the facts intentionally hidden from overseeing authorities which have led to the sudden crumble, affecting a large section of the ordinary people cannot be let go lightly.

According to me, the system is in place for early warning, like a burglar alarm. Fraud has covered it up like switching off the alarm before thieving.

Asset- liability mismatch and consequent mismanagement was an important reason.

Short term funds were used for long term investments, which is clearly against the rules of financial prudence. It was not corrected in time even after a 30% increase in short term borrowings. The debt trap was thus inevitable.

The allegation of the role of the corporate structure consisting of multiple layers of holding and subsidiary companies may have helped the management mask the pointed findings of an impending debt crisis. The structure may not have been faulty by itself, but it could have been used as an instrument to hide the insolvency crisis for some period till it surfaced.

The financial mess could have been better addressed by:

Issuing long term instruments with roll-over facilities.

The fund flow planning for each project could have been done with care and calculations to match assets with liabilities.

The auditors should have been able to see and report the impending crisis while taking particular note of the debt non-servicing.

Fresh issues of CPs were in violation of RBI regulations. RBI should have taken action on fresh issue while older issues had defaulted.

The CRA should have used better market intelligence and surveillance and should have been able to gauge company's financial irregularities.

The company could have a proper Risk Management system so that the problem can be detected at an early stage.

Most importantly, the management should have been honest and not tried to resort to unfair self-enrichment using public money.

Ans. to Q. (4)

CAMEL Stands for Capital, Assets, Management, Earnings and Liquidity. The CAMEL model adopted by the Rating Agencies deserves special attention; it focuses on the following aspects:

- 1) **Capital** –Composition of Retained Earnings and External Funds raised; Fixed dividend component for preference shares and fluctuating dividend component for equity shares and adequacy of long term funds adjusted to gearing levels; ability of issuer to raise further borrowings.
- 2) **Assets** – Revenue generating capacity of existing/proposed assets, fair values, technological/ physical obsolescence, linkage of asset values to turnover, consistency, appropriation of methods of depreciation and adequacy of charge to revenues. Size, ageing and recoverability of monetary assets viz receivables and its linkage with turnover.
- 3) **Management** – Extent of involvement of management personnel, team-work, authority, timeliness, effectiveness and appropriateness of decision making along with directing management to achieve corporate goals.
- 4) **Earnings** – Absolute levels, trends, stability, adaptability to cyclical fluctuations ability of the entity to service existing and additional debts proposed.
- 5) **Liquidity** – Effectiveness of working capital management, corporate policies for stock and creditors, management and the ability of the corporate to meet their commitment in the short run.

These five aspects form the five core bases for estimating credit worthiness of an issuer which leads to the rating of an instrument. Rating agencies determine the pre-dominance of positive /negative aspects under each of these five categories and these are factored in for making the overall rating decision.

The Camel Model is basically used in case of banking companies. Since, operations of banking companies are quite large and complicated; it seems that this model can also be used in case of large public offerings of debt securities.

Alternative Solution

Camel stands for Capital, Assets, Management, Earnings, and Liquidity.

- (a) Capital signifies the shareholder's Equity and primarily is the long term funds available in an enterprise. The philosophy of accumulation of reserve and retained earnings for funding long term assets will be a noteworthy aspect.

- (b) Evaluation of Assets should include fair values, physical/ technological obsolescence etc.
- (c) Management – the quality of management personnel, the corporate goals, the authority matrix, effectiveness of decision making will all be considered and evaluated.
- (d) Earnings – The level and trend of earnings, ability to service the existing and the proposed debts will all have to undergo due diligence.
- (e) Liquidity – How well the working capital requirements and cash flow situations are managed and how well is ALM issues are addressed.

CAMEL is a basic due diligence model and works well for most Credit rating situations. However, for large public offerings of investment securities, CRAs must use market intelligence and also keep their eyes and ears open for any market, industry, company related information that may have a bearing on the company's ability to service the debts.

Ans. to Q. (5)

My order of rating would be:

- 1) A – the company mismanagement
– due to asset-liability mismatch, fraudulent measures of non-disclosure
- 2) C – the rating agency

which turned a blind eye and encouraged more funding and gave an A1 and chose to maintain it despite defaults. It disobeyed statutory compliance requirements and misled the public and other investors with a high rating.

- 3) B, the auditors

who had access to information on defaults and kept silent. They have not reported to SEBI, they were required to observe and issue a certificate to the debenture trustees. They were required to report it to the RBI. Moreover, auditors would encompass the statutory auditors, the internal auditors and the auditors eligible to issue certificates under SEBI and RBI.

- 4) The regulator

The regulator has hundreds of filings taking place on a routine basis. Unless an alarm rings, they will not invoke their powers to inspect an entity for wrong reporting or noncompliance. If the auditors had qualified their report or had not issued a certificate of compliance for debenture servicing, regulators would have certainly taken note of this. Regulators can be blamed if they did not take action in spite of CRA/auditors doing their jobs). In this case, regulators are both SEBI and the RBI.

The order has to be: 1- company, 2- auditor, 3- CRA and 4- Regulator

Or 1- company, 2- CRA, 3- auditor and 4- Regulator

Alternative:

the order can be 1- Company, 2- CRA, 3- Regulator, 4- Auditors;

Reason: 1, 2 and 4 as above. For 3- The Regulators act only reactively and are trigger happy to blame everybody other than themselves.

QUESTION NO. - II

CASE STUDY

There are nearly 12 Lakh students who aspire to get in to one of the Indian Institutes of Technology which number over 20 all over India. There are many private coaching academies which train aspiring students to take on the challenging entrance tests, popularly known as IIT-JEE, as only about 11,000 students would finally make it to one of the IITs. JEET Academy (Pvt. Ltd. Co.) headquartered in a tier-II city in the Northern India, is a cult name in the field of coaching for IIT aspirants, right through their 9th grade up to class-XII. It is predominantly owned by one Mr. Ashwath Gupta, who, himself an IITan, started this academy in a small scale after a stint of employment abroad.

Of course, there are many such coaching academies and JEET has been doing fairly well among stiff competition, presently training around 22,000 students annually, with the numbers growing steadily. JEET has been sending nearly 1400 to 1600 students annually to various IITs and its success rate @ 6 to 7.5% has been consistently better than the overall success rate of IITs, which has been less than 1%. The professors, numbering around 300 of the academy, a good number of them from IITs themselves, were enthusiastic to develop the institution further.

There was, of course, a good scope for JEET to expand as Ashwath knew that in cities like Hyderabad, Kolkata, Chennai, Bengaluru and even a few centres abroad, there were untapped potential. There were technological advancements like remote classes through Skype, online interactions, mobile phone apps, prometric type of testing etc. that needed to be taken advantage of. Ashwath needed to invest heavily in infrastructure facilities also, besides opening centres in various cities, hiring teaching talents etc.

Not wanting to go through the debt or IPO routes, he slowly explored the options of Private Equity investments. His ambitions were funneled by two Private Equity firms -one a big ticket firm from UK called Blue Diamond and one mid-size PE fund by name Aquarius based out of Mumbai. Though Ashwath was not keen to divest any of his holdings in the Academy, as he became aware that it would not be possible for him to expand his business horizon without additional infusing of funds and as was more averse to debt, he mentally decided that he would divest a 'portion of his stake in favour of a new PE investor but was keen to get a good valuation for his business.

Both the PE funds sent him term sheets, on the basis of the financial projections given by JEET, as below (post PE infusion):

PROJECTED FINANCIALS		(₹ in crores)			
	2016-17	2017-18	2018 -19	2019-20	2020-21
Income					
Tuition Fees	133.70	180.50	243.60	304.50	380.60
Study Material sales	6.60	9.90	14.80	22.20	33.40
Exam Fees	3.40	4.60	6.10	8.30	11.20
	143.70	195.00	264.50	335.00	425.20
Expenses					
HR Expenses	59.20	74.00	92.50	115.60	144.80
Rentals	9.80	12.30	15.30	19.30	24.00
Marketing	14.40	17.30	20.70	24.90	29.90
Admn & Operating Exp	9.00	10.70	13.10	15.50	18.60
	92.40	114.30	141.60	175.30	217.30
Net Operating Revenue	51.30	80.70	122.90	159.70	207.90
Interest Earned	5.20	5.80	7.20	8.40	9.50
PBT	56.50	86.50	130.10	168.10	217.40
Taxes	19.78	30.28	45.54	58.80	76.09
PAT	36.72	56.22	84.56	109.30	141.31

The salient features of Term Sheets sent by Aquarius and Blue Diamond UK are as below:

AQUARIUS (MUMBAI) TERM SHEET: PROPOSAL 'A'

A. The investment amount is the aggregate of the following:

1. Compulsorily Convertible Preference Shares ("CCPS") each to be issued by the company to the Investors at face value (total subscription amount being ₹22 crores). These CCPS are required to be compulsorily converted (along with CCPS obtained post conversion as mentioned in sub-clause 4 below), at the option of the Investors, into so many Equity Shares of the Company based on the valuation determined in accordance with Clause 2 below;
2. Such number of Equity Shares of the Company to be purchased from the Promoters by the Investors for a consideration of ₹11 crores at a price per share which is 20% lower than the price per share determined for conversion of CCPS into Equity Shares in accordance with Clause 2 below;

3. The "Warrant(s)" to be issued by the Company to the Investors free of cost, at the time of issue of CCPS (as mentioned in preceding sub- clause 2) entitling the Investors to subscribe to CCPS at face value for the total consideration of ₹11 crores. Such option to subscribe to CCPS will have to be exercised from July, 1, 2017 to December 31, 2018.

B. Pre-Money Valuation and Post-Money Valuation and ESOP

The actual post-money equity valuation will be at 12 times multiple of the audited consolidated FY 2016-17 Profit After Tax, adjusted for any extraordinary items, etc. This is subject to a maximum post-money valuation of ₹ 440 crores and a minimum valuation of ₹ 340 crores. Accordingly, the minimum pre-money valuation will be ₹ 296 crores and maximum pre money valuation will be ₹ 396 crores.

At maximum post-money valuation, Investor Securities (assuming the CCPS on an as-converted basis) will represent 8 percent of the post issued and paid up capital of the Company immediately after the closure of the round and post exercise of the warrants they will represent 12 percent of post issued and paid up Capital assuming all the Warrants have been converted.

The current equity (prior to current funding round) is 100 percent held by Promoters. On or before June 30, 2018, the Promoter will transfer, at a price decided by the Promoter, such number of equity shares to Employees/close associates/friends/relatives such that post investment of ₹ 22 Crores by Investors, and after the above-mentioned transfer, the percentage stake held by Employees/close associates/friends/relatives is a maximum of 10 percent and by the Investors is 8 percent (all assuming conversion happens at ₹440 Crores post-money).

C. Board of Directors

The Investors will have the right to nominate a Director ("Investor Director") on the Board of the Company and in the select Board Committees.

D. Exit Provisions

The Company and Promoters shall endeavor to list its common shares on 'recognized stock exchanges in India, by way of an IPO/Offer for Sale, no later than four (4) years from the date of initial investment by the Investors. In case of Offer for Sale, the Investors shall be entitled to participate in the offer by offering Investor Securities on pro-rata (fully diluted) basis. The Company shall undertake to bear all the expenses related to the listing of the equity shares. The IPO shall be considered as a "Qualified IPO" for the purpose of the clauses below, only if the following conditions are satisfied.

- (a) The floor price per share in IPO is such that it gets an IRR of at least 15 percent on purchase price (subject to adjustments for stock dividends, splits, combinations, and similar events).
- (b) The gross proceeds of the offer to the public by means of a fresh issue of shares are not less than ₹150 Crores.

In the event that the Company is unable to provide the Investors with an exit via a Qualified IPO, the Investors will have following alternatives.

E. Sale to Third-Party Buyers

If the Investors exit has not happened in the manner contemplated above, within 5 years from the date of initial investment by the Investors, Promoters shall be required to enter into an agreement with the Investors to sell up to a maximum of same number of shares as are held by the Investors at that point in time, along with all of the Investors' shareholding, to a third- party buyer. It is clarified that for the purpose of this Clause, the Investors shall be entitled to sell to any third party including Competitors.

F. Brand Equity:

The Brand value which has been the exclusive ownership of the owner Mr. Ashwath has to be transferred to the Company, at no cost.

G. Others

Besides the above, there are usual terms and conditions regarding end-use of investment funds, anti-dilution rights, minimum holding period of investment, investors' rights to future rounds of funding, non-compete, non- disclosure, exclusivity etc.

BLUE DIAMOND, UK's TERM SHEET: PROPOSAL 'B'

Issuer	: JEET Academy, a Company Incorporated in India.
Securities	: Series A Preferred Stock (the "Series A Preferred")
Company Valuation	: ₹ 600 crores post-money, i.e., 16x of the audited FY 2016-17 PAT (R/a to nearest hundred)
Present Offering	: ₹ 150 crores
Consideration	: Cash
Number of securities	: 5,00,000 shares
Price per share	: ₹ 300
Dividends	: Dividend rate. 8% Noncumulative
Dividends (continued)	: Priority. Senior to Common Equity
Liquidation preference	: Amount. Original purchase price plus accrued dividends
Priority	: Senior to common
Participation	: After payment of preferential liquidation proceeds, the Series A Preferred does not participate in further liquidation proceeds.

Redemption: Outstanding shares of Series A Preferred will be redeemed on March 31, 2021, at purchase price plus declared dividends from the closing date plus 4% p.a. If the Series A Preferred is not redeemed on the date or dates set for redemption, the redemption price will increase to the purchase price plus declared dividends plus 10% per annum from the date originally set for redemption.

Conversion: The Series A Preferred may be converted at any time, at the option of the holder, into shares of common stock. The conversion rate will initially be 1:1, subject to anti-dilution and other customary adjustments.

Automatic conversion: Each share of preferred stock will automatically convert into common stock, at the then applicable conversion rate, upon (i) the closing of a firmly underwritten public offering of common stock (a "Qualified Public Offering"), or (ii) the consent of the holders of a majority of the then outstanding shares of the preferred stock.

Anti-dilution Adjustment: The conversion price of the Series A Preferred will be subject to adjustment, on a broad-based weighted-average basis, if the Company issues additional securities at a price per share less than the then applicable conversion price, except in specified circumstances.

(Not necessary for this case study)

General voting rights: Each share of preferred stock will have the right to a number of votes equal to the number of shares of common stock issuable upon conversion of each such share of preferred stock. The preferred stock will vote with the common stock on all matters except as specifically provided in the articles of incorporation or as otherwise required by law.

Voting for directors: The holders of Series A Preferred will be entitled to elect two directors. Any additional directors will be elected by the holders of preferred stock and common stock voting together.

Right of first refusal; If the Promoter proposes to transfer any common stock or other securities convertible into or exercisable for common stock, the holders of Series A Preferred will have a right of first refusal (on a pro rata basis based on the Company's outstanding securities (on an as-converted and as-exercised basis) with respect to the proposed transfer. The rights of first refusal will be subject to customary exceptions and will terminate on a Qualified Public Offering.

In the background of the Private Equity investments scenario in India and with reference to the case study given and the Term sheets, the questions need to be answered.

You are required to answer **all** of the following Multiple-Choice Questions in Part-A and also, give reasoned replies (in about **150** to **200** words) to each of the questions in Part-B.

PART-A**(10 x 2 = 20 Marks)**

1. *In a Venture Capital Investment deal, valuation is done on the basis of*
 - (A) *Pre-money Valuation*
 - (B) *Post-money Valuation*
 - (C) *Valuation as per Company Law*
 - (D) *Valuation as per SEBI Formula*
2. *The most important thing that a Promoter looks for, during a Private Equity Investment Deal is*
 - (A) *PE investor's domain knowledge*
 - (B) *Maximum valuation offered by the PE Investor*
 - (C) *PE investor's track record*
 - (D) *PE Investor's expected IRR*
 - (E) *Deal structure*
3. *The most important thing that a Private Equity Investor looks for, during a Private Equity Investment Deal is*
 - (A) *No. of Directorships in the Board (leaning towards Majority of the Board)*
 - (B) *Control of the Company*
 - (C) *Business Model and Promoter qualities*
 - (D) *Duration & Mode of Exit offered by the Promoter*
 - (E) *Promoter Education and experience in the Business*
4. *The Key difference between Private Equity Investor & Venture Capital Investor is*
 - (A) *Size / Extent of Investment*
 - (B) *Intent of Control / Takeover of Investee Company Age & growth of Investee Company*
 - (C) *Stage of Investment*
 - (D) *All of the above*
5. *The term Sheet in a Private Equity Deal is*
 - (A) *of utmost importance to Investor & binding on Promoter*
 - (B) *of utmost importance to Promoter & binding on Investor*

- (C) *of no importance to Promoter & Investor and Companies Act will prevail*
- (D) *of importance only where the Investor chooses to exit via an IPO*
6. *The right by which the majority of the shareholders bind the minority shareholders in the event of sale / transfer of shares is known as*
- (A) *Pre-emptive*
- (B) *Predatory*
- (C) *Democratic*
- (D) *Drag along*
7. *In the given case study, the preferred exit strategy for the investors is*
- (A) *Buy back by the Promoters at a pre-agreed valuation*
- (B) *Public Offering after a given period of time*
- (C) *Sale to Third Parties*
- (D) *A combination of the above*
8. *In any PE investment, the investor would insist on the following:*
- (A) *Forensic audit*
- (B) *Financial Due Diligence by a reputed external consultancy firm*
- (C) *Complete audit of operations and financials*
- (D) *All of the above*
9. *Who is an angel investor?*
- (A) *One who provides the seed capital*
- (B) *One who accepts the maximum valuation*
- (C) *One who is prepared to take the risk of zero return*
- (D) *One who has a domain experience in the field in which the investee company operates*
10. *What is that minimum rate of return that needs to get generated before profit sharing begin?*
- (A) *Harvest Rate*
- (B) *Hurdle Rate*
- (C) *Term sheet Rate*

(D) Bridge Rate

PART -B

1. Even as the Promoter is contemplating between proposal A and proposal B, the Investors and the Promoters are worried about the impact of Angel Tax. You are required to present a note to the Joint Meeting of the Board and the Potential investors on the implications of Angel Tax (legal position as of 31st October, 2018). **(8 Marks)**
2. You are the CFO of the Company who has been given the task of choosing one of the 2 proposals and you choose the proposal from Blue Diamond over that of Aquarius. Prepare a brief note providing at least 4 reasons (each not exceeding 50 words) for your choice. **(4 Marks)**
3. After much deliberations the Board of the Company has chosen to consider Proposal Aquarius over Proposal Blue Diamond. What in your view would the Board have found compelling merits in proposal Aquarius? (each reasoning may not exceed 50 words) **(6 Marks)**
4. If you were Ashwath, now with a feel of your company's worth, will you contemplate postponing the PE idea for 2 more years? (The projected financials as given herein are pre-expansion plans - with a regular growth rate). Evaluate this in the background of the need to obtain better market share, changing environment in the area of such tutorial education, ceding some managerial control to outsiders etc. **(4 Marks)**
5. Write Short Notes on: **(3 + 2 + 3 = 8)**
 - (A) Leveraged Buy Out
 - (B) Carry
 - (C) Vulture Fund

Answer to Case Study - II

PART – A

- 1 (A)
- 2 (E) or (B)
- 3 (C)
- 4 (E)
- 5 (A)
- 6 (D)
- 7 (B)
- 8 (B)

9 (C)

10 (B)

PART – B**Ans. to Q. (1)****Note to the Joint Meeting of the Board on the implications of Angel Tax**

The term 'Angel Tax' is not a term used in the Income Tax Act. Its usage is in the context of capital markets where **start-ups funded by angel funds or angel investors** as per SEBI Regulations.

The tax on the funds supplied to an entity in the form of share price in excess of its fair market value is termed angel tax.

An angel fund has to register itself as an angel fund with SEBI and can invest only in registered start-ups, in companies with turnover of less than ₹ 25 crores. Jeet has a turnover of more than ₹ 100 crores. Hence, neither the funding of Aquarius nor of Blue Diamond can be termed as angel funding. Therefore the concept of angel tax does not arise for either of the funds, based on each of the term sheets.

Jeet (P) Ltd is not eligible to seek exemption available for start-ups because:

Jeet (P) Ltd. has a turnover of more than ₹100 crores. The term sheet of Blue Diamond specifies that ₹ 600 crores represents 16 X PAT (last audited) which means $PAT = 600/16 = ₹ 37.5$ crores. Going by financials given for 2016-17, which, even if taken as a projection, relates to a turnover of 143.70 Rs crores. Hence as per audited accounts, in one year there was surely a turnover in excess of ₹100 crores.

In view of this, Jeet (P) Ltd. cannot qualify for registration as a start-up under the 'Start up India' provisions under the DIPP. Hence, it is not entitled to any exemption under the Income Tax Act.

But Jeet (P) Ltd. can escape from the provisions of the Income Tax Act, charging excess over fair market value of share price as income because:

The Income Tax Act provides that where shares are issued at a price above the fair market value, such excess is treated as income from other sources in the hands of the recipient (Jeet (P) Ltd.). Market value determined for an unlisted company prescribes discounted cash flow method concurred by a merchant banker or the formula based on book value of net assets including intangibles or a value arrived as the saleable value of net assets as on valuation date, to the satisfaction of the assessing officer.

The rate taxable for Jeet (P) Ltd. will be the corporate tax rate in force applicable along with cess and also surcharge applicable, since Jeet(P) Ltd. is making adequate profits. However, the following argument may be adopted by Jeet:

We find from the Term Sheets that Aquarius shows a lower valuation (₹ 396) crores than Blue Diamond (600 – 150 = 450 crores). Blue Diamond may have attributed more value towards the intangibles like goodwill and therefore, having obtained a market value for a much higher amount, Jeet may safely argue before the Income Tax Assessing Officer that the money obtained from Aquarius was not in excess of the fair market value and therefore not be subjected to the provisions of section 56(2).

Jeet may obtain a fair market value from a merchant banker to substantiate that Aquarius's value is not in excess of the fair market value and hence funds of Aquarius will not attract the provisions of the Income Tax Act.

The Income Tax Act imposes tax on receipts from a resident. Since Blue Diamond is not a resident, this section will not apply for funding from Blue Diamond.

However, Blue Diamond's funding will have to obey the FDI, FEMA and other RBI regulations.

Procuring valuations from merchant bankers is an expensive proposition for start-ups than going through Chartered Accountants.

This will further add to cost as the start-ups are already struggling to meet their ends. Business will suffer as most of them are struggling to pay salaries and incur other business expenses.

Ans. to Q. (2)

Blue Diamond is preferred because:

Blue Diamond's post money valuation = 600 cr ₹ = 16 x audited PAT of Jeet, which means Jeet's audited PAT = 37.5.

Pre-money value will be 600 – 150 = 450.

Pre-money valuation of Jeet's business is $450/37.5 = 12$ times the PAT by Blue Diamond.

Aquarius's pre-money value = 396 cr (max) which is 10.56 times the audited PAT.

Thus Blue Diamond offers a better valuation of the existing business of Jeet.

Or

Blue Diamond offers higher valuation of the company Jeet at 16 x while Aquarius has a value only at 12 X.

Aquarius appears to be paying only $22 + 11 + 11 = 44$ crores, which is also substantiated by pre-money to post money spread $(440-396) = (340-296)$, whereas Blue Diamond is funding ₹ 150 crores.

Hence there is almost 3 times more funding by Blue Diamond.

Blue Diamond only demands the right of first refusal, while Aquarius demands that Jeet sells an equal quantity of shares as held by Aquarius even to a competitor in case IPO fails, thus reducing compulsorily, Jeet's stake.

Blue Diamond's term sheet talks about one simple instrument- viz. Preference shares, while Aquarius's term sheet talks about a more complex issue of CCPS, equity and warrants.

Blue Diamond does not stipulate brand transfer while Aquarius wants immediate brand transfer at no extra payment. In Blue Diamond's offer, brand transfer may fetch more money at a later stage.

Blue Diamond may be more valuable in future since it has better brand recognition internationally.

Blue Diamond may offer better scalability with access to advanced technology.

With Blue Diamond, the market in foreign countries may be tapped more easily.

Aquarius quotes the purchase price of equity shares at 20 % lower than the conversion price. This may be disadvantageous for Jeet.

Ans. to Q. (3)

Aquarius may have been preferred by the Board because:

Jeet's Board may have been confident of making a successful and qualified IPO by gross proceeds to the public of at least 150 crores at the end of the fourth year. Going by substantial growth in revenue and current valuation, Jeet is in a position to even directly implement an IPO successfully in the current year or even before the fourth year. Hence, failure of IPO and consequent entry of competitors may not even be a threatening possibility in their perception.

For the present operations, they may prefer that one alien person on their Board will be better than two, as mandated by Blue Diamond.

The technological advantage envisaged in the Blue Diamond alliance may be easily acquired as a paid resource. It is not essential that the funding person provides technology for operational success. Funding person only needs to pump in funds. Technology advantage can be separately obtained.

For the near future, 44 cr ₹ would have been sufficient for Jeet without having to bother about foreign repatriation repercussions under RBI, SEBI and Income Tax Act.

The Board may view Aquarius deal as not parting much control, since Ashwath can hold on to his holdings. Therefore, even after the IPO, the brand of Jeet is not seen as different from Ashwath. He would still be practically controlling a larger entity than before. Ashwath himself is

from IIT and therefore, will be confident of continuing to manage the education more than any new director in the organisation.

Blue Diamond's exit is well safe guarded – if Jeet is successful, it will opt to convert into equity. If not, it will exit after redeeming at the end of 2021 at purchase price plus dividends plus interest on delayed payments. Dividends are senior and non-cumulative and therefore more cash outlay is involved, but the amount supplied by Blue Diamond is far in excess of Aquarius to outweigh interim cash flows as a disadvantage. However, the protected exit option will be a strain on Jeet's resources after it has invested Blue Diamond's inflows into its expansion activities. This squeeze will not happen in the event of success, whereupon Blue Diamond will convert into equity. It will happen if Jeet's expansion is not as successful as anticipated and then, preference shares have to be redeemed at original price and paid with interest on delays. This might make the Board opt in favour of Aquarius.

Aquarius may have a better feel of the local market and its requirements, regulations and terms than Blue Diamond and hence preferred for better strategic alliance.

Aquarius's proposal may more aligned to the promoter's interests.

The preferred shares of investors of Proposal Blue Diamond (B) will be redeemed. Further, if the redemption is not met on time, redemption price plus extra amount has to be shelled out. Secondly, Preferred Shares can be converted at any time at the option of the holder. This shows that too much benefit is given to the investors of Proposal B which is not the case in Proposal Aquarius.

Ans. to Q. (4)

Alternative I

Ashwath can wait for two more years for a PE or go for an IPO now and avoid a PE itself because of the following factors:

The financials, assuming that profits are pre-expansion as given in the question, the turn over increases from 143.70 to 425.20 crores, by about 35 % per annum, is excellent. Hence, IPO can be tried even at this stage or at any time. The exact requirement for immediate expansion is not given in the data. For this growth and granting that Jeet is beyond the start-up stage, an IPO is likely to be highly successful at any stage. Ashwath has to only decide on when to go for it. It is certainly better to go for an IPO and retain promoter's control up to 75 % as the maximum permissible prescribed level. The advantage of a private equity over an IPO in terms of compliance with SEBI regulations on fresh issue and the work involved in an IPO will be outweighed by the interference of operation by inviting the PE funders on the Board. Moreover, IPO has to happen within the next five years even in the case of PE proposal. It is better to have an IPO now itself.

Expansion through IPO could be considered immediately on his own terms, considering that NEET and other competitive exams can be handled as another business opportunity.

The basic financial position is very strong, considering the projections of PAT, PBT and an immensely great growth in turnover by about 35 % p.a. The projections may be considered fairly realistic, since the figures for 2016-17, 17-18 and 18-19 may be taken as actual or close to actuals.

The overall success rate in IIT entrance is $11000/12,00,000 = 0.91\%$, while Jeet has a success rate of 6 to 7.5 %, which is very high. It is bound to enjoy great goodwill and will be a huge success operationally. It can even afford to take risks in fields other than IIT, even if it decides on expansion into coaching for new areas like NEET or IAS or other worldwide exams like Olympiad or SAT. IPO therefore is bound to be successful.

The market share can be improved substantially and there is ample scope of growth within the IIT entrance field itself. Hence, there is immense growth potential in terms of volume even if the fee structure remains without upward revision. When the IPO is bound to be successful, Ashwath will be entitled to hold a maximum of 75 % of the post issue holding. The number of holders will be diversified and he need not worry about parting with control or losing his brand. Both will not happen and he can still enjoy control over a larger entity. He can practice good corporate governance also and give more incentives to the faculty who are mainly responsible for the success of the teaching.

Video and other advanced technology may not be very expensive compared to live classes at different centres, for which the costs are particularly high for the faculty, who are the key success points in the training scenario. Ashwath can retain popular teachers who produce results by making them part of the issue and sharing control with them rather than third party investors. He can generate cash flows for operational advancement by pooling in the faculties' huge salary costs as partly cash and partly shares in his company, so that they, who would have anyway invested their huge surpluses elsewhere, invest it in Ashwath's company.

Alternative II

Ashwath may lose face in the market if his IPO is not successful in the next two years. Valuations are likely to increase, but in the wake of competition, which is continuously growing in the market and supporting TV ads, invading households with anxious parents through internet, social media and game oriented learning, mock tests and websites, together with published success stories, which can really shift the interest of people into competitors' fold, there is also the chance that Ashwath's passive play can see the downside of revenue. Then, even PE investors may offer lesser value for the business. In this sense, it is better to take one of these offers, or even consider some more offers and quickly decide on a PE with better terms and part with some control instead of heading a waning business.

We have instances in the past where in this field, leaders such as Brilliant Tutorials and its competitors have almost been wiped out by newcomers.

The major risk factor now is that the whole show is being run by Ashwath single-handedly. If he has a health issue or for some reason, not able to operate at this speed, enthusiasm and efficiency, the whole organisation can be wiped out. There will be no PE offers nor will he be able to get out of the onset of a vicious circle of fall in revenue due to students drifting to competition. There have been the stories of many coaching academies in IIT, CA, IAS, Bank Exams, Overseas exams like GATE, TOEFL, IELTS, etc. who have had this problem. In this light, it will be better to make an IPO, induct administrative talent, encourage competent faculty and share ownership and control with the right people, so that the whole organisation enjoys a professional growth and is not threatened by one person’s temporary disability.

Alternative Answer:

	Postpone PE idea for two more years	Choose a PE now itself. Do not postpone the PE
(i)	The pre-expansion financials have a 35% annual growth in turnover. This is healthy and he may use his own profits for growth rather than going for a PE now.	Annually increasing turnover may give better valuations of PE now. If the turnover is not maintained or decreases, PEs will interpret a downward business swing and will offer lesser value later. Hence it is better to use PE now while there is an increasing trend.
(ii)	Market Share: There is untapped potential market in Hyderabad, Kolkata, Chennai, Bengaluru and other centres. Moreover, Jeet is presently training only 22000 students out of 12 lakh growing numbers.	
	Some centres can be started now, or only some main centres started with existing profits and reserves. After two more years of rapid turnover growth from these centres, PE valuations are bound to be much greater. Better negotiations can be made.	More centres need to be opened immediately and Jeet should not wait for competitors to establish their presence. Own profits will not be sufficient for opening parallel and simultaneous centres. Hence PE should be taken now.
(iii)	Changing environment in tutorial education: Technological advancements like Skype, online interactions, mobile phone apps, hiring talented teachers, etc. are necessary to retain and increase the market share.	
	Some of these will not entail substantial incremental costs. These could be	Scaling by competitors may be seen as a great threat, requiring Jeet to also employ

	funded from the current profits, generate more revenue and have better PE valuation after two years.	technology in addition to centres. PE now will give the required scale up to prevent small time competitors entering or growing to threaten Jeet's expansion efforts later.
(iv)	Ceding Managerial Control: This is inevitable for large scaling efforts, whether through IPO or PE.	
	After two years, if the turnover is kept increasing, lesser control needs to be parted with. In case of an IPO, no single entity will need to threaten Jeet. Moreover, professional management may be a healthier thing for the company in the long run. However, since Jeet is averse to shedding control now, PE may be postponed to enable him have better negotiations.	If the rate of growth falls below the high 35% p.a., PE at a later stage may involve more ceding of control. Hence it is better to take advantage now itself.

Ans. to Q. (5)

(A) Leveraged Buy Out (LBO) - The increasingly complex nature of commerce and its applications have given rise to a new category of 'strategic investors' – private equity (PE) firms who scout for enterprises in the 'rough', acquire the same using a clever mix of debt and equity (typically at 70:30 debt to equity), and then targeting to sell the same within a medium term period, say 3 to 5 years. In the process, they leverage on the debt and create value (both perceived and real) and then they either spin off the management control to another entity for a price, or go for an outright sale.

Some of the examples of a successful LBO deal include the buyout by Tata Steel of UK's Corus, and the acquisition of SLI Sylvania by Havells India.

Alternative Solution:

(A) Leveraged Buy Out is the acquisition of another company using significant amounts of debts or borrowed money to meet the cost of acquisition. The assets of the company being acquired are themselves used as collateral for the loans, along with the assets of the acquiring company. The purpose of LBOs is to allow companies to make large acquisition without having to commit a lot of capital. Such buyouts carry huge debt and hence huge interest. Because of the high debt levels, the debt securities themselves are not of investment grade.

(B) Carry - Carried interest or simply stated as 'carry' is the share of profits of the General Partner in excess of the investment made by him in the portfolio. A 'carry' clause would mean a 'carried interest' in the profits of the venture either for a certain pre-determined number of years,

or till harvest. The GP (General Partner) usually stands to earn a portion of both management fee as well as carry. Carried interest gets payable after the hurdle rate is achieved.

Alternative Solution

Carry is the percentage which an investor is entitled to in the returns that are over and above the hurdle rate. Where the returns are equal to or less than the hurdle rate, there is no carry.

(C) Vulture Fund

A Vulture fund is a hedge fund, private equity fund or distressed debt fund, that invest in debt considered to be very weak or in default, known as distressed securities. Investors in the fund profit by buying debt at a discounted price and using other methods to gain a larger amount than the invested amount. The investee may include companies and even countries. Vulture funds have had success in bringing attachment and recovery actions against sovereign debtor governments, usually settling with them before realizing the attachments in forced sales. Settlements typically are made at a discount in hard or local currency or in the form of new debt issuance.

The term “vulture fund” is a metaphor and is used to compare the behavior of such funds to vulture birds “preying” on debtors in financials distress and in many cases leaving the debtor in a worse state. The term is often used to criticize the fund for strategically profiting off of debtors that are in financial distress, and thus is frequently considered derogatory.

Alternative Solution

A **Vulture Fund** is a fund that purchases securities in distressed investments which are considered to be very weak or in default or equities that are or near bankruptcy.

These funds are managed by hedge funds using various types of alternative strategy to obtain profit for their investors.

Vulture funds generally invest in government debts. For example, in Argentina's debt crisis, Vulture fund played a prominent role. Besides that, they also invest in real estate properties and highly leveraged firms.

QUESTION NO. - III

CASE STUDY

Suraksha Mutual Fund is one of the successful Mutual Funds operating in India and among other things, they have Index Fund and also Exchange Traded Fund (both NIFTY plans).

Table- A gives the Portfolio of Index Fund NIFTY Plan and Exchange Trade Fund (NIFTY Plan) of Suraksha MF.

Table- B gives the Key information of Index Fund NIFTY Plan of Suraksha MF.

Table- C gives the Key information of Exchange Trade Fund (NIFTY Plan) of the same Mutual Fund.

These have been given for illustrative purposes only. Not all of the data required as per the statutory disclosure policy have been presented in the above tables. Information may not have been presented with intent or for the reason that it is irrelevant.

TABLE -A

		Table-A	
Monthly Portfolio Statement as on December 31,2017		INDEX FUND-NIFTY PLAN (An open ended scheme replicating/tracking NIFTY 50)	ETF NIFTY BSES (An Open Ended Index Exchange Traded Fund)
Name of the Instrument	Industry / Rating	% to NAV	% to Net Assets
<i>Equity & Equity related</i>			
<i>(a) Listed / awaiting listing on Stock Exchanges</i>			
<i>HDFC Bank Limited</i>	<i>Banks</i>	10.46%	10.47%
<i>Reliance Industries Limited</i>	<i>Petroleum Products</i>	8.81%	8.82%
<i>Housing Development Finance Corporation Limited</i>	<i>Finance</i>	7.45%	7.45%
<i>Infosys Limited</i>	<i>Software</i>	5.75%	5.75%
<i>ITC Limited</i>	<i>Consumer Non - Durables</i>	5.54%	5.55%
<i>ICICI Bank Limited</i>	<i>Banks</i>	5.33%	5.33%
<i>Tata Consultancy Services Limited</i>	<i>Software</i>	4.57%	4.57%
<i>Larsen & Toubro Limited</i>	<i>Construction Project</i>	4.07%	4.08%
<i>Kotak Mahindra Bank Limited</i>	<i>Banks</i>	3.85%	3.85%
<i>Hindustan Unilever Limited</i>	<i>Consumer Non - Durables</i>	2.98%	2.99%
<i>State Bank of India</i>	<i>Banks</i>	2.55%	2.55%
<i>Axis Bank Limited</i>	<i>Banks</i>	2.52%	2.53%

<i>Maruti Suzuki India Limited</i>	<i>Auto</i>	<i>2.28%</i>	<i>2.28%</i>
<i>IndusInd Bank Limited</i>	<i>Banks</i>	<i>1.88%</i>	<i>1.88%</i>
<i>Mahindra & Mahindra Limited</i>	<i>Auto</i>	<i>1.72%</i>	<i>1.72%</i>
<i>Bajaj Finance Limited</i>	<i>Finance</i>	<i>1.44%</i>	<i>1.44%</i>
<i>Asian Paints Limited</i>	<i>Consumer Non - Durables</i>	<i>1.42%</i>	<i>1.42%</i>
<i>HCL Technologies Limited</i>	<i>Software</i>	<i>1.23%</i>	<i>1.23%</i>
<i>NTPC Limited</i>	<i>Power</i>	<i>1.16%</i>	<i>1.16%</i>
<i>Sun Pharmaceuticals Industries Limited</i>	<i>Pharmaceuticals</i>	<i>1.09%</i>	<i>1.09%</i>
<i>Oil & Natural Gas Corporation Limited</i>	<i>Oil</i>	<i>1.06%</i>	<i>1.06%</i>
<i>Power Grid Corporation of India Limited</i>	<i>Power</i>	<i>1.05%</i>	<i>1.05%</i>
<i>Tech Mahindra Limited</i>	<i>Software</i>	<i>1.04%</i>	<i>1.04%</i>
<i>UltraTech Cement Limited</i>	<i>Cement</i>	<i>0.96%</i>	<i>0.96%</i>
<i>Bharti Airtel Limited</i>	<i>Telecom-Services</i>	<i>0.95%</i>	<i>0.95%</i>
<i>Coal India Limited</i>	<i>Minerals/Mining</i>	<i>0.93%</i>	<i>0.93%</i>
<i>Hero MotoCorp Limited</i>	<i>Auto</i>	<i>0.93%</i>	<i>0.93%</i>
<i>Tata Steel Limited</i>	<i>Ferrous Metals</i>	<i>0.90%</i>	<i>0.90%</i>
<i>Bajaj Finserve Limited</i>	<i>Finance</i>	<i>0.90%</i>	<i>0.90%</i>
<i>Titan Company Limited</i>	<i>Consumer Durables</i>	<i>0.89%</i>	<i>0.89%</i>
<i>Vedanta Limited</i>	<i>Non-Ferrous Metals</i>	<i>0.86%</i>	<i>0.86%</i>
<i>Wipro Limited</i>	<i>Software</i>	<i>0.86%</i>	<i>0.86%</i>
<i>Bajaj Auto Limited</i>	<i>Auto</i>	<i>0.85%</i>	<i>0.85%</i>
<i>Yes Bank Limited</i>	<i>Banks</i>	<i>0.77%</i>	<i>0.77%</i>
<i>India Oil Corporation Limited</i>	<i>Petroleum Products</i>	<i>0.76%</i>	<i>0.76%</i>
<i>Hindalco Industries Limited</i>	<i>Non-Ferrous Metals</i>	<i>0.76%</i>	<i>0.76%</i>
<i>Grasim Industries Limited</i>	<i>Cement</i>	<i>0.75%</i>	<i>0.75%</i>
<i>GAIL (India) Limited</i>	<i>Gas</i>	<i>0.75%</i>	<i>0.75%</i>
<i>Eicher Motors Limited</i>	<i>Auto</i>	<i>0.74%</i>	<i>0.74%</i>
<i>Dr. Reddy's Laboratories Limited</i>	<i>Pharmaceuticals</i>	<i>0.73%</i>	<i>0.73%</i>
<i>Tata Motors Limited</i>	<i>Auto</i>	<i>0.72%</i>	<i>0.72%</i>
<i>JSW Steel Limited</i>	<i>Ferrous Metals</i>	<i>0.72%</i>	<i>0.72%</i>

<i>Adani Ports and Special Economic Zone Limited</i>	<i>Transportation</i>	<i>0.70%</i>	<i>0.70%</i>
<i>Bharat Petroleum Corporation Limited</i>	<i>Petroleum Products</i>	<i>0.67%</i>	<i>0.67%</i>
<i>Indiabulls Housing Finance Limited</i>	<i>Finance</i>	<i>0.65%</i>	<i>0.65%</i>
<i>UPL Limited</i>	<i>Pesticides</i>	<i>0.64%</i>	<i>0.64%</i>
<i>Zee Entertainment Enterprises Limited</i>	<i>Media & Entertainment</i>	<i>0.61%</i>	<i>0.61%</i>
<i>Cipla Limited</i>	<i>Pharmaceuticals</i>	<i>0.61%</i>	<i>0.61%</i>
<i>Bharti Infratel Limited</i>	<i>Telecom - Equipment & Accessories</i>	<i>0.51%</i>	<i>0.51%</i>
<i>Hindustan Petroleum Corporation Limited</i>	<i>Petroleum Products</i>	<i>0.43%</i>	<i>0.43%</i>
Subtotal		99.80%	99.86%
(b) UNLISTED			
Subtotal		<i>NIL</i>	<i>NIL</i>
Total		99.80%	99.86%
Money Market Instruments		-	-
<i>Triparty Repo</i>		<i>0.36%</i>	<i>2.36%</i>
Total		0.36%	2.36%
<i>Cash Margin - CCIL \$</i>		-	-
Net Current Assets		-0.16%	-2.22%
GRAND TOTAL		100.00%	100.00%
\$ Less Than 0.01% of NAV			

TABLE -B - Key information**SURAKSHA INDEX FUND NIFTY PLAN**

The Product is suitable for Investors who are seeking

- Long Term Capital Growth
- Investment in Equity & equity related securities and portfolios replicating the composition of the NIFTY 50.

Current Investment Philosophy

The Scheme employs an investment approach designed to track the performance of the NIFTY 50 Index. The Scheme seeks to achieve this goal by investing in securities constituting the NIFTY 50 Index in same proportion as in the Index.

Benchmark	NIFTY 50
Fund Size	₹135.89 crores (Month End :137.23 crores)
NAV as on 31/12/2017 Direct	Regular Growth Plan: ₹ 18.1422 Direct Growth Plan: ₹ 18.7067
Volatility Measure	Standard Deviation 4.18 Beta 0.98 Sharpe Ratio 0.10
Load Structure	Entry Load: Nil
	Exit Load: 0.25% if redeemed or switched out on or before completion of 7 days from the date of allotment of units. Nil thereafter.
Total Expense Ratio	Regular, other than Direct 1.05% Direct 0.29%

TABLE - C - Key information**SURAKSHA EXCHANGE TRADED FUND NIFTY PLAN**

The Product is suitable for Investors who are seeking

- Long Term Capital Growth
- Investment in Equity & equity related securities and portfolios replicating the composition of the NIFTY 50

Current Investment Philosophy

The Scheme employs a passive investment approach designed to track the performance of NIFTY 50 Index. The Scheme seeks to achieve this goal by investing in securities constituting NIFTY 50 Index in same proportion as in the Index.

Benchmark	NIFTY 50
Fund Size	999,14 crores (Month End: 1048.98 crores)
NAV as on 31/12/2017	₹ 1136.2932
Volatility Measure	Standard Deviation 4.16 Beta 0.98

	Sharpe Ratio 0.12
Load Structure	Entry Load: Nil Exit Load: Nil
Total Expense Ratio	0.11 %
Pricing (per unit)	1/10th of Index
Exchange	Listed NSE

PART - A

You are required to select the most appropriate answer.

(Where reasons have to be given, the same is indicated in the question)

1. An investor is required to have a----- and----- to purchase/sell an ETF of a Mutual Fund as distinguished from an Index Fund/Others funds of a Mutual Fund: **(2 Marks)**
 - (A) Share Trading Account and DP Account
 - (B) ISIN Account and Fund Account
 - (C) MF Trading Account and MF Holding Account
 - (D) Securities Ledger Account and Bank Account

2. The Index Fund is expected to Mirror the underlying benchmark in terms of return. However there is always a difference between the returns of an Index Fund and the returns of the underlying benchmark. **(2 Marks)**
 - (A) Trailing error
 - (B) Tracking error
 - (C) Mirror error
 - (D) Random error

3. The main advantage(s) of an Exchange Traded Fund over an Indexed Fund is **(2 Marks)**
 - (A) Low Expense Ratio.
 - (B) At Par returns with Underlying benchmark
 - (C) Transaction in Small quantities
 - (D) All of the above

4. Both the Index Funds & ETF of Mutual Funds are expected to closely mimic the underlying index in terms of gross returns. In this regard which of the following is true? **(2 Marks)**
 - (A) The returns of both, ETF & Index Funds are identical to the underlying index.

- (B) The return of ETF is closer to the underlying index than the Index Fund of a similar nature.
- (C) The return of Index Fund is closer to the underlying index than the ETE Fund of a similar nature.
- (D) None of the above

5. Which of the following is true of ETF? **(2 Marks)**

- (A) ETFs can be used for generating returns through intra-day trading.
- (B) ETFs can be invested to generate returns of the market.
- (C) ETFs can be used as an ideal investment for hedging / arbitrage.
- (D) All of the above

6. Which of the following statement describes the NIFTY ETF the best? **(2 Marks)**

- (A) The NIFTY ETF is closest representation of NIFTY Index Fund.
- (B) NIFTY ETF can itself be viewed as a Stock.
- (C) NIFTY ETF is a distinct security with no relation to NIFTY Index Fund nor does it have any features of a stock.
- (D) NIFTY ETF is a NIFTY Index Fund in the form of a stock.

7. Write in the relevant column against each statement, given below, if it is True or False as regards an Index Fund / ETF. (Reproduce this in your answer sheet) **(6 x 3 = 18 Marks)**

Sl. No.	Statement	True or False
1	Request for purchase / sale of an index fund can be done outside market hours.	
2	An Index Fund provides for taking advantage of Intraday price movements.	
3	Liquidity or redemption is a problem associated with the Index Fund.	
4	ETFs and Index Funds follow a passive fund allocations strategy.	
5	ETFs allow for diversification beyond geographical boundaries without underlying knowledge of foreign stocks.	

6	<i>ETFs can be replicated only in respect of Stock Based Indices.</i>	
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PART – B**(20 Marks)**

The Indian Mutual Fund Industry has grown from ₹ 6.6 Trillion in August 2013 to about ₹ 24.70 Trillion Rupees by October 2018, signifying a 4(four) fold rise in around 5 years. This is expected to grow exponentially owing to factors such as High economic growth rate, under-penetration of Investment through the Mutual Fund Vehicle, drop in FD rates; emergence of a newer working class comprising of youth wanting to diversify their investment horizon etc., This has resulted in a proliferation of Fund Houses and Fund Schemes with more than 35 Mutual Fund Houses and thousands of schemes to invest - leaving the MF investor with a unique proposition of being spoilt for choice on the one hand to selecting a fund with a fund house meeting his requirements within the Ocean.

With this backdrop in mind, you are required to discuss on the recent circular carried out by SEBI on the categorization and rationalization of Mutual Fund Schemes.*

Your answer should inter-alia provide for

- (A) A brief note on the rationalisation*
- (B) Broad categorization*
- (C) Sub-categorization within the broad categorization (mention all sub- categories but restricted to 5 in each broad category)*
- (D) Basis for Sub-categorization in respect of Equity Oriented Mutual Fund*

** Wrongly typed as regulation.*

Answer to Case Study - III

PART - A

- 1 (A)**
- 2 (B)**
- 3 (D)**
- 4 (B)**
- 5 (D)**
- 6 (D)**

Ans to Q (7)

Sl. No.	True or False
1	True
2	False
3	False
4	True
5	True
6	False

PART – B**Ans. to Q (A)****Note on the rationalization of the scheme**

It is desirable that different schemes launched by a Mutual Fund are clearly distinct in terms of asset allocation, investment strategy etc. Further, there is a need to bring in uniformity in the characteristics of similar type of schemes launched by different Mutual Funds. This would ensure that an investor of Mutual Funds is able to evaluate the different options available, before taking an informed decision to invest in a scheme.

Categories have been designed based on investment objectives (say equity schemes will invest predominantly in the equity shares of companies, debt schemes will invest in debt instruments, etc. Within the main category, sub categories are designed based on investment (say equity within mid cap or small cap or large cap), or sector, or income yield, (say dividend yield fund), or tax benefit scheme (ELSS). These categories are in relation to only open ended schemes.

Recently SEBI has come up with regulations for rationalization and categorization of mutual Fund schemes to bring uniformity in the functioning of the AMCs and standardization of Mutual Fund schemes across specific categories. As per this regulation, the fund House has to define its schemes clearly. SEBI has specified 36 categories of mutual fund schemes in total spread over five broad categories. As per the new regulations, the AMCs will not be allowed to offer two different schemes with identical investment mandates.

Categories have been designed based on investment objectives (say equity schemes will invest predominantly in the equity shares of companies, debt schemes will invest in debt instruments, etc). Within the main category, sub categories are designed based on investment (say equity within mid cap or small cap or large cap), or sector, or income yield, (say dividend yield fund), or tax benefit scheme (ELSS).

Ans. to Q (B)

The Schemes would be broadly classified in the following groups:

- a. Equity Schemes
- b. Debt Schemes
- c. Hybrid Schemes
- d. Solution Oriented Schemes
- e. Other Schemes

Ans. to Q (C)

The sub-categorization within the broad categorization is as follows (restricted to 5 in each broad category):

1. Equity Schemes

- (i) Multi Cap Fund
- (ii) Large Cap Fund
- (iii) Large & Mid Cap Fund
- (iv) Mid Cap Fund
- (v) Small cap Fund
- (vi) Dividend Yield Fund
- (vii) Value Fund/Contra Fund
- (viii) Focused Fund
- (ix) Sectoral/ Thematic Fund
- (x) ELSS (Equity Linked Saving Scheme)

2. Debt Schemes

- (i) Overnight Fund
- (ii) Liquid Fund
- (iii) Ultra Short Duration Fund
- (iv) Low Duration Fund
- (v) Money Market Fund
- (vi) Short Duration Fund
- (vii) Medium Duration Fund
- (viii) Medium to Long Duration Fund

- (ix) Long Duration Fund
- (x) Dynamic Bond Fund
- (xi) Corporate Bond Fund
- (xii) Credit Risk Fund
- (xiii) Banking and PSU Fund
- (xiv) Gilt Fund
- (xv) Gilt Fund with 10 years constant duration
- (xvi) Floater Fund

3. Hybrid Schemes

- (i) Conservative Hybrid Fund
- (ii) Balanced Hybrid Fund
- (iii) Aggressive Hybrid Fund
- (iv) Dynamic Asset Allocation or Balanced Advantage
- (v) Arbitrage Fund
- (vi) Multi Asset Allocation
- (vii) Equity Savings

(Note: Foreign securities will not be treated as a separate class)

4. Solution Oriented Schemes

- (i) Retirement Fund
- (ii) Children's Fund

5. Other Schemes

- (i) Index Funds/ ETFs or Exchange Traded Funds
- (ii) FoFs or Fund of Funds (Overseas/ Domestic)

Ans. to Q (D)

Basis for sub Categorization in respect of Equity Oriented Mutual Fund

Lots of variations and irregularities were noticed in equity funds as regard their asset allocation and definitions. There was lack of clarity regarding what constituted a specific category of mutual fund. The asset allocation and the overall risk profile of the fund were also not followed as per the mandate. It was common to have a large cap equity fund to substantially invest in small cap stocks. The differentiation between large cap and multi cap fund was thin. As a result there were

variations amongst similar schemes of different funds houses and also variation across frame due to ever changing constitution of the securities.

Basis for Sub categorization of Equity Oriented MF:

Investment Objective (say Large cap fund invests 80 % of its assets in large cap companies, sector fund invests 80 % in a specific sector, etc.)

Yield based (say dividend fund- invests in dividend yielding stock, value fund follows a value investment strategy)

Tax Saving (ELSS is used for tax savings purpose and has a lock in period of 3 years)

Alternative Solution

Basis for sub-categorization in respect of Equity Oriented Mutual Fund

Sr. No.	Category of Schemes	Scheme Characteristics	Type of scheme (uniform description of scheme)
1	Multi Cap Fund	Minimum investment in equity & equity related instruments - 65% of total assets.	Multi Cap Fund- An open ended equity scheme investing across large cap, mid cap, small cap stocks.
2	Large Cap Fund	Minimum investment in equity & equity related instruments of large cap companies- 80% of total assets.	Large Cap Fund- An open ended equity scheme predominantly investing in large cap stocks.
3	Large & Mid Cap Fund	Minimum investment in equity & equity related instruments of large cap companies- 35% of total assets Minimum investment in equity & equity related instruments of mid cap stocks- 35% of total assets.	Large & Mid Cap Fund- An open ended equity scheme investing in both large cap and mid cap stocks.
4	Mid Cap Fund	Minimum investment in equity & equity related instruments of mid cap companies- 65% of total assets.	Mid Cap Fund- An open ended equity scheme predominantly investing in mid cap stocks.
5	Small cap Fund	Minimum investment in equity & equity related instruments of small cap companies- 65% of total assets.	Small Cap Fund- An open ended equity scheme predominantly investing in small cap stocks.